

Application No: A.10-10-001
Exhibit No.: SDG&E - 4
Witness: Kenneth J. Deremer

_____)
Application of San Diego Gas & Electric Company)
(U 902-E) for Adoption of its 2011 Energy Resource)
Recovery Account Revenue Requirement and)
Competitive Transition Charge Revenue Requirement)
Forecasts)

A.10-10-001
(Filed October 1, 2010)

SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED REBUTTAL TESTIMONY
OF KENNETH J. DEREMER

****PUBLIC VERSION****

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

MARCH 4, 2011



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**PREPARED REBUTTAL TESTIMONY
OF KENNETH J. DEREMER**

I. INTRODUCTION

The purpose of my rebuttal testimony is to address the conclusions and recommendations in the testimony of Division of Ratepayer Advocate witness Cynthia Walker regarding San Diego Gas & Electric Company’s (“SDG&E’s”) request for recovery of 2011 costs associated with its Commission-approved revised Power Purchase Agreement with the Otay Mesa Energy Center (“OMEC PPA”). Pursuant to the Commission’s approval of the revised OMEC PPA, SDG&E’s 2011 Energy Resource Recovery Account (“ERRA”) forecast includes \$ [REDACTED] million in cost recovery associated with the impact of Generally Accepted Accounting Principles (“GAAP”) rules requiring SDG&E to consolidate OMEC’s financial statements. As explained in further detail below, according to the relevant GAAP rules, the financial statements of a power provider (here, that would be OMEC) that meet the definition of a variable-interest entity (“VIE”) must be consolidated with the financial statements of the power purchaser (here, that would be SDG&E), when it is determined that the power purchaser is the primary beneficiary of the power provider. In other words, SDG&E is required by GAAP to consolidate the financial position and results of OMEC and include OMEC’s assets and liabilities, including debt, as if OMEC was either legally owed by or a part of SDG&E, which in turn impacts the balance between SDG&E’s equity and debt.

In its decision approving the revised OMEC PPA (D.06-09-021), the Commission authorized the recovery, in the ERRA proceeding, of equity rebalancing costs so as to mitigate the financial impact of consolidation. These costs were specifically tied to a revenue requirement formula approved by DRA and other parties in the Joint Petition for

1 approval of the revised OMEC PPA. Additionally, these costs were part of an integrated
2 proposal that included SDG&E assuming additional ownership obligations to a power
3 plant it did not build nor operate during the first 10 years of operations given the contract
4 structure with OMEC – an arrangement that DRA and the other settling parties evaluated
5 as an alternative to the cost of building another power plant to provide much needed in-
6 basin supplies over the next 30-years (the assumed useful life of OMEC). Moreover,
7 according to D.06-09-021, DRA’s only basis upon which to challenge these costs is if
8 further evidence suggests that consolidation is not required. Contrary to D.06-09-021 and
9 prior ERRA forecast decisions approving equity rebalancing costs for 2009 and 2010,
10 DRA claims that SDG&E does not have authority to recover such costs. DRA’s
11 argument is based on the misapplication of a subsequent decision (D.07-12-049) in
12 SDG&E’s most recent Cost of Capital proceeding (A.07-05-007).

13 Accordingly, my rebuttal testimony will:

- 14 • refute DRA’s assertion that D.06-09-021 did not approve explicit recovery
15 of OMEC equity rebalancing costs;
- 16 • validate that in order for SDG&E to comply with GAAP, that SDG&E is
17 required to include the financial statements and financial results of OMEC
18 within SDG&E’s financial statements for Securities Exchange
19 Commission (“SEC”) reporting and that SDG&E has further incurred the
20 economic cost to rebalance its capital structure; and
- 21 • clarify that the equity rebalancing mechanism proposed in SDG&E’s most
22 recent Cost of Capital proceeding (A.07-05-007) was directed at
23 prospective costs for future purchase power agreements, and the

1 Commission's rejection of that mechanism did not overturn what had been
2 previously approved for OMEC in D.06-09-021.

3 **II. DRA ERRONEOUSLY ASSERTS THAT THE OMEC DECISION**
4 **MERELY APPROVED COST CAPS FOR EQUITY REBALANCING**

5 On page 4 of Ms. Walker's testimony, she claims that SDG&E does not have the
6 authority to recover equity rebalancing costs associated with the Otay Mesa project
7 because among other claims:

8 D.06-09-021 merely adopted cost caps in the event the Securities and
9 Exchange Commission required SDG&E to consolidate its financial
10 statements with OMEC, and if that consolidation resulted in the need
11 for SDG&E to increase the amount of equity in its capital structure.

12 This conclusion misstates D.06-09-021 and ignores the extensive record that was
13 developed in the filed Joint Petition of San Diego Gas & Electric Company (U 902-E),
14 The Division of Ratepayer Advocates, The Utility Reform Network, and the Utility
15 Consumers Action Network for Modification of Decision 04-06-011 and Decision 06-02-
16 031 ("Joint Petition"), dated July 3, 2006.¹

17 The Joint Petition requested the approval of a revised 10-year PPA between
18 SDG&E and OMEC, a wholly owned subsidiary of Calpine, for output from a 583 MW
19 natural gas plant. The provisions of the revised OMEC PPA provided substantial benefits
20 to ratepayers.² The revised OMEC PPA included explicit reference and a condition
21 precedent that the CPUC approve rate recovery for additional equity required to maintain
22 SDG&E's authorized capital structure resulting from consolidation of OMEC on
23 SDG&E's balance sheet utilizing a substantially higher debt structure – i.e. 75% debt,
24 rather than SDG&E's 45% authorized debt level. These equity costs were included in the

¹ The Joint Petition is Attached hereto as Exhibit A. Note that the original OMEC PPA was approved by the Commission in D.04-06-011 and D.06-02-031.

² These benefits are mentioned throughout D.06-09-021, and more specifically Findings of Fact 10.

1 economic analysis yielding the greatest value to customers under the revised OMEC PPA
2 structure. The revised OMEC PPA structure and benefits were thoroughly addressed
3 during the proceeding and were analyzed against the applicable costs, including the
4 equity rebalancing costs associated with consolidation. This resulted in the development
5 and submittal of the Joint Petition, to which DRA was a party.³

6 The Joint Petition identified cost savings and other benefits that could be achieved
7 through the inclusion of a put and call option that would allow SDG&E to take ownership
8 of the plant in 2019. As fully explained in the Joint Petition⁴, this provision would
9 require SDG&E to take on additional risk, which would come at a cost if OMEC met the
10 criteria of a VIE and if SDG&E were determined to be the primary beneficiary of OMEC.
11 Under these circumstances, according to a GAAP rule known as Financial Accounting
12 Standards Board Interpretation No. 46 (“FIN 46 (R)”), SDG&E would be required to
13 consolidate the financial position and results of OMEC in SDG&E’s financial statements.
14 As stated in the Joint Petition, absent a recovery provision for the additional costs
15 incurred from equity rebalancing, SDG&E would not have entered into the revised
16 transaction:

17 Receiving authorization for cost recovery for these financial effects [referring to
18 the impacts of consolidation] is, however, an essential aspect of this Joint PFM for
19 SDG&E, and SDG&E will not proceed with the Revised PPA without
20 Commission approval of SDG&E’s recovery of these accounting costs, subject to
21 the agreed-upon caps.⁵

22 Thus, equity rebalancing was an integral part of a mutually beneficial commercial
23 arrangement involving ownership obligations with a third-party independent generation

³ Footnote 1 of the Joint Petition notes that SDG&E was “authorized by TURN, UCAN and DRA to sign this Joint Petition on behalf of the Joint Parties.”

⁴ See Section V of the Joint Petition and Section VI of Appendix B (Decl. of Michael Schneider) to the Joint Petition.

⁵ Joint Petition at p. 3.

1 company (OMEC) that yielded the most beneficial economic outcome to SDG&E's
2 customers. In addition, the inclusion of a put and call option in the revised OMEC PPA,
3 which gave rise to the consolidation requirements, were needed to ensure expedient
4 bankruptcy court approval of the disposition of the OMEC asset and allow Calpine to
5 secure financing to construct OMEC.

6 The Joint Petition and the final decision clearly acknowledged the fact that FIN 46
7 (R) could require consolidation and provided specific recovery for the equity rebalancing
8 costs associated with such consolidation (not simply cost caps) in future ERRA
9 proceedings. Indeed, the cost caps represented a condition put forth by the settling parties
10 (DRA, TURN and UCAN) and accepted by SDG&E to both limit the recognized rate
11 recovery of equity rebalancing in case of higher than projected construction costs of
12 OMEC and to acknowledge that FIN 46 (R) was a relatively new GAAP rule and that
13 DRA, TURN, and UCAN were not prepared "to take a position on one aspect of
14 SDG&E's analysis regarding costs associated with the financial accounting effects due to
15 certain features" of the revised OMEC PPA.⁶ This "one aspect of SDG&E's analysis"
16 concerned the issue of consolidation, but despite this concern, DRA supported the revised
17 OMEC PPA, including the cost recovery associated with FIN 46 (R):

18 As noted above, although DRA, TURN, and UCAN are not taking a
19 position at this time on SDG&E's FIN 46(R) analysis, they remain
20 supportive of the transaction overall, including the revenue requirement
21 that includes the dollars associated with FIN 46(R), subject to the agreed-
22 upon caps.⁷

23 The annual revenue requirements associated with FIN 46 (R) were identified in Exhibit 2
24 of the supporting declaration of Michael Schneider, which is Appendix B to the Joint
25 Petition

⁶ Joint Petition at pp. 2-3.

⁷ Joint Petition at p. 18.

1 Ultimately, as clearly indicated in the following Findings of Fact, Conclusion of
2 Law and Ordering Paragraphs of D.06-09-021, the Commission recognized DRA's
3 limited concern and ruled that unless future evidence suggests that consolidation is not
4 required, SDG&E is entitled to recover the costs associated with such consolidation,
5 subject to the agreed-upon caps:

6 Finding of Fact 14:

7 We find the other revisions to the original PPA, ***including the rate***
8 ***recovery to cover any filing and reporting requirements SDG&E might***
9 ***have with the SEC pursuant to FIN 46 (R), with the agreed upon***
10 ***maximum amount eligible for recovery***; the performance and heat
11 incentive mechanisms with the agreed upon caps; and option for SDG&E
12 to elect the superior cost-sharing mechanism for the allocation of the local
13 area reliability costs ***to all be reasonable, in the interest of SDG&E***
14 ***ratepayers, and positive enhancements to the original PPA.***⁸

15 Finding of Fact 15:

16 ***If future evidence suggests that FIN 46 (R) does not require***
17 ***consolidation*** of the Otay Mesa plant with SDG&E financials, then TURN
18 and UCAN reserve the right to petition for an appropriate adjustment to
19 SDG&E's capital structure. The agreed upon caps are as follows:

20 2009 - \$16.0 million // 2010 - \$15.5 million // 2011 - \$15.0 million // 2012 - \$14.4
21 million // 2013 - \$13.9 million // 2014 - \$13.4 million // 2015 - \$12.8 million //
22 2016 - \$12.3 million // 2017 - \$11.8 million // 2018 - \$11.2 million.⁹

23 Conclusion of Law 1:

24 The Revised Otay Mesa PPA is reasonable, is in the public interest, and
25 should be approved. The Revised Otay Mesa PPA includes the Put and
26 Call Options at the expiration of the ten-year period; the changed in-
27 service date from January 2008 to May 1, 2009; performance and heat
28 incentives, with caps; limited cost recovery for SDG&E if it has increased
29 costs for filing and reporting obligation under FIN 46(R); and the option
30 for the utility to choose between RMR treatment or the cost sharing
31 mechanism set forth in D.04-12-048, for the local area reliability costs.¹⁰

⁸ D.06-09-021 at p. 17 (emphasis added).

⁹ D.06-09-021 at p. 17 (emphasis added).

¹⁰ D.06-09-021 at p. 18.

1 Ordering Paragraph 3:

2 ***SDG&E is authorized to record the costs of this Revised PPA in the***
3 ***Electric Resource Recovery Account*** and other appropriate accounts,
4 depending on the cost allocation mechanism that is ultimately adopted for
5 the Otay Mesa plant.¹¹

6 Ordering Paragraph 4:

7 ***SDG&E is authorized to recover the costs, subject to the agreed upon***
8 ***caps and potential future adjustment to SDG&E's capital structure,***
9 ***associated with the equity re-balancing SDG&E deems necessary*** due to
10 filing and reporting requirements of FIN 46(R) and the consolidation of
11 the OMEC financial data with SDG&E's quarterly and annual financial
12 statements to the Securities and Exchange Commission.¹²

13 Since consolidation of OMEC is still required for SDG&E to comply with GAAP,
14 as explained in more detail below, cost recovery of the equity rebalancing costs, subject
15 to the caps listed in D.06-09-021, remains valid. DRA's claim that only the cost caps
16 were adopted, absent approval of recovery of the costs themselves, makes no sense and is
17 not supported by the Joint Petition (to which DRA was a party) or the final decision
18 approving the Joint Petition. Accordingly, DRA's attempt to back out of the Joint
19 Petition and re-litigate the equity rebalancing cost recovery issue should be rejected as an
20 inappropriate collateral attack on a prior Commission decision.

21 **III. TO COMPLY WITH GAAP, SDG&E CONTINUES TO BE REQUIRED**
22 **TO CONSOLIDATE THE FINANCIAL STATEMENTS OF OMEC AND**
23 **THEREFORE SDG&E IS ENTITLED TO CONTINUE RECOVERING**
24 **THE COSTS ASSOCIATED WITH THE IMPACT OF SUCH**
25 **CONSOLIDATION**

26 In Ms. Walker's testimony, she does not raise an issue with the fact that to comply
27 with GAAP, SDG&E is required to consolidate OMEC's financial statements. Indeed,
28 contrary to Finding of Fact 14, Ms. Walker does not identify any "future evidence"
29 indicating that SDG&E is not required to consolidate. Instead, as noted above, Ms.

¹¹ D.06-09-021 at p. 19 (emphasis added).

¹² D.06-09-021 at pp. 19-20 (emphasis added).

1 Walker claims that D.06-09-021 “merely adopted cost caps in the event that” the SEC
2 requires consolidation and if consolidation resulted in the need for SDG&E to increase its
3 equity. Putting aside the fact that Ms. Walker’s testimony is inconsistent with the
4 Commission’s rulings in D.06-09-021, below, SDG&E shows that consolidation is
5 required and that such consolidation had real consequences to the equity in SDG&E’s
6 capital structure.

7 **A. GAAP Requires Consolidation**

8 In accordance with GAAP, the OMEC contract was and continues to be analyzed
9 under both FIN 46 (R) and FAS 167 (also referred to as ASU 2009-17), which amended
10 FIN 46 (R). Both analyses concluded that OMEC is a VIE and that SDG&E is the
11 primary beneficiary, which results in the requirement that SDG&E consolidate the
12 financial statements of OMEC within SDG&E’s financial statements to comply with
13 GAAP and SEC reporting requirements. Moreover, as required by the SEC, SDG&E has
14 its financial statements audited annually by an external auditor for independence and to
15 give reasonable assurance that the financial statements present fairly, in all material
16 respects, in conformity with GAAP. The auditor’s report is included in SDG&E’s 10-K
17 Annual Report which is submitted to the SEC. The 2009 and 2010 10-Ks include both
18 Sempra Energy’s Consolidated Financial Statements and SDG&E’s Consolidated
19 Financial Statements, both of which include the consolidation of OMEC. The SEC
20 requires registrants, such as SDG&E, to present their audited financial statements in
21 accordance with GAAP. The SEC reviews the statements and reserves the right to
22 identify any accounting or disclosure irregularities. Neither SDG&E nor Sempra Energy
23 have received any deficiency letters from the SEC with regards to the consolidation of
24 OMEC in their financial statements filed with the SEC.

1 During the discovery phase of this 2011 ERRA forecast proceeding, DRA
2 questioned SDG&E's procedure for determining whether the OMEC PPA was required to
3 be consolidated under FIN 46 (R). In response, SDG&E provided DRA the most recent
4 comprehensive analysis performed by SDG&E and audited by Deloitte & Touche,
5 SDG&E's external auditor. This analysis concluded that OMEC met the strict criteria
6 requiring consolidation, including the determination that it was a VIE and that SDG&E
7 was the primary beneficiary of the VIE. Ms. Walker's testimony does not raise an issue
8 with this determination, nor with SDG&E's calculation of the rebalancing revenue
9 requirement, in its testimony.

10 **B. Consolidation Of OMEC Has Resulted In Impacts To SDG&E's**
11 **Capital Structure**

12 Regarding SDG&E's need to increase equity costs, SDG&E has been maintaining
13 a recorded CPUC common equity ratio above authorized since 2007, in part to reflect that
14 its consolidated balance sheet (as analyzed by credit agencies) reflects the higher
15 proportional debt as a result of the consolidation of OMEC. The equity rebalancing cost
16 associated with FIN 46 (R) consolidation is included as part of the cost of maintaining the
17 higher equity ratio. This was well documented and addressed in the Joint Petition
18 approved in D.06-09-021.

19 Since 2007, when SDG&E first starting consolidating OMEC, the cost SDG&E
20 has incurred for retaining excess equity beyond its authorized equity level has exceeded
21 the cap put in place in D.06-09-021. More specifically, for 2009 – 2010, SDG&E's
22 common equity as a percent of total capitalization was 53% (compared to 49%
23 authorized). This has a cost to SDG&E shareholders since SDG&E only recovers in rates
24 the equity costs up to its authorized capital ratios (currently 49% of its capital structure),
25 absent the equity rebalancing cost recovery. Since the cost of common equity (11.1%

1 authorized) is higher than the cost of debt (5.62% authorized), SDG&E is incurring
2 higher overall costs by increasing equity and reducing debt by a corresponding amount to
3 rebalance its capital structure due to the consolidation of OMEC. The actual cost to
4 SDG&E for maintaining this higher equity ratio is well [REDACTED] the prescribed caps in
5 D.06-09-021. Equity rebalancing provides cost recovery for a portion of these additional
6 capital financing costs.

7 For purposes of establishing the forecasted ERRR revenue requirement for this
8 cost, SDG&E uses the methodology approved in D.06-09-021 and reflected in Exhibit 2
9 to the declaration of Michael Schneider. Indeed, during the discovery period preceding
10 its rebuttal testimony in this ERRR proceeding, DRA asked SDG&E how it calculated
11 the equity rebalancing revenue requirement, and SDG&E explained that it used the
12 method approved in D.06-09-021 and provided DRA with a copy of the Excel
13 spreadsheet that constitutes Exhibit 2 to Michael Schneider's declaration.¹³ Ms. Walker's
14 testimony does not raise an objection to the appropriateness of using this methodology, as
15 well she can't, since DRA approved of the methodology in the Joint Petition and it was
16 approved by the Commission, subject to the caps listed in D.06-09-021. Moreover, as
17 shown in the revenue requirement spreadsheet attached hereto as Exhibit B, the revenue
18 requirement for 2011 is \$ [REDACTED] million, which is [REDACTED] the \$15 million cap for 2011 listed
19 in D.06-09-021.

20 **IV. THE COMMISSION'S DECISION IN SDG&E'S MOST RECENT COST**
21 **OF CAPITAL PROCEEDING (D. 07-12-049) IS NOT APPLICABLE TO**
22 **THE COMMISSION'S APPROVAL OF COST RECOVERY IN THE**
23 **OMEC DECISION (D.06-09-021).**

24 In DRA's testimony, Ms Walker's claims that:

¹³ This spreadsheet is attached hereto as Exhibit B.

1 The adoption of SDG&E's cost of capital in D.07-12-049 resulted from a
2 comprehensive analysis, including SDG&E's PPA with OMEC. It would
3 be inconsistent with D.07-12-029 [sic] for the Commission to allow
4 SDG&E to recover equity rebalancing costs as part of its ERRA forecast
5 revenue requirement.¹⁴

6 Here, Ms Walker is implying that since the Commission rejected SDG&E's proposal to
7 establish a prospective recovery mechanism for equity rebalancing costs for future PPA's,
8 then the authority that SDG&E has been previously given to recover specific OMEC
9 rebalancing costs in D.06-09-021 had been nullified. As shown below, Ms. Walker's
10 conclusions are incorrect and her analysis mischaracterizes the Commission's ruling in
11 D.07-12-049.

12 The rulings in D.06-09-021, as shown in Section II above, clearly demonstrate
13 that the equity rebalancing costs associated with OMEC were clearly addressed in the
14 proceeding and that the CPUC authorized their recovery if it was deemed necessary for
15 OMEC to be consolidated under FIN 46 (R). Furthermore, this recovery was to take
16 place via the ERRA, which recovers the appropriate costs associated with the PPA.

17 As it relates to the most recent Cost of Capital proceeding (A.07-05-007),
18 SDG&E proposed an overall equity rebalancing mechanism to apply to any *future* PPA
19 that was required to be consolidated under FIN 46 (R) or subject to debt equivalency.¹⁵
20 In fact, in testimony in A.07-05-007, SDG&E witness Michael Schneider makes specific
21 reference to the previously approved equity rebalancing provision for OMEC, but states
22 that there is a further need for an ongoing mechanism to recover prospective costs for
23 future PPAs.¹⁶ DRA correctly states that in D.07-12-049, the CPUC rejected SDG&E's

¹⁴ DRA Testimony of C. Walker at p. 4, lines 14-18.

¹⁵ Testimony of Michael M. Schneider (at p. MMS-18) in A.07-05-007, attached hereto as Exhibit C.

¹⁶ Testimony of Michael M. Schneider (at p. MMS-27) in A.07-05-007, attached hereto as Exhibit C.

1 prospective rebalancing mechanism.¹⁷ However, there is no mention, nor was there any
2 intent, in the decision that the cost recovery provision previously approved specifically
3 for the OMEC PPA should be overturned as a result of the Cost of Capital decision. No
4 party submitted testimony regarding the appropriateness of the cost recovery of equity
5 rebalancing associated with the revised OMEC PPA. Moreover, there is language in the
6 body of D.07-12-049 clearly indicating that it was intended to apply on a prospective
7 basis:

8 Although SDG&E seeks approval of its equity rebalancing mechanism back to May 8,
9 2007, the date of its application, we decline that request on the basis that any approval
10 back to May 8, 2007 would conflict with our practice of authorizing rates on a
11 prospective basis. However, *we will consider this on a prospective basis.*¹⁸

12 The approval date of OMEC pre-dates the Cost of Capital decision, and SDG&E
13 actually was required to start consolidating OMEC in 2007. Therefore, any rejection of
14 recovery for equity rebalancing going forward would not apply to OMEC. DRA, along
15 with SDG&E, UCAN, and TURN, previously had supported the Joint Petition for the
16 approval of OMEC and now appears to be misapplying a later decision to change course
17 and get the OMEC decision overturned. Overturning the OMEC decision would require a
18 Petition for Modification, which DRA has not filed. Accordingly, the ERRA forecast
19 proceeding is clearly an inappropriate venue to challenge a prior Commission decision
20 approving recovery of costs associated with a revised PPA.

21 It should also be noted that recovery of amounts ██████████ the caps for 2009 and
22 2010 were approved in the Commission's 2009 and 2010 ERRA forecast decisions,
23 without objection by DRA. Moreover, in DRA's Report regarding SDG&E's ERRA
24 compliance for the 2009 record year (A.10-06-001), DRA did not raise any issues

¹⁷ See D.07-12-049, Conclusions of Law 28.

¹⁸ See D.07-12-049, at p. 39 (emphasis added).

1 regarding the OMEC rebalancing costs recovered in 2009. For example, DRA’s Report
2 did not claim that recovery of such costs were in violation of D.07-12-049. Ultimately,
3 DRA concluded that “[a]s a result of its review, DRA found no exceptions of a material
4 nature requiring adjustments to SDG&E’s ERRAs, TCBA, or the other five memorandum
5 accounts.”¹⁹ Ms. Walker’s testimony in this ERRA forecast proceeding, just months after
6 DRA’s Report in the 2009 ERRA compliance proceeding, is completely inconsistent with
7 this conclusion.

8 **V. CONCLUSION**

9 As described in this testimony, SDG&E filed the revised OMEC PPA, in large
10 part, to provide significant benefit to ratepayers as compared to other alternatives. “DRA,
11 TURN, and UCAN joined in the Joint Petition because they agreed that SDG&E
12 customers would realize these benefits through the provisions of the revised PPA.”²⁰
13 DRA and the other parties recognized that securing the benefits would include some
14 costs. The costs associated with equity rebalancing were an explicit condition precedent
15 to SDG&E’s agreement to enter into the revised OMEC PPA as supported by the settling
16 parties, including DRA. DRA now claims that the OMEC decision did not approve
17 specific equity rebalancing cost recovery (merely cost caps) and that the subsequent Cost
18 of Capital decision addressing a prospective mechanism for future PPAs, somehow
19 voided the approval of cost recovery in the OMEC decision. These assertions are false
20 and unsupported by the record and language in the applicable decisions. D.06-09-021
21 grants clear authority for SDG&E to recover equity rebalancing costs, subject to the
22 stated caps and barring future evidence that consolidation was not required. SDG&E has
23 demonstrated that consolidation continues to be required and DRA does not dispute this

¹⁹ DRA Report in A.10-06-001, dated November 22, 2010, at p. 1-4, lines 8-10.

²⁰ D. 06-09-021, page 7 under “Discussion”.

1 fact. Consequently, DRA's recommendation to remove SDG&E's equity rebalancing
2 costs from the 2011 ERRA revenue requirement forecast should be rejected.

3 This concludes my rebuttal testimony.

4 **VI. QUALIFICATIONS**

5 My name is Kenneth J. Deremer and my business address is 8330 Century Park
6 Court, San Diego, California 92123. I am currently employed by SDG&E as the Director
7 of Financial Analysis & Assistant Treasurer. My responsibilities include overseeing the
8 development, analysis, and implementation of revenue requirements, regulatory accounts,
9 and cost recovery strategies for SDG&E. I assumed my current position in January 2009
10 after serving as the Director of Tariffs and Regulatory Accounts since May 2007, where
11 my responsibilities included the implementation and oversight of the utilities' tariffs and
12 regulatory accounts, including the preparation of testimony in various regulatory
13 proceedings, including the General Rate Case. Prior to May 2007, I served as the
14 Regulatory Accounts Manager since April 2002. In that position, I managed the process
15 for implementing and maintaining regulatory accounts, including serving testimony in
16 ERRA proceedings.

17 I have been employed by SDG&E and Sempra Energy since 1991. In addition to
18 my work experience described above, I worked from 1999 through 2002 as a Regulatory
19 Tariff Administrator and held various positions in the Financial Reporting Department.

20 I received a Bachelors of Science in Business Administration from the University
21 of California, Riverside in June 1987. I also received a Masters in Business
22 Administration, with an emphasis in Finance, from the University of California, Riverside
23 in December 1989.

24 I have previously testified before this Commission.

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APPENDIX C: DECLARATION OF VICTOR KRUGER (SDG&E)

APPENDIX D: DECLARATION OF DANIEL BAERMAN (SDG&E)

owned indirect subsidiary of Calpine Corporation (“Calpine”), relating to its approximately 573 MW natural gas-fired combined-cycle power plant under construction in southern San Diego County (the “Otay Mesa Project”).

As discussed below, DRA, TURN, and UCAN join in this Petition because they recognize that SDG&E customers are likely to realize substantial benefits from the Otay Mesa Project as a result of the changed provisions contained in the Revised PPA. As such, the interests of SDG&E’s customers, and the interests of energy consumers statewide, are represented by the Joint Parties. UCAN represents residential and small commercial customers in SDG&E’s service territory. TURN represents a wider array of ratepayer interests throughout the State, as does DRA. The support of DRA, TURN and UCAN for this Joint Petition reinforces the value and benefits contained in this Revised PPA. Their support should provide the Commission with significant additional bases for approving this Revised PPA quickly and without hearings.

The Revised PPA includes generally the same terms and conditions as the original power purchase agreement that the Commission previously approved in D.04-06-011 and D.06-02-031 (“Original PPA”), but it also contains numerous significant enhancements that make the Revised PPA a more attractive opportunity for SDG&E’s customers than the prior agreement. The Letter Agreement memorializing the terms of the Revised PPA is provided in Attachment A.^{3/} While DRA, TURN, and UCAN join SDG&E to support approval of the Revised PPA, as discussed in more detail in Section V below, they do not take a position on one aspect of SDG&E’s analysis regarding the costs associated with

^{3/} SDG&E will submit the Revised PPA in its entirety once the definitive agreement has been finalized consistent with the provisions of the Letter Agreement attached herewith. SDG&E seeks Commission approval to proceed with this transaction, however, on the basis of this Joint Petition and the accompanying Attachments and Declarations.

the financial accounting effects due to certain features of the Revised PPA. Accordingly, to accommodate their reservations at this time, SDG&E has agreed to cap these potential future accounting costs created by the Revised PPA at the levels set forth herein and in the Declaration of Michael M. Schneider (Section VI). Receiving authorization for cost recovery for these financial effects is, however, an essential aspect of this Joint PFM for SDG&E, and SDG&E will not proceed with the Revised PPA without Commission approval of SDG&E's recovery of these accounting costs, subject to the agreed-upon caps.

Along these lines, this Joint PFM should be regarded as a "package" for approval and should the Commission sever and not approve any particular piece of the Revised PPA as presented in this Joint PFM, then any Joint Party can withdraw its support for the Revised PPA, and SDG&E reserves the right not to move forward with this transaction. Furthermore, Commission approval of the Revised PPA as presented in this Joint PFM will moot the outstanding Application for Rehearing filed by TURN and UCAN regarding the Original PPA that was approved again in D.06-02-031.

The Joint Parties also urge the Commission to act on this Joint Petition expeditiously, thereby facilitating the start of commercial operations and significant customer benefits by May 1, 2009. Along these lines, the Joint Parties are also filing today a Motion for Order Shortening Time for parties to respond to the PFM. Expedient review and approval of this Joint Petition are essential to ensure that the Otay Mesa Project will be on-line when it is needed, and for SDG&E's customers to receive at the earliest reasonable opportunity the multitude of benefits that the Otay Mesa Project offers.

In addition, since the Original PPA was first approved, the Commission has adopted a local capacity requirement in R.05-12-013. The Otay Mesa Project provides an economic local resource that will benefit SDG&E's customers immediately in meeting this requirement and providing needed long-term grid reliability. Further delays in commencement of commercial operation beyond 2009 will also reduce the RMR benefits achievable in that calendar year, requiring SDG&E's customers to incur otherwise unnecessary RMR costs. The Commission has also very recently pointed to the urgent need for new resources in Southern California beginning in 2009.^{4/} Nor should expeditious review be unduly burdensome because the Commission has already carefully assessed and recognized the benefits of and need for the Otay Mesa Project on several prior occasions. The new information provided in this Joint Petition builds upon these existing records; therefore, the time necessary to consider this Joint Petition should not be lengthy.

To briefly summarize key benefits of the Revised PPA, because of the "Put" and "Call" Options that now are included, SDG&E will likely own and operate a 573 MW generation asset with a 30-year useful life that will be located in SDG&E's service territory.^{5/} The "Put" Option, exercisable at Calpine's sole discretion at the expiration of the 10-year PPA, would require SDG&E to purchase the Otay Mesa Project at a price of [REDACTED], subject to certain conditions and adjustments as explained in the Declarations of James P. Avery and Mr. Schneider. The Joint Parties seek approval of the Put Option as part of this Joint PFM and there would be no additional Commission review or approval opportunity prior to Calpine's potential exercise of the Put Option

^{4/} See, e.g., Proposed Decision dated June 20, 2006, issued in R.06-02-013, pp. 3-4.

^{5/} The ratemaking and cost recovery mechanisms that would apply at that time will be filed upon exercise of the Put/Call Options.

after this Joint PFM is granted. A “Call” Option, exercisable at SDG&E’s sole discretion at the expiration of the 10-year PPA, would require OMEC to sell the Otay Mesa Project to SDG&E at a purchase price of [REDACTED], also subject to adjustments and conditions as described in the attached Declarations. Unlike the Put Option, SDG&E would seek further Commission review and approval prior to exercising the Call Option in the Revised PPA.

By virtue of this arrangement, SDG&E avoids future market price risks and cost escalation risks associated with construction of the Otay Mesa Project or future resource procurement in case the Revised PPA is not in place. Further, under the prices adopted for the Put Option, SDG&E would own the Otay Mesa Project in 2019 at a price that would be significantly below that of the Net Book Value of the Palomar Energy Center (“Palomar”) in 2019. Under the price adopted for the Call Option, SDG&E would have an option to own the Otay Mesa Project in 2019 at a price that would be slightly higher than the Net Book Value for Palomar in 2019. SDG&E believes, however, that price will be significantly less than market alternatives available at that time. In the event that market conditions change between now and 2019 whereby it may not be economic to own the Otay Mesa Project at the Call Option price, then SDG&E would not exercise that Option to protect its customers from these higher costs. As such, SDG&E’s customers should receive a greater level of Net Present Value (“NPV”) savings than were projected under the Original PPA approved by the Commission in D.04-06-011 and D.06-02-031.

With these Put and Call Options, the Revised PPA also avoids the “Year 11” problem where, at the end of the 10-year delivery term, if no other generation has been built in SDG&E’s load pocket and aging plants in the area have retired, SDG&E would

be totally dependent on the Otay Mesa Project to serve its load and meet its longer-term grid reliability needs, with no other viable alternative. An additional prominent, beneficial feature of the Revised PPA are two forms of incentive mechanisms, which will give Calpine ongoing encouragement to build, operate and maintain a high performing facility. The first incentive mechanism covers the incremental output capacity of the plant and the second covers the heat-rate. If certain performance thresholds are met, then capped incentive payments will be made. The details of all of these benefits and savings are described further in the accompanying Declarations.

Finally, the modifications to D.04-06-011 and D.06-02-031 that are required due to the Revised PPA are relatively minor, and they are set forth in Attachment B. They highlight the Revised PPA terms and conditions, including the new on-line date, the Put/Call Options, capped rate recovery for the financial effects that result from the Put/Call Options, performance incentives, and approval of a primary and alternative approach to seek cost recovery from all customers in SDG&E's service territory who benefit from the enhanced grid reliability provided by the Otay Mesa Project.

II.

THE NEED FOR THE OTAY MESA PROJECT HAS ALREADY BEEN CLEARLY ESTABLISHED AND APPROVED BY THE COMMISSION

In D.04-06-011, the Commission approved five proposals SDG&E presented to meet its short-term and long-term grid reliability needs. Additionally, SDG&E presented for Commission approval the Original PPA between SDG&E and OMEC whereby, beginning January 1, 2008, and continuing for a 10-year delivery term, OMEC would supply SDG&E power from the Otay Mesa Project under construction in southern San

Diego County.^{6/} The reasons the Commission cited for approval of the Original PPA focused specifically, and almost entirely, on the benefits generated by the construction and operation of the gas-fired combined cycle Otay Mesa Project in SDG&E's service territory:

Our approval of the Otay Mesa PPA will allow a clean, new and efficient generator to be built within SDG&E's service territory. As demonstrated in the Declarations of SDG&E witnesses, the Otay Mesa project has already successfully completed the long and complicated permitting process. The Otay Mesa PPA is reasonably priced, and it will help ensure that there is adequate and reliable electric power available to California electric customers. The approval of the Otay Mesa PPA will allow older units in SDG&E's service territory to eventually be retired, the net effect being that electric generation within SDG&E's service territory will be much cleaner and more efficient. Moreover, our failure to approve this PPA could result in the loss of a resource that could not be replaced easily.^{7/}

The Commission also observed the benefits of having the plant constructed in SDG&E's service territory, including having the plant available when it is needed, acknowledging that a significant amount of SDG&E's local capacity need is met by larger old units, and recognizing that the associated costs of building a more than 500 MW facility in the future will inevitably exceed the costs of building the Otay Mesa Project today:

However, as discussed above, to reject Otay Mesa now, and risk that Calpine will not build the facility absent a contract with SDG&E, puts SDG&E in jeopardy of not having the plant on-line when it is needed, and the associated costs of building a 500 plus MW facility in the future are sure to exceed the costs of the build-out of Otay Mesa today. We are, moreover, aware that a significant amount of SDG&E's load demand is met by larger old units currently operating within SDG&E's service territory. These units are under no contractual obligation to remain in service, and given the recent determination by owners of such older plants elsewhere in the state to furlough or shut their facilities down, there is a

^{6/} The projects that were acquired in the 2003 Grid Reliability RFP were the result of a competitive solicitation that included the participation of an independent observer.

^{7/} D.04-06-011, p. 61.

real risk that SDG&E could be short of power as soon as 2008 without Otay Mesa. In addition, if any of the current DWR contracts were no longer delivering power to SDG&E, the utility would *need* the power from Otay Mesa sooner, and perhaps closer to its on-line date of 2008. ... Again, we are faced with the need to be provident when we are not prescient. We accordingly find that approving the Otay Mesa PPA is the provident and prudent thing for us to do.^{8/}

TURN and UCAN filed a joint Application for Rehearing of D.04-06-011, which eventually led the Commission to conclude in D.05-06-062 that a limited rehearing of D.04-06-011 should be granted. According to D.05-06-062, the Commission should not have considered the Original PPA as a “winning bidder” in SDG&E’s RFP, but rather as a bilateral contract to meet needs outside the scope of the RFP. Because the Commission previously found that the Original PPA is needed and is consistent with SDG&E’s long-term resource plan,^{9/} it limited the scope of the rehearing to the sole purpose of determining whether the Original PPA provides ratepayer benefits and is reasonable pursuant to PUC Section 454.5(c)(3).

In its decision upon rehearing, D.06-02-031, the Commission again approved SDG&E’s execution of the Original PPA, finding that the Original PPA does in fact benefit ratepayers, is reasonable, and is in the public interest pursuant to PUC Section 454.5(c)(3). Once again, focusing on the beneficial attributes of the generation facility itself, the Commission stated:

We found [footnote omitted], and again find that the Otay Mesa PPA will provide the following benefits:

^{8/} D.04-06-011, p. 64, emphasis in original.

^{9/} D.04-06-011, pp. 2, 67; In addition, in the decision granting the CPCN for the Otay Mesa Transmission, the Commission stated that “It is clear that we determined that SDG&E ‘needed’ the Otay Mesa Generating Plant when we approved the 10-year Power Purchase Agreement (PPA) in D.04-06-011” (D.05-06-061, p. 57).

- a. Provide substantial benefits both to the customers of SDG&E and to the state as a whole.
- b. Allow [SDG&E] to reduce its RMR costs.
- c. Provide state-of-the-art, low heat-rate, economical, clean power to SDG&E's service territory.
- d. Increase overall efficiency and reliability in SDG&E's service territory.
- e. Provide a cost effective "insurance policy" in the event of another energy crisis.
- f. Allow older units in SDG&E['s] service territory to eventually be retired [resulting] in electric generation within SDG&E's service territory [being] much cleaner and more efficient.

It has been eighteen months since our decision in D.04-06-011, and since that time the state has become even more concerned and focused on resource adequacy, not just for the three investor-owned utilities, but for all LSEs. ... The OMEC is located in an ideal location to address reliability and resource concerns for all LSEs in the San Diego area. With its ability to connect with the OMPPA Transmission lines, OMEC becomes an attractive replacement for the aging, less clean and less efficient, power plants the utility now has to rely on for RMR output.

... There is no evidence in the record that a comparable facility, with the positive factors associated with the PPA, but without the negatives, is a realistic enough option to support our rejection of this PPA. No other project has come forward indicating that it is poised to be constructed in SDG&E's service territory in the near term, even though price and other key commercial terms related to the Otay Mesa PPA were known.^{10/}

In the midst of the rehearing process, however, on December 20, 2005, Calpine and various affiliates and subsidiaries of Calpine (but not including OMEC) commenced

^{10/} D.06-02-031, pp. 16, 17. In addition, the Commission has generally recognized the need for new generation towards the end of the decade in the long-term resource planning proceeding. For example, in D.04-12-048, the Commission stated: "There is also the concern that the utilities may need to enter into new contracts (and/or construct) new capacity to ensure that California has sufficient resources toward the latter years of this decade" (p. 58). In order to meet that timeframe and for resources to be on-line when needed, "it may be necessary to begin construction of those projects in the very near term" (Id.). More recently, in commencing the 2006 long-term resource planning proceeding, the Commission has again expressed its intent to take adequate, even urgent, steps to "ensure construction of and investment in new generation in a timely fashion" (R.06-02-013, p. 8).

bankruptcy proceedings by filing voluntary petitions to restructure under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York, which cases are being jointly administered under Case #05-60199. Under financial stress, Calpine took this action in order to allow continued operations at its power plants and facilities in the U.S., Canada, and Mexico, strengthen its balance sheet, protect its assets, and enhance the value of its business, the company and many of its subsidiaries.

Thus, due to a confluence of circumstances, the need to consider alternate arrangements to the Original PPA became apparent. After pursuing various alternatives, SDG&E and Calpine ultimately settled on the Revised PPA that is memorialized in the Letter Agreement provided in Attachment A. The Revised PPA accomplishes the primary objectives of SDG&E, which are to preserve and improve upon the economics of the Original PPA already approved, as well as to create the opportunity to obtain the Otay Mesa Project at a fair and reasonable price after the 10-year delivery term in the Revised PPA has expired. With the possible ownership of the plant, SDG&E's customers will have dedicated to them a state-of-the-art, low heat-rate, generation facility that will provide them with economic, clean power well beyond the Revised PPA's 10-year delivery term. This will allow SDG&E's customers to avoid the price uncertainty that would otherwise occur upon expiration of the Revised PPA for a facility expected to be vital to system reliability in 2019 and beyond.

As addressed herein and in the attached Declarations, it is highly desirable and in SDG&E customers' best interests that the Otay Mesa Project be in-service by May 1, 2009. SDG&E needs the power plant to provide additional local and system reliability

and to reduce RMR costs. The Otay Mesa Project will also provide an additional dispatchable resource to supplant the reallocated Williams D product.^{11/}

III.

THE REVISED PPA OFFERS NUMEROUS SIGNIFICANT ENHANCEMENTS TO THE ORIGINAL PPA

The Revised PPA retains the primary features of the Original PPA that was approved in D.04-06-011 and D.06-02-031. For example, the 10-year delivery term remains, as does the original capacity payment and the basis for that payment. The new on-line date is May 1, 2009, but in order to meet that date Commission approval at the September 21, 2006 Business Meeting is essential because construction of the project, including financing and other necessary pre-construction activities, cannot recommence until the Commission issues a final (non-appealable) decision granting the Joint PFM.

Enhancements to the Original PPA include both a “Put” and a “Call” Option. At the end of the 10-year term of the Revised PPA, SDG&E shall have the option to “Call,” or purchase, the Otay Mesa Project at a pre-negotiated price that nearly 13 years after the construction of Palomar, still compares favorably to Palomar and avoids the market price risk to which SDG&E would otherwise be subject at the end of the Original PPA term. In the event the market conditions in 2019 suggest that it would not be prudent to exercise this option, SDG&E can elect not to exercise the Call Option. In the event SDG&E does not elect the Call Option, then Calpine shall have the right to “Put” the Otay Mesa Project to SDG&E. The price that SDG&E would have to pay for the plant under the Put Option, however, is significantly below the Net Book Value of Palomar in 2019 dollars. For the purposes of SDG&E’s economic analysis, both of these prices for

^{11/} See D.05-12-021.

either the Call or the Put include the financial effects of FIN 46(R), discussed in further detail below and in the Schneider Declaration.

To ensure that SDG&E will only acquire a plant that is functioning well and in good condition at the end of the 10-year delivery term, the Put and Call Option exercise prices are contingent upon the Otay Mesa Project being designed, constructed, operated, and maintained in accordance with manufacturers' specifications and prudent industry standards. SDG&E has the right to verify the condition and status of the Otay Mesa Project to confirm that the project is in good operating condition and has been properly maintained prior to the Put or Call Options being exercised (see Declaration of Daniel Baerman).

SDG&E has also included in the Revised PPA capped performance incentive payments (1) if the Otay Mesa Project capacity performance [REDACTED], and (2) for meeting and maintaining a specific heat-rate performance standard [REDACTED]. If the Otay Mesa Project exceeds these performance thresholds, then incentives are paid, up to a cap, in recognition of the increased benefits to customers. These and other Revised PPA terms are summarized below:

Terms

- COD Target May 1, 2009
- Debt/Equity 75/25
- 10-year delivery term from COD
- Capacity Payment \$9.75 kW/mo (\$117 kW/yr)
- Put and Call Options after 10-year delivery term for buy-out of Otay Mesa Project
- Put Price [REDACTED] (\$2019)
- Call Price [REDACTED] (\$2019)
- Capacity performance incentive payment, capped, over 10-year delivery term
- Heat-rate performance incentive payment, capped, over 10-year delivery term

Conditions

- CPUC approval at the September 21, 2006 Business Meeting
- CPUC approval for compensation in rates to reflect additional equity as required to maintain SDG&E's authorized capital structure resulting from consolidation of OMEC on SDG&E's balance sheet (FIN 46(R))
- SDG&E to require certain financial information and certifications upon effective date of Revised PPA as specified in the agreement
- Bankruptcy court approval by November 1, 2006
- Initial new and clean Otay Mesa Project performance benchmarked to Palomar performance under pre-defined engineering standards

IV.

**THE ATTACHED DECLARATIONS DESCRIBE THE
CHANGED CIRCUMSTANCES AND SIGNIFICANT BENEFITS
THAT WILL BE ACHIEVED UNDER THE REVISED PPA**

The Declarations attached herewith and summarized below describe new or changed facts that support the modifications requested in this Joint Petition and identify the numerous customer benefits resulting from the Revised PPA. Rule 47 requires that petitions for modification be filed within one year of the effective date of the decision, but if more than one year has elapsed, the petition must also explain why it could not have been presented within one year. As noted above, the circumstances of the Calpine bankruptcy developed with finality in late 2005, and there clearly was no opportunity or need to modify D.04-06-011 before that time. Given the recent changed circumstances and new facts relevant to customer benefits from the Revised PPA and SDG&E's potential ownership of the Otay Mesa Project, there is ample basis to conclude that granting this Joint Petition is in the public interest, even though the Original PPA was approved more than one year ago.

The Declaration of James P. Avery (Appendix A) is presented to provide evidence of the new and changed facts requiring the modification of D.06-02-031 and

D.04-06-011 more than one year after its effective date. Mr. Avery addresses why the Revised PPA is reasonable and is a good deal for SDG&E and its customers, explaining among other details the benefits of the Put/Call Options and performance incentives. Mr. Avery also points out that the Revised PPA and SDG&E's ownership of the Otay Mesa Project will not eliminate SDG&E's anticipated need to issue an RFP this year for additional capacity after 2010.

The Declaration of Michael M. Schneider (Appendix B) describes the economics of the Revised PPA and the benefits of the Put and Call Options compared to SDG&E constructing the plant itself. Mr. Schneider also describes the effects of FIN 46(R), which according to SDG&E's assessment requires SDG&E to consolidate OMEC on its balance sheet when SDG&E files its annual and quarterly reports with the Securities and Exchange Commission ("SEC"). SDG&E therefore needs to raise additional equity to offset the additional debt it must carry due to FIN 46(R) requirements. This requires an amount of rate recovery necessary to cover this equity infusion starting at the commercial operation date of the Otay Mesa Project, subject to the caps and conditions that the Joint Parties have agreed upon. Finally, Mr. Schneider describes the substantial residual benefits customers will realize from the Otay Mesa Project after the first 10 years the facility is in service.

The Declaration of Victor Kruger (Appendix C) describes the RMR savings that strongly support having the Otay Mesa Project on-line in 2009.

The Declaration of Daniel Baerman (Appendix D) describes SDG&E's plans for overseeing the design, construction, operation, and maintenance of the Otay Mesa Project. This monitoring will ensure that the plant delivers its expected benefits during

the delivery term, as well as ensure that the Otay Mesa Project is in good operating condition upon exercise of the Put/Call Options.

In addition to being Joint Signatories to this PFM, TURN, UCAN, and DRA expect to file separate comments in support of the Joint PFM on the expedited response date set forth in the proposed schedule below.

V.

APPROVAL ON A NON-PRECEDENTIAL BASIS OF THE COSTS TO BE RECOVERED TO ACCOUNT FOR THE IMPACTS OF FIN 46(R) IS AN ESSENTIAL COMPONENT OF THIS PETITION

Under the Revised (and Original) PPA, OMEC is responsible for constructing and securing all necessary permits for the construction and operation of a power plant to supply 100% of its generated output for a 10-year period to SDG&E, commencing from the date the power plant is placed into commercial operation. The Revised PPA that SDG&E and OMEC are entering into includes both a Put Option, exercisable at OMEC's sole discretion, and a Call Option, exercisable at SDG&E's sole discretion, at the end of the 10-year delivery term. As a result of changes in the financial aspects of this project, including the debt/equity ratio along with the Put and Call Options, SDG&E was required to re-assess the accounting implications to SDG&E of this transaction.

Based on its analysis, SDG&E has concluded that FIN 46(R) requires SDG&E to report the consolidated financial statements that include the financial data of the Otay Mesa Project in its annual and quarterly SEC filings. After the consolidation, SDG&E's reported consolidated capital structure will have much higher leverage.^{12/} To offset the

^{12/} In SDG&E's 2006 Cost of Capital decision, D.05-12-043 (pages 11-12), the Commission concluded that SDG&E's currently authorized capital structure is, "... balanced, intended to maintain an investment grade rating, to attract capital, consistent with the law, in the public interest. ..."

impact of the consolidation on SDG&E's capital structure, SDG&E needs to increase the amount of equity in its capital structure in order to bring SDG&E's capital structure back to authorized. To this end, SDG&E is requesting rate recovery necessary to cover this equity re-balancing starting at the commercial operation date of the Otay Mesa Project, subject to the agreed-upon caps. If the Commission does not authorize this cost recovery, SDG&E will not proceed with the Revised PPA.

While DRA, TURN, and UCAN support this Revised PPA for SDG&E, they are not at this time taking a position on SDG&E's application of FIN 46(R) because of the lack of "real world" experience with FIN 46(R) in this context. If future evidence suggests that FIN 46(R) does not require SDG&E to adopt the proposed increases in equity associated with the Put and Call Options, TURN, UCAN, and DRA reserve the right to petition the Commission to adjust SDG&E's capital structure accordingly. Nevertheless, the Joint Parties have agreed to maximum amounts eligible for recovery pursuant to SDG&E's proposed FIN 46(R) treatment, as detailed in the Schneider Declaration. DRA, TURN, and UCAN also emphasize that, even with the agreed-upon limits for FIN 46(R) for this Revised PPA, their support for this single transaction should not signal a precedent for whether DRA, TURN, and UCAN would necessarily support incorporation of FIN 46(R) effects in the future for similar transactions.

While the details of the application of FIN 46(R) in this context are addressed in the Schneider Declaration, SDG&E's analysis is also summarized below. In December 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46(R) (FIN 46(R)), *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*, to provide guidance on the identification of and financial reporting for, entities

over which control is achieved through means other than voting rights. Such entities are known as variable-interest entities (VIEs). It is the general interpretation by independent accounting firms that Paragraph B13 of FIN 46(R) stipulates that a contract to purchase the entire output of a single plant entity at something other than a fixed price constitutes a “variable interest” in that entity. FIN 46(R) requires, therefore, that the “primary beneficiary” of a VIE’s activities consolidate the financial statements of the VIE when issuing the primary beneficiary’s financial statements. If one enterprise is exposed to the majority of the expected losses while another enterprise has the right to a majority of the expected residual returns of the VIE, the enterprise that is exposed to the majority of the expected losses would be considered the primary beneficiary.^{13/}

Based on the review of the Revised PPA with the Put and Call Options, key important features of the transaction that implicate FIN 46(R) are (1) SDG&E limits the OMEC owner from potential losses of its equity investment as a result of the fixed and variable payment obligations by SDG&E included in the Revised PPA and the Put Option; and (2) SDG&E holds the right to receive certain of OMEC’s residual returns and caps the OMEC owner’s rights to residual returns as a result of the Call. Because two of the five conditions described in FIN 46(R) as indicative of a VIE do exist, SDG&E concludes that OMEC will be considered to be a VIE. It is the opinion of SDG&E that one of the Put or Call options will be exercised, either due to contractual obligation (Put Option) or economic consideration (Call Option). Therefore, it is assumed that SDG&E will be the owner of the power plant after the term of the Revised PPA. As such, based on SDG&E’s assessment of the requirements of FIN 46(R), SDG&E will be required to consolidate the financial statements of OMEC.

^{13/} FIN 46(R), Paragraph 14.

In sum, based on the information available at this time and the analyses performed to date:

1. SDG&E is the Primary Beneficiary of OMEC as a result of the terms of the Put Option as this Put Option limits the OMEC shareholder's potential losses as the exercise price is fixed and determinable and the OMEC shareholder retains the sole right to exercise this Put Option;
2. SDG&E is the Primary Beneficiary of OMEC as a result of the terms of the Call Option as this Call Option limits the OMEC shareholder's potential earnings as the exercise price is fixed and determinable and SDG&E retains the sole right to exercise this Call Option; and
3. As it has been determined that SDG&E is the Primary Beneficiary of OMEC, in accordance with the terms and conditions of FIN 46(R), the financial statements of OMEC will be required to be consolidated with SDG&E's financial statements whenever SDG&E is reporting its consolidated financial results and financial condition.

Because SDG&E is absorbing OMEC's financial performance under this transaction, it is seeking the cost recovery necessary to maintain its authorized capital structure. SDG&E has also limited the effects due to FIN 46(R) by including in the Revised PPA a term that the project shall be limited to a debt/equity ratio of 75/25 and in no event shall the debt exceed [REDACTED] (the Call price negotiated in the Revised PPA). As noted above, although DRA, TURN, and UCAN are not taking a position at this time on SDG&E's FIN 46(R) analysis, they remain supportive of the transaction overall, including the revenue requirement that includes the dollars associated with FIN 46(R), subject to the agreed-upon caps.

VI.

THE LOCAL AREA RELIABILITY COSTS OF THE OTAY MESA PROJECT SHOULD BE ALLOCATED TO ALL CUSTOMERS IN SDG&E'S SERVICE TERRITORY WHO BENEFIT

The Joint Parties urge the Commission to allocate a portion of the local area reliability costs of the Revised PPA to all customers in SDG&E's service territory who

benefit from the addition of the Otay Mesa Project, not just to SDG&E's bundled customers. This objective is consistent with SDG&E's current methodology for allocating Palomar costs, the Commission's goal in the resource planning decisions (D.04-01-050 and D.04-12-048), the new resource planning rulemaking (R.06-02-013), and the proposed decision that was just issued in Phase I of R.06-02-013. In addition, the Revised PPA was negotiated in the same general time frame as the PPAs submitted by Pacific Gas and Electric Company as a result of its recent long-term request for offers and should be eligible for the same type of cost allocation should SDG&E choose to pursue that option and depending on how the implementation details of the mechanism develop.

This cost allocation issue may be addressed on a long-term basis through implementation of the CAISO's MRTU and possibly through one of the capacity market mechanisms being considered in Phase 2 of the resource adequacy proceeding. Unless and until any such future market structure changes are in place, however, the Commission must adopt an alternative means of ensuring that the costs of local area aspects of new generation are fairly spread among all customers in a utility's service territory who benefit from the increased grid reliability.

Thus far, SDG&E has generally been able to accomplish such an equitable cost allocation through an RMR contract for Palomar. SDG&E proposes to use the same approach for the Otay Mesa Project in future years and until either the Commission adopts an appropriate alternative approach for allocating costs or the CAISO adopts alternative market mechanisms. SDG&E recognizes that RMR contracts do not represent a long-term solution, but during the interim *and assuming the negotiation of acceptable*

payments from the CAISO, an RMR contract will provide an effective means of allocating costs among all customers in SDG&E's service territory who benefit from the reliability provided by new generation in SDG&E's load pocket, such as the Otay Mesa Project. The other Joint Parties also support this approach as a primary alternative in this situation.

The Joint Parties also request, however, that the Commission explicitly provide the option (but not requirement) for SDG&E to seek cost recovery for the Otay Mesa Project under the mechanism currently pending in the Phase 1 Proposed Decision of R.06-02-013. SDG&E believes that it is not at this time apparent that such mechanism will provide a superior alternative to the RMR contract approach that SDG&E has used previously, particularly on an interim basis. Should the Phase 1 details be addressed in an acceptable manner, however, SDG&E seeks the right to avail itself of that cost recovery alternative for the Otay Mesa Project should that prove to be the best course of action. The other Joint Parties strongly endorse this secondary alternative as well.

VII.

A REASONABLE, BUT EXPEDITED, SCHEDULE CAN BE ADOPTED

As noted above, a condition of the Revised PPA is that SDG&E obtain non-appealable Commission approval by November 1, 2006. This will require the Commission to render its decision on this matter at the September 21, 2006 Business Meeting. Furthermore, the Joint Parties believe that it is possible for the Commission to adopt an aggressive schedule for this Joint Petition because the Commission has previously found that this plant is needed, the Original PPA is in the public interest, and the Revised PPA merely improves upon the Original PPA that was already approved

(twice). This Joint Petition builds upon the record already established in R.01-10-024, and the changed circumstances and necessary justifications supporting the Revised PPA are sufficiently detailed in the attached Declarations. Rule 47(h) provides that the Commission may modify a decision without hearings, which should be no problem here because this is now the third time that the Otay Mesa Project has been before the Commission for consideration. As such, an aggressive schedule such as the one that follows can be undertaken without the need for evidentiary hearings.

This schedule should allow the Commission to vote out a final decision no later than the first meeting in October, 2006.

Joint Petition for Modification filed/served:	July 3, 2006
Expedited Responses to Joint Petition filed/served:	July 17, 2006
Replies to Responses filed/served:	July 21, 2006
Proposed Decision:	August 2006
Final Decision Issued:	September 21, 2006

VIII.

REQUESTED MODIFICATIONS OF D.04-06-011 AND D.06-02-031

The Joint Parties request that the Commission, based upon the accompanying Declarations, modify D.04-06-011 and D.06-02-031 as shown in Attachment B. These changes include modifications to the text of the decision and modifications to the Findings of Fact, Conclusions of Law, and the Ordering Paragraphs. The purpose of these modifications is to acknowledge the Commission's determinations, based on the supporting Declarations, that:

- (1) Significant changed circumstances have occurred since the issuance of D.04-06-011 and D.06-02-031 that justify the Revised PPA;

(2) Those changed circumstances occurred more than one year after D.04-06-011 was issued and could not have been anticipated such that the filing of this Joint Petition could have been filed within the one-year time period;

(3) It is in SDG&E's customers' best interests that the Otay Mesa Project be placed in service by May 1, 2009;

(4) Recovery of the additional costs that result from the impacts of FIN 46(R) is reasonable and is approved on a non-precedential basis, and cost recovery should be authorized, limited to the amounts agreed upon by the Joint Parties;

(5) Recovery of the local area reliability costs of the Revised PPA from all customers in SDG&E's service territory who benefit from the increased reliability is reasonable, and the proposed primary and alternative mechanisms for achieving this goal are approved;

(6) The Revised PPA, including all of its new and revised terms, is reasonable, in the public interest and is approved;

(7) Acquisition by SDG&E of the Otay Mesa Project at the end of the 10-year delivery term pursuant to OMEC's exercise of its Put Option is hereby approved.

IX.

THE PROTECTIVE ORDER ISSUED ON JANUARY 14, 2004, IN THIS PROCEEDING PERTAINS TO ALL CONFIDENTIAL INFORMATION SUPPORTING THIS JOINT PETITION

On January 14, 2004, the presiding ALJ adopted an Amended Protective Order specific to confidential materials developed or produced as part of the phase of R.01-10-024 dealing with SDG&E's motion to enter into new electric resource contracts resulting

from its RFP (SDG&E's "RFP Motion"). It was the RFP Motion that resulted in D.04-06-011, one of the decisions that is the subject of this Joint Petition.

That ruling pertained (and still pertains) to materials submitted or produced in this docket that are part of, or relate to, SDG&E's Procurement Plans. The ruling amended the Protective Order so as to broaden it to include "any filing, submittal, or testimony pertaining or relating to the bids submitted in response to SDG&E's May 16, 2003, Grid Reliability Capacity RFP, to the extent that the information in question was designated by the bidders as confidential, proprietary, commercially sensitive or trade secret." The Protective Order already applied to (and the Amended Protective Order also applies to): "any materials submitted or produced in connection with the review, revision or approval of any initial or revised SDG&E Procurement Plan" and well as "any other materials that are made subject to this Protective Order by any assigned ALJ, Law and Motion ALJ, or Assigned Commissioner, or by the CPUC."

The amount of confidential information in this Joint Petition is minimal, relating primarily to competitive, commercially sensitive or proprietary information about SDG&E's electric energy resources or related data that, if known publicly, would disadvantage SDG&E's ability to participate effectively in energy markets. In addition, SDG&E seeks confidential treatment for proprietary and competitively sensitive information of Calpine. Both redacted and unredacted versions of the Joint Petition and Declarations are being filed today.

This process is in keeping with the legislative mandate of Public Utilities Code Section 454.5(g) that the Commission "shall adopt appropriate procedures to ensure the confidentiality of any market sensitive information ... resulting from or related to its

[electrical corporation's] approved procurement plan." This Joint Petition, requesting authorization for SDG&E to enter into a Revised PPA, is in furtherance of and consistent with SDG&E's approved Procurement Plan.

As is true in all other similar or related proceedings, members of SDG&E's Procurement Review Group will be provided access to all confidential materials to the extent those members agree (or have agreed) to the provisions of the appropriate nondisclosure agreement. Likewise, members of the Commission's staff will be provided full access consistent with Public Utilities Code Sections 454.5(g) and 583, and General Order 66-C.

X.

CONCLUSION

For the reasons stated above, the Joint Parties respectfully request the Commission issue a decision finding that the Revised PPA is in the public interest and modifying D.04-06-011 and D.06-02-031 in the manner described herein and consistent with Attachment B:

- (1) Significant changed circumstances have occurred since the issuance of D.04-06-011 and D.06-02-031 that justify the Revised PPA;
- (2) Those changed circumstances occurred more than one year after D.04-06-011 was issued and could not have been anticipated such that the filing of this Joint Petition could have been filed within the one-year time period;
- (3) It is in SDG&E's customers' best interests that the Otay Mesa Project be placed in service by May 1, 2009;
- (4) Recovery of the additional costs that result from the impacts of FIN 46(R) is reasonable and is approved on a non-precedential basis, and cost recovery should be authorized, limited to the amounts agreed upon by the Joint Parties;
- (5) Recovery of the local area reliability costs of the Revised PPA from all customers in SDG&E's service territory who benefit from the increased

reliability is reasonable and the proposed primary and alternative mechanisms for achieving this goal are approved;

- (6) The Revised PPA, including all of its new and revised terms, is reasonable, in the public interest, and is approved; and
- (7) Acquisition by SDG&E of the Otay Mesa Project at the end of the 10-year delivery term pursuant to OMEC's exercise of its Put Option is hereby approved.

The Joint Parties also request that the Commission expedite its review of this Joint Petition so that the Otay Mesa Project can go into commercial operation and begin delivering its substantial benefits by May 1, 2009.

DATED this 3rd day of July, 2006, at San Diego, California.

Respectfully submitted,



LISA G. URICK
Attorney for
San Diego Gas & Electric Company
101 Ash Street, HQ-13D
San Diego, California 92101-3017
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ATTACHMENT A



Debra L. Reed
President & COO

8330 Century Park Court
San Diego, CA 92123-1530

Tel: 858.650.6110
Fax: 858.650.6106
dreed@SempraUtilities.com

June 14, 2006

Mr. Robert Fishman
Calpine Corp.
50 West San Fernando Street
San Jose, CA 95113

Dear Bob:

In response to your June 7th letter, we offer the following as terms and conditions of a proposed transaction between SDG&E and Calpine's subsidiary Otay Mesa Energy Center, LLC ("Project Company") relating to the Otay Mesa Energy Center (the "Project"). We have tried to address the issues raised in your letter in a manner that will work for both parties

▪ Transactions:

- SDG&E and Project Company will enter into a PPA generally on the same terms and conditions as the PPA approved by the CPUC on Feb. 16, 2006 as modified as described in this letter.
- SDG&E and Project Company will enter into the lease transactions described below in order to protect and provide for the option transactions described below.

▪ PPA Terms:

- COD Target May 1, 2009.
- Delay LD's start May 30, 2009.
- Debt/Equity ratio at 75/25 but in no event shall the debt exceed [REDACTED].
- Final and non-appealable CPUC Decision approving transactions described in this letter by November 1, 2006.
 - In addition, SDG&E will require CPUC approval for compensation in rates to authorize additional equity as required to meet its authorized capital structure resulting from consolidating Project Company to SDG&E's balance sheet pursuant to FIN 46. In order to minimize those

costs, Project Company's debt/equity ratio shall be no greater than 75/25.

- Upon the effective date of the PPA, SDG&E will require certain financial information and certifications (including financial statements, financial schedules and supporting documentation, and access to records and personnel) no less frequently than as of the end of each calendar quarter to perform the necessary financial consolidations on SDG&E's financial statements pursuant to FIN 46(R) and as required under the Sarbanes-Oxley Act of 2002.
- Approval by bankruptcy court by Nov. 1, 2006.
- Capacity Payment: \$9.75/kW-mo per original PPA
- Capacity Performance Payment: [REDACTED] maximum over the 10 year term of the PPA
 - [REDACTED] for every kW greater than the [REDACTED]
- Heat-rate Performance Payment: [REDACTED] maximum over the 10 year term of the PPA
 - [REDACTED] for every Btu/kWh lower than the sum [REDACTED]
- The Project's initial new and clean performance will be benchmarked to [REDACTED]
[REDACTED]
- Annual Performance tests shall be performed for Capacity and Heat-rate per PPA but under the [REDACTED]
[REDACTED]
- [REDACTED]
[REDACTED]
- The payment provisions of the PPA would remain unchanged from the previously approved PPA. The additional performance payments (Capacity Performance Payment and Heat-rate Performance Payment) [REDACTED]
[REDACTED].

- Lease and Option Transactions:
 - Project Company will assign the existing ground lease to SDG&E. SDG&E will enter into a ground sublease with Project Company on substantially the same terms as the existing ground lease as modified as described below, so that, except for the Put Option (defined below) and the Call Option (defined below), Project Company will have the same rights and obligations as it currently has under the existing ground lease, and will be able to expand, modify or refinance the Project and otherwise deal with the Project freely as it chooses.
 - If Project Company defaults under the PPA, SDG&E will have no remedy or cross default under the ground sublease. The parties will consider including a provision in the sublease that, upon a termination of the PPA following an SDG&E default or the expiration of the Call Option without it having been exercised, SDG&E will upon request of Project Company and in consideration of \$1.00 (a) assign to Project Company its interest in the existing ground lease and (b) terminate the ground sublease, in addition to any other remedies Project Company may have as a result of such default. This provision will only be included in the sublease if SDG&E is satisfied that it will not adversely affect the transaction structure in any material respect.
 - The ground sublease (and related three-party consent agreement) will provide for full lender protections customary for non-recourse project financings of ground leased projects.
 - Project Company and ground lessor will enter into a recognition agreement, including (i) recognition by ground lessor of Project Company as lessee under the ground lease if the sublease terminates and (ii) agreement to enter into new ground lease with Project Company on same terms and conditions as existing lease in the event the lease and/or sublease are rejected by SDG&E. Project Company's rights under the recognition agreement will be assignable to the project lenders.
 - The ground sublease will provide for an option in favor of Project Company (the "Put Option") to require SDG&E to purchase the Project as of the 10th anniversary of the COD for a purchase price equal to [REDACTED], as adjusted as described below. The Put Option shall be exercisable upon the 10th anniversary of the COD. In addition, the Put Option shall be exercisable anytime between the termination of the PPA as a result of the default of SDG&E and the 10th anniversary of the COD; provided, however, that if Project Company exercises the Put Option following such SDG&E default, the amount by which (i) the Put Option purchase price exceeds (ii) the then NPV of the Put Option purchase price as if exercised at the end of the PPA term shall be offset from any PPA damages then owed to Project Company (but not against the Put Option purchase price) to the extent the PPA damages were not already reduced as a result of the exercise of

the Put Option.

- The ground sublease will provide for an option in favor of SDG&E (the “Call Option”) to require Project Company to sell the Project for a purchase price equal to [REDACTED], as adjusted as described below. The Call Option shall be exercisable upon the 10th anniversary of the COD. In addition, the Call Option shall be exercisable anytime between the termination of the PPA as a result of the default of Project Company and the 10th anniversary of the COD; provided, however, that if SDG&E exercises the Call Option following such Project Company default, the Call Option purchase price shall be offset by the amount of any PPA damages then owed to SDG&E, but only to the extent the resulting Call Option payment is no less than the Project Company’s senior debt.
- Each of the Put Option and the Call Option shall not be exercisable by Project Company or SDG&E, as applicable, following a termination of the PPA as a result of the default by Project Company or SDG&E, as applicable.
- The Put Option and Call Option exercise prices are contingent upon the Project being designed, constructed, operated, and maintained in accordance with manufacturers’ specifications and prudent industry standards using manufacturers’ approved parts. In addition, the Project shall be free and clear of all liens other than permitted liens. SDG&E shall have the right to verify the condition/status of the Project through a standard due diligence investigation to verify that the Project is in good operating condition and has been maintained accordingly. SDG&E will have full access to operation and maintenance records, plans and contracts as part of its assessment of the Project. Shortly prior to the closing of the Put Option or the Call Option, the performance of the Project will be benchmarked to initial new and clean performance. If the actual performance is more than five percent inferior to the initial new and clean performance, both the Put Option and Call Option exercise prices will be adjusted downward. Liquidated damages and minimum acceptance criteria to be negotiated.
- The Project shall have been designed, constructed, operated, and maintained in accordance with manufacturers’ specifications and prudent industry standards and, at closing, shall be subject to completion and successful passing of industry standard performance tests including capacity (base and peak), heat-rate (base and peak), reliability, emissions, sound, steam bypass, and availability (start-up, load rejection, and load following) tests, and as otherwise in general accordance with ASME PTC 46 and tests for compliance with requirements of applicable permits.
- The ground sublease will incorporate the obligations of the existing Negative Pledge Agreement except that the debt/equity level will be as described herein.

[REDACTED]

[REDACTED]

[REDACTED]

▪ Other PPA and Option Terms:

- The obligations under the PPA and the Call Option will be secured by a security interest in favor of SDG&E. Such security interest will be junior to Project Company's senior project financing and it, along with any related subordination agreement or intercreditor arrangements, will otherwise be on terms that are customary for the protection of senior lenders in non-recourse project financings.
- Monitoring of construction, operation, and maintenance by SDG&E with arbitration provisions for actions outside of manufacturers' specifications and/or prudent industry standards.
- Project Company shall not amend any leases, permits, easements, etc. that will in any way impair the operation of the Project or allocate obligations to the post-closing period without the prior written consent of SDG&E, which consent shall not be unreasonably withheld.
- All leases, permits, easements, entitlements, etc. shall be valid for the 30-year minimum life of the Project.
- Liabilities related to the Project, including environmental liabilities, shall generally be allocated to SDG&E if related to the post-closing period and to

Project Company if related to the pre-closing period.

- Prior to COD, Project Company shall be prohibited from assigning the PPA except in connection with a financing of the Project or with SDG&E's prior approval in its sole discretion. After COD, Project Company shall be prohibited from assigning the PPA except in connection with a financing of the Project or with SDG&E's prior approval not to be unreasonably withheld. A change in ownership or control of Project Company shall be considered an assignment.
- Promptly following execution of this letter, Project Company will seek confirmation from project finance lenders that the foregoing lease structure is financeable on a non-recourse basis. Project Company will keep SDG&E informed regarding its progress and allow SDG&E an opportunity to confer with such lenders regarding any unreasonable impediments to financing that such lenders perceive related to the structure. To the extent that the foregoing lease structure is not reasonably financeable on a non-recourse basis, SDG&E will in good faith consider alternative structures that provide SDG&E with reasonably equivalent protection against Project Company defaults.

In order to move forward, it is our intent to enter into a settlement agreement with the three intervenors, TURN, UCAN and the DRA. This settlement agreement will then be filed as a joint petition for modification of the CPUC's decision approving the PPA. This is not a new proceeding and as such, the outstanding appeal of the Commission's Decision of the PPA by the appealing intervenors would become moot. It is our expectation that the Commission can then act promptly so that this amended PPA will be considered as the "final non-appealable CPUC approval CP" before the November 1, 2006 deadline, presuming no appeals by others.

If this representation comports with your understanding of our agreement, please sign below indicating your acceptance, and return to my attention.

Please note that this letter is not intended to constitute a binding contract to negotiate definitive agreements or to consummate the transactions summarized herein. This letter is intended to be good faith summary of the terms that are currently proposed by the parties. Neither party shall have any obligation to consummate any of the transactions summarized herein until each of the parties has executed and delivered definitive agreements. With that in mind, we would like to turn our efforts to definitive documentation. In light of the November 1, 2007 deadline for CPUC approval, we would like to target to have the definitive agreements completed by July 14, 2006.

Mr. Robert Fishman
June 14, 2006
Page 7

We look forward to hearing from you.


Sincerely,

SAN DIEGO GAS & ELECTRIC COMPANY

By: Debra L. Reed
Name: Debra L. Reed
Title: President and Chief Operating
Officer

Agreed to by,

Calpine Corp.

By: 
Name: Robert Fishman
Title: EXECUTIVE VICE PRESIDENT -
POWER OPERATIONS

ATTACHMENT B

PROPOSED MODIFICATIONS TO D.04-06-011

- Leave description of project proposals as currently drafted, but insert new section as “**F. Changed Circumstances Regarding Otay Mesa**” (top of mimeo, p. 13), which would read as follows:

On December 20, 2005, Calpine and various affiliates and subsidiaries of Calpine commenced bankruptcy proceedings by filing voluntary petitions to restructure under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York, which cases are being jointly administered under Case #05-60199. Thus, due to a confluence of this and other circumstances, the need to consider alternate arrangements to the PPA originally proposed in D.04-06-011 became apparent. After pursuing various alternatives, SDG&E and Calpine ultimately settled on the Revised PPA that is memorialized in the Letter Agreement provided in Attachment A to the Joint Petition for Modification filed regarding this decision and D.06-02-031. The Revised PPA provides that the Otay Mesa Project would come on-line by May 1, 2009, and it also includes “Put” and “Call” Options where SDG&E is likely to own the project at the end of the 10-year term. Capacity and heat-rate performance incentives are also part of the Revised PPA. The Joint Petition was filed by SDG&E, TURN, UCAN, and DRA on July 3, 2006, and an expedited response and reply period ensued. Because this is the third time the Commission has considered the Otay Mesa Project and the Declarations and Joint Party support provided a complete set of materials on which to base the Commission’s decision, no hearings were held. The Revised PPA accomplishes the primary objectives of SDG&E, which are to preserve and improve upon the economics of the Original PPA already approved in D.04-06-011, as well as to create the opportunity for SDG&E to obtain the Otay Mesa Project at a fair and reasonable price after the 10-year delivery term in the Revised PPA has expired. This Revised PPA replaces the Original PPA approved in this Order.

- Leave description of parties’ positions the same, but insert new section as “**L. SDG&E/TURN/UCAN/DRA**” (top of mimeo, p. 26), which would read as follows:

Since D.04-06-011 was issued, DRA, TURN, and UCAN now join SDG&E in the Petition for approval of the Revised PPA because they recognize that SDG&E customers are likely to achieve substantial benefits from the Otay Mesa Project as a result of the changed provisions contained in the Revised PPA. In the Joint Petition, the interests of SDG&E’s customers, and the interests of energy consumers statewide, are represented by the Joint Parties. UCAN represents residential and small commercial customers in SDG&E’s service territory. TURN represents a wider array of ratepayer interests throughout the State, as does DRA. The support of DRA, TURN and UCAN for this Joint Petition reinforces the value and benefits contained in this Revised PPA. The Revised PPA includes

generally the same terms and conditions as the original power purchase agreement that the Commission previously approved in D.04-06-011, but it also contains numerous significant enhancements that make the Revised PPA a more attractive opportunity for SDG&E's customers than the prior agreement.

While DRA, TURN, and UCAN join SDG&E to support approval of the Revised PPA, they do not take a position on one aspect of SDG&E's analysis regarding the costs associated with the financial accounting effects due to certain features of the Revised PPA. Accordingly, to accommodate their reservations at this time, SDG&E has agreed to cap these potential future accounting costs created by the Revised PPA at the levels set forth in the Joint Petition. Receiving authorization for cost recovery for these financial effects is, however, an essential aspect of this Joint PFM for SDG&E, and SDG&E will not proceed with the Revised PPA without Commission approval of SDG&E's recovery of these accounting costs, subject to the agreed-upon caps.

The Joint Parties also urge the Commission to allocate a portion of the local area reliability costs of the Revised PPA to all customers in SDG&E's service territory who benefit from the addition of the Otay Mesa Project, not just to SDG&E's bundled customers. This objective is consistent with SDG&E's current methodology for allocating Palomar costs, the Commission's goal in the resource planning decisions (D.04-01-050 and D.04-12-048), the new resource planning rulemaking (R.06-02-013), and the proposed decision that was just issued in Phase I of R.06-02-013. The Revised PPA was negotiated in the same general time frame as the PPAs submitted by Pacific Gas and Electric Company as a result of its recent long-term request for offers and should be eligible for the same type of cost allocation should SDG&E choose to pursue that option.

Thus far, SDG&E has generally been able to accomplish such an equitable cost allocation through an RMR contract for Palomar. SDG&E proposes to use the same approach the Otay Mesa Project in future years and until either the Commission adopts an appropriate alternative approach for allocating costs or the CAISO adopts alternative market mechanisms. SDG&E recognizes that RMR contracts do not represent a long-term solution, but during the interim *and assuming the negotiation of acceptable payments from the CAISO*, an RMR contract will provide an effective means of allocating costs among all customers in SDG&E's service territory who benefit from the reliability provided by new generation in SDG&E's load pocket, such as the Otay Mesa Project. The other Joint Parties also support this approach as a primary alternative in this situation.

The Joint Parties also request, however, that the Commission explicitly provide the option (but not requirement) for SDG&E to seek cost recovery for the Otay Mesa Project under the mechanism currently pending in the Phase 1 Proposed Decision of R.06-02-013. SDG&E seeks the right to avail itself of that cost recovery alternative for the Otay Mesa Project should that prove to be the best course of action. The other Joint Parties strongly endorse this secondary alternative as well.

- At mimeo, p. 64, replace the paragraph f) **The Benefits of a 10-Year PPA** with the following:

Since the Original PPA was first approved, the Commission has adopted a local capacity requirement in R.05-12-013. The Otay Mesa Project provides an economic local resource that will benefit SDG&E's customers immediately in meeting this requirement and providing needed long-term grid reliability. Further delays in commencement of commercial operation beyond 2009 will also reduce the RMR benefits achievable in that calendar year, requiring SDG&E's customers to incur otherwise unnecessary RMR costs. Because of the "Put" and "Call" Options that now are included in the Revised PPA, SDG&E will likely own and operate a 573 MW generation asset with a 30-year useful life that will be located in SDG&E's service territory.

The "Put" Option, exercisable at Calpine's sole discretion at the expiration of the 10-year PPA, would require SDG&E to purchase the Otay Mesa Project at an already negotiated price, subject to certain conditions and adjustments. The Joint Parties seek approval of the Put Option as part of this Joint PFM and there would be no additional Commission review or approval opportunity prior to Calpine's potential exercise of the Put Option after this Joint PFM is granted. A "Call" Option, exercisable at SDG&E's sole discretion at the expiration of the 10-year PPA, would require OMEC to sell the Otay Mesa Project to SDG&E at an already negotiated price, also subject to adjustments and conditions. Unlike the Put Option, SDG&E would seek further Commission review and approval prior to exercising the Call Option in the Revised PPA.

By virtue of this arrangement, SDG&E avoids future market price risks and cost escalation risks associated with construction of the Otay Mesa Project or future resource procurement in case the Revised PPA is not in place. With these Put and Call Options, the Revised PPA also avoids the "Year 11" problem where, at the end of the 10-year delivery term, if no other generation has been built in SDG&E's load pocket and aging plants in the area have retired, SDG&E would be totally dependent on the Otay Mesa Project to serve its load and meet its longer-term grid reliability needs, with no other viable alternative.

SDG&E has also included in the Revised PPA capped performance incentive payments (1) if the Otay Mesa Project exceeds a certain capacity performance standard and (2) for meeting and maintaining a specific heat-rate performance standard. If the Otay Mesa Project exceeds certain performance thresholds in terms of capacity and heat-rate, then incentives are paid, up to a cap, in recognition of the increased benefits to customers. The details of all of these benefits and savings are described in the Declarations to the Joint Petition.

- At mimeo, p. 66, in "h) **SDG&E's Conditions,**" add the following sentence at the end of that paragraph:

We are, however, approving SDG&E's request to recover rates for the equity offset related to the FIN 46 effects detailed by SDG&E, subject to the caps and conditions agreed upon by the Joint Parties.

- Revise/Add to the Findings of Fact as follows:

31. The Joint Parties propose a 10-year PPA for the Otay Mesa Project, with Put/Call Options and FIN 46 rate recovery (subject to agreed upon caps and conditions) beginning upon the commercial operation of the plant, which will now be May 1, 2009. If future evidence suggests that FIN 46(R) does not require consolidation of the Otay Mesa Project with SDG&E's financials, then TURN/UCAN/DRA reserve the right to petition for an appropriate adjustment to SDG&E's capital structure. TURN, UCAN, and DRA also emphasize that their position regarding this transaction should not be regarded as a precedent for any future similar transaction. The agreed-upon caps (in nominal dollars) are as follows:

2009 - \$16.0 million // 2010 - \$15.5 million // 2011 - \$15.0 million
2012 - \$14.4 million // 2013 - \$13.9 million // 2014 - \$13.4 million
2015 - \$12.8 million // 2016 - \$12.3 million // 2017 - \$11.8 million
2018 - \$11.2 million

##. Since the Original PPA was first approved, the Commission has adopted a local capacity requirement in R.05-12-013. The Otay Mesa Project provides an economic local resource that will benefit SDG&E's customers immediately in meeting this requirement and providing needed long-term grid reliability.

##. Because of the "Put" and "Call" Options that now are included in the PPA, SDG&E will likely own and operate a 573 MW generation asset with a 30-year useful life that will be located in SDG&E's service territory.

##. The need for the Otay Mesa Project has already been established and approved by the Commission.

##. Under the Revised PPA, SDG&E avoids future market price risks and cost escalation risks associated with construction of the Otay Mesa Project or future resource procurement in case the Revised PPA is not in place.

##. At the end of the 10-year term of the Revised PPA, SDG&E shall have the option to "Call," or purchase, the Otay Mesa Project at a pre-negotiated price that nearly 13 years after the construction of Palomar, still compares favorably to Palomar and avoids the market price risk to which SDG&E would otherwise be subject at the end of the Original PPA term.

##. In the event the market conditions in 2019 suggest that it would not be prudent to exercise this option, SDG&E can elect not to exercise the Call Option.

In the event SDG&E does not elect the Call Option, then Calpine shall have the right to “Put” the Otay Mesa Project to SDG&E. The price that SDG&E would have to pay for the plant under the Put Option, however, is significantly below the Net Book Value of Palomar in 2019 dollars.

##. If the Otay Mesa Project exceeds certain performance thresholds in terms of capacity and heat-rate, then under the Revised PPA incentives are paid, up to a cap, in recognition of the increased benefits to customers.

##. The Commission should also allocate a portion of the local area reliability costs of the Revised PPA to all customers in SDG&E’s service territory who benefit from the addition of the Otay Mesa Project, not just to SDG&E’s bundled customers. The RMR contract option or the mechanism being developed in Phase I of R.06-02-013 are both alternatives that may be used to achieve this cost allocation. Otay Mesa qualifies for the treatment of the R.06-02-013 mechanism, should SDG&E choose to avail itself of that option for Otay in lieu of the RMR contract approach.

##. Approval of the Otay Mesa Project does not obviate the need for SDG&E to conduct a long-term RFO in 2006 for capacity needs in 2010 and beyond.

- Add the following Conclusions of Law, beginning with new COL 10:

10. Significant changed circumstances have occurred since the issuance of D.04-06-011 and D.06-02-031 that justify the Revised PPA.

##. Those changed circumstances occurred more than one year after D.04-06-011 was issued and could not have been anticipated such that the filing of this Joint Petition could have been filed within the one-year time period.

##. It is in SDG&E’s customers’ best interests that the Otay Mesa Project be placed in service by May 1, 2009.

##. Recovery of the additional costs that result from the impacts of FIN 46(R) is reasonable and is approved on a non-precedential basis, and cost recovery should be authorized, limited to the amounts and other conditions agreed upon by the Joint Parties.

##. Recovery of the local area reliability costs of the Revised PPA from all customers in SDG&E’s service territory who benefit is reasonable and the proposed primary and alternative mechanisms for achieving this goal are reasonable as well.

##. The Revised PPA, including all of its new and revised terms, is reasonable, in the public interest, and is approved.

##. Acquisition by SDG&E of the Otay Mesa Project at the end of the 10-year delivery term pursuant to OMEC's exercise of its Put Option is hereby approved.

- Revise Ordering Paragraph 7 to read as follows:
 7. SDG&E may execute the Otay Mesa Power Purchase Agreement (PPA) that is the subject of the Joint Petition for Modification and that will include the terms and conditions of the Letter Agreement filed with the Joint Petition (Attachment A). SDG&E is authorized to record the costs of this PPA in the ERRA and other appropriate accounts depending on the cost allocation mechanism that is ultimately adopted for the Otay Mesa Project. SDG&E is authorized to recover the costs, subject to the agreed upon caps, associated with the equity re-balancing necessary due to application of FIN 46(R) and the consolidation of the OMEC financial data with SDG&E's quarterly and annual financial statements to the SEC.

PROPOSED CHANGES TO D.06-02-031

- At mimeo, p. 2, insert the following paragraph at the end of Section “**II. BACKGROUND**”:

On December 20, 2005, Calpine and various affiliates and subsidiaries of Calpine commenced bankruptcy proceedings by filing voluntary petitions to restructure under Chapter 11 of the United States Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York, which cases are being jointly administered under Case #05-60199. Thus, due to a confluence of this and other circumstances, the need to consider alternate arrangements to the PPA originally proposed in D.04-06-011 became apparent. After pursuing various alternatives, SDG&E and Calpine ultimately settled on the Revised PPA that is memorialized in the Letter Agreement provided in Attachment A to the Joint Petition for Modification filed regarding this decision and D.06-02-031. The Revised PPA provides that the Otay Mesa Project would come on-line by May 1, 2009, and it also includes “Put” and “Call” Options where SDG&E is likely to own the project at the end of the 10-year term. Capacity and heat-rate performance incentives are also part of the Revised PPA. The Joint Petition was filed by SDG&E, TURN, UCAN, and DRA on July 3, 2006, and an expedited response and reply period ensued. Because this is the third time the Commission has considered the Otay Mesa Project and the Declarations and Joint Party support provided a complete set of materials on which to base the Commission’s decision, no hearings were held. The Revised PPA accomplishes the primary objectives of SDG&E, which are to preserve and improve upon the economics of the Original PPA already approved in D.04-06-011, as well as to create the opportunity for SDG&E to obtain the Otay Mesa Project at a fair and reasonable price after the 10-year delivery term in the Revised PPA has expired. This Revised PPA replaces the Original PPA approved in this Order. Approval of this Revised PPA as filed under the Joint Petition will also moot the Joint Application for Rehearing of this decision that was filed by TURN and UCAN.

- At mimeo, p. 4, insert the following paragraphs at the end of Section “**III. SUMMARY OF PARTIES’ POSITIONS**”:

Since D.04-06-011 was issued, DRA, TURN, and UCAN now join SDG&E in the Petition for approval of the Revised PPA because they recognize that SDG&E customers are likely to achieve substantial benefits from the Otay Mesa Project as a result of the changed provisions contained in the Revised PPA. In the Joint Petition, the interests of SDG&E’s customers, and the interests of energy consumers statewide, are represented by the Joint Parties. UCAN represents residential and small commercial customers in SDG&E’s service territory. TURN represents a wider array of ratepayer interests throughout the State, as does DRA. The support of DRA, TURN and UCAN for this Joint Petition reinforces the value and benefits contained in this Revised PPA. The Revised PPA includes

generally the same terms and conditions as the original power purchase agreement that the Commission previously approved in D.04-06-011, but it also contains numerous significant enhancements that make the Revised PPA a more attractive opportunity for SDG&E's customers than the prior agreement.

While DRA, TURN, and UCAN join SDG&E to support approval of the Revised PPA, they do not take a position on one aspect of SDG&E's analysis regarding the costs associated with the financial accounting effects due to certain features of the Revised PPA. Accordingly, to accommodate their reservations at this time, SDG&E has agreed to cap these potential future accounting costs created by the Revised PPA at the levels set forth in the Joint Petition. Receiving authorization for cost recovery for these financial effects is, however, an essential aspect of this Joint PFM for SDG&E, and SDG&E will not proceed with the Revised PPA without Commission approval of SDG&E's recovery of these accounting costs, subject to the agreed-upon caps.

The Joint Parties also urge the Commission to allocate a portion of the local area reliability costs of the Revised PPA to all customers in SDG&E's service territory who benefit from the addition of the Otay Mesa Project, not just to SDG&E's bundled customers. This objective is consistent with SDG&E's current methodology for allocating Palomar costs, the Commission's goal in the resource planning decisions (D.04-01-050 and D.04-12-048), the new resource planning rulemaking (R.06-02-013), and the proposed decision that was just issued in Phase I of R.06-02-013. The Revised PPA was negotiated in the same general time frame as the PPAs submitted by Pacific Gas and Electric Company as a result of its recent long-term request for offers and should be eligible for the same type of cost allocation should SDG&E choose to pursue that option.

Thus far, SDG&E has generally been able to accomplish such an equitable cost allocation through an RMR contract for Palomar. SDG&E proposes to use the same approach for the Otay Mesa Project in future years and until either the Commission adopts an appropriate alternative approach for allocating costs or the CAISO adopts alternative market mechanisms. SDG&E recognizes that RMR contracts do not represent a long-term solution, but during the interim *and assuming the negotiation of acceptable payments from the CAISO*, an RMR contract will provide an effective means of allocating costs among all customers in SDG&E's service territory who benefit from the reliability provided by new generation in SDG&E's load pocket, such as the Otay Mesa Project. The other Joint Parties also support this approach as a primary alternative in this situation.

The Joint Parties also request, however, that the Commission explicitly provide the option (but not requirement) for SDG&E to seek cost recovery for the Otay Mesa Project under the mechanism currently pending in the Phase 1 Proposed Decision of R.06-02-013. SDG&E seeks the right to avail itself of that cost recovery alternative for the Otay Mesa Project should that prove to be the best course of action. The other Joint Parties strongly endorse this secondary alternative as well.

- At mimeo, p. 18, insert the following paragraphs at the end of Section “IV. DISCUSSION”:

Since the Original PPA was first approved, the Commission has adopted a local capacity requirement in R.05-12-013. The Otay Mesa Project provides an economic local resource that will benefit SDG&E’s customers immediately in meeting this requirement and providing needed long-term grid reliability. Further delays in commencement of commercial operation beyond 2009 will also reduce the RMR benefits achievable in that calendar year, requiring SDG&E’s customers to incur otherwise unnecessary RMR costs. Because of the “Put” and “Call” Options that now are included in the Revised PPA, SDG&E will likely own and operate a 573 MW generation asset with a 30-year useful life that will be located in SDG&E’s service territory.

The “Put” Option, exercisable at Calpine’s sole discretion at the expiration of the 10-year PPA, would require SDG&E to purchase the Otay Mesa Project at an already negotiated price, subject to certain conditions and adjustments. The Joint Parties seek approval of the Put Option as part of this Joint PFM and there would be no additional Commission review or approval opportunity prior to Calpine’s potential exercise of the Put Option after this Joint PFM is granted. A “Call” Option, exercisable at SDG&E’s sole discretion at the expiration of the 10-year PPA, would require OMEC to sell the Otay Mesa Project to SDG&E at an already negotiated price, also subject to adjustments and conditions. Unlike the Put Option, SDG&E would seek further Commission review and approval prior to exercising the Call Option in the Revised PPA.

By virtue of this arrangement, SDG&E avoids future market price risks and cost escalation risks associated with construction of the Otay Mesa Project or future resource procurement in case the Revised PPA is not in place. With these Put and Call Options, the Revised PPA also avoids the “Year 11” problem where, at the end of the 10-year delivery term, if no other generation has been built in SDG&E’s load pocket and aging plants in the area have retired, SDG&E would be totally dependent on the Otay Mesa Project to serve its load and meet its longer-term grid reliability needs, with no other viable alternative.

SDG&E has also included in the Revised PPA capped performance incentive payments (1) if the Otay Mesa Project exceeds a certain capacity performance standard and (2) for meeting and maintaining a specific heat-rate performance standard. If the Otay Mesa Project exceeds certain performance thresholds in terms of capacity and heat-rate, then incentives are paid, up to a cap, in recognition of the increased benefits to customers. The details of all of these benefits and savings are described in the Declarations to the Joint Petition.

- Revise/Add to Findings of Fact as follows:

1. SDG&E and the Joint Parties are seeking approval of a 10-year PPA with Put/Call Options for power from the 573 MW Otay Mesa gas-fired, combined cycle power plant that will come on-line by May 1, 2009.

##. The Joint Parties propose a 10-year PPA for the Otay Mesa Project, with Put/Call Options and FIN 46 rate recovery (subject to agreed upon caps and conditions) beginning upon the commercial operation of the plant, which will now be May 1, 2009. If future evidence suggests that FIN 46(R) does not require consolidation of the Otay Mesa Project with SDG&E's financials, then TURN/UCAN/DRA reserve the right to petition for an appropriate adjustment to SDG&E's capital structure. TURN, UCAN, and DRA also emphasize that their position regarding this transaction should not be regarded as a precedent for any future similar transaction. The agreed-upon caps (in nominal dollars) are as follows:

2009 - \$16.0 million // 2010 - \$15.5 million // 2011 - \$15.0 million
2012 - \$14.4 million // 2013 - \$13.9 million // 2014 - \$13.4 million
2015 - \$12.8 million // 2016 - \$12.3 million // 2017 - \$11.8 million
2018 - \$11.2 million

##. Since the Original PPA was first approved, the Commission has adopted a local capacity requirement in R.05-12-013. The Otay Mesa Project provides an economic local resource that will benefit SDG&E's customers immediately in meeting this requirement and providing needed long-term grid reliability.

##. Because of the "Put" and "Call" Options that now are included in the PPA, SDG&E will likely own and operate a 573 MW generation asset with a 30-year useful life that will be located in SDG&E's service territory.

##. The need for the Otay Mesa Project has already been established and approved by the Commission.

##. Under the Revised PPA, SDG&E avoids future market price risks and cost escalation risks associated with construction of the Otay Mesa Project or future resource procurement in case the Revised PPA is not in place.

##. At the end of the 10-year term of the Revised PPA, SDG&E shall have the option to "Call," or purchase, the Otay Mesa Project at a pre-negotiated price that nearly 13 years after the construction of Palomar, still compares favorably to Palomar and avoids the market price risk to which SDG&E would otherwise be subject at the end of the Original PPA term.

##. In the event the market conditions in 2019 suggest that it would not be prudent to exercise this option, SDG&E can elect not to exercise the Call Option. In the event SDG&E does not elect the Call Option, then Calpine shall have the right to "Put" the Otay Mesa Project to SDG&E. The price that SDG&E would

have to pay for the plant under the Put Option, however, is significantly below the Net Book Value of Palomar in 2019 dollars.

##. If the Otay Mesa Project exceeds certain performance thresholds in terms of capacity and heat-rate, then under the Revised PPA incentives are paid, up to a cap, in recognition of the increased benefits to customers.

##. The Commission should also allocate a portion of the local area reliability costs of the Revised PPA to all customers in SDG&E's service territory who benefit from the addition of the Otay Mesa Project, not just to SDG&E's bundled customers. The RMR contract option or the mechanism being developed in Phase I of R.06-02-013 are both alternatives that may be used to achieve this cost allocation. Otay Mesa qualifies for the treatment of the R.06-02-013 mechanism, should SDG&E choose to avail itself of that option for Otay in lieu of the RMR contract approach.

##. Approval of the Otay Mesa Project does not obviate the need for SDG&E to conduct a long-term RFO in 2006 for capacity needs in 2010 and beyond.

- Add the following Conclusions of Law:
 1. Significant changed circumstances have occurred since the issuance of D.04-06-011 and D.06-02-031 that justify the Revised PPA.
 2. It is in SDG&E's customers' best interests that the Otay Mesa Project be placed in service by May 1, 2009.
 3. Recovery of the additional costs that result from the impacts of FIN 46(R) is reasonable and is approved on a non-precedential basis, and cost recovery should be authorized, limited to the amounts and other conditions agreed upon by the Joint Parties.
 4. Recovery of the local area reliability costs of the Revised PPA from all customers in SDG&E's service territory who benefit is reasonable and the proposed primary and alternative mechanisms for achieving this goal are reasonable as well.
 5. The Revised PPA, including all of its new and revised terms, is reasonable, is in the public interest, and is approved.
 6. Acquisition by SDG&E of the Otay Mesa Project at the end of the 10-year delivery term pursuant to OMEC's exercise of its Put Option is hereby approved.
- Replace Ordering Paragraphs 1 and 2 to read as follows:

1. SDG&E may execute the Otay Mesa Power Purchase Agreement (PPA) that is the subject of the Joint Petition for Modification and that will include the terms and conditions of the Letter Agreement filed with the Joint Petition (Attachment A).
2. SDG&E is authorized to record the costs of this PPA in the ERRA and other appropriate accounts depending on the cost allocation mechanism that is ultimately adopted for the Otay Mesa Project.
3. SDG&E is authorized to recover the costs, subject to the agreed upon caps, associated with the equity re-balancing necessary due to application of FIN 46(R) and the consolidation of the OMEC financial data with SDG&E's quarterly and annual financial statements to the SEC.

APPENDIX A

DECLARATION OF
JAMES P. AVERY
SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
July 3, 2006



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**DECLARATION OF
JAMES P. AVERY
SAN DIEGO GAS & ELECTRIC COMPANY**

I. INTRODUCTION

The purpose of my declaration is to explain the following:

1. New and changed facts surrounding the Otay Mesa Project require the modification of D.04-06-011 more than one year after its effective date; D.06-02-031 should also be modified as described in the accompanying Joint Petition for Modification;
2. Execution of a new 10-year power purchase agreement (Revised PPA) between SDG&E and Otay Mesa Energy Center, LLC (OMEC) on substantially similar terms as in the original CPUC approved 10-year power purchase agreement (Original PPA) between SDG&E and OMEC, dated February 5, 2004, but that will now allow for the potential ownership of the facility, will result in a significantly lower Net Present Value (NPV) cost over the life of the project than would have been realized under the Original PPA;
3. Performance incentives included in the Revised PPA that will ensure that OMEC will build, operate and maintain the Otay Mesa Project to the highest standards;
4. It is critical for SDG&E's customers that the Commission expedite approval of the Revised PPA to facilitate timely commercial operation; and
5. The Revised PPA does not change SDG&E's long term resource plan or obviate the need for additional new firm generation resources pursuant to future Requests for Offers (RFO) and new transmission infrastructure.

First, some background. Upon rehearing in this proceeding, the CPUC again approved SDG&E's Original PPA with OMEC, a subsidiary of the Calpine Corporation (Calpine). The Original PPA was based upon the Otay Mesa Project going into service on January 1, 2008. Prior to this rehearing, the CPUC had determined that the Otay Mesa Project was clearly

1 “needed.”^{1/} The Original PPA was recognized as benefiting SDG&E’s customers by offering
2 highly efficient, low emission gas-fired generation in SDG&E’s service territory that would
3 satisfy a significant portion of SDG&E customers’ Reliability-Must-Run (RMR) obligations,
4 thereby reducing costs to SDG&E’s customers. The benefits of the Original PPA have been
5 even further improved since they were most recently reviewed by the Commission in
6 D.06-02-031 and as memorialized in the Revised PPA with OMEC that is described herein.

7 **II. NEW AND CHANGED FACTS REQUIRE THE MODIFICATION OF**
8 **D.04-06-011 AND D.06-02-031**

9 Under the Original PPA, it was a condition precedent that the Otay Mesa Project be
10 owned by a bankruptcy remote entity, OMEC. On December 20, 2005, Calpine and a number of
11 its subsidiaries filed for Chapter 11 bankruptcy protection. Given the new facts that SDG&E
12 learned subsequent to that time regarding Calpine’s bankruptcy situation and Calpine’s and
13 OMEC’s ability to complete the Otay Mesa Project per the terms of the Original PPA, the need
14 to consider alternate arrangements became necessary. To prevent the potential loss of the Otay
15 Mesa Project resource, SDG&E discussed various scenarios with Calpine that would secure the
16 facility for SDG&E’s customers’ long-term use. In its decision on rehearing (D.06-02-031), the
17 Commission found that the Original PPA offered meaningful ratepayer benefits. Nevertheless,
18 due to the outstanding Conditions Precedent to the Original PPA, Calpine’s bankruptcy, as well
19 as significant opposition to the Original PPA, it became appropriate for SDG&E to renegotiate
20 the deal, ultimately resulting in the Revised PPA being addressed in the Joint Petition.

21 **III. CUSTOMER BENEFITS**

22 The Revised PPA presents a compelling opportunity to add significant new generation to
23 southern California by May 2009 that provides a cost-effective, local area reliability resource at
24 lower long-term costs to SDG&E’s customers than the Original PPA. As discussed in the
25 Schneider Declaration, the CPUC’s approval of the Original PPA and the record supporting that
26 approval, demonstrated that the Original PPA provided clear economic benefits to SDG&E’s

27 _____
28 ^{1/} See, e.g., “It is clear that we determined that SDG&E ‘needed’ the Otay Mesa Generating Plant
when we approved the 10-year Power Purchase Agreement (PPA) in D.04-06-011” (D.05-06-011,
p. 62).

1 customers. Under the Revised PPA, SDG&E will have the option to acquire the Otay Mesa
2 Project at the end of the 10-year delivery term at a price it believes will be attractive relative to
3 other alternatives. After 10 years of operation of the Otay Mesa Project, the time at which the
4 Original PPA would have expired, SDG&E's customers will have the benefit of ownership of the
5 facility for the remainder of its useful life, thereby avoiding the potential of having to pay higher,
6 post-PPA rents for this generation resource that SDG&E believes would be priced just below the
7 cost of new replacement generation. Under OMEC's merchant ownership and operation as
8 contemplated under the Original PPA, SDG&E's customers would have been subject to market
9 conditions and market based rates in a highly capacity constrained region at the end of the 10-
10 year delivery term. Under the Revised PPA, SDG&E will have the right to all of the output from
11 the Otay Mesa Project during the 10-year delivery term. At the end of the 10-year delivery term,
12 SDG&E will have an option to own and operate the Otay Mesa Project. As such, the CPUC will
13 have regulatory oversight of a resource located in a southern California load pocket for duration
14 of plant life. Further, SDG&E's customers will benefit from the use of a cost-effective, state-of-
15 the-art, dispatchable, low heat-rate and clean generating facility for thirty years or longer.

16 These attributes are particularly important from a reliability perspective. The ability to
17 have firm, in-basin generation simply cannot be cost effectively met by other technologies,
18 renewable or fossil. At present, widely available renewable technologies have delivery
19 characteristics that are primarily either baseload or as-available. There are still substantial
20 hurdles to overcome before renewable, dispatchable generation will be a viable option for
21 meeting local area reliability needs. As to the use of other fossil fuels, there are presently no
22 other alternatives, other than gas-fired generation, that can meet air emissions criteria.

1 **IV. PERFORMANCE INCENTIVES**

2 Prominent, beneficial features of the Revised PPA are two forms of incentive
3 mechanisms, which will give Calpine ongoing encouragement to build, operate and maintain a
4 high performing facility. The first incentive mechanism covers the incremental output capacity
5 of the plant and the second covers the heat-rate. As part of our negotiations with Calpine, we
6 utilized [REDACTED].

7 **Capacity Incentive Mechanism** - Since it is expected that the Otay Mesa Project will
8 have [REDACTED], it was appropriate to compensate OMEC for that incremental
9 amount of capacity [REDACTED]. In order to ensure that
10 OMEC designs, builds and then operates the plant under good industry standards throughout the
11 10-year delivery term, we felt it was beneficial to design a performance incentive that would
12 compensate OMEC if and only if the plant is capable of maintaining an output capacity [REDACTED]
13 [REDACTED].

14 The Capacity Performance Incentive is designed to compensate OMEC for the amount of
15 capacity that is provided at the plant that is in excess of the peak performance [REDACTED]
16 [REDACTED]. The Revised PPA includes the following provision:

- 17 o Capacity Performance Payment: [REDACTED] maximum over the 10-year term
- 18 of the PPA
- 19 o [REDACTED] for every kW greater than the [REDACTED]
- 20 [REDACTED]

21 In this way, OMEC could receive up to [REDACTED] for each and every year that
22 the [REDACTED]

23 [REDACTED]. In order to receive this incentive, the Otay Mesa Project will have to provide [REDACTED]
24 [REDACTED] for each and every year for the
25 10-year delivery term of the Revised PPA. Because [REDACTED], this
26 incentive, if met, translates into a project that will be capable of generating [REDACTED]. SDG&E
27 based the [REDACTED] incentive on an amount that is representative of what SDG&E is currently
28 paying for the peaking capacity out of the [REDACTED]. In this way, SDG&E will be

1 able to realize some local area peaking capacity that will be available at a heat-rate that is
2 approximately equivalent to the new Miramar power plant that was put in service in 2005. The
3 decision to spread out this incentive mechanism over the 10-year delivery term was to ensure
4 that OMEC maintained this peak performance throughout the 10-year delivery term.

5 **Heat-Rate Incentive Mechanism** - With respect to heat-rate, the Otay Mesa Project is
6 being designed to utilize dry cooling instead of the wet cooling systems that were employed at
7 Palomar. As a result, SDG&E's customers will realize a substantial savings in O&M as a result
8 of not requiring the high levels of make-up water that are required at Palomar. However, dry
9 cooling technology typically requires more ancillary loading at the plant site, which reduces the
10 net effective heat-rate of the project. In order to overcome this addition to ancillary loading,
11 OMEC could install more efficient systems at its project to make up for the higher loading,
12 however this would come at a cost. Therefore, SDG&E has designed a performance incentive
13 mechanism that will provide an incentive to OMEC to design, build and operate the project at the
14 lowest possible heat-rate.

15 The Heat-Rate Performance Incentive is designed to compensate OMEC for the savings
16 that will be realized by utilizing dry cooling technology that could match the heat-rate
17 performance of a power plant that employs wet cooling. The Revised PPA, therefore, includes
18 the following provision:

- 19 ○ Heat-rate Performance Payment: [REDACTED] maximum over the 10-year term
20 or the PPA
- 21 ○ [REDACTED] for every Btu/kWh lower than [REDACTED]
22 [REDACTED]

23 In this way, OMEC could receive a performance incentive payment up to [REDACTED]
24 [REDACTED] for each and every year that the heat-rate at the Otay Mesa Project is below [REDACTED]
25 [REDACTED]. In order to receive
26 the full amount, the Otay Mesa Project will have to establish a baseload heat-rate of [REDACTED]
27 [REDACTED]. The
28 guaranteed heat-rate that was included in the Original PPA at full baseload was [REDACTED]

1 [REDACTED] . SDG&E based the [REDACTED]
2 [REDACTED]
3 [REDACTED] . In this way, SDG&E

4 will be able to realize economic savings for its customers for this lower heat-rate. The decision
5 to spread out this incentive mechanism over the 10-year delivery term was to ensure that OMEC
6 maintained this exceptional heat-rate level.

7 In the event that OMEC is unable to meet either the capacity performance targets or the
8 heat-rate performance targets, then no performance payments will be made to OMEC. In the
9 event they meet these targets, then the savings to SDG&E's customers more than compensate for
10 these performance payments.

11 **V. NEED FOR EXPEDITED APPROVAL**

12 SDG&E needs prompt CPUC approval to secure capital cost savings for the summer of
13 2009 and prevent the loss of a permitted site for large scale generation within its service territory.
14 As discussed in further detail in the Declaration of Victor Kruger, roughly \$50 million dollars in
15 RMR (or its future equivalent) costs for calendar year 2009 can be avoided if the Otay Mesa
16 Project is commissioned by May 1, 2009. No other project could be permitted and constructed
17 by May 2009 that would achieve this benefit. This point is reinforced in the Proposed Decision
18 On New Generation And Long-Term Contract Proposals And Cost Allocation (R.06-02-013,
19 Issued on June 20, 2006): "At this point in time, we are faced with the urgent need to bring new
20 capacity on line as soon as 2009, at least for Southern California" (p. 3).

21 The Otay Mesa Project serves to avoid more expensive RMR energy and capacity that
22 presently is scheduled out of economic merit by the CAISO to maintain system reliability. As
23 described more fully below, full use of the plant capacity for reliability will be realized as soon
24 as the plant can go into service. RMR energy and capacity savings will accrue every year that
25 RMR units exist in SDG&E's service territory because all new generation in SDG&E's portfolio
26 will reduce the need for the older and less efficient RMR facilities.

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1 SDG&E believes this to be an outstanding opportunity for SDG&E to secure in the near
2 term new, highly efficient and low emission, large scale dispatchable generation in SDG&E's
3 service territory. A permitted site in a load center in southern California has substantial intrinsic
4 value that is difficult to replicate because of the significant challenges in permitting
5 infrastructure projects. Indeed, the certainty of any project, despite its overwhelming need, is
6 never a foregone conclusion. Once approved and permitted by regulatory agencies, the project
7 completion risks are substantially reduced when developed within guidelines afforded by the
8 various permits.

9 The Revised PPA, including the "Call" and "Put" Options at the end of the 10-year
10 delivery term, offers the Bankruptcy Court a viable transaction that will result in the highest
11 value for the facility assets because the facility assets as a going concern have a higher market
12 value than the liquidation value of its parts. It is anticipated that approval from the Bankruptcy
13 Court will occur quickly as the Revised PPA appears to be the highest and best use of these
14 assets, and will generate the best return to Calpine's creditors.^{2/}

15 **VI. SDG&E NEEDS ADDITIONAL IN-BASIN GENERATION AND SYSTEM**
16 **TRANSMISSION**

17 The Revised PPA will not eliminate the need to issue an RFP for additional in-basin
18 capacity required after 2010, nor will it supplant the need for the Sunrise Powerlink. The
19 Revised PPA merely provides the option for SDG&E to lock-in this resource after the 10-year
20 term of the Original PPA at what is expected to be a favorable price.

21 Consistent with the CPUC's resource adequacy requirements, including a local
22 component, and SDG&E's long-term resource plans, SDG&E will need significant additional in-
23 basin capacity additions. Given the quantity of additional resource needs, and the lead time
24 needed to allow new generation to compete with existing generation, SDG&E plans to initiate a
25 long-term RFP process in the fall of 2006 for additional in-basin generation consistent with
26 SDG&E's 2006 long-term resource plan that the CPUC will review this year in R.06-02-013.

27
28 ^{2/} Calpine's filing with its bankruptcy court will be as soon as definitive documents are finalized
with approval expected as early as 60 days from the date of filing.

1 The need for the proposed Sunrise Powerlink is also based in large part on grid reliability
2 requirements. In A.05-12-014, SDG&E showed a number of scenarios, including cases with and
3 without the Otay Mesa Project and the possible retirement of the existing older generation
4 facilities in the service area. While the timing of the retirement of the Encina and South Bay
5 facilities^{3/} is up to their respective owners, the fact remains that these facilities have slow starting
6 units with higher heat-rates than today's quick start units. To meet system reliability needs,
7 these units are often kept at minimum loads (at even less efficient heat-rates often as high as
8 15,000 Btu/kWh) in order to be available for dispatch, thereby resulting in expensive energy and
9 inefficient use of natural gas. At a combined capacity of over 1,600 MW, these old units,
10 coupled with SDG&E's projected load growth, will dictate the need for significant new in-basin
11 resources in addition to the Otay Mesa Project.

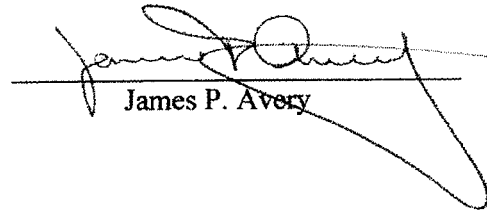
12 VII. CONCLUSION

13 The confluence of circumstances surrounding the recent bankruptcy of Calpine created
14 the need for SDG&E to enter into the Revised PPA in order to have the facility's benefits
15 accrue to SDG&E's customers beginning by May 2009. The Revised PPA also affords
16 SDG&E the opportunity to lock-in long-term benefits from the project beyond the 10-year
17 delivery term in the Original PPA. Those benefits are significant and include not just the
18 addition of a cost-effective, state-of-the-art, dispatchable, low heat-rate and clean generating
19 facility for thirty years or longer, but also a facility that if in-service by May 2009 will allow
20 SDG&E customers to save \$50 million in RMR costs alone in calendar year 2009. The CPUC
21 should therefore grant the Joint PFM and approve the Revised PPA, consistent with the
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25 ^{3/} Despite attractive gas and electric interconnections, the proximity of these facilities to the coast
26 suggests higher and better uses other than electric generation only facilities. Further, public
27 records for South Bay indicates summer capacity reductions in 2008 due to permit restrictions
28 associated with the thermal impacts on the receiving estuary from once-through cooling. Given
the expiration of its lease with the Port in November 2009 and the subsequent decommissioning
obligations, the future of the existing facilities at South Bay appears clearer. Finally, the issue of
once-through cooling has implications to the Encina facility as its lease with the State for certain
properties may trigger the elimination or mitigation of this type of cooling, thereby bringing the
longevity of this facility into question.

1 Commission's findings on two previous occasions. SDG&E emphasizes, however, that this
2 action by the CPUC will not obviate the need for new transmission infrastructure and additional
3 new firm, in-basin generation resources. To this end, SDG&E will initiate a solicitation this fall
4 after submittal of its 2006 long term resource plan to the CPUC.

5 I declare under penalty of perjury that the foregoing is true and correct, and that this
6 Declaration was executed on July 3, 2006, at San Diego, California.

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1 **VIII. STATEMENT OF QUALIFICATIONS**

2 My name is James P. Avery. My business address is 8330 Century Park Court,
3 San Diego, California, 92123. I am employed by San Diego Gas & Electric Company (SDG&E)
4 as Senior Vice President – Electric. I oversee the company’s generation business unit, electric
5 transmission engineering, grid operations, construction and maintenance, and electric distribution
6 operations. I attended Manhattan College, New York City, New York, graduating with a
7 Bachelor of Engineering Degree in Electrical Engineering with a major field of study in Electric
8 Power. Prior to that, I attained an Associates Degree in the field of Electrical Engineering from
9 New York City Community College. Prior to joining SDG&E in 2001, I was a consultant with
10 R.J. Rudden Associates, one of the nation’s leading management and economic consulting firms
11 specializing in energy and utility matters. Prior to that, I functioned as the chief executive officer
12 of the electric and gas operations at Citizens Utilities Company, a multi-service organization that
13 provided electric, gas, telecom, water and wastewater services in over 20 states across the nation.
14 I am currently on the Board of Directors of the California Power Exchange, and I also served as
15 a member of the Board of Directors of Vermont Electric Power Company, a transmission only
16 company serving the state of Vermont, and I held positions at American Electric Power Service
17 Corporation.

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APPENDIX B

**DECLARATION OF
MICHAEL M. SCHNEIDER
SAN DIEGO GAS & ELECTRIC COMPANY**

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
July 3, 2006**



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**DECLARATION OF
MICHAEL M. SCHNEIDER
SAN DIEGO GAS & ELECTRIC COMPANY**

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I. INTRODUCTION

This declaration provides SDG&E's comprehensive assessment of SDG&E's revised agreement with the Otay Mesa Energy Center (OMEC) for a new 10-year PPA and purchase provisions for the eventual ownership of the Otay Mesa 573 MW combined cycle plant (Otay Mesa Project). This Revised PPA provides significant customer benefits and is the most favorable option among the viable energy resource alternatives. The basis of this economic assessment is the comparison of SDG&E's participation in a 10-year PPA containing specific terms for outright ownership of the Otay Mesa Project after the PPA term in 2019 (Option A – PPA/Ownership) as compared to other theoretical alternative options such as:

1. Option B (Turnkey) - OMEC theoretically builds the Otay Mesa Project under Turnkey at Palomar Costs – key reference point for in-basin generation
2. Option C (SDG&E Builds) - SDG&E theoretically builds and owns the Otay Mesa Project at current Cost Estimates
3. Option D (Original PPA in RFP) – SDG&E theoretically enters into 10-year PPA without ownership provisions, evaluated over a 30-year horizon – consistent with the 2003 Grid Reliability RFP

The starting point for the foregoing comparison is the analysis presented previously by SDG&E as part of the record underlying D.06-02-031, which was issued on rehearing in this proceeding. In the Rehearing Proceeding, by comparing the original 10-year PPA with Calpine based on the capacity and energy of a new combined cycle power plant (i.e., the OMEC) against an energy resource alternative relying on a combination of combined cycle contracts, new peaking capacity and local unit contracts, SDG&E demonstrated that SDG&E's customers would obtain generation-related benefits of \$86.5 million (2008 NPV) from the original PPA as compared to the energy resource alternatives. This analysis highlighted the importance of

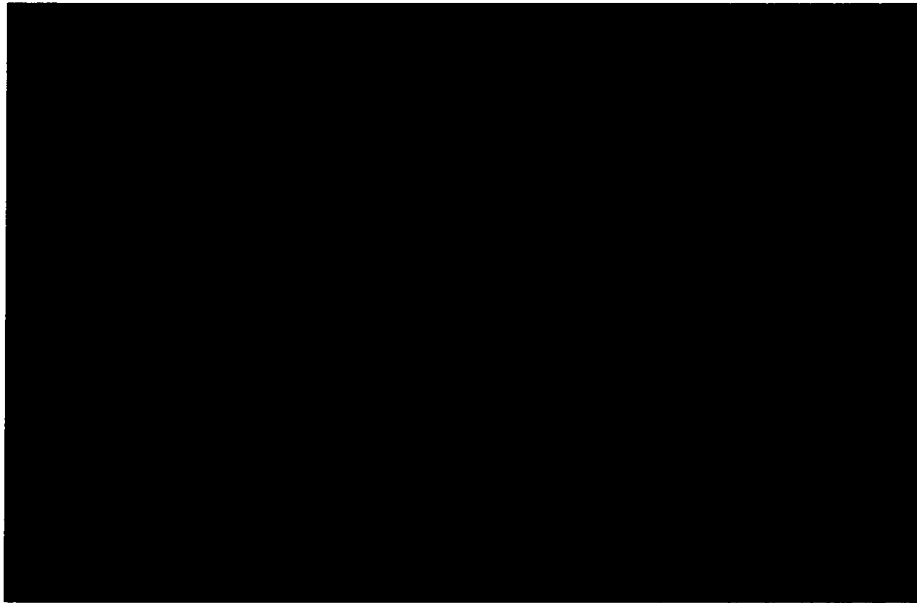
1 getting a combined cycle power plant into service within San Diego's service territory as soon as
2 possible to capture the benefits of an efficient generation source.

3 SDG&E has updated that analysis to cover the 10-year time period mid-year 2009
4 through 2019, which is discussed further in Sections II and III below. All other key assumptions
5 used to develop the analysis remained unchanged from the rehearing. Table MMS-3 shows the
6 results of the updated analysis that is consistent with the conclusion reached in the rehearing.
7 That is, customers receive \$56.4 million in benefits on a NPV basis (2009\$) when comparing the
8 Revised PPA against the energy resource alternatives. A significant portion of the benefits relate
9 to a reduction in RMR costs that SDG&E customers will realize once the Otay Mesa Project
10 goes into service – benefits that will exist regardless of whether SDG&E or OMEC own the Otay
11 Mesa Project. These benefits would apply to Options A through D summarized above,
12 representing the only options available to get a combined cycle power plant built in San Diego
13 by 2009.

14 The second phase of the analysis presented below addresses the additional benefits
15 created for customers under the PPA/Ownership Option that is associated with the certainty of
16 plant ownership at a specified price after the Revised PPA delivery term at either a "Put" (Option
17 A1) or "Call" (Option A2) price level that results in a life cycle NPV to customers well below
18 that if SDG&E were to build a similar plant itself (Option C).

19 The NPV comparison between Option A1, A2, and Option C are presented in Table
20 MMS-1 below and are explained in more detail in Section IV below.

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Under Option A1 where, after the 10-year PPA period, SDG&E acquires the Otay Plant at the Put price of \$ [REDACTED], customers recognize NPV net benefits of \$ [REDACTED] for the period mid-year 2009 through 2039 in 2009\$, when compared to Option C where SDG&E would build the plant itself at a cost of \$ [REDACTED]. Likewise, under Option A2 where, after the 10-year PPA period, SDG&E acquires the Otay Plant by exercising the Call option for \$ [REDACTED], customers recognize NPV net benefits of \$ [REDACTED] for the period mid-year 2009 through 2039 in 2009\$, when compared to Option C where SDG&E would build the plant itself at a cost of \$ [REDACTED].

The economic assessments of Options A through D are based on what customers will ultimately be charged in future rates on a NPV basis over a 30-year period. In addition, NPV comparisons in 2009\$ of the Turnkey Option B and Original PPA Option D are summarized in Table MMS-4 and are discussed in Section V below. The Turnkey Option B theoretically assumes that OMEC would build the Otay Mesa Project at a cost similar to Palomar, approximately \$527.2 million in 2009\$, and subsequently sell the plant to SDG&E as a turnkey. Although the Turnkey Option B produces favorable NPV results for customers over the 30-year period (in between options A1 and A2), this option is presented solely as a reference point because there is no such option available to SDG&E at this time and this option does not reflect SDG&E's most recent cost estimates. However, it does establish an important data point

1 because it represents a cost comparison of the most recent combined cycle power plant placed in
2 service within SDG&E's service territory. The Original PPA Option D financial results are
3 essentially the same as the SDG&E Build Option C over the 30-year period on a NPV basis in
4 2009\$, but imposes greater exposure risks to customers in mid-year 2019 when SDG&E must
5 replace the 10-year PPA with the purchase of a new replacement plant subject to uncertain future
6 market prices and conditions.

7 SDG&E's revised agreement with OMEC under the PPA/Ownership Option A also, in
8 SDG&E's assessment, imposes an obligation on SDG&E to consolidate the financials of the
9 OMEC with those of SDG&E under FIN 46(R). FIN 46(R) is described in further detail in
10 Section VI below. The agreement with OMEC limits OMEC's leverage under this project to no
11 more than 75%/25% debt/equity. After the consolidation, SDG&E's consolidated capital
12 structure reported in its Securities and Exchange Commission ("SEC") filings will have much
13 higher leverage and will be misaligned with SDG&E's authorized capital structure. In the 2006
14 Cost of Capital decision, D.05-12-043 (pages 11-12), the Commission concluded that SDG&E's
15 currently authorized capital structure is, "... balanced, intended to maintain an investment grade
16 rating, to attract capital, consistent with the law, in the public interest and should be adopted."
17 To offset the impact of consolidation on SDG&E's capital structure, SDG&E needs to increase
18 equity to rebalance to the authorized structure. To that end, SDG&E is requesting rate recovery
19 necessary to cover this equity re-balancing starting at the commercial operation date of the Otay
20 Mesa Project. Such rate recovery is capped, however, as detailed below and pursuant to an
21 agreement in this Joint Petition with TURN, UCAN, and DRA whereby ratepayers will not be
22 responsible for more than the nominal dollar amounts shown. In addition, TURN, UCAN, and
23 DRA take no position on SDG&E's FIN 46 analysis, but understand that SDG&E must adhere to
24 appropriate accounting requirements. If future evidence suggests that FIN 46 does not require
25 the Otay Mesa Project to be placed on the SDG&E balance sheet, then TURN, UCAN, and DRA
26 reserve the right to petition the Commission to adjust SDG&E's capital structure accordingly.

1 **II. BENEFITS ASSOCIATED WITH OTAY MESA PPA**

2 D.06-02-031 endorsed SDG&E's assessment of why customer benefit from the original
3 10-year PPA (Option 1 in the Rehearing Proceeding) as compared with SDG&E meeting its
4 commensurate long-term resource commitment assuming alternative procurement options
5 (Option 2 in the Rehearing Proceeding). For reference, Option 2 consisted of 200 MWs of new
6 in-basin capacity and 373 MWs of existing capacity by 2010. Costs applicable to the Original
7 PPA, including capacity and fixed, variable, ancillary service, debt equivalence, CO2 costs, and
8 RMR were included in the analysis and shown on a NPV basis discounted over a period of 10
9 years (2008-2017) assuming a discount rate of 8.18%. The discount rate of 8.18% at the time of
10 the analysis was SDG&E's then currently authorized rate of return (ROR) for electric generation
11 assets regulated by the Commission. The NPV benefits resulting from these cost items when
12 comparing Options 1 and 2 was \$86.5 million over the period 2008-2017 as identified in
13 Attachment 1 of the direct testimony of SDG&E witness Michael M. Schneider on page MMS-4
14 filed in the Rehearing Proceeding, and in Table MMS-2 below. The largest net costs to
15 customers when comparing Options 1 and 2 were the capacity and fixed costs and debt
16 equivalence cost components totaling \$56.9 million on a NPV basis. However, the largest net
17 benefits to customers when comparing Options 1 and 2 originated from variable operating and
18 maintenance, fuel, and RMR costs associated with Option 2 (alternative procurement option) that
19 do not occur under Option 1. These benefits amount to \$143.4 million on a NPV basis.
20

21 **SAN DIEGO GAS & ELECTRIC**
22 **PPA 10 Year Benefits**
23 **(\$ 2008)**

24 **Table MMS-2**

Description	Total NPV Benefits	Total NPV Costs	Total Net NPV
Capacity & Fixed Costs		\$ (50.2)	\$ (50.2)
Variable Costs (Variable O&M + Fuel)	\$ 94.6		\$ 94.6
Ancillary Service Costs	\$ 3.5		\$ 3.5
Debt Equivalence		\$ (6.6)	\$ (6.6)
CO2 Costs	\$ 2.8		\$ 2.8
RMR Costs	\$ 42.6		\$ 42.6
Total PPA 10 Year Benefits	\$ 143.4	\$ (56.9)	\$ 86.5

1 **III. PPA/OWNERSHIP BENEFITS OVER PPA TERM (2009-2018)**

2 As part of the current analysis, an update was performed on the benefits to customers
 3 derived from the new PPA shown in Section II above. This analysis was updated to reflect a
 4 May 1, 2009 commercial operation date (instead of January 1, 2008) for the Otay Mesa Project,
 5 at which point under its current agreement with OMEC, SDG&E’s customers would begin
 6 receiving energy under the new 10-year PPA. Consistent with the assumptions used in the
 7 rehearing analysis, Option 1 is the 10-year PPA and Option 2 consists of 200 MWs of new in-
 8 basin capacity and 373 MWs of existing capacity by 2010. Costs applicable to the new PPA,
 9 including capacity and fixed, variable, ancillary service, debt equivalence, CO2 costs, and RMR
 10 were included in this analysis, and shown on a NPV basis discounted over a period of 10 years
 11 (2009-2019) assuming a discount rate of 8.18% consistent with the discount factor used in the
 12 rehearing analysis. The discount rate of 8.18% was at the time of the rehearing analysis
 13 SDG&E’s current authorized rate of return (“ROR”) for electric generation assets regulated by
 14 the Commission. The NPV benefits that result from these cost items when comparing Options 1
 15 and 2 is \$56.4 million over the period 2009-2019 as shown below in Table MMS-3 of this
 16 testimony.

17 **TABLE MMS-3**

18 **SAN DIEGO GAS & ELECTRIC**
 19 **PPA 10 Year Benefits**
 20 **(\$ 2009)**

Description	Total NPV Benefits	Total NPV Costs	Total Net NPV
Capacity and Fixed Cost	\$ 532.7	\$ (534.4)	\$ (1.7)
Variable Costs (Variable O&M + Fuel)	\$ 38.3	\$ -	\$ 38.3
Ancillary Service Costs	\$ 1.6	\$ -	\$ 1.6
Debt Equivalence	\$ 21.3	\$ (26.0)	\$ (4.7)
CO2 Costs	\$ 1.0	\$ -	\$ 1.0
RMR Costs	\$ 21.9	\$ -	\$ 21.9
Total PPA 10 Year Benefits	<u>\$ 616.8</u>	<u>\$ (560.4)</u>	<u>\$ 56.4</u>

25
 26 By entering into the PPA/Ownership Option A agreement with OMEC, SDG&E
 27 preserves the benefits of the original 10-year PPA at \$117 kW/year. As a result of updating the
 28 rehearing analysis to reflect a May 1, 2009 commercial operation date (mid-year 2009) under the

1 new PPA, the NPV benefits of \$86.5 million in 2008\$ for the Original PPA decrease to \$56.4
2 million in 2009\$ for the Revised PPA. The conclusion, however, is consistent with the prior
3 approved PPA, and SDG&E's analysis thus shows that benefits still accrue to customers despite
4 a delay of 18 months.

5 **IV. OWNERSHIP BENEFITS OVER THE REMAINING LIFE OF PLANT (2019-2038)**

6 As discussed in Section I of this testimony, financial analysis was conducted on the
7 PPA/Ownership Options A1 and A2 compared to the SDG&E Build Option C in an effort to
8 draw theoretical comparisons between each option. SDG&E's analysis shows (as illustrated in
9 Table MMS-1 and 4 of this testimony) that customers are better off under the PPA/Ownership
10 Option A where SDG&E enters into a new 10-year PPA with OMEC with a provision to
11 purchase the Otay Mesa Project at the end of the 10-year delivery term under either a Put Option
12 A1 or Call Option A2, as compared to the SDG&E Build Option C.

13 As part of the 10-year PPA agreement for Option A, SDG&E negotiated two forms of
14 performance incentive mechanisms with OMEC that relate to both plant capacity and heat rate.
15 These performance incentive mechanisms are described in more detail in the Declaration of
16 James P. Avery. SDG&E estimates that customers would recognize NPV (2009\$) benefits of
17 \$ [REDACTED], and \$ [REDACTED] resulting from OMEC plant capacity and heat rate performance
18 incentives respectively. Although SDG&E recognizes the existence of these incentive
19 performance benefits, SDG&E has excluded them from Option A economic analysis in an effort
20 to maintain a conservative approach to the overall analysis.

21 PPA/Ownership Option A1 assumes SDG&E enters into a new 10-year PPA with
22 OMEC, and at the end of that period (2019) must purchase the Otay Mesa Project at a minimum
23 Put price of \$ [REDACTED]. The analysis for Option A1 was prepared over a 30-year period that
24 begins mid-year 2009 to 2039. The new 10-year PPA was priced at \$117kW/yr and assumed
25 annual delivered capacity to SDG&E from the Otay Mesa Project of 573 MW for a total annual
26 cost of \$67.0 million. In addition to the cost of the PPA, an annual average cost of
27 approximately \$13.5 million was also included over the 10-year delivery term as a result of
28 specific accounting compliance reporting required by the SEC as part of FIN 46(R), as explained

1 in more detail in Section VI below. This annual cost represents the change in the revenue
2 requirement for SDG&E as a result of having to rebalance its capital structure after consolidating
3 its financial statements with the financial statements of OMEC as required by FIN 46(R). In
4 addition, annual costs of approximately \$150,000 were also included over the 10-year PPA
5 period, and represent SDG&E's site operation supervision labor costs involved in overseeing the
6 construction and operation of the Otay Mesa Project. All costs were escalated at 2.5% annually.
7 The NPV of these costs during the 10-year delivery term is \$ [REDACTED] in 2009\$ as identified
8 in Table MMS-4. At the end of the 10-year delivery term beginning mid-year 2019, Option A1
9 analysis assumes OMEC would exercise the Put and cause SDG&E to purchase the plant at a
10 cost of \$ [REDACTED]. A revenue requirement based on SDG&E's current authorized debt
11 equity structure and return on equity (ROE) of 10.7% was calculated on the \$ [REDACTED] over
12 a 20-year period (mid year 2019 to 2039). Annual O&M expenses similar to the Palomar Plant
13 were also included as part of the revenue requirement. The NPV of the revenue requirement
14 over a 20-year period mid-year 2019-2039 is \$ [REDACTED] in 2009\$. The total NPV of Option
15 A1 over the 30-year period mid-year 2009 to 2039 is \$ [REDACTED] in 2009\$. The NPVs were
16 calculated assuming a discount rate of 8.23%, which represents SDG&E's authorized ROR for
17 electric generation assets regulated by the CPUC.

18 PPA/Ownership Option A2 analysis and costs are identical to Option A1 with one
19 exception. Under Option A2 at the end of the 10-year delivery term beginning in mid-year 2019,
20 the analysis assumes OMEC will sell the Otay Mesa Project for no more than the Call price of
21 \$ [REDACTED]. The NPV of the revenue requirement over a 20-year period mid-year 2019-2039
22 is \$ [REDACTED] in 2009\$. The total NPV of Option A2 over the 30-year period mid-year 2009
23 to 2039 is \$ [REDACTED] in 2009\$. The NPVs were calculated assuming a discount rate of
24 8.23% which is the same as SDG&E's authorized ROR for electric generation assets regulated
25 by the Commission.

26 The SDG&E Build Option C analysis theoretically assumes that SDG&E constructs the
27 Otay Mesa Project at a cost of [REDACTED] and that the plant is placed in service mid-year
28 2009. The completed construction cost of [REDACTED] was derived from the following cost

1 components which were based on due diligence conducted by SDG&E and Engineering
 2 Procurement Construction (EPC) preliminary cost estimates:

- 3 1. SDG&E estimate of the cost to complete construction of the Otay Mesa
 4 Project based on EPC of [REDACTED]
- 5 2. SDG&E estimate of ownership cost such as spare parts, offsite
 6 improvements, etc., for an estimated total of [REDACTED]
- 7 3. Purchase Price from OMEC of [REDACTED]
- 8 4. Other Costs of [REDACTED]

9 Items 1-4 totaling [REDACTED] are presented in 2008\$ and were escalated by 2.5% for
 10 one-half year to reflect a mid-year 2009 in service date amount of [REDACTED]. A revenue
 11 requirement based on SDG&E's current authorized debt equity structure and return on equity
 12 ("ROE") of 10.7% was calculated on the [REDACTED] over a 30-year period (mid-year 2019 to
 13 2039). Annual O&M expenses similar to the Palomar Plant were also included as part of the
 14 revenue requirement. The NPV of the revenue requirement over a 20-year period mid-year
 15 2019-2039 is [REDACTED] in 2009\$. The total NPV of the SDG&E Build Option C over the
 16 30-year period mid-year 2009 to 2039 is [REDACTED] in 2009\$. The NPVs were calculated
 17 assuming a discount rate of 8.23%, which represents SDG&E's authorized ROR for electric
 18 generation assets regulated by the Commission.

19 **TABLE MMS-4**

20 **Options A through D**
 21 **Summary of Financial Information**
 22 **NPV in 2009\$**

Option	Capital Costs		NPV		
	Nominal \$		Discounted \$ at 8.23%		
	Mid-year 2009	Mid-year 2019	Mid-year 2009-2019	Mid-year 2019-2039	Mid-year 2009-2039
[REDACTED]	\$	[REDACTED]	\$	[REDACTED]	[REDACTED]
[REDACTED]	\$	[REDACTED]	\$	[REDACTED]	[REDACTED]
Turnkey (B)	\$ 527.2		\$ 529.9	\$ 230.9	\$ 760.8
[REDACTED]	\$	[REDACTED]	\$	[REDACTED]	[REDACTED]
Original PPA (D)	\$	667.6	\$ 448.3	\$ 396.1	\$ 844.5

1 In summary, Table MMS-4 shows that the total NPV over the 30-year period mid-year 2009-
2 2039 for PPA/Ownership Options A1 and A2 is \$ [REDACTED], respectively.
3 The theoretical SDG&E Build Option C over the same time period has a total NPV of [REDACTED]
4 [REDACTED]. In each case, the PPA/Ownership Options A1 and A2 have a lower total NPV when
5 compared to the SDG&E Build Option C. This translates into net benefits to customers of
6 \$ [REDACTED] under Option A1 and \$ [REDACTED] under Option A2 over the 30-year period.
7 Securing the benefits of the 10-year PPA at a price of \$117 kW/Yr discussed in Section III,
8 together with the buyout Option introduced in PPA/Ownership Option A at either the Put price
9 of \$ [REDACTED] or the Call price of \$ [REDACTED], is better for SDG&E customers than the potential risk
10 exposure associated with constructing a new plant like Otay in mid-year 2009 at a cost of [REDACTED]
11 [REDACTED] under the SDG&E Build Option C. For more detailed information regarding
12 assumptions and comparisons of Options A through D, please refer to attached Exhibit 1.

13 **V. COMPARISON OF OTHER OPTIONS**

14 The Turnkey Option B financial analysis theoretically assumes that OMEC would build
15 the Otay Mesa Project at a cost similar to Palomar or at a cost of \$527.2 million in 2009\$, and
16 after its completion, sell the plant to SDG&E. The Turnkey Option B was included in this
17 overall analysis because it represents the most recent cost comparison available to SDG&E at
18 this time to build a plant similar to the Otay Power plant in SDG&E's service territory. The
19 \$527.2 million turnkey cost was calculated by taking Palomar's completed cost of construction
20 in mid-year 2006 of \$484.3 escalated at 2.5% annually to mid-year 2009\$. Similar to the
21 theoretical SDG&E Build Option C above, a revenue requirement based on SDG&E's current
22 authorized debt/equity structure and ROE of 10.7% was calculated on the \$527.2 million over a
23 30-year period (mid-year 2009 to 2039). Annual O&M expenses similar to the Palomar Plant
24 were also included as part of the revenue requirement and escalated at 2.5% annually. The total
25 NPV of the Turnkey Option B over the 30-year period mid-year 2009 to 2039 is \$760.8 million
26 in 2009\$, and is shown in Table MMS-4 of this testimony. The NPV was calculated assuming a
27 discount rate of 8.23%, which represents SDG&E's authorized ROR for electric generation
28 assets regulated by the Commission.

1 The NPV of the Turnkey Option B of \$760.8 million as compared to the NPV of
2 PPA/Ownership Option A1 (Put) of [REDACTED] is higher by a net \$ [REDACTED] over the
3 30-year analysis period. This clearly shows that SDG&E customers would benefit substantially
4 under Option A1 if SDG&E were to acquire the Otay Mesa Project at the Put of \$ [REDACTED]
5 in mid-year 2019. On the other hand, the NPV of PPA/Ownership Option A2 (Call) of \$ [REDACTED]
6 [REDACTED] is \$ [REDACTED] greater than the NPV of the Turnkey Option B of \$760.8 million over
7 the same 30-year period, as shown in Table MMS-4. Although the NPV of Option A2 is greater
8 by \$ [REDACTED] as compared to the Turnkey Option B, Option A2 is very attractive to SDG&E
9 customers because it is highly unlikely that the Otay Mesa Project could be constructed by mid-
10 year 2009 at a cost similar to Palomar, and SDG&E has the option to evaluate market conditions
11 closer to 2019 and not exercise the Call if the price is out of market or for other reasons.
12 Construction costs have risen significantly since 2004 due to hurricane Katrina, however, which
13 caused widespread destruction in the State of Louisiana, as well as rising oil and gasoline prices.
14 It is therefore likely that construction costs will continue to increase, and customers would
15 benefit significantly if SDG&E were able to acquire the Otay Mesa Project in mid-year 2019 at
16 the Call price of \$ [REDACTED].

17 The Original PPA Option D analysis assumes that SDG&E purchases power from the
18 Otay Mesa Project under a 10-year PPA similar to the PPA/Ownership Option A. Then, in
19 mid-year 2019, SDG&E acquires a new combined cycle plant similar to the Otay Mesa Project
20 replacing energy from the expired 10-year PPA for the remaining 20 years of the analysis. The
21 analysis also assumes that SDG&E will pay market price for the plant in mid-year 2019 at a cost
22 of \$667.6 million as shown in Table MMS-4 of this testimony. The method for calculating
23 market value was based on Palomar's estimated cost to complete in mid-year 2006 of \$484.3
24 million and escalated at 2.5% to mid-year 2019. Because the analysis assumes a new
25 replacement plant, a revenue requirement was calculated on the \$667.6 million plant costs and
26 included operating and maintenance costs similar to Palomar escalated at 2.5%, depreciation,
27 taxes, and return. The revenue requirement calculation was based on SDG&E's current
28 authorized debt/equity structure and ROE of 10.7%. The revenue requirement represents what

1 customers will ultimately be charged over the plant's economic life of 30 years. The time
2 horizon for this analysis ends in mid-year 2039. Because this analysis assumes that a new
3 replacement plant with a 30-year life was placed in service mid-year 2019, it was necessary to
4 introduce an end effects assumption into the analysis to address the remaining 10 years of
5 undepreciated plant. Replacement cost new (net of depreciation) less remaining book value was
6 used to calculate end effects on the generation asset and is consistent with methodology used in
7 the Grid Reliability RFP analysis for Palomar and the rehearing. The end effects calculation
8 resulted in customers receiving a credit or reduction to the revenue requirement in the last year of
9 \$11.9 million on a NPV basis. Consequently, the NPV over the 30-year analysis period under
10 the Original PPA Option D is \$844.5 million as shown in Table MMS-4. This includes the 10-
11 year PPA period at \$117 kW/Yr, and the remaining 20-year revenue requirement period for the
12 facility including end effects, discounted at 8.23%, which represents SDG&E's authorized ROR
13 for electric generation assets regulated by the Commission.

14 Table MMS-4 shows that for the period mid-year 2009-2039, the NPV of \$ [REDACTED]
15 for PPA/Ownership Option A1 when compared to the NPV of \$844.5 million for the Original
16 PPA Option D, yields benefits to customers of \$ [REDACTED] over the 30-year analysis period.
17 Likewise, over the same time period mid-year 2009-2039, the NPV of \$ [REDACTED] for
18 PPA/Ownership Option A2 when compared to the NPV of \$844.5 million for the Original PPA
19 Option D yields benefits to customers of \$ [REDACTED]. The buy-out option included in Option
20 A1 (Put) and A2 (Call) is an extremely attractive feature because it provides SDG&E with price
21 certainty to acquire the Otay Mesa Project at either \$ [REDACTED] or [REDACTED] in mid-year
22 2019. This substantially reduces risk to SDG&E customers of the market price volatility
23 associated with either the purchase or construction of a new power plant in SDG&E's service
24 territory in mid-year 2019.

25 In addition to generating a favorable NPV when compared to theoretical Options B-D, as
26 shown in Table MMS-4, PPA/Ownership Option A also provides mitigation of risks inherent in
27 the alternative options. The Revised PPA shifts construction risk and cost escalation risk away
28 from SDG&E and also mitigates market risk with the Call and Put Options. For example, under

1 the SDG&E Build Option C, SDG&E would construct a new power plant, and assume all the
2 risks associated with construction cost overruns or delays in the in-service date of the plant. The
3 Revised PPA locks in the price of \$117/kW, so both SDG&E and customers are shielded from
4 potential cost overruns. Under the Original PPA Option D, SDG&E is subject to market risk
5 associated with purchasing a new combined cycle plant in year 2019 when the PPA ends. The
6 Revised PPA locks in a Call and Put price level that is consistent with the depreciated book value
7 of the plant, which limits SDG&E's exposure to market forces in the event that inflation in the
8 purchase price of power plants continues to rise at the high level seen in recent months.

9 **VI. FINANCIAL IMPACT OF FIN 46(R)**

10 **A. Definition and Applicability of FIN 46(R)**

11 The Financial Accounting Standards Board (FASB) issued FASB Interpretation No.
12 46(R) (FIN 46(R)), *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*,
13 in 2003 to provide guidance on the identification of and financial reporting for, entities over
14 which control is achieved through means other than voting rights. Such entities are known as
15 variable-interest entities (VIEs). In accordance with the requirements of FIN 46(R), the financial
16 statements of a power provider that meets the definition of a VIE needs to be consolidated with
17 the financial statements of the power purchaser if it is determined that the power purchaser is the
18 Primary Beneficiary (see definition below in Step 2).

19 SDG&E has concluded that the terms of the Revised PPA impose an obligation on
20 SDG&E to consolidate the financial statements of OMEC with those of SDG&E to comply with
21 FIN 46(R). SDG&E has performed the following analysis related to FIN 46(R) as it pertains to
22 the new PPA and the proposed Put and Call Options:

23 **Step 1 - Determine whether Otay is a VIE**

24 In accordance with FIN 46(R), an entity is considered a VIE if any of the following
25 factors are present:

- 26 • The equity investors lack the risks or rewards of ownership (a cap or floor
27 exists on expected losses or gains); or

- The equity investors have not invested enough for the entity to stand on its own without additional support.

Based on the review of the new PPA with OMEC and the Put and Call Options, it has been concluded:

- SDG&E limits OMEC equity investors from potential losses of their equity investment as a result of the fixed and variable payment obligations by SDG&E included in the Revised PPA and the Put Option; and
- SDG&E holds the right to receive certain of the OMEC equity investors' residual returns and caps the OMEC equity investors' rights to residual returns as a result of the Call.

Therefore, SDG&E concludes that OMEC meets the definition of a VIE.

Step 2 – If Otay is a VIE, determine whether SDG&E is the Primary Beneficiary

FIN 46(R) defines the Primary Beneficiary as the party that (1) absorbs a majority of the expected losses; (2) receives a majority of the expected residual returns; or (3) both. Because the OMEC equity investors essentially have the option to sell (the Put Option) their equity investment to SDG&E at a specified date and price, this Put Option limits the losses that OMEC equity investors can incur from their investment in OMEC. In addition, the Call Option, which SDG&E is able to execute at a specified date and price, limits the OMEC equity investors' residual return on their equity investment in OMEC. These factors result in SDG&E being designated as the Primary Beneficiary.

Based on SDG&E's assessment of the requirements of FIN 46(R), SDG&E will be required to consolidate the financial statements of OMEC when filing annual and quarterly reports with the SEC. The effective date of the consolidation may be as early as the date when the new agreement becomes effective, enforceable and no longer subject to any conditions precedent to performance thereunder. SDG&E is in discussions with its independent accountants to determine the appropriate effective date of consolidation. The following sections describe the impacts and costs associated with the consolidation, as well as the cost recovery proposal,

1 subject to the caps and conditions described herein and in the Joint Petition pursuant to the
 2 agreement among SDG&E, TURN, UCAN, and DRA.

3 **B. Financial Consolidation Impacts**

4 The new agreement with OMEC limits OMEC's leverage to no more than 75%/25%
 5 debt/equity. As a result of the requirement to consolidate the financial statements of OMEC with
 6 the financial statements of SDG&E, upon completion of the plant construction, the total assets,
 7 liabilities and minority interest on SDG&E's consolidated balance sheet are expected to increase
 8 as follows:

9 Plant	\$527 Million
10 Long-Term Debt	\$395 Million
11 Minority Interest	\$132 Million

12 The following pro forma capital structure for SDG&E, on a consolidated basis, in 2009
 13 reflects the above mentioned changes.

14 **Table MMS-5 SDG&E Pro Forma Capital Structure for 2009**

	SDG&E				Otay Alone	
	Without Otay		With Otay			
16 Debt	2,277	45.21%	2,672	48.04%	395	75.00%
17 Preferred	213	4.23%	213	3.83%		
18 Minority Interest	-	0.00%	132	2.37%		
19 Common Equity	2,546	50.56%	2,546	45.77%	132	25.00%
20 Capitalization	5,036	100.00%	5,563	100.00%	527	100.00%

21 Minority Interest will be shown as a new line item reflecting OMEC's equity amount,
 22 which will change based on OMEC's operating results and the amount of investment capital at
 23 risk. SDG&E is required to reflect all changes in OMEC's assets and liabilities, including any
 24 further assets or liabilities assumed by OMEC, on its balance sheet on an ongoing basis when
 25 reporting its financial position on a consolidated basis.

26 **C. Financial Consolidation Costs**

27 In D.05-12-043 (the 2006 Cost of Capital decision), the Commission stated that "we must
 28 ensure that the utilities' adopted equity ratios are sufficient to maintain reasonable credit ratings

1 and to attract capital” (page 4) and that SDG&E’s currently authorized capital structure is,
2 “...balanced, intended to maintain an investment grade rating, to attract capital, consistent with
3 the law, in the public interest...” (pages 11-12). SDG&E’s capital structure on a consolidated
4 basis will be misaligned with its authorized capital structure after consolidating OMEC into its
5 financial statements, as shown in Table MMS-5. As a result, SDG&E needs to increase its
6 equity to offset the impact of the additional debt. Rebalancing its capital structure to the
7 authorized structure will result in additional costs, as shown in the “Consolidation Impact”
8 worksheet (“Exhibit 2”), which need to be recovered in rates. Exhibit 2 shows that SDG&E,
9 while treating minority interest as equity, needs to still increase equity to offset the \$264 million
10 of additional debt in order to rebalance its capital structure to the authorized structure. By
11 adding equity in an amount equal to 49% (authorized equity factor) of \$264 million and reducing
12 debt by the same amount, SDG&E will resume the authorized capital structure. Using the
13 authorized cost of equity of 10.7%, factoring in the gross-up for income tax expense and the
14 authorized cost of debt of 5.25%, SDG&E has calculated the revenue requirements associated
15 with rebalancing. On a NPV basis, the premium associated with capital structure rebalancing
16 equals \$71.9 million over the 10-year delivery term of the Revised PPA. This premium takes
17 into account removal of \$20 million in debt equivalency costs that had been factored into the
18 Original PPA NPV calculations.

19 **D. Ratemaking Requirements**

20 As a condition to proceeding with the Revised PPA, the Commission must approve the
21 recovery of the additional costs resulting from rebalancing its capital structure to the authorized
22 structure, subject to the caps agreed to with TURN, UCAN, and DRA. The annual revenue
23 requirement associated with the rebalancing costs is shown in Exhibit 2. Although SDG&E may
24 be required to consolidate OMEC’s financial statements with its own financial statements as
25 early as the date when the new agreement becomes effective, enforceable and no longer subject
26 to any conditions precedent to performance thereunder, SDG&E is not proposing to recover the
27 associated costs from customers until construction of the plant is complete and energy begins to
28

1 flow under the terms of the contract. The agreed-upon caps (in nominal dollars) are as follows:

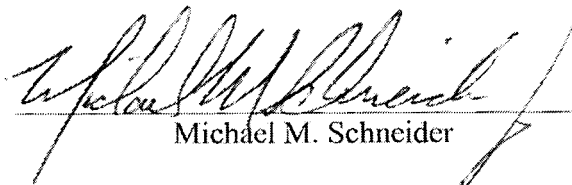
2 2009 - \$16.0 million // 2010 - \$15.5 million // 2011 - \$15.0 million
3 2012 - \$14.4 million // 2013 - \$13.9 million // 2014 - \$13.4 million
4 2015 - \$12.8 million // 2016 - \$12.3 million // 2017 - \$11.8 million
5 2018 - \$11.2 million

6 These caps are a condition to TURN's, UCAN's, and DRA's support for the Revised
7 PPA. Furthermore, if future evidence suggests that FIN 46(R) does not require consolidation of
8 the Otay Mesa Project with SDG&E's financials, then TURN/UCAN/DRA reserve the right to
9 petition for an appropriate adjustment to SDG&E's capital structure. In sum, SDG&E will not
10 seek additional rate recovery for rebalancing costs that exceed these levels if the plant costs or
11 debt amounts from the OMEC produce higher rebalance costs. Upon completion of the plant, if
12 OMEC's consolidated debt is below the amount estimated, SDG&E will recalculate the
13 rebalancing costs and recover the lower amount in rates. SDG&E believes that it is just and
14 reasonable to recover rebalancing costs in rates once the Otay Mesa Project goes into service and
15 benefits the customers.

16 **E. Conclusion**

17 The new agreement with OMEC, PPA/Ownership Option A, is the most economic option
18 for SDG&E's customers compared to other alternatives, as shown in Table MMS-4, above.
19 Therefore, SDG&E requests the Commission to approve its proposal herein, including contract
20 terms and recovery of the costs associated with rebalancing its capital structure shown in
21 Exhibit 2, subject to the agreed-upon caps, in rates beginning at the starting date of the new PPA
22 10-year delivery term.

23 I declare under penalty of perjury that the foregoing is true and correct and that this
24 Declaration was executed on the 3rd day of July, 2006, at San Diego, California.

25 
26 Michael M. Schneider
27
28

1 **VII. QUALIFICATIONS**

2 My name is Michael M. Schneider. I am employed with San Diego Gas & Electric
3 Company as the Director of Financial Strategy and Analysis for SDG&E and Southern
4 California Gas Company. My business address is 8330 Century Park Court, San Diego,
5 California 92123-1530.

6 I received a Bachelor of Economics degree from the University of Arizona in 1987. I
7 received a Masters of Business Administration from George Mason University with an emphasis
8 in finance and accounting in 1990. I have been employed by SDG&E since 1992. I have held
9 various positions throughout my 14 years with SDG&E, including pricing analyst, regulatory
10 case manager, Manager of Pricing, Director of Business Analysis, and Director of Business
11 Planning and Budgets.

12 In my current capacity, I am responsible for financial and economic assessment of the
13 utilities' business functions and activities related to operations, capital investments, financing
14 and regulatory proceedings.

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Exhibit 1

SAN DIEGO GAS & ELECTRIC
CALPINE COMPARISON ANALYSIS
(\$ 2009)

"Privileged and Confidential; Protected Materials pursuant to Protective Order adopted in R.01-10-024; Subject to PUC Code Section 583 and General Order 66-C; Privileged and Confidential Proprietary/Commercially Sensitive Data"

No.	Description	1st Year Capital Exp. \$ 2009	1st Year Capital Exp. \$ 2019	10yrs NPV 2009-2019	20yrs NPV 2019-2039	Total NPV 2009-2038	Key Assumptions (g)
(a)	(b)	(c)	(d)	(e)	(e)	(f)	(g)

REHEARING PROCEEDING BENEFITS

(1) Otay PPA Rehearing Update base on Mid year 2009 through 2019

\$ 56.4 10-yr PPA at 117 \$/kw/yr assuming mid-year 2009. \$ 56.4

PLANT ECONOMICS

(2) Palomar - \$527.2 million in \$ 527.2 \$ 529.9 \$ 230.9 \$ 760.8 Cap Ex based on latest estimate for Palomar Plant. Palomar 2006 cost at \$485 MM escalated by 2.5% for years 2007 & 2008 and one half year 2009=\$527.2 million. Analysis assumes plant is placed in service mid-year 2009. Analysis assumes a 30 year period 2009-2039. Plant is depreciated over 30 yrs. Plant NPV shown in 2009 \$ with discount rate of 8.23%.

(3) [Redacted]

(4) 10 Yr PPA with New Replacement Plant (similar to Palomar) in mid-year 2019 at cost of \$667.6 million. (Option D) \$ 667.6 \$ 448.3 \$ 396.1 \$ 844.5 10 yr PPA at 117 \$/kW/yr and capacity at 573 Mw mid-year 2009-2019. Cost of replacement plant in 2019 is new plant with 30 yr life at \$667.6 million. \$667.6 was calculated by escalating Palomar costs of 484.3 million in 2006 by 2.5% through mid-year 2019. Includes end effects in 2039 based on RCNLD less BV. Gain credited back to ratepayers at the end of 2038 is \$137.7 million. PPA includes Debt Equivalence. ROR and discount rate is at 8.23%.

(5) 10 Yr PPA with Debt Equivalence \$ 448.3 \$ 448.3 Based on 573 MW at \$117/kW-yr. Consistent with OTAY PPA Rehearing. Discount rate = 8.23%. Discount period = mid-year 2009-2019.

SDG&E / CALPINE - Agreement June 2, 2006

(6a) [Redacted]

(6b) [Redacted]

Exhibit 2
San Diego Gas & Electric
Financial Impact of Otay Consolidation
Debt 75%/ Equity 25%

"Privileged and Confidential; Protected Materials pursuant to Protective Order adopted in R.01-10-024; Subject to PUC Code

Section 583 and General Order 66-C; Privileged and Confidential Proprietary/Commercially Sensitive Data"

	Without Calpine					With Otay				
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Capitalization	5,036									
Debt	2,277	45.21%								
Preferred	213	4.23%								
Common Equity	2,546	50.56%								
	5,036									

Additional Debt	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
OTAY										

Restructure Cost - Otay										
Revenue requirement for mitigating debt	-	-								
Restructure Cost - Otay										
PPA	1	2	3	4	5	6	7	8	9	10

Rebalance Capital Structure										
Equity	49%									
Debt										

Ratepayer perspective										
(revenue requirement)										
Equity										
Debt										
Revenue req change										
NPV										
Debt Equivalency										
Premium										

Fed tax rate	35.0000%
State tax rate	8.840%
Composite (t)	40.746%
Tax Factor	59.254%

APPENDIX C

**DECLARATION OF
VICTOR J. KRUGER
SAN DIEGO GAS & ELECTRIC COMPANY**

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
July 3, 2006**



1 **DECLARATION OF**
2 **VICTOR J. KRUGER**
3 **SAN DIEGO GAS & ELECTRIC COMPANY**

4 **I. INTRODUCTION**

5 The purpose of my declaration is to quantify the impact of the Otay Mesa Project on
6 Reliability Must-Run (RMR) costs for 2009. The amount of RMR savings is extremely sensitive
7 to precisely when in 2009 the Otay Mesa Project becomes available for RMR use. As such, the
8 RMR savings are evaluated for the Otay Mesa Project in-service dates of each month from May
9 through December 2009.

10 The term "RMR costs" is used in my testimony to cover several different types of
11 reliability related costs that must be incurred to assure the local transmission area is operated
12 safely and in compliance with all the regulatory bodies that have jurisdiction. Basically, enough
13 local generation must always be running to prevent blackouts from most possible coincident
14 transmission and generation problems. All these costs for the San Diego area are accumulated in
15 SDG&E's Reliability Services (RS) rate. The current RS rate is dominated by RMR costs (over
16 99%), but other reliability related transmission costs are included. Reliability costs may move
17 from RMR contracts to other mechanisms in the future as the market design in California
18 changes. However, the reliability costs will remain whether they are RMR contract related or
19 provided by a replacement method under a new program. These costs will remain until the San
20 Diego area always has enough transmission import capability to not need any local generation to
21 survive a transmission problem. The magnitude of local reliability costs will decrease over time
22 with investments, but it may not be cost effective to ever entirely eliminate them.

23 RMR savings can be related to either capacity or energy. The new capacity supplied by
24 the Otay Mesa Project will be provided by SDG&E to the CAISO to meet RMR requirements.
25 The Otay Mesa Project capacity will allow the CAISO to contract for less non-SDG&E capacity.
26 The CAISO charges non-SDG&E capacity costs to SDG&E as the responsible utility. As such,
27 SDG&E customers benefit from the Otay Mesa Project capacity because they are not charged
28 with the CAISO RMR-contracted capacity costs.

1 SDG&E customers also benefit from the Otay Mesa Project RMR energy. The Otay
2 Mesa Project will have a much better heat rate than the old RMR units it will displace. The Otay
3 Mesa Project will provide energy at much lower cost than the displaced RMR units whenever the
4 CAISO needs local energy to maintain transmission system reliability. This will provide
5 SDG&E customers RMR energy cost savings as well.

6 **II. THE OTAY MESA PROJECT RMR CAPACITY SAVINGS VARY BY MONTH**

7 RMR capacity needs are evaluated on a one in five year (80/20) peak. SDG&E is a late
8 summer peaking utility. The chances of hitting an 80/20 peak before July are extremely small.
9 However, the probability of the peak occurring before August is too large to risk not having all
10 needed RMR capacity available to provide for local transmission reliability. The capacity of the
11 old displaced RMR units will not be needed for any of 2009 if the Otay Mesa Project is in-
12 service for July. If the Otay Mesa Project is in-service after July, all the capacity of the old RMR
13 units will be needed and there will be little or no capacity savings from the Otay Mesa Project for
14 2009. As such, the value the Otay Mesa Project for RMR capacity savings is extremely sensitive
15 to an in-service date before July. This was recently demonstrated with the Palomar plant. In the
16 case of Palomar, which had an expected in service date of July 2006, the ISO did not retain
17 existing RMR units but instead planned on Palomar coming on line.

18 The RMR capacity savings from the Otay Mesa Project by month-in-service are shown in
19 Attachment VJK-1. The savings for in-service before July range from \$32.5 million to \$43.5
20 million depending on which old RMR units are displaced. The \$32.5 million figure is based on
21 the Otay Mesa Project displacing 561 MW of old RMR capacity at \$58/kW/year (Average
22 column). An additional \$7.0 million (Premium column) may be saved by the Otay Mesa Project
23 if it can eliminate cost shifting of common plant costs from displaced RMR units to remaining
24 RMR units at the same plant. The greatest savings would come from the complete elimination of
25 an RMR plant. Lesser savings would occur from eliminating less than the entire plant, but
26 groups of units that share common facilities (control rooms, etc.). The Otay Mesa Project may
27 also save another \$4.0 million (Timing column) by eliminating the need to keep an extra old unit
28 under RMR contract in 2008 (so that it is available to cover increased RMR need in 2009

1 because of local load growth). Alternatively, the \$4.0 million may have to be spent on building
2 peakers early to allow the old RMR unit to retire in 2008.

3 **III. THE OTAY MESA PROJECT RMR ENERGY SAVINGS**

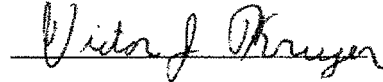
4 RMR energy savings from the Otay Mesa Project are smaller than for capacity, but they
5 are more predictable. The Otay Mesa Project energy costs will normally be below market, so it
6 creates little or no RMR energy costs when providing energy for reliability. Without the Otay
7 Mesa Project, additional old RMR units will have to be kept running at minimum generation for
8 most of the year to provide transmission reliability. Enough local generation must always be
9 running so that the transmission system does not experience voltage collapse and can be restored
10 to normal operation within 30 minutes after both the most critical generation trips (normally
11 Palomar) and the most critical transmission line opens up (normally SWPL). The Otay Mesa
12 Project will save from \$10.0 million with a May in-service date to \$1.0 million with a December
13 in-service date, in 2009 (column Minimum Generation). The Otay Mesa Project will also
14 provide RMR energy savings related to generation and transmission line outages. When an
15 outage occurs, extra RMR reliability energy is needed to keep the transmission system within all
16 operating limits. The Otay Mesa Project will save from \$3.6 million with an May in-service date
17 to \$1.0 million with a December in-service date, in 2009 (column Outages). Most scheduled
18 outages are expected outside of the summer/early fall peak load period. That is why the savings
19 are expected mainly in the fourth quarter of the year. The RMR energy savings range for the
20 Otay Mesa Project of \$13.6 million to \$2.0 million (Energy Sub-Total column) is conservative
21 because RMR energy savings from forced outages and to cover peak loads are not quantified and
22 are not included in those figures. Also, any additional energy needed to cover extended local
23 generator or transmission outages (for maintenance or construction etc.) would further increase
24 the Otay Mesa Project RMR energy savings.

25 **IV. SUMMARY OF OTAY MESA PROJECT RMR SAVINGS**

26 SDG&E ratepayer RMR benefits from the Otay Mesa Project range from \$2.0 million to
27 \$57.1 million in 2009 (columns Total Minimum and Maximum). The RMR savings of the Otay
28 Mesa Project are extremely sensitive to when the Otay Mesa Project goes in-service. The exact

1 critical date would have to be decided by the CAISO, but the difference between a May and an
2 August in-service date could be \$47.6 million. So expediting the process of getting the Otay
3 Mesa Project in-service is critical to providing SDG&E ratepayers all possible RMR savings.

4 I declare under penalty of perjury that the foregoing is true and correct and that this
5 Declaration was executed on June 30, 2006, as San Diego, California.

6
7 

8 Victor J. Kruger

9
10 **V. STATEMENT OF QUALIFICATIONS**

11 My name is Victor J. Kruger. I am a Team Lead in the Grid Operation Services Section
12 within the Electric Grid Operations Department for SDG&E. My business address is 9060 Friars
13 Road, San Diego, California, 92108.

14 I have a Bachelor of Science Degree in Electrical Engineering, from the University of
15 Minnesota – Minneapolis, Minnesota Institute of Technology. I have been employed at SDG&E
16 since May of 2004. Prior to coming to SDG&E, I held the positions of Risk Manager for
17 Progress Energy and supervisor of cost of service and rate design for Wisconsin Electric.

18 In my current capacity, I am responsible administering all grid contracts (including RMR
19 contracts) and providing RMR cost projections.

Summary Page

RMR SAVINGS BY OMEC IN-SERVICE DATE IN 2009

RMR Starts In 2009	Energy			Capacity					Total	
	Minimum Generation	Outages	Sub-Total	Average	Premium	Timing	Minimum	Maximum	Minimum	Maximum
May	\$ 10.0	\$ 3.6	\$ 13.6	\$ 32.5	\$ 7.0	\$ 4.0	\$ 32.5	\$ 43.5	\$ 46.1	\$ 57.1
June	\$ 9.0	\$ 3.0	\$ 12.0	\$ 32.5	\$ 7.0	\$ 4.0	\$ 32.5	\$ 43.5	\$ 44.5	\$ 55.5
July	\$ 8.0	\$ 3.0	\$ 11.0	\$ 32.5	\$ 7.0	\$ 4.0	\$ 32.5	\$ 43.5	\$ 43.5	\$ 54.5
August	\$ 6.5	\$ 3.0	\$ 9.5	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 9.5	\$ 9.5
September	\$ 4.5	\$ 3.0	\$ 7.5	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 7.5	\$ 7.5
October	\$ 3.0	\$ 3.0	\$ 6.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 6.0	\$ 6.0
November	\$ 2.0	\$ 2.0	\$ 4.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 4.0	\$ 4.0
December	\$ 1.0	\$ 1.0	\$ 2.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 2.0	\$ 2.0

Capacity Savings:

Average - Is the average estimated RMR cost by unit of \$58/kW/Yr.

Premium - Is the extra cost caused by shifting common plant costs to remaining RMR units at the same plant.

Timing - Is the extra cost of keeping an extra unit in 2008 to cover 2009 load growth or building peakers early.

Assumption:

RMR starting for OMEC in August would not allow any old RMR contracts to be terminated for 2009.

The risk of not being able to cover the one in five year (late summer peak) is too high.

APPENDIX D

DECLARATION OF
DANIEL BAERMAN
SAN DIEGO GAS & ELECTRIC COMPANY

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
July 3, 2006**



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**DECLARATION OF
DANIEL BAERMAN
SAN DIEGO GAS & ELECTRIC COMPANY**

I. INTRODUCTION

The purpose of my declaration is to describe, relative to the Otay Mesa Project, SDG&E's plan to monitor construction, operations and maintenance of the facility. In addition, it is to describe performance testing for initial acceptance tests and annual capacity and heat rate performance payment tests.

The objective of SDG&E's monitoring of the Otay Mesa Project's construction, operation and maintenance is to provide evidence that the Owner, Otay Mesa Energy Center, LLC (OMEC), is constructing, operating and maintaining the power generation facility to the requirements of the power purchase agreement. In addition, the SDG&E monitoring activities will provide an ongoing indication of the facility's condition. The implementation of SDG&E construction, operation and maintenance monitoring plan is in anticipation of SDG&E's ownership at the end of the 10-year power purchase agreement.

The power purchase agreement will require OMEC to engineer, construct, operate and maintain the facility to the agreement's specifications, milestones, manufacturers' specifications, government approvals and laws and good industry practice. SDG&E will have review, inspection and monitoring rights of the engineering, construction, start-up, testing, operation and maintenance activities. Arbitration shall be used to rectify disputes.

II. MONITORING ENGINEERING, CONSTRUCTION, START-UP

SDG&E generation personnel with project management experience will regularly observe and inspect the Otay Mesa Project through its execution process, commissioning, start-up and testing. OMEC has the obligation to provide SDG&E with a project schedule, access to monitor project activities and monthly progress reports. The monthly progress reports will review the status of the project for each element of the project schedule, identify major issues and evaluate the status of each category of project activity (engineering, procurement, construction, start-up and testing). In addition, OMEC and SDG&E will hold regularly

1 scheduled meetings for reviewing project progress, monthly reports and compliance with the
2 project requirements and project schedule. OMEC will also develop a compliance plan
3 according to the CEC license requirements and submit monthly compliance reports during the
4 design and construction period that includes a compliance matrix containing each condition of
5 the CEC's decision (see CEC Docket No. 99 AFC 5), April 18, 2001).

6
7 **III. PERFORMANCE TESTS AND ANNUAL TESTING**

8 The power purchase agreement requires OMEC to perform capacity (base and peak) and
9 heat rate tests as a condition of commercial operation and to establish the initial contract
10 capacity. Tests are also required for emissions, reliability, availability, noise and bypass system.
11 Detailed test procedures shall be based on agreed upon protocols and will be developed by
12 OMEC for SDG&E approval prior to use. Capacity and heat rate tests will be performed in
13 general accordance with the appropriate American Society of Mechanical Engineers (ASME)
14 Performance Test Code. SDG&E will witness the capacity and heat rate tests, receive certified
15 test results and will have approval rights of the test results. In addition, the initial capacity and
16 heat rate tests for the Otay Mesa Project will be corrected to the same reference conditions as the
17 initial capacity and heat rate tests for the Palomar Energy Project.

18 After commercial operation, performance tests will be conducted annually to establish the
19 contractual capacity and heat rate. The annual capacity and heat rate tests will be conducted in
20 accordance with the same testing standards and procedures used for the initial performance tests.
21 These annual capacity and heat rate tests will be corrected to the Palomar initial performance test
22 reference conditions and benchmarked to manufacturers' degradation curves.

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1 **IV. MONITORING OPERATIONS AND MAINTENANCE**

2 OMEC will be responsible for completing construction, commissioning and testing the
3 Otay Mesa Project. OMEC will enter the plant into commercial operation upon the successful
4 completion of acceptance testing. SDG&E will monitor engineering, construction and
5 acceptance of the facility. Once the facility enters commercial operation, OMEC will operate
6 and maintain the facility utilizing their personnel throughout the term of the power purchase
7 agreement.

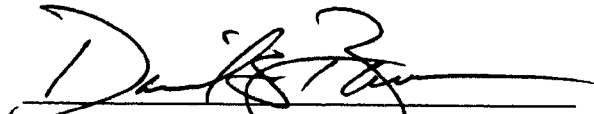
8 SDG&E will monitor operation and maintenance of the facility utilizing a combination of
9 planning and reporting tools and observation. Prior to commercial operation, OMEC will
10 develop an Operation and Maintenance Procedure that details how the facility will be operated
11 and maintained to manufacturers' specifications and prudent industry standards. SDG&E will
12 review and approve this Procedure.

13 Prior to January of each year after commercial operation, OMEC will develop and submit
14 to SDG&E an Annual Operating and Maintenance Plan for the following year. This Plan will
15 detail actual and projected production from the facility, track equipment operating statistics
16 against maintenance requirements, plan ongoing, routine and major maintenance and identify
17 operating and maintenance issues for the year. Reporting requirements for the Otay Mesa
18 Project will include monthly operations and maintenance reports, maintenance outage and major
19 maintenance reports and forced outage reports.

20 SDG&E and OMEC will regularly meet to review the operations and maintenance status
21 of the facility. SDG&E will have inspection rights of the facility during the 10-year power
22 purchase agreement period. In addition, the condition of the facility will be analyzed by a
23 standard due diligence process prior to SDG&E's purchase at the end of the power purchase
24 agreement.

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1 I declare under penalty of perjury that the foregoing is true and correct and that this
2 Declaration was executed on the 3rd day of July, 2006, at San Diego, California.

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6 Daniel Baerman
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1 **V. QUALIFICATIONS**

2 My name is Daniel S. Baerman. My business address is 2300 Harveson Place,
3 Escondido, California 92029. I am employed by San Diego Gas & Electric Company (SDG&E)
4 as Director, Electric Generation.

5 My present responsibilities include setting policy and standards for the management of
6 SDG&E's generation assets. In this capacity I am responsible for managing, directing, planning
7 and coordinating the overall site operation and maintenance of the Palomar and Miramar power
8 plants.

9 I hold a Bachelor of Science degree in Marine Engineering from the United States
10 Merchant Marine Academy at Kings Point, New York.

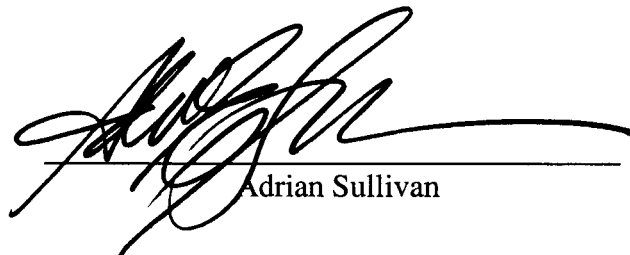
11 I joined SDG&E in February 2005 in my current position. I have been employed in the
12 power generation industry for more than 20 years in positions of increasing responsibility. I
13 have experience with operations and maintenance, construction management, commissioning,
14 mobilization and plant outfitting both in the US and abroad. I have managed 7 power plants and
15 commissioned 13 plants of varying technologies in my career. I am familiar with several
16 technologies including coal-fired boilers, internal combustion reciprocating engines,
17 aeroderivative gas turbines and heavy industrial gas turbines.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing **JOINT PETITION OF SAN DIEGO GAS & ELECTRIC COMPANY (U 902-E), THE DIVISION OF RATEPAYER ADVOCATES, THE UTILITY REFORM NETWORK, AND THE UTILITY CONSUMERS ACTION NETWORK FOR MODIFICATION OF DECISION 04-06-011 AND DECISION 06-02-031** on all parties of record in R.01-10-024 by electronic mail and by U.S. mail to those parties who have not provided an electronic address to the Commission. I have also sent hard copies by overnight mail to the Assigned Administrative Law Judge and Assigned Commissioner.

Dated at San Diego, California, this 3rd day of July, 2006.



Adrian Sullivan

Exhibit B

San Diego Gas & Electric
Financial Impact of Otay Consolidation
Debt 75%/ Equity 25%

PUBLIC VERSION (CONFIDENTIAL PURSUANT TO P.U. CODE 583 AND GO 66-C)

	Without Calpine	With Otay
Capitalization	5,036	
Debt	2,277	45.21%
Preferred	213	4.23%
Common Equity	2,546	50.56%
	5,036	

Additional Debt

OTAY	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
------	------	------	------	------	------	------	------	------	------	------	------

Restructure Cost - Otay

Revenue requirement for mitigating debt c - -

Restructure Cost - Otay

1 2 3 4 5 6 7 8 9 10 10

PPA

Rebalance Capital Structure

Equity 49%

Debt

- - - - - - - - - -

Ratepayer perspective

(revenue requirement)

Equity

Debt

Revenue req change

NPV

Debt Equivalency

Premium

Fed tax rate 35.000%

State tax rate 8.840%

Composite (t) 40.746%

Tax Factor 59.254%

Weighted Cost of Capital	Capital Ratio	Cost	Wtd Cost	After tax (A/T WACC)	Pre tax (A/T WACC)	
Weighted avg RoR Debt	45.25%	5.75%	2.60%	1.54%	2.60%	
Weighted avg RoR Preferred Equity	5.75%	6.83%	0.39%	0.39%	0.66%	
Weighted avg RoR Common Equity	49.00%	10.70%	5.24%	5.24%	8.84%	1.6876
Selected RoR ----->		Total RoR >	8.23%	7.17%	12.10%	

Exhibit C

Application No.: 07-05-_____

Exhibit No.: _____

Witness: Michael M. Schneider

Date: May 8, 2007

Application No. 07-05-_____
Exhibit No. SDGE-4

SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED DIRECT TESTIMONY OF
MICHAEL M. SCHNEIDER

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

May 8, 2007

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1 **PREPARED DIRECT TESTIMONY OF**
2 **MICHAEL M. SCHNEIDER**
3 **ON BEHALF OF SDG&E**

4 **I. PURPOSE**

5 The purpose of my testimony is to provide an overview of San Diego Gas & Electric
6 Company's (SDG&E's) business and regulatory risks and an analysis of risks vis-à-vis a proxy
7 group of similar companies, in support of the recommended authorized rate of return, including
8 return on equity (ROE). Further, I outline our proposed cost recovery mechanism to address
9 debt equivalence and Financial Accounting Standards Board (FASB) Interpretation Number
10 46(R) (FIN 46(R)).

11 SDG&E's business and regulatory risk can be grouped into three distinct categories:
12 (1) investment risk, (2) energy market uncertainty and power procurement risk, and (3)
13 regulatory and legislation uncertainty. In addition to providing an overview of SDG&E's
14 changing business structure which inherently contains more risk, I assess business and regulatory
15 risks across a proxy group of utility companies to define SDG&E's risk profile as compared to
16 the group.

17 Finally, I address SDG&E's equity rebalancing proposal which mitigates the negative
18 impacts that certain power purchase agreements (PPAs) and business arrangements have on
19 SDG&E's creditworthiness.¹ This proposal is critical to protect SDG&E's creditworthiness
20 given the increased PPAs that SDG&E will enter into as a result of replacing the California
21 Department of Water Resources (CDWR) energy contracts and meeting the State-wide

¹ This proposal was adopted by the CPUC in its approval of Calpine. It was reintroduced in SDG&E's long term procurement plan and later moved to this proceeding.

1 renewable standard. The combination of these events will increase SDG&E's PPA portfolio.
2 Additionally, FIN46(R) accounting rules require SDG&E to consolidate financial statements of
3 certain counterparties. The proposed equity rebalancing mechanism mitigates negative impacts
4 on SDG&E's credit ratios caused by consolidation under current accounting rules and rating
5 agency treatment of PPAs.

6 The risks and uncertainties presented below are interrelated and should be considered in
7 the aggregate when determining an appropriate ROE for SDG&E. The testimony shows that
8 SDG&E is exposed to considerable and varied risks, similar to the other California electric
9 investor owned utilities (IOUs).

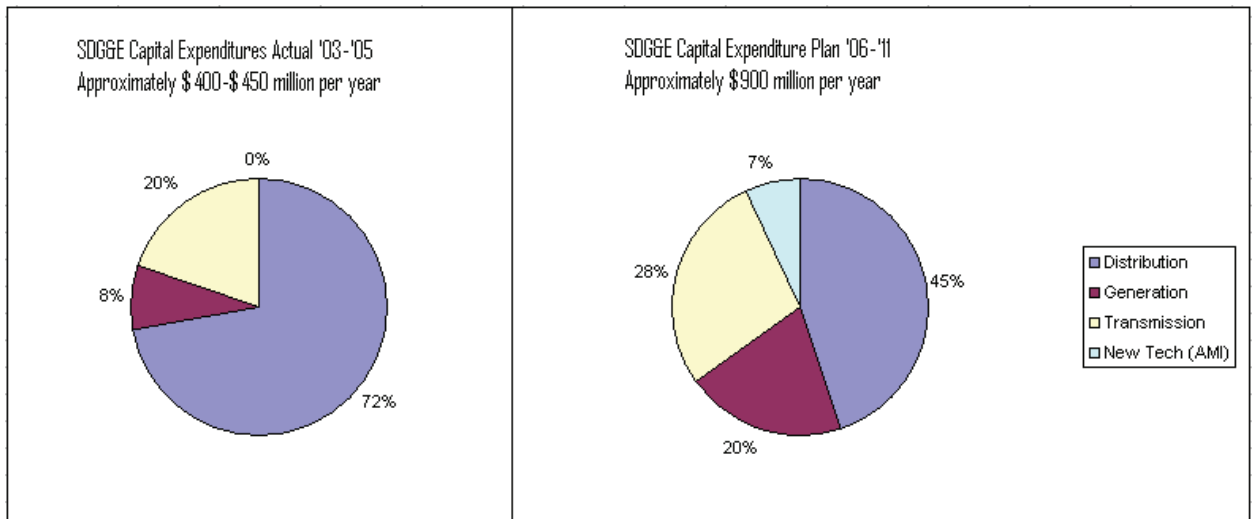
10 **II. BUSINESS STRUCTURE AND INVESTMENT RISK FACTORS**

11 **A. Business Structure and Investment Risk**

12 SDG&E is in the midst of a major capital investment program which includes significant
13 and necessary investments in utility infrastructure. Over the next five years, SDG&E plans to
14 spend approximately \$4 billion in capital investments, which includes approximately \$2.5
15 billion in CPUC-jurisdictional investments. This capital investment program which averages
16 about \$900 million per year is more than double SDG&E's historic investment level of between
17 \$400 and \$450 million and is necessary to improve and expand its infrastructure, and expand its
18 services to better serve a growing customer base. This expansion of services includes reentering
19 the electric generation power plant business, making transmission investments necessary to
20 relieve congestion and provide needed transmission access into San Diego, investing in
21 renewables and other supply and demand resources to ensure the future energy needs are met in
22 the San Diego region, and investing in new technologies like the Advanced Metering
23 Infrastructure (AMI). This comprehensive investment program will not only help increase

1 energy reliability and support customer growth, but also help mitigate future cost increases for
2 customers.

3 SDG&E is a full service provider and has moved back into an integrated utility business
4 structure similar to pre-electric industry restructuring with an investment scale and mix as
5 presented in the chart below.



6

7 1. Near-Term Generation Investments

8 SDG&E was ordered to sell off most of its generation assets and in 1999, substantially
9 exited the electric generation business with the sale of its Encina and South Bay power plants.

10 SDG&E reentered the generation business in 2006, purchasing the 46 megawatt (MW) Miramar
11 Energy Peaking Facility and the 550MW combined cycle power plant at the Palomar Energy
12 Center. This combined \$528 million investment required a \$200 million equity infusion from
13 SDG&E's parent company and was more than SDG&E's entire 2004 capital spending level,
14 exemplifying new risks to SDG&E in magnitude of investment.

15 Entering into the generation business brings with it substantially different risks than those
16 realized in transmission and distribution (T&D), which must be adequately reflected in

1 SDG&E's overall cost of capital. These include: risk associated with operating modern and
2 complex technology, the uncertainty of how the Commission will ensure full recovery of capital
3 and operating costs, and the discrete and substantial risk related to generation investments of this
4 size. For example, one minor event can cause expensive repairs and substantial downtime, and
5 the associated replacement power costs.

6 A combination of baseload and peaking generation is expected to be acquired under a
7 combination of PPAs and direct ownership, the former negatively impacting SDG&E's credit
8 ratios, and the latter increasing SDG&E's operational responsibilities. The new Miramar and
9 Palomar generation facilities represent modern technologies and differ significantly from the
10 Encina and South Bay steam plants built in the 1960s. SDG&E has two operational groups, one
11 for the Palomar Energy Center and one responsible to operate the peaking facilities. While
12 deriving synergy with its operation of the Miramar Energy Facility, maintaining and operating
13 the peaking facilities is a different risk profile than operating the large baseload Palomar facility.
14 Peaking facilities do not run very often, yet when called upon, must be highly reliable despite
15 having very stringent and complex environmental emission controls. Pursuant to the recently
16 announced settlement agreement with the State of California, SDG&E will have the option to
17 acquire the Sempra El Dorado 480 MW combined cycle plant in Boulder City, Nevada in 2011.
18 This facility adds additional risk from two perspectives. First, it creates another regulatory risk
19 since it is under the State of Nevada's jurisdiction. Second, it employs dry cooling. While much
20 of the facility is similar in design as the Palomar Energy Center, dry cooling offers an additional
21 challenge since dry cooling is not the industry standard for these facilities.

22 SDG&E has entered into a ten year agreement with Calpine to procure energy from the
23 Otay Mesa Energy Center (OMEC) facility under a PPA beginning in 2009, after which time

1 (year 2019) SDG&E may purchase the plant subject to the terms of a put or call arrangement.
2 OMEC is expected to begin construction of the 573 MW plant mid-year 2007 with an expected
3 completion date of May 2009. Based on the signed contract, SDG&E will purchase all 573 MW
4 of power produced at a fixed PPA price. The Commission has previously approved FIN46(R)
5 cost recovery similar to the one recommended in this proceeding to mitigate the credit exposure
6 impact related to this agreement. At the end of the ten year period, OMEC could exercise its put
7 option to sell the plant to SDG&E for a fixed price, or SDG&E could exercise its call option to
8 purchase the plant from OMEC for a fixed price. By entering into such an agreement, SDG&E
9 has shielded its customers from the construction risks of building such a plant, and the
10 potentially high market price of purchasing a similar plant in 2019. This facility is of the same
11 configuration as the Palomar Energy Center, but like El Dorado, will be dry cooled.

12 **2. Transmission Investments**

13 A significant portion of the renewable resources SDG&E currently forecasts it will need
14 to meet its renewable portfolio standards (RPS) requirement are contingent on transmission
15 expansion. This adds uncertainty to SDG&E's ability to meet its RPS goal since much of the
16 identified renewable resources are located in remote areas with little or no existing transmission
17 infrastructure. Accessing these resources will require major transmission upgrades or additions.

18 Because SDG&E does not anticipate that in-service area renewable resources alone will
19 be adequate to meet its RPS goal, SDG&E will need to procure a significant portion of its
20 renewable resources from other areas in California. Given SDG&E's current import capability
21 and the high level of use of this capability by other market participants, SDG&E's ability to
22 access out of area resources at an acceptable price will require an expansion of import capability.
23 By enhancing the ability to import power into the San Diego load center and tapping renewable

1 potential in northern and eastern portions of Southern California, the overall cost of meeting the
2 State's renewable resource goals should be reduced. The scale of the infrastructure required to
3 meet the State's renewable resource goal, and short timetable allowed to meet those goals add to
4 the uncertainty and risk of the required capital investment.

5 SDG&E plans to invest \$1.3 to \$2.0 billion in Federal Energy Regulatory Commission
6 (FERC) jurisdictional transmission investments in the near future, including Sunrise Power Link
7 and the Otay Power Loop. These investments are necessary to ensure adequate transmission
8 capacity so that SDG&E can meet its RPS goals. These other required investments will be
9 competing with distribution and generation related projects in SDG&E's capital budgeting
10 process. In planning its capital budgets, SDG&E must give priority to projects determined
11 necessary to meet its obligation to serve. It must allocate capital to essential projects while
12 maintaining its CPUC-approved capital structure over time. In the case of Palomar, for example,
13 dividends were suspended to help achieve a balanced capital structure after the investment. With
14 many essential projects competing for limited financial and human capital, and the huge
15 expected capital outlay in the near future, the financial markets will view SDG&E as facing
16 increased risk.

17 **3. Nuclear Risk-San Onofre Nuclear Generating Station**

18 SDG&E's investment risk also includes continued minority ownership of San Onofre
19 Nuclear Generating Station (SONGS). Southern California Edison Company (SCE), the
20 majority owner and operating agent has requested CPUC authority to invest approximately \$926
21 million in a steam generation replacement project (SGRP). SDG&E has agreed to participate in
22 SGRP, but recognizes significant risks associated with the investment due to the cost caps
23 adopted by the CPUC. Specifically, there is considerable construction and cost control risk as

1 the upgrade requires moving 600 ton steam generators via barge from Long Beach, up the beach,
2 and into the containment structures through holes cut in their concrete walls - a process that has
3 never been done before. The prospect of being required to participate in future capital projects
4 represents significant cost management risks for SDG&E over which it has little control. In the
5 SGRP proceeding, SDG&E requested that SCE's authorized ROE of 11.60% be applied to
6 SDG&E's investment in SONGS to reflect this additional risk. In approving SDG&E's
7 participation in the project, the CPUC indicated a preference to address this request in this cost
8 of capital proceeding.

9 **4. Resource Portfolio Standard (RPS) Goals and Renewables**

10 In addition to SDG&E's current investments in electric generation, SDG&E also plans to
11 acquire significant additional renewable resources through a combination of PPAs and potential
12 ownership in renewable resource projects, including wind, geothermal, solar and other
13 technologies. Currently, state law requires that SDG&E meet a 20% renewable resource mix by
14 2010. In order to achieve the 20% goal by 2010, SDG&E will need to procure approximately
15 3,515 gigawatt hours (GWh) of renewable energy. Currently, SDG&E has under contract
16 through 2010 approximately 2,552 GWh of renewable energy, which is 14.5% of the baseline
17 retail energy supply needs for 2010. Only 8.4%, or 1,085 GWh, are currently in operation and
18 the additional 6.1% are planned for operation by 2010. Achieving a 20% goal by 2010 requires
19 SDG&E to procure an additional 963 GWh of renewable energy. If it fails to meet the 20% RPS
20 requirement by 2010, SDG&E could be subject to penalties of \$50/MWh up to a maximum
21 amount of \$25 million per year. These penalties would be borne by SDG&E's shareholders and
22 pose a risk considering the challenges associated with transmission constraints and uncertainty
23 surrounding emerging technologies.

1 For much of the planned renewables capacity already under contract, project construction
2 has not begun and construction financing has not been secured. Many of these projects are at
3 risk of not being completed in time to meet our 2010 RPS goals. Having to secure significantly
4 more renewable resources than SDG&E presently has under contract entails significantly more
5 risk. Unlike traditional large-scale generation projects, renewable resource projects often involve
6 smaller counterparties that are less creditworthy, imposing greater project risk on SDG&E.
7 Renewable resource projects can often involve new or emerging technologies, which are not
8 fully proven or reliable. This causes SDG&E to incur additional risks related to potential
9 nonperformance or inadequate performance. For example, Pacific Wind, which was expected to
10 deliver 603 GWh, was recently delayed until 2011, forcing SDG&E to acquire an additional 3%
11 toward the 2010 goal. Other renewable resource contracts have delivered below expectations as
12 well.

13 In addition, a significant portion of the renewable resources SDG&E currently forecasts it
14 will need to meet its RPS requirements are contingent on transmission expansion. At best, this
15 adds to the uncertainty of SDG&E meeting its RPS goals. At worst, this raises the probability of
16 not being able to meet the RPS goals. These risks arise from the fact that much of the identified
17 renewable resource potential for SDG&E's service area is located in remote areas with minimal
18 or no existing transmission infrastructure. Accessing these resources will require major
19 transmission upgrades or additions, and involve difficult siting, licensing and construction
20 activities. These activities increase SDG&E's risk related to project costs, completion and
21 performance. The scale of the infrastructure that will be required to meet the State's renewable
22 resource goals, and the fact that these goals must be met in less than three years, adds to the
23 uncertainty and risk of the required capital investments.

1 **5. Advanced Metering Infrastructure**

2 In (D.)07-04-043, the Commission authorized SDG&E to spend over \$570 million in
3 AMI technology over the next five years. Over 2.3 million electric and gas meters will be
4 replaced or retrofitted with solid-state, communicating metrology. This investment in emerging
5 technology represents significant performance, installation, and operating risks to SDG&E.

6 AMI will impact all customers and almost all business processes at SDG&E. AMI
7 requires significant planning and start-up phases prior to meter deployment. Key start-up
8 activities include business process redesign, significant personnel management, and installation
9 of a two-way communication network and information technology infrastructure. AMI requires
10 redesign of many crucial business processes including meter workflow management, customer
11 services, billing and revenue collections, and meter procurement, potentially disrupting those
12 processes. This adds both cost management and revenue collection risks.

13 **6. Comparability to other California Electric IOUs**

14 SDG&E faces the same regulatory environment, competes in the same capital markets,
15 faces comparable procurement challenges, and has similar planned investments in emerging and
16 unproven technologies as compared to the other California IOUs. Therefore, SDG&E should
17 receive an authorized ROE commensurate with the other California electric IOUs.

18 Representatives of SDG&E have been asked directly by equity investors why its authorized ROE
19 is much lower than the other California electric IOUs, indicating that SDG&E has a similar risk
20 profile.

1 **B. Energy Market Uncertainty**

2 **1. Electricity Market Design**

3 There are a number of unresolved issues regarding electricity market redesign that
4 represent a potential for increased or uncertain costs and risks to SDG&E’s customers and
5 certain of SDG&E’s assets. One such area includes the repeated delays and uncertainty
6 surrounding the California Independent System Operator’s (ISO) proposed market redesign, the
7 Market Redesign Technology Update (MRTU). The eventual resolution of these market design
8 issues will impact the value of assets held by market participants in ways that are difficult to
9 predict and also result in new and uncertain cost allocations. Additional risks include uncertain
10 standards for meeting resource adequacy requirements and the potential market for merchant
11 generation capacity.

12 **C. Regulatory and Legislative Risks**

13 Regulatory risks encompass the uncertainty of various future regulatory actions. In this
14 regard, SDG&E faces uncertainty related to its decisions made prior to receiving clear decision-
15 making authority from regulatory and or legislation bodies. One form of this risk is the lag
16 between the time SDG&E begins development of long-lead energy projects (including
17 generation, transmission rights-of-way, and AMI) and when it receives related Commission
18 approval. SDG&E also faces potential uncertainty associated with multiple agency oversight
19 and decision-making authority. Finally, regulatory risks include uncertainty of government
20 interaction in energy policy making and implementation issues, including outstanding legislative
21 actions that would change, expand or eliminate current energy laws.

1 **1. Direct Access (DA)**

2 On April 16, 2007, the Alliance for Retail Energy Markets, *et al.*, filed a Petition in
3 Docket P.06-12-002 requesting that the Commission commence a rulemaking or open an
4 investigation to adopt a regulation and establish rules with respect to how and when the Direct
5 Access DA retail market should be reopened in California. The petition seeks to reopen DA in
6 California by January 1, 2008. There is considerable uncertainty concerning whether the
7 Commission has the requisite statutory authority to reinstate DA on its own initiative at this time
8 or whether additional legislation would be required. The petition also acknowledges the need to
9 resolve a variety of additional issues to ensure the viability of a DA retail market including
10 determining an appropriate market structure, rules regarding switching between competitive
11 service and default service, and the application of cost responsibility for recovery of bonds and
12 public purpose programs.

13 On April 24, 2007, Commissioner Peevey issued a proposed decision (PD), in Docket
14 P.06-12-002, granting the petition for a rulemaking and instituting a rulemaking to determine
15 whether, when, or how DA should be restored. In the PD, Commissioner Peevey indicated that
16 the rulemaking proceeding will be separated into three phases. Phase 1 will address the
17 Commission’s legal authority to lift the DA suspension. Phase 2 will address the public policy
18 merits and prerequisites for lifting the DA suspension; and, Phase 3 will address the rules
19 applicable to a reinstatement of the DA program.

20 Should DA be reinstated without first attempting to correct remaining market flaws that
21 caused the energy crisis, SDG&E would face an increased possibility of stranded cost with
22 uncertain recovery. Pursuant to the PD, SDG&E could be required to take on a portion of the
23 existing CDWR energy contracts further increasing SDG&E’s debt equivalence level imputed by
24 rating agencies.

1 **2. Environmental Regulations**

2 SDG&E faces rising costs related to environmental regulation in the form of traditional
3 regulation of air and water quality, and similar environmental issues, as well as climate change
4 and greenhouse gas regulation.

5 Annually, dozens of new laws are proposed relating to the environment. These proposals
6 have covered a range of areas including defining new environmental violations, increasing
7 penalties for violations, increasing reporting and notice requirements, and making more stringent
8 the requirements necessary to comply with environmental requirements. As these laws and
9 regulations increase, the work needed to ensure continued compliance with the spirit and letter of
10 environmental laws must increase accordingly. It also increases the cost of new technology
11 needed to maintain compliance. And, it increases the potential for third party litigation alleging
12 SDG&E’s implication in claimed environmental violations.

13 Regulation relating to climate change is only now evolving, but it is likely to have far-
14 reaching impacts on SDG&E’s business decisions and obligations. Additionally, the Climate
15 Action Team's recent report on sources of greenhouse gas reductions in California has already
16 foreshadowed the potential that utilities will be asked to reduce greenhouse gas emissions by a
17 disproportionate share. Moreover, since there are some sectors of the economy that are harder to
18 reach, it may be that the State will ask other sectors to pick up an additional share of greenhouse
19 gas reduction burdens. It is difficult to estimate the scope of change to normal business activities
20 that new climate change requirements could impose on SDG&E. However, the impacts will
21 spread across SDG&E, not just in resource acquisition, energy efficiency, and demand reduction,
22 but also in a range of operational areas, as well as in ongoing reporting and participation in a
23 range of regulatory rulemaking processes to define the best way to manage greenhouse gas

1 emissions. Further, SDG&E faces not only State greenhouse gas regulation, but will likely face
2 federal greenhouse gas regulation, which may not be consistent in scope.

3 **3. Future Regulatory Actions**

4 SDG&E has made necessary commitments to generation, including renewable resources,
5 before the Commission has decided key issues, the most important of which is the customer base
6 to be served by these resources. For SDG&E's most recent generation purchases, it has been
7 necessary for SDG&E to commit capital and move forward with investment prior to final
8 Commission approval of the revenue requirements for capital and O&M, and the cost recovery
9 framework to apply to these investments. While the Commission has worked diligently to
10 address outstanding issues in electricity regulation, the need to make commitments before all key
11 elements of the regulatory environment are decided increases the risk that SDG&E may not
12 recover its full costs.

13 As described above, SDG&E is facing large and increasing investment requirements for
14 AMI, renewable energy, generation overall, and transmission to deliver the energy to load and
15 assure the reliability of electricity service. To meet Commission goals for demand response,
16 renewable energy, resource adequacy, and to ensure reliable electric service to our customers,
17 SDG&E has had to move forward with commitments on a very large scale and scope relative to
18 the size of the company. The regulatory approval lag between related parts of the delivery system
19 could leave some investments at risk. For example, Sunrise Power Link (SRP) is necessary to
20 import much of the renewable energy required under the 2010 RPS goals, and SDG&E is making
21 significant commitments to renewable energy without approval. Construction is beginning on
22 renewable generation where transmission capacity may not be available. The result is that over
23 the next several years SDG&E is entering a new business environment, with a large and material

1 portion of its ratebase and cash flow commitments in areas where regulatory policy is not yet
2 fully developed. Accordingly, it is difficult for SDG&E and the investment community to assess
3 the risk of adverse regulatory outcomes. For example, it is not clear how the Commission might
4 address poor or mediocre performance by renewable developers that result in higher energy costs
5 and/or lower than promised energy output.

6 **4. Multiple Agency Oversight**

7 There are pending changes to market structure, resource adequacy requirements, and
8 tradability of generation capacity and renewable energy credits. Multiple agencies are involved
9 in these determinations: ISO, Commission, California Energy Commission (CEC), FERC, and in
10 some cases the legislature. Action by one agency could create complications or conflicts with the
11 standards of another agency, with the utilities caught in the middle. Even coordinated action may
12 substantially impact the costs and risk to portfolio positions, and may impact the value of
13 electricity contracts and assets.

14 **5. Political and Policy Uncertainty**

15 The utility business requires sound and stable energy policy supporting long-term
16 investments and decisions necessary to promote stable, low cost energy and infrastructure. An
17 unstable market environment creates significant uncertainty regarding the recovery of
18 investments and areas of focus necessary to promote a long-term energy marketplace. The
19 energy crisis and the State's response to it created exactly such an environment.

20 California continues to struggle to implement post-energy crisis energy strategies. The
21 State continues to wait for the implementation of market reform by the ISO. It continues to
22 explore the development of capacity markets and structures that could readily accommodate load
23 migration – something the State failed to even consider when it first implemented DA. While

1 California has shown interest in re-opening competitive retail markets, and has already opened
2 them for Community Choice Aggregation, the crucial prerequisites – working wholesale markets
3 and ensuring resource adequacy without stranding costs with load migration – are not yet in
4 place. The growing pains of incomplete post-energy crisis policies combined with pressures to
5 evolve those energy markets create significant uncertainty for the State.

6 The political environment that exists in California has magnified this uncertainty. As
7 legislative policy makers develop new approaches for supporting various policies, the State has
8 applied those policies unevenly to energy suppliers. For example, the State has had an RPS for
9 years, imposing obligations on certain retail electricity suppliers to increase the level of
10 renewable energy in their portfolios. However, that RPS does not apply to all retail sellers in the
11 State – it explicitly excludes municipal utilities from RPS obligations. Likewise, the State has
12 numerous laws favoring certain energy-related public policies, and has new proposals each year.
13 However, many of these policies also do not apply uniformly to all retail suppliers – e.g., the Self
14 Generation Incentive Program, endorsed by AB970 several years ago, Resource Adequacy
15 requirements under Public Utilities Code Section 380, DA, net metering, AB1X rate caps,
16 California Alternate Rates for Energy (CARE) programs, etc.

17 The consequence of this uneven application of the obligations of state policies to
18 different retail suppliers is to create inadvertent incentives to seek means to bypass the costs
19 associated with those obligations. This creates an unnecessarily unstable environment for
20 making future investment and business decisions. This was one of the major problems with the
21 structures that led to the energy crisis, and it is a lingering problem post-energy crisis.

1 **D. Business Risk Summary**
2

3 SDG&E is engaged in an aggressive capital investment program by investing in modern
4 and in some cases emerging technologies to continue to meet the growing energy demands in the
5 San Diego region. SDG&E will be investing at unprecedented levels and in a varied portfolio
6 of generation, T&D and emerging technologies.

7 SDG&E must plan to meets its RPS goal of 20% renewable sources by 2010. To meet its
8 RPS goal, SDG&E plans to acquire substantial additional renewable resources, which often
9 involve new and emerging technologies exposing SDG&E to risks of non performance. In
10 addition, renewable resources are typically located in remote areas far away from urban load
11 centers. This fact will necessitate new transmission infrastructure be planned and built by 2010.
12 SDG&E plans to acquire these renewable resources through a combination of PPAs and potential
13 ownership in renewable resource projects. Further, SDG&E is planning to invest significant
14 capital in the SONGS SGRP project with substantial construction risks, and AMI with sizable
15 technology risks.

16 Finally, SDG&E continues to face an uncertain regulatory and legislative environment.
17 DA is gaining momentum in the California regulatory arena, and increasingly stringent
18 environmental laws are being regularly proposed and passed. Multiple agency oversight and
19 continued state energy policy uncertainty will add risk to SDG&E.

20 **III. PROXY GROUP RISK ANALYSIS**

21 In his accompanying testimony, Company witness Gary Hayes determined that based
22 purely on a series of equity-return analyses, SDG&E should earn an 11.60% ROE. By
23 interpreting Mr. Hayes' results in light of various business risks with which I am familiar and
24 bringing to bear certain data not found in Mr. Hayes' study, I am able to corroborate that a fair

1 and reasonable ROE for SDG&E cannot possibly be any lower than the recommended 11.60%.
2 The following analyses compare SDG&E with the proxy group across a variety of publicly
3 available and widely accepted risk metrics, whenever sufficient data was available to make a
4 reasonable comparison.

5 **A. State Regulatory Environment**

6 Two state regulatory ranking systems were evaluated to compare SDG&E's regulatory
7 environment with those of the proxy group: Value Line's and Regulatory Research Associates'
8 (RRA). (See Appendix A.)

9 While RRA recently upgraded its view of the California regulatory environment from
10 Average/2 to Average/1 (slightly less risky than average), Value Line continues to rank
11 California as Below Average. Taken in combination, SDG&E faces average regulatory risk as
12 compared to the proxy group; this clearly supports an ROE at the midpoint of Mr. Hayes' zone
13 of reasonableness.

14 **B. RPS Goals**

15 As discussed above, California's approaching RPS goals pose significant and varied risks
16 to SDG&E. Of the 22 states that currently have RPS goals, California's are the most aggressive.

17 To evaluate the impact of RPS goals on expected returns, the proxy group presented by
18 Mr. Hayes was segmented based on pending RPS goals. (See appendix B).

19 The proxy group was segmented by those companies facing RPS goals in any state of
20 operation versus those not facing any RPS goals. The resulting capital weighted average ROE²

² Capital weighted average refers to the average ROE weighted by the market capitalization.

1 for those companies facing any RPS goals is 11.80%, 160 basis points higher than for the
2 segment facing no RPS goals. This suggests that SDG&E's ROE lies in the middle to upper
3 zone of Mr. Hayes' range of results.

4 **C. Relative Scale of Capital Expenditures**

5 SDG&E is engaging in an unprecedented capital spending program, as discussed above.
6 In 2006, SDG&E had negative free cash flow, defined as cash flow from or used by operations
7 and investment, of \$670 MM, representing outflows equal to 17.7% of its total book
8 capitalization. (See appendix C). This negative trend is expected to continue into the near
9 future, as SDG&E continues its planned investments program.

10 In the aggregate, the proxy group's 2006 free cash inflows of positive \$10.2 billion
11 represent approximately 2.3% of its total book capitalization. Only 17 of the 44 proxy
12 companies had free cash outflows in 2006, with SDG&E having the largest as a percent of its
13 total book capitalization. These findings suggest that SDG&E's ROE lies in the middle to upper
14 zone of Mr. Hayes' range of results.

15 **IV. COST RECOVERY PROPOSAL FOR MITIGATING ADVERSE CREDIT** 16 **IMPACTS OF DEBT EQUIVALENCE AND FIN 46(R)**

17 In this section, SDG&E proposes a mechanism to calculate and recover costs associated
18 with mitigating the adverse credit impacts of both debt equivalence and FIN 46(R) arising from
19 future PPA contracts. The cost recovery mechanism for mitigating the impact of debt
20 equivalence is based upon the direction provided in D.04-12-048 (Ordering Paragraph No. 26 f),
21 "Debt equivalency will be considered when evaluating PPA bids," and will be updated using
22 S&P's current calculation methodology. In addition, SDG&E provides an overview of the

1 accounting and financial reporting requirements associated with FIN 46(R) financial
2 consolidation of certain PPA counterparties,^{3/} and presents SDG&E's cost recovery proposal for
3 rebalancing its consolidated capital structure to the authorized structure. SDG&E initially made
4 these cost recovery proposals in its Long Term Procurement Plan (LTPP) proceeding, but on
5 May 2, 2007, Administrative Law Judge (ALJ) Brown granted Division of Ratepayer Advocates
6 (DRA) motion to strike that portion of the testimony and instructed SDG&E to address its
7 proposals in this proceeding.

8 AB 57 states that, "the commission may not approve a feature or mechanism for an
9 electrical corporation if it finds that the feature or mechanism would impair the restoration of an
10 electrical corporation's creditworthiness or would lead to the deterioration of an electrical
11 corporation's creditworthiness." Therefore, SDG&E requests that the Commission adopt the
12 cost recovery proposals presented below to provide a mechanism to ensure timely recovery of
13 the costs associated with the incremental equity capital required (1) to mitigate the adverse credit
14 impacts of PPA debt equivalence; or (2) to rebalance SDG&E's capital structure to the
15 authorized capital structure to mitigate any adverse credit impacts of FIN 46(R) consolidation.
16 This mechanism should be effective as of the date of this application.

17 **A. Debt Equivalence**

18 **1. Definition and Applicability**

19 Rating agencies include long-term fixed obligations such as PPAs in their credit risk
20 analysis in order to conduct a meaningful comparison between utilities that build generation and

^{3/} Credit rating agencies consider either FIN 46(R) consolidated financials or assess debt equivalents associated with PPAs, not both.

1 utilities that enter into PPAs. These obligations are treated as additional debt during the financial
2 ratio assessment.

3 As part of its credit review, S&P evaluates three ratios as critical components of a
4 company's credit profile: (1) Funds From Operations (FFO) / Debt, which measures how many
5 years it would take for a company to repay all of its debt with internally generated cash flows;
6 (2) FFO / Interest Expense, which measures the "headroom" a company has in fulfilling its
7 current interest payments; and (3) Debt / Capitalization, which is a financial leverage indicator
8 and measures how much cushion equity provides in fulfilling a company's total debt obligations.
9 Debt equivalence negatively impacts all three ratios. Thus, unless mitigated, a PPA will
10 negatively impact SDG&E's credit profile evidenced by degraded credit ratios. On November 1,
11 2006, S&P published refinements to its methodology for calculating debt equivalence associated
12 with PPAs, as described in further detail below.

13 **2. S&P Methodology for Calculating Debt Equivalence**

14 S&P determines the debt equivalence that it will add to a utility's balance sheet as a result
15 of entering into a PPA by calculating the net present value (NPV) of the annual capacity
16 payments over the life of a contract. Where the annual capacity payments are specified in the
17 contract, S&P employs that information to calculate debt equivalence. Where the PPA contract
18 payments are unspecified or stated as a single, all-in energy price, S&P uses a proxy capacity
19 charge, stated in dollars per kW/yr, and multiplies that charge by the kW under contract. S&P
20 determines the proxy capacity charge, which is based on the prevailing cost to develop and
21 finance a combustion turbine, considered the marginal unit of energy. S&P discounts the
22 remaining capacity payments using the average cost of debt to determine the NPV of the
23 remaining fixed payments. The NPV of the remaining fixed payments is multiplied by a risk

1 factor assigned by S&P to determine the debt equivalence associated with a PPA. S&P assigns
2 different risk factors to represent its view of the likelihood that the utility may not fully recover
3 PPA costs on a timely basis. For purposes of evaluating SDG&E’s PPA contracts, S&P uses a
4 risk factor of 25%.

5 **3. Cost Recovery for Debt Equivalence**

6 In D.05-12-043, the Commission stated that “we must ensure that the utilities’ adopted
7 equity ratios are sufficient to maintain reasonable credit ratings and to attract capital” (p. 4) and
8 that SDG&E’s currently authorized capital structure is “...balanced, intended to maintain an
9 investment grade rating, to attract capital, consistent with the law, in the public interest...” (pp.
10 11-12). Although the Commission recognized in D.04-12-048 that debt equivalence imposes a
11 real cost on the utilities and should be taken into consideration in the economic evaluation of
12 bids, up to this point the Commission has not prescribed an explicit methodology for the utilities
13 to evaluate and recoup costs associated with mitigating the adverse impact of debt equivalence
14 that ensures timely cost recovery.

15 As SDG&E continuous to operate under its MICAM, it is appropriate that the
16 Commission address debt equivalence mitigation for a PPA at the time the PPA is presented to
17 the Commission for approval. This will allow for timely review and implementation of
18 appropriate mitigation measures.

19 This proposal is consistent with the legislative direction to the Commission expressed in
20 AB 57 that a utility be ensured “timely recovery of prospective procurement costs” through
21 “upfront standards and criteria by which the acceptability and eligibility for rate recovery of a
22 proposed procurement transaction will be known by the electrical corporation prior to execution
23 of the transaction” and be protected from any feature or mechanism that “would lead to a

1 deterioration of an electrical corporation's creditworthiness." Waiting until SDG&E's next Cost
2 of Capital (COC) proceeding to implement credit mitigation will not ensure in most cases
3 SDG&E's ability to recover its costs associated with approved PPAs in a timely manner,
4 especially when the next COC proceeding is significantly beyond the approval date of a new
5 contract.

6 Therefore, SDG&E strongly recommends that the revenue requirements associated with
7 debt equivalency mitigation as set forth herein be adopted for contracts submitted to the CPUC
8 for approval as of May 8, 2007, which would allow use of the most recent S&P methodology for
9 calculating debt equivalence. By adding equity in an amount equal to the authorized equity
10 factor (proposed to remain 49%) of the imputed debt equivalent and reducing debt by the same
11 amount, SDG&E will effectively resume the authorized capital structure for credit purposes.
12 Using the authorized cost of common equity (proposed 11.60%), factoring in the gross-up for
13 income tax expense and the authorized cost of debt (proposed 5.55%), SDG&E can calculate the
14 revenue requirements associated with this effective rebalancing. In the event of changes to the
15 authorized capital structure and cost of capital, SDG&E would substitute the future authorized
16 levels in the debt equivalence mitigation calculation. Appendix D describes the calculation of
17 revenue requirements associated with debt equivalence mitigation and an illustration calculation
18 is shown in Appendix E.

19 **B. FIN 46(R)**

20 **1. Definition and Applicability of FIN 46(R)**

21 The FASB issued FIN 46(R), *Consolidation of Variable Interest Entities, an*
22 *Interpretation of ARB No. 51*, in 2003 to provide guidance on the identification of and financial
23 reporting for entities over which control is achieved through means other than voting rights.

1 Such entities are known as variable-interest entities (VIEs). In accordance with the requirements
2 of FIN 46(R), the financial statements of a power provider that meets the definition of a VIE
3 needs to be consolidated with the financial statements of the power purchaser if it is determined
4 that the power purchaser is the primary beneficiary.

5 In accordance with FIN 46(R), an entity is considered a VIE if any of the following
6 factors are present:

- 7 • The equity investors lack the risks or rewards of ownership (a cap or floor exists
8 on expected losses or gains); or
- 9 • The equity investors have not invested enough for the entity to stand on its own
10 without additional support.

11 In such cases, FIN 46(R) requires that the “primary beneficiary” of a VIE’s activities
12 consolidate the financial statements of the VIE when issuing the primary beneficiary’s financial
13 statements. The primary beneficiary is defined as the enterprise that absorbs the majority of the
14 negative and positive variability (expected losses and expected residual returns) in a VIE.

15 If an entity is a VIE, then it is determined whether SDG&E is the primary beneficiary.
16 FIN 46(R) defines the primary beneficiary as the party that (1) absorbs a majority of the expected
17 losses; (2) receives a majority of the expected residual returns; or (3) both. In other words, the
18 Primary Beneficiary absorbs a majority of the negative or positive variability in cash flows
19 generated by a VIE.

20 It is the general interpretation by independent accounting firms that Paragraph B13 of
21 FIN 46(R) stipulates that a contract to purchase the entire output of a single-plant entity at
22 something other than a fixed price constitutes a “variable interest” in that entity. Most entities
23 with which SDG&E negotiates procurement contracts are VIEs because PPAs typically involve

1 purchasing the entire output of a plant over a number of years, often via a tolling arrangement
2 where SDG&E absorbs the risk and responsibility for procuring fuel.

3 In addition, SDG&E has found through its experience in negotiating PPAs that most of
4 these VIEs are highly leveraged, and can be unwilling to negotiate lower debt to equity ratios
5 without increasing the contract prices.

6 **2. Financial Consolidation Impacts and Costs**

7 If SDG&E is determined to be the primary beneficiary of a VIE, SDG&E will be required
8 to consolidate the financial statements of that entity when filing annual and quarterly reports with
9 the Security and Exchange Commission (SEC). The effective date of the consolidation may be
10 as early as the date when the new agreement becomes effective, enforceable and no longer
11 subject to any conditions precedent to performance.

12 As a result of this requirement to consolidate the financial statements of an entity with the
13 financial statements of SDG&E, the total assets, liabilities and minority interest on SDG&E's
14 consolidated balance sheet are expected to increase. Minority interest will be shown as a new
15 line item reflecting the entity's equity amount, which will change over time based on operating
16 results and the amount of investment capital at risk. SDG&E is required to reflect all changes in
17 the entity's assets and liabilities on its balance sheet on an ongoing basis when reporting its
18 financial position on a consolidated basis.

19 SDG&E's capital structure on a consolidated basis would be misaligned with its
20 authorized capital structure after consolidating an entity that is highly leveraged into its financial
21 statements. To support SDG&E's creditworthiness and realign its capital structure to the
22 authorized one, SDG&E would need to increase its equity to offset the impact of the additional
23 debt. Rebalancing its capital structure to the authorized structure would result in additional costs

1 to be recovered in rates. The Commission recognized this requirement in D.06-09-021, and
2 authorized SDG&E to “recover the costs associated with the equity rebalancing SDG&E
3 deems necessary due to filing and reporting requirements of FIN 46(R) and the consolidation of
4 OMEC financial data with SDG&E’s quarterly and annual financial statements to the Securities
5 and Exchange Commission” (Ordering Paragraph No. 4, pages 18-19). SDG&E’s cost recovery
6 proposal applicable to FIN 46(R) is illustrated in Appendix F.

7 **3. Contractual Mitigation Option**

8 For contracts subject to FIN 46(R) consolidation, SDG&E plans to pursue contractual
9 mitigation measures to minimize negative impacts to SDG&E’s balance sheet. If a counterparty
10 agrees to finance its project in a manner consistent with SDG&E’s capital structure, FIN 46(R)
11 impacts will be immaterial because the minority interest is treated as part of capital by the rating
12 agencies. Consequently, SDG&E plans to request contractual limits on the percentage and/or
13 amount of leverage. If a counterparty cannot lower its leverage, then SDG&E would request
14 recovery of the additional costs due to consolidation at the time the contract is submitted for
15 Commission approval.

16 **4. Cost Recovery Proposal for FIN 46(R)**

17 The illustrative calculation in Appendix G shows that SDG&E, while treating minority
18 interest as equity, needs to further increase equity to offset the additional debt in order to
19 rebalance its capital structure to the authorized structure. By adding equity in an amount equal to
20 the authorized equity factor (proposed to remain 49%) and reducing debt by the same amount,
21 SDG&E will resume the authorized capital structure. Using the authorized cost of common
22 equity (proposed 11.60%), factoring in the gross-up for income tax expense and the authorized

1 cost of debt (proposed 5.55%), SDG&E can calculate the revenue requirements associated with
2 rebalancing. In the event of changes to the authorized capital structure and cost of capital,
3 SDG&E would substitute the future authorized levels in the FIN 46(R) mitigation revenue
4 requirement calculation.

5 SDG&E may be required to consolidate an entity's financial statements with its own
6 financial statements as early as the date when the new contractual agreements become effective,
7 enforceable and no longer subject to any conditions precedent to performance. As a result, as the
8 counterparties ramp up their debt levels during the plant construction period, SDG&E
9 simultaneously would require additional equity to mitigate any negative credit impacts
10 associated with the additional debt amounts reported in its consolidated financial statements. In
11 that event, SDG&E proposes to calculate and accrue the costs associated with rebalancing its
12 capital structure during the construction period and recover those costs once the PPA term
13 begins. SDG&E is not proposing to recover the associated costs from customers until
14 construction of the plant is complete and energy begins to flow under the terms of the contract.
15 SDG&E believes that it is just and reasonable to recover rebalancing costs in rates once these
16 projects go into service and begin to benefit customers. SDG&E requests that the Commission
17 authorize SDG&E to include revenue requirements associated with rebalancing its capital
18 structure to the authorized capital structure as a result of mitigating FIN 46(R) consolidation for
19 contracts submitted to the CPUC for approval as of the date of this application.

20 It is imperative that SDG&E preserve its credit profile and maintain a solid balance sheet
21 to support planned infrastructure growth while entering into renewable PPAs to reach its RPS
22 goals, replacing CDWR contracts due to expire, and securing contracts to meet projected growth
23 in energy demand. As SDG&E continues to enter into PPAs, the potential for consolidation

1 under FIN 46(R) imposes significant, growing risk of degrading SDG&E's credit ratios. The
2 Commission approved SDG&E's ratemaking proposal for costs associated with rebalancing its
3 capital structure due to FIN 46(R) consolidation in D.06-09-021. The Commission did not,
4 however, authorize this mitigation measure for all future projects, which exposes SDG&E to cost
5 recovery risk when negotiating future transactions. Therefore, SDG&E proposes to include the
6 revenue requirement associated with mitigating FIN 46(R) consolidation in the advice letter
7 filings for approval of PPA contracts and described herein in order to ensure timely and equitable
8 assurance of cost recovery and preserve SDG&E's credit profile.

9 **V. SUMMARY**

10 SDG&E is necessarily engaged in an aggressive capital investment program by investing
11 in modern and in some cases emerging technologies to continue to meet the growing energy
12 demands in the San Diego region. To ensure it can meet its customer service and regulatory
13 requirements now and into the future, SDG&E must continue to make significant investments in
14 utility infrastructure, new businesses, and emerging technologies. It must do this in a dynamic
15 and changing market and an uncertain regulatory environment.

16 SDG&E recently reentered the electric generation business, and plans for large
17 investments in generation capacity. Reentering the generation business brings with it
18 substantially different risks than T&D, including operating unfamiliar modern technology, and
19 uncertainty of cost recovery, energy policy and SDG&E's retail base.

20 While it grows its generation assets, SDG&E must plan to meets its RPS goal of 20%
21 renewable sources by 2010. To meets its RPS goal, SDG&E plans to acquire substantial
22 additional renewable resources, which often involve new and emerging technologies exposing
23 SDG&E to risk of non performance. In addition, renewable resources are typically located in
24 remote areas far away from urban load centers. This fact will necessitate new transmission

1 infrastructure be planned and built by 2010. SDG&E plans to acquire these renewable resources
2 through a combination of PPAs and potential ownership in renewable resource projects.

3 Obligations under PPAs often extend out several years, and rating agencies calculate debt
4 equivalence associated with this future obligation. Entering into PPAs therefore degrades
5 SDG&E's credit profile. When a PPA requires consolidation under FIN 46(R), SDG&E must
6 consolidate the financial statements of the power provider with its own financials. This can
7 further degrade SDG&E's credit profile and expose SDG&E to the cost of increasing equity to
8 mitigate the adverse effects on its balance sheet.

9 While making large infrastructure investments, SDG&E will continue to invest in other
10 large and risky projects. SDG&E is planning to invest significant capital in the SONGS SGRP
11 project with substantial construction risks, and AMI with sizable technology risks.

12 The size and number of essential projects SDG&E is planning is unprecedented. SDG&E
13 faces a challenging capital planning process which requires the utility to allocate capital to
14 essential projects while maintaining a CPUC approved capital structure.

15 The business and regulatory risks that have been identified in my testimony justify a
16 commensurate return be provided to investors. I strongly support the 11.60% ROE proposed in
17 this filing.

18 This concludes my prepared direct testimony.

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1 **VI. STATEMENT OF QUALIFICATIONS**

2 My name is Michael M. Schneider. I am employed by SDG&E as the Treasurer and
3 Director of Finance for SDG&E and Southern California Gas Company. My business address is
4 8330 Century Park Court, San Diego, California 92123-1530.

5 I received a Bachelor of Economics degree from the University of Arizona in 1987. I
6 received a Masters of Business Administration from George Mason University with an emphasis
7 in finance and accounting in 1990. I have been employed by SDG&E since 1992. I have held
8 various positions throughout my 15 years with SDG&E, including Regulatory Case Manager,
9 Pricing Manager, Director of Business Analysis, and Director of Business Planning and Budgets.

10 In my current capacity as Treasurer and Director of Finance, I am responsible for the
11 utilities' 5-year financial plan, financial standards, financial and economic analysis, revenue
12 requirements for major capital investments, and cash flow forecasting. I have previously testified
13 before both the Federal Energy Regulatory Commission and California Public Utilities
14 Commission.

15

1 **Appendix A – State Regulatory Environment**

2 **A. State Regulatory Environment**

3 Two state regulatory ranking systems were evaluated to compare SDG&E’s regulatory
4 environment with those of the proxy group: Value Line’s and Regulatory Research Associates’
5 (RRA). (See Appendix A.)

6 While RRA recently upgraded its view of the California regulatory environment from
7 Average/2 to Average/1 (slightly less risky than average), Value Line continues to rank
8 California as Below Average. Taken in combination, SDG&E faces average regulatory risk as
9 compared to the proxy group; this clearly supports an ROE at the midpoint of Mr. Hayes’ zone
10 of reasonableness.

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1 Appendix A – State Regulatory Environment

Value Line State Regulatory Ranking				
Company Name	State of Operation	State	Score	Score
San Diego Gas & Electric	CA	CA	Below Average	3
Exelon Corporation	IL,PA	IL	Below Average	3
Northeast Utilities	CT,MA,NH	CT	Below Average	3
DTE Energy Company	MI	MI	Below Average	3
Edison International	CA	CA	Below Average	3
PG&E Corporation	CA	CA	Below Average	3
Southern California Gas Company	CA	CA	Below Average	3
CenterPoint Energy, Inc.		TX	Average	2
Ameren Corporation	IL,MO	MO	Average	2
Cleco Corporation	LA	LA	Average	2
Entergy Corporation	AR,LA,MS,TX	LA	Average	2
Great Plains Energy, Inc.	KS	MO	Average	2
Pinnacle West Capital Corporation	AZ,NV	AZ	Average	2
PNM Resources, Inc.	NM	NM	Average	2
PPL Corporation	MD,PA	PA	Average	2
UniSource Energy Corporation	AZ	AZ	Average	2
Westar Energy, Inc.	KS,OK	KS	Average	2
ALLETE, Inc.	MN,WI	MN	Average	2
Consolidated Edison, Inc.	NJ,NY,PA	NY	Average	2
Constellation Energy Group, Inc.	MD	MD	Average	2
Energy East Corporation	CT,MA,ME,NH,NY	ME	Average	2
OGE Energy Corp.	AR,OK,TX	OK	Average	2
Otter Tail Corporation	MN,ND,SD	MN	Average	2
Pepco Holdings, Inc.		DC	Average	2
Public Service Enterprise Group Incorporated	NJ	NJ	Average	2
Xcel Energy, Inc.	AZ,CO,KS,MI,MN,ND,NM,OK,SD,TX,WI,WY	MN	Average	2
Avista Corporation	CA,ID,MT,OR,WA	WA	Average	2
SCANA Corporation	SC	SC	Average	2
Southern Company	AL,FL,GA,MS	GA	Average	2
Dominion Resources, Inc.	LA,NC,OH,PA,VA,WV	VA	Average	2
Progress Energy, Inc.	FL,NC,SC	NC	Average	2
IDACORP, Inc.	ID	ID	Above Average	1
American Electric Power Company, Inc.	AR,IN,KY,LA,MI,OH,OK,TN,TX,VA,WV	OH	Above Average	1
Black Hills Corporation	MT,SD,WY	SD	Above Average	1
DPL Inc.	OH	OH	Above Average	1
FirstEnergy Corp.	NJ,NY,OH,PA	OH	Above Average	1
Hawaiian Electric Industries, Inc.	HI	HI	Above Average	1
NSTAR	MA	MA	Above Average	1
Alliant Energy Corporation	IA,IL,MN,WI	WI	Above Average	1
FPL Group, Inc.	FL	FL	Above Average	1
NiSource Inc.	IN,MA,MD,ME,NH,OH	IN	Above Average	1
TECO Energy, Inc.	FL	FL	Above Average	1
Vectren Corporation	IN,OH	IN	Above Average	1
Wisconsin Energy Corporation	MI,WI	WI	Above Average	1
Sorted in order of most risky to least risky				
			Mean	1.8
			Median	2.0

The “Numeric Score” column is a translation of the Value Line Score, as defined below:

Below Average = 3 Average = 2 Above Average = 1

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Appendix A – State Regulatory Environment (Continued)

Company Name	RRA State Regulatory Ranking		Score	Numeric Score
	State of Operation	State		
Exelon Corporation	IL,PA	IL	Below Average / 2	2.75
CenterPoint Energy, Inc.		TX	Below Average / 1	2.50
Ameren Corporation	IL,MO	MO	Average / 3	2.25
Cleco Corporation	LA	LA	Average / 3	2.25
Entergy Corporation	AR,LA,MS,TX	LA	Average / 3	2.25
Great Plains Energy, Inc.	KS	MO	Average / 3	2.25
IDACORP, Inc.	ID	ID	Average / 3	2.25
Northeast Utilities	CT,MA,NH	CT	Average / 3	2.25
Pinnacle West Capital Corporation	AZ,NV	AZ	Average / 3	2.25
PNM Resources, Inc.	NM	NM	Average / 3	2.25
PPL Corporation	MD,PA	PA	Average / 3	2.25
UniSource Energy Corporation	AZ	AZ	Average / 3	2.25
Westar Energy, Inc.	KS,OK	KS	Average / 3	2.25
ALLETE, Inc.	MN,WI	MN	Average / 2	2.00
American Electric Power Company, Inc.	AR,IN,KY,LA,MI,OH,OK,TN,VA,WV	OH	Average / 2	2.00
Black Hills Corporation	MT,SD,WY	SD	Average / 2	2.00
Consolidated Edison, Inc.	NJ,NY,PA	NY	Average / 2	2.00
Constellation Energy Group, Inc.	MD	MD	Average / 2	2.00
DPL Inc.	OH	OH	Average / 2	2.00
DTE Energy Company	MI	MI	Average / 2	2.00
Energy East Corporation	CT,MA,ME,NH,NY	ME	Average / 2	2.00
FirstEnergy Corp.	NJ,NY,OH,PA	OH	Average / 2	2.00
Hawaiian Electric Industries, Inc.	HI	HI	Average / 2	2.00
OGE Energy Corp.	AR,OK,TX	OK	Average / 2	2.00
Otter Tail Corporation	MN,ND,SD	MN	Average / 2	2.00
Pepco Holdings, Inc.		DC	Average / 2	2.00
Public Service Enterprise Group Incorporated	NJ	NJ	Average / 2	2.00
Xcel Energy, Inc.	AZ,CO,KS,MI,MN,ND,NM,OK,SD,TX,WI,WY	MN	Average / 2	2.00
San Diego Gas & Electric	CA	CA	Average / 1	1.75
Avista Corporation	CA,ID,MT,OR,WA	WA	Average / 1	1.75
Edison International	CA	CA	Average / 1	1.75
NSTAR	MA	MA	Average / 1	1.75
PG&E Corporation	CA	CA	Average / 1	1.75
SCANA Corporation	SC	SC	Average / 1	1.75
Southern Company	AL,FL,GA,MS	GA	Average / 1	1.75
Dominion Resources, Inc.	LA,NC,OH,PA,VA,WV	VA	Above Average / 3	1.50
Alliant Energy Corporation	IA,IL,MN,WI	WI	Above Average / 2	1.25
FPL Group, Inc.	FL	FL	Above Average / 2	1.25
NiSource Inc.	IN,MA,MD,ME,NH,OH	IN	Above Average / 2	1.25
Progress Energy, Inc.	FL,NC,SC	NC	Above Average / 2	1.25
TECO Energy, Inc.	FL	FL	Above Average / 2	1.25
Vectren Corporation	IN,OH	IN	Above Average / 2	1.25
Wisconsin Energy Corporation	MI,WI	WI	Above Average / 2	1.25
Sorted in order of most risky to least risky				
			Mean	1.92
			Median	2.00

RRA maintains three principal rating categories for regulatory climates: Above Average, Average, and Below Average. Within the principal rating categories, the numbers 1, 2, and 3 indicate relative position. The designation 1 indicates a stronger rating; 2, a mid-range rating; and, 3, a weaker rating. The evaluations are assigned from an investor perspective and indicate the relative regulatory risk associated with the ownership of securities issued by the jurisdiction’s utilities. The evaluation reflects RRA’s assessment of the probable level and quality of the earnings to be realized by the state’s utilities as a result of regulatory, legislative, and court actions.

The “Numeric Score” column is a translation of the RRA Score, as defined below:

Below Average/3 = 3.00	Average/3 = 2.25	Above Average/3 = 1.50
Below Average/2 = 2.75	Average/2 = 2.00	Above Average/2 = 1.25
Below Average/1 = 2.50	Average/1 = 1.75	Above Average/1 = 1.00

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Appendix A – State Regulatory Environment (Continued)

Composite State Regulatory Ranking			
Company Name	State of Operation	State	Numeric Score
Exelon Corporation	IL,PA	IL	2.88
Northeast Utilities	CT,MA,NH	CT	2.63
DTE Energy Company	MI	MI	2.50
San Diego Gas & Electric	CA	CA	2.38
Edison International	CA	CA	2.38
PG&E Corporation	CA	CA	2.38
CenterPoint Energy, Inc.		TX	2.25
Ameren Corporation	IL,MO	MO	2.13
Cleco Corporation	LA	LA	2.13
Entergy Corporation	AR,LA,MS,TX	LA	2.13
Great Plains Energy, Inc.	KS	MO	2.13
Pinnacle West Capital Corporation	AZ,NV	AZ	2.13
PNM Resources, Inc.	NM	NM	2.13
PPL Corporation	MD,PA	PA	2.13
UniSource Energy Corporation	AZ	AZ	2.13
Westar Energy, Inc.	KS,OK	KS	2.13
ALLETE, Inc.	MN,WI	MN	2.00
Consolidated Edison, Inc.	NJ,NY,PA	NY	2.00
Constellation Energy Group, Inc.	MD	MD	2.00
Energy East Corporation	CT,MA,ME,NH,NY	ME	2.00
OGE Energy Corp.	AR,OK,TX	OK	2.00
Otter Tail Corporation	MN,ND,SD	MN	2.00
Pepco Holdings, Inc.		DC	2.00
Public Service Enterprise Group Incorporated	NJ	NJ	2.00
Xcel Energy, Inc.	AZ,CO,KS,MI,MN,ND,NM,OK,SD,TX,WI,WY	MN	2.00
Avista Corporation	CA,ID,MT,OR,WA	WA	1.88
SCANA Corporation	SC	SC	1.88
Southern Company	AL,FL,GA,MS	GA	1.88
Dominion Resources, Inc.	LA,NC,OH,PA,VA,WV	VA	1.75
IDACORP, Inc.	ID	ID	1.63
Progress Energy, Inc.	FL,NC,SC	NC	1.63
American Electric Power Company, Inc.	AR,IN,KY,LA,MI,OH,OK,TN,TX,VA,WV	OH	1.50
Black Hills Corporation	MT,SD,WY	SD	1.50
DPL Inc.	OH	OH	1.50
FirstEnergy Corp.	NJ,NY,OH,PA	OH	1.50
Hawaiian Electric Industries, Inc.	HI	HI	1.50
NSTAR	MA	MA	1.38
Alliant Energy Corporation	IA,IL,MN,WI	WI	1.13
FPL Group, Inc.	FL	FL	1.13
NiSource Inc.	IN,MA,MD,ME,NH,OH	IN	1.13
TECO Energy, Inc.	FL	FL	1.13
Vectren Corporation	IN,OH	IN	1.13
Wisconsin Energy Corporation	MI,WI	WI	1.13
Sorted in order of most risky to least risky			
			Mean
			2.00

Numeric Score is the average of the RRA Numeric Score and the Value Line Numeric Score.

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1 **Appendix B – Renewable Standards – RPS Goals**

2 **B. RPS Goals**

3 As discussed above, California’s approaching RPS goals pose significant and varied risks
4 to SDG&E. Of the 22 states that currently have RPS goals, California’s are the most aggressive.

5 To evaluate the impact of RPS goals on expected returns, the proxy group presented by
6 Mr. Hayes was segmented based on pending RPS goals. (See appendix B).

7 The proxy group was segmented by those companies facing RPS goals in any state of
8 operation versus those not facing any RPS goals. The resulting capital weighted average ROE
9 for those companies facing any RPS goals is 11.80%, 160 basis points higher than for the
10 segment facing no RPS goals. This suggests that SDG&E’s ROE lies in the middle to upper
11 zone of Mr. Hayes’ range of results.

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1 Appendix B – Renewable Standards – RPS Goals

Company Name	State	Goal	Date	Goal	Date	Company Name	State	Goal	Date	Goal	Date
ALLETE, Inc.	MN	10%	2015			NiSource Inc.	IN				
	WI	10%	2015				MA	4%	2009		
Alliant Energy Corporation	IA	10%	2010				MD				*
	IL						ME	30%	2007		*
	MN	10%	2015				NH				
	WI	10%	2015				OH				
Ameren Corporation	NONE					Northeast Utilities	CT	10%	2010	14%	2010
American Electric Power Company, Inc.	TX						MA	4%	2009		
Avista Corporation	CA	20%	2010	33%	2020		NH				
	ID					NSTAR	MA	4%	2009		
	MT	5%	2008	10%	2010	OGE Energy Corp.	TX				*
	OR					Otter Tail Corporation	MN	10%	2015		*
	WA						ND				
Black Hills Corporation	MT	5%	2008	10%	2010	Otter Tail Corporation	NONE				
	SD					Pepco Holdings, Inc.	DC	11%	2022		
	WY					PG&E Corporation	CA	20%	2010	33%	2020
CenterPoint Energy, Inc.	TX					Pinnacle West Capital Corporation	AZ	15%	2025		
Cleco Corporation	LA						NV			20%	2015
Consolidated Edison, Inc.	NJ	23%	2021			PNM Resources, Inc.	NM	10%	2011		
	NY	25%	2013			PPL Corporation	MD				*
	PA	18%	2020				PA	18%	2020		
Constellation Energy Group, Inc.	MD					Progress Energy, Inc.	NONE				
Dominion Resources, Inc.	LA					Public Service Enterprise Group Incorporated	NJ	23%	2021		
	NC					San Diego Gas & Electric	CA	20%	2010	33%	2020
	OH					SCANA Corporation	SC				
	PA	18%	2020			Sempra Energy	CA	20%	2010	33%	2020
	VA					Southern California Gas Company	CA	20%	2010	33%	2020
Dominion Resources, Inc.	NONE					Southern Company	NONE				
DPL Inc.	NONE					TECO Energy, Inc.	FL				
DTE Energy Company	NONE					UniSource Energy Corporation	AZ	15%	2025		
Edison International	CA	20%	2010	33%	2020	Vectren Corporation	NONE				
Energy East Corporation	CT	10%	2010	14%	2010	Westar Energy, Inc.	NONE				
	MA	4%	2009			Wisconsin Energy Corporation	MI				
	ME	30%	2007				WI	10%	2015		
	NH						AZ	15%	2025		
	NY	25%	2013			Xcel Energy, Inc.	CO	3%	2007	10%	2015
Entergy Corporation	TX						KS				
Exelon Corporation	IL						MI				
	PA	18%	2020				MN	10%	2015		*
FirstEnergy Corp.	NJ	23%	2021				ND				
	NY	25%	2013				NM	10%	2011		
	OH						OK				
	PA	18%	2020				SD				
FPL Group, Inc.	FL						TX				*
Great Plains Energy, Inc.	KS						WI	10%	2015		
Hawaiian Electric Industries, Inc.	HI	15%	2015	20%	2020		WY				
IDACORP, Inc.	ID										

* - State Notes

TX satisfied through any renewable technology, but the most recent

MD and municipal solid waste-to-energy projects. Maryland P

NV Each major utility's resource mix must include eligible renewable energy resources starting at 6% and rising by 3% every two years to 20% by 2015.

MN Only a good faith effort required

IA 105 mW Shared between 2 IOUs; 2010 (In legislature)

ME No penalty for non-compliance

None Company has no RPS goals in any state of operation

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Appendix B – Renewable Standards (Continued)

Proxy Segment facing any RPS Goals

Company	MVE	ROE**	RPS Goal*
AEP	19.00	12.84%	TRUE
Allete	1.40	11.41%	TRUE
Alliant Energy	5.30	11.84%	TRUE
Avista Corporation	1.20	12.22%	TRUE
Black Hills Corporation	1.20	12.20%	TRUE
Centerpoint Energy	5.70	15.78%	TRUE
CLECO Corporation	1.50	15.15%	TRUE
Consolidated Edison	12.60	9.84%	TRUE
Constellation Energy Group	14.00	12.25%	TRUE
Dominion Resources	30.00	12.50%	TRUE
Edison International	14.80	12.61%	TRUE
Energy East Corp	3.70	10.95%	TRUE
Entergy Corporation	21.10	11.15%	TRUE
Exelon Corp	43.00	11.34%	TRUE
FirstEnergy	20.00	10.65%	TRUE
FPL Group	24.20	11.35%	TRUE
Great Plains Energy	2.60	10.56%	TRUE
Hawaiian Electric	2.20	10.40%	TRUE
Idacorp	1.60	11.43%	TRUE
NiSource	6.60	11.07%	TRUE
Northeast Utilities	4.50	12.84%	TRUE
NSTAR	3.70	10.43%	TRUE
OGE Energy	3.50	11.15%	TRUE
Pepco Holdings	5.10	11.13%	TRUE
PG&E Corporation	17.20	12.93%	TRUE
Pinnacle West	4.90	11.91%	TRUE
PNM Resources	2.10	11.93%	TRUE
PPL Corporation	14.00	11.53%	TRUE
Progress Energy	12.70	11.15%	TRUE
PSEG	18.80	12.92%	TRUE
Scana Corporation	4.90	9.94%	TRUE
Sempra Energy	15.00	11.45%	TRUE
TECO Energy	3.50	12.29%	TRUE
Unisource Energy	1.30	11.50%	TRUE
Wisconsin Energy	5.70	10.82%	TRUE
Xcel Energy	9.50	13.44%	TRUE
Cap Weighted proxy segment average		11.80%	

Proxy Segment not facing RPS Goals

Company	MVE	ROE	RPS Goal*
Ameren	10.40	10.71%	FALSE
DPL	3.40	13.84%	FALSE
DTE Energy	8.40	10.81%	FALSE
Otter Tail Corporation	1.00	10.10%	FALSE
Southern Corporation	27.00	9.25%	FALSE
Vectren Corporation	2.20	10.51%	FALSE
Westar Energy	2.40	11.17%	FALSE
Cap Weighted proxy segment average		10.20%	

* TRUE if a company faces an RPS goals in any state of operation.

** ROE is the average ROE of all methods employed by Mr. Hayes.

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1 **Appendix C – Free Cash flow to Total Book Capitalization Relative Scale of Capital**
2 **Expenditures**
3 2006

4 **C. Relative Scale of Capital Expenditures**

5 SDG&E is engaging in an unprecedented capital spending program, as discussed above.

6 In 2006, SDG&E had negative free cash flow, defined as cash flow from or used by operations
7 and investment, of \$670 MM, representing outflows equal to 17.7% of its total book
8 capitalization. (See appendix C). This negative trend is expected to continue into the near
9 future, as SDG&E continues its planned investments program.

10 In the aggregate, the proxy group's 2006 free cash inflows of positive \$10.2 billion
11 represent approximately 2.3% of its total book capitalization. Only 17 of the 44 proxy
12 companies had free cash outflows in 2006, with SDG&E having the largest as a percent of its
13 total book capitalization. These findings suggest that SDG&E's ROE lies in the middle to upper
14 zone of Mr. Hayes' range of results

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1 **Appendix C – Free Cash flow to Total Book Capitalization Relative Scale of Capital**
2 **Expenditures**
3 **2006**

Company Name	Operating Cash Flow (\$000)	Investing Cash Flow (\$000)	FCF (\$000)	Total Capitalization, at	FCF/Total Capitalization
San Diego Gas & Electric	397,000	(1,067,000)	(670,000)	3,787,000	-17.69%
PNM Resources, Inc.	244,424	(799,575)	(555,151)	4,235,077	-13.11%
Cleco Corporation	91,443	(251,022)	(159,579)	1,565,664	-10.19%
Great Plains Energy, Inc.	308,982	(475,707)	(166,725)	2,679,202	-6.22%
FPL Group, Inc.	2,498,000	(3,807,000)	(1,309,000)	22,263,000	-5.88%
American Electric Power Company, Inc.	2,732,000	(3,743,000)	(1,011,000)	23,480,000	-4.31%
IDACORP, Inc.	169,778	(253,040)	(83,262)	2,276,956	-3.66%
Consolidated Edison, Inc.	1,354,000	(1,918,000)	(564,000)	17,041,000	-3.31%
Wisconsin Energy Corporation	729,800	(939,300)	(209,500)	7,201,400	-2.91%
Pinnacle West Capital Corporation	393,502	(568,733)	(175,231)	6,716,095	-2.61%
ALLETE, Inc.	142,500	(154,700)	(12,200)	1,055,300	-1.16%
Westar Energy, Inc.	255,986	(290,328)	(34,342)	3,307,675	-1.04%
Vectren Corporation	310,200	(337,400)	(27,200)	2,891,200	-0.94%
CenterPoint Energy, Inc.	991,000	(1,056,000)	(65,000)	10,743,000	-0.61%
Black Hills Corporation	259,695	(268,097)	(8,402)	1,580,987	-0.53%
Pepeco Holdings, Inc.	202,600	(229,100)	(26,500)	9,216,600	-0.29%
Southern Company	2,820,000	(2,834,000)	(14,000)	27,977,000	-0.05%
Ameren Corporation	1,279,000	(1,266,000)	13,000	13,149,000	0.10%
PPL Corporation	1,758,000	(1,617,000)	141,000	13,310,000	1.06%
UniSource Energy Corporation	282,659	(246,081)	36,578	2,529,180	1.45%
Dominion Resources, Inc.	4,005,000	(3,494,000)	511,000	32,771,000	1.56%
PG&E Corporation	2,714,000	(2,427,000)	287,000	18,366,000	1.56%
DTE Energy Company	1,456,000	(1,194,000)	262,000	14,808,000	1.77%
Otter Tail Corporation	80,246	(65,581)	14,665	803,731	1.82%
Energy East Corporation	379,494	(227,759)	151,735	6,985,779	2.17%
NSTAR	533,461	(411,518)	121,943	4,598,820	2.65%
Xcel Energy, Inc.	1,923,996	(1,550,110)	373,886	13,334,151	2.80%
OGE Energy Corp.	569,500	(483,500)	86,000	2,953,100	2.91%
Avista Corporation	201,466	(139,715)	61,751	2,036,958	3.03%
DPL Inc.	308,700	(229,500)	79,200	2,512,700	3.15%
Edison International	3,593,000	(2,992,000)	601,000	18,213,000	3.30%
SCANA Corporation	753,000	(531,000)	222,000	6,557,000	3.39%
NiSource Inc.	1,156,200	(732,500)	423,700	11,446,100	3.70%
TECO Energy, Inc.	566,900	(351,700)	215,200	5,629,000	3.82%
FirstEnergy Corp.	1,939,000	(1,109,000)	830,000	20,545,000	4.04%
Hawaiian Electric Industries, Inc.	286,052	(140,677)	145,375	3,168,990	4.59%
Sempra Energy	1,629,000	(866,000)	763,000	13,165,000	5.80%
Northeast Utilities	407,074	117,064	524,138	7,071,274	7.41%
Entergy Corporation	3,419,415	(1,899,149)	1,520,266	17,899,281	8.49%
Exelon Corporation	4,835,000	(2,762,000)	2,073,000	23,139,000	8.96%
Public Service Enterprise Group Incorporated	1,929,000	(241,000)	1,688,000	18,475,000	9.14%
Constellation Energy Group, Inc.	525,300	560,100	1,085,400	9,900,400	10.96%
Progress Energy, Inc.	1,912,000	271,000	2,183,000	17,610,000	12.40%
Alliant Energy Corporation	420,700	468,000	888,700	4,594,800	19.34%
Total	52,764,073	(42,552,628)	10,211,445	453,589,420	2.25%
Mean	1,199,183	(967,105)	232,078	10,308,850	1.29%
Median	568,200	(507,250)	82,600	7,136,337	1.67%

Appendix C Continued

Parent Company Name	Utility Company Name	Electric Distribution	Gas Distribution	Operating Cash Flow (\$000)	Investing Cash Flow (\$000)	FCF (\$000)	Total Capitalization, at Book (\$000)	FCF % of Total Capitalization
ALLETE, Inc.	Minnesota Power, Inc.	Yes	No	NA	NA	NA	NA	NA
ALLETE, Inc.	Superior Water, Light & Power Co.	Yes	Yes	NA	NA	NA	NA	NA
Alliant Energy Corporation	South Beloit Water, Gas & Electric	Yes	Yes	NA	NA	NA	NA	NA
Ameren Corporation	Electric Energy Inc.	Yes	No	NA	NA	NA	NA	NA
American Electric Power Company, Inc.	Kingsport Power Company	Yes	NA	NA	NA	NA	NA	NA
American Electric Power Company, Inc.	Wheeling Power Co	Yes	NA	NA	NA	NA	NA	NA
Black Hills Corporation	Cheyenne Light, Fuel and Power Company	Yes	Yes	NA	NA	NA	NA	NA
Consolidated Edison, Inc.	Pike County Light & Power Co	Yes	Yes	NA	NA	NA	NA	NA
Consolidated Edison, Inc.	Rockland Electric Company	Yes	NA	NA	NA	NA	NA	NA
Dominion Resources, Inc.	East Ohio Gas Company	No	Yes	NA	NA	NA	NA	NA
Dominion Resources, Inc.	Hope Gas, Inc.	No	Yes	NA	NA	NA	NA	NA
Dominion Resources, Inc.	Peoples Natural Gas Company	No	Yes	NA	NA	NA	NA	NA
DTE Energy Company	Citizens Gas Fuel Company	No	Yes	NA	NA	NA	NA	NA
Energy East Corporation	Berkshire Gas Company	No	Yes	NA	NA	NA	NA	NA
Energy East Corporation	Southern Connecticut Gas Company	No	Yes	NA	NA	NA	NA	NA
Entergy Corporation	Entergy Louisiana Holdings, Inc.	Yes	No	NA	NA	NA	NA	NA
FirstEnergy Corp.	Pennsylvania Power Company	Yes	No	NA	NA	NA	NA	NA
Hawaiian Electric Industries, Inc.	Hawaii Electric Light Co Inc	Yes	No	NA	NA	NA	NA	NA
Hawaiian Electric Industries, Inc.	Maui Electric Company	Yes	No	NA	NA	NA	NA	NA
NISource Inc.	Bay State Gas Company	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Columbia Gas of Kentucky	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Columbia Gas of Maryland	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Columbia Gas of Ohio	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Columbia Gas of Pennsylvania	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Columbia Gas of Virginia	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Kokomo Gas & Fuel Company	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Northern Indiana Fuel & Light Company, Inc.	No	Yes	NA	NA	NA	NA	NA
NISource Inc.	Northern Indiana Public Service Co.	Yes	Yes	NA	NA	NA	NA	NA
NISource Inc.	Northern Utilities, Inc.	No	Yes	NA	NA	NA	NA	NA
Northeast Utilities	Holyoke Power & Electric Company	Yes	NA	NA	NA	NA	NA	NA
Northeast Utilities	Yankee Gas Services Company	No	Yes	NA	NA	NA	NA	NA
NSTAR	Cambridge Electric Light Company	Yes	No	NA	NA	NA	NA	NA
NSTAR	Commonwealth Electric Company	Yes	No	NA	NA	NA	NA	NA
NSTAR	NSTAR Gas Company	No	Yes	NA	NA	NA	NA	NA
Sempra Energy	Frontier Energy	No	Yes	NA	NA	NA	NA	NA
TECO Energy, Inc.	Peoples Gas System	No	Yes	NA	NA	NA	NA	NA
UniSource Energy Corporation	UNS Electric, Inc.	Yes	No	NA	NA	NA	NA	NA
UniSource Energy Corporation	UNS Gas, Inc.	No	Yes	NA	NA	NA	NA	NA
Vectren Corporation	Vectren Energy Delivery of Ohio, Inc.	No	Yes	NA	NA	NA	NA	NA
Westar Energy, Inc.	Kansas Gas and Electric Company	Yes	No	NA	NA	NA	NA	NA
Westar Energy, Inc.	Western Resources - KPL	Yes	No	NA	NA	NA	NA	NA
Wisconsin Energy Corporation	Edison Sault Electric Company	Yes	No	NA	NA	NA	NA	NA
Wisconsin Energy Corporation	Wisconsin Gas LLC	No	Yes	NA	NA	NA	NA	NA

1 **Appendix D - Procedure to Calculate and Mitigate the Adverse Credit Impact of**
2 **Debt Equivalence Associated With a Long-Term Contract**

3 1) Determine the fixed capacity payment for each year of the contract;
4 2) Where the contract does not specify a capacity payment, use S&P's proxy
5 capacity charge based on the cost to develop and finance a combustion turbine, stated in dollars
6 per kW / yr, and multiply that charge by the kW under contract;

7 3) Discount remaining capacity payments with a discount rate equal to the cost of
8 debt to determine the NPV of the remaining fixed payments;

9 4) Multiply the NPV by a risk factor assigned by S&P (currently 25% for SDG&E)
10 to determine the debt equivalence;

11 5) Additional common equity, equal to the authorized equity percentage (proposed
12 to remain 49% for SDG&E) of the debt equivalence amount will be added to the capital structure
13 to offset debt equivalence impacts. The increased amount of equity will be used to pay down
14 debt; therefore, the debt is reduced by the same amount;

15 6) Associated revenue requirement is equal to the incremental equity amount
16 multiplied by ((authorized return on equity * net to gross tax multiplier) – cost of debt to be
17 offset and/or retired); and

18 7) The total contract cost recoverable through rates equals the PPA costs plus the
19 revenue requirement associated with the incremental equity required to mitigate the adverse
20 credit impact of the PPA's debt equivalence.

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Appendix E - Illustrative Debt Equivalence Financial Impact

Contract Costs (\$/kW-yr)		150												
Contracted Capacity in MW		100												
Capacity Payment (\$/kW-yr)		100												
PPA - Including Debt Equivalence														
		2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
PPA Cost		15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Revenue requirement for mitigating debt equivalence		2.0	2.0	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2	
Carrying cost - PPA		17.0	17.0	16.9	16.9	16.8	16.7	16.6	16.6	16.5	16.4	16.3	16.2	
		1	2	3	4	5	6	7	8	9	10	11	12	
Capacity Payment		10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
NPV of remaining PPA	5.6%	119.0	115.6	112.0	108.2	104.3	100.0	95.6	90.9	85.9	80.7	75.2	69.4	
Risk factor	25%													
Debt equivalent		29.8	28.9	28.0	27.1	26.1	25.0	23.9	22.7	21.5	20.2	18.8	17.3	
Rebalance Capital Structure														
Equity	49%	14.6	14.2	13.7	13.3	12.8	12.3	11.7	11.1	10.5	9.9	9.2	8.5	
Debt		(14.6)	(14.2)	(13.7)	(13.3)	(12.8)	(12.3)	(11.7)	(11.1)	(10.5)	(9.9)	(9.2)	(8.5)	
		-	-	-	-	-	-	-	-	-	-	-	-	
Ratepayer perspective														
(revenue requirement)														
Equity		2.9	2.8	2.7	2.6	2.5	2.4	2.3	2.2	2.1	1.9	1.8	1.7	
Debt		(0.8)	(0.8)	(0.8)	(0.7)	(0.7)	(0.7)	(0.6)	(0.6)	(0.6)	(0.5)	(0.5)	(0.5)	
Revenue req change		2.0	2.0	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2	
NPV of Rev Requirement Change		14.1	1.9	1.7	1.5	1.3	1.2	1.0	0.9	0.8	0.7	0.6	0.5	0.4
Assumptions:														
Based on 100 MW plant contracted for a 20-year term														
Debt equivalence calculated based on S&P methodology														
Assumes contract costs of \$150/kW-yr with capacity payments of \$100/kW-yr														
Assumes proposed cost of capital and capital structure														
Fed tax rate		35.000%												
State tax rate		8.840%												
Composite (t)		40.746%												
Tax Factor		59.254%												
Proposed Weighted Cost of Capital														
		Capital Ratio	Cost	Wtd Cost	After tax (AT WACC)	Pre tax (AT WACC)								
Weighted avg RoR Debt		43.25%	5.55%	2.51%	1.49%	2.51%								
Weighted avg RoR Preferred Equity		5.75%	6.77%	0.39%	0.39%	0.66%								
Weighted avg RoR Common Equity		49.00%	11.60%	5.68%	5.68%	9.59%	1.6876							
Selected RoR ----->				Total RoR >	8.58%	7.56%	12.76%							

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1 **Appendix F - Procedure to Calculate and Mitigate FIN 46(R) Impacts Associated With a**
2 **Long-Term Contract**

3 1) Determine the estimated cost to construct the plant, and percentage of debt and
4 equity financing used by the counterparty;

5 2) Multiply the debt and equity financing percentages by the cost to construct the
6 plant to determine the additional amount of debt, which is equal to (project debt – project
7 equity), associated with consolidating the plant under FIN 46(R);

8 3) Additional common equity, equal to the authorized equity percentage (proposed
9 to remain 49% for SDG&E) of the additional debt amount (offset by minority interest) will be
10 added to the capital structure to offset FIN 46(R) consolidation impacts. The increased amount
11 of equity will be used to pay down debt; therefore, the consolidated debt is reduced by the same
12 amount;

13 4) Associated revenue requirement is equal to the incremental equity amount
14 multiplied by ((authorized return on equity * net to gross tax multiplier) – cost of debt to be
15 offset and/or retired); and

16 5) The total contract cost recoverable through rates equals the PPA costs plus the
17 revenue requirement associated with rebalancing the utility's capital structure as a result of
18 mitigating the adverse impact of FIN 46(R) consolidation.
19

1 Appendix G - Illustrative Fin 46(R) Financial Impact

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	Without New Contract 2008		With New Contract		New Contract	
Debt	2,263	45.25%	2,338	45.83%	75	75%
Preferred	288	5.75%	288	5.64%	-	-
Common Equity	2,450	49.00%	2,475	48.53%	25	25%
Capitalization	5,000		5,100		100	100.00%

	Additional Debt due to Contract	\$	50	Loan Amortization over 20 years											
				2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				1	2	3	4	5	6	7	8	9	10	11	12
Consolidated Additional Debt			50.0		47.5	45.0	42.5	40.0	37.5	35.0	32.5	30.0	27.5	25.0	22.5
Rebalance Capital Structure															
Equity	49%		24.5	23.3	22.1	20.8	19.6	18.4	17.2	15.9	14.7	13.5	12.3	11.0	
Debt			(24.5)	(23.3)	(22.1)	(20.8)	(19.6)	(18.4)	(17.2)	(15.9)	(14.7)	(13.5)	(12.3)	(11.0)	
Ratpayer perspective (revenue requirement)															
Equity			4.8	4.6	4.3	4.1	3.8	3.6	3.4	3.1	2.9	2.6	2.4	2.2	
Debt			(1.4)	(1.3)	(1.2)	(1.2)	(1.1)	(1.0)	(1.0)	(0.9)	(0.8)	(0.7)	(0.7)	(0.6)	
Revenue req change			3.4	3.3	3.1	2.9	2.7	2.6	2.4	2.2	2.1	1.9	1.7	1.5	
NPV			21.2	3.2	2.8	2.4	2.1	1.8	1.6	1.4	1.2	1.0	0.8	0.7	0.6

Assumptions:

Cost to construct plant of \$100 million
 Hypothetical total capitalization for 2008
 Construction financed 75% debt and 25% equity
 PPA term of 20 years equals debt amortization period
 Assumes proposed cost of capital and capital structure

Fed tax rate	35.000%
State tax rate	8.540%
Composite (t)	40.746%
Tax Factor	59.254%

Proposed Weighted Cost of Capital	Cost		After tax		Pre tax
	Capital Ratio	Cost	Wtd Cost	(A/T WACC)	
Weighted avg RoR Debt	45.25%	5.55%	2.51%	1.49%	2.51%
Weighted avg RoR Preferred Equity	5.75%	6.77%	0.39%	0.39%	0.66%
Weighted avg RoR Common Equity	49.00%	11.60%	5.68%	5.68%	9.59%
Selected RoR			8.58%	7.56%	12.76%

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**BEFORE THE PUBLIC UTILITIES
COMMISSION OF THE STATE OF CALIFORNIA**

**DECLARATION
OF KENNETH J. DEREMER**

A.10-10-001

Application of San Diego Gas & Electric Company (U 902 E)
For Adoption of its 2011 Energy Resource Recovery Account (ERRA) Forecast Revenue
Requirement and Competitive Transition Charge (CTC) Revenue Requirement Forecasts

I, Kenneth J. Deremer do declare as follows:

1. I am the Director of Financial Analysis and Assistant Treasurer for San Diego Gas and Electric Company ("SDG&E"). I included my Prepared Rebuttal Testimony ("Testimony") in support of SDG&E's October 1, 2010 Application for Adoption of its 2011 Energy Resources Recovery Account (ERRA) Forecast Revenue Requirement and Competitive Transition Charge (CTC) Revenue Requirement Forecasts. Additionally, as Director of Financial Analysis and Assistant Treasurer I am thoroughly familiar with the facts and representations in this declaration and if called upon to testify I could and would testify to the following based upon personal knowledge.

2. I am providing this Declaration to demonstrate that the confidential information ("Protected Information") in support of the references falls within the scope of data provided confidential treatment in the IOU Matrix ("Matrix") attached to the Commission's Decision (D) 06-06-066 (the Phase I Confidentiality decision). Pursuant to the procedure set forth in D.08-04-023 for Testimony in a formal proceeding, I am addressing each of the following five features of Ordering Paragraph 2 of D.06-06-066:

- that the material constitutes a particular type of data listed in the Matrix;
- the category or categories in the Matrix the data correspond to;
- that SDG&E is complying with the limitations on confidentiality specified in the Matrix for that type of data;

- that the information is not already public; and
- that the data cannot be aggregated, redacted, summarized, masked or otherwise protected in a way that allows partial disclosure.

3. The confidential information contained in my testimony constitutes material, market sensitive, electric procurement-related information that is within the scope of Section 454.5(g) of the Public Utilities Code.¹ As such, the Protected Information provided by SDG&E is allowed confidential treatment in accordance with Appendix I – IOU Matrix in D.06-06-066.

Confidential Information	Matrix Reference	Reason for Confidentiality And Timing
KJD-1 line 10	XI	Procurement costs; confidential for 3 years
KJD-10 lines 4, 18	XI	Procurement costs; confidential for 3 years
KJD-12 line 21	XI	Procurement costs; confidential for 3 years

4. I am not aware of any instances where the Protected Information has been disclosed to the public. To my knowledge, no party, including SDG&E, has publicly revealed any of the Protected Information.

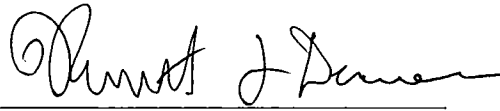
5. I will comply with the limitations on confidentiality specified in the Matrix for the type of data that is provided herewith.

6. The Protected Information cannot be provided in a form that is aggregated, partially redacted, or summarized, masked or otherwise protected in a manner that would allow further disclosure of the data while still protecting confidential information.

¹ In addition to the details addressed herein, SDG&E believes that the information being furnished in my Testimony is governed by Public Utilities Code Section 583 and General Order 66-C. Accordingly, SDG&E seeks confidential treatment of this data under those provisions, as applicable.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this 4th day of March, 2011, at San Diego, California.

A handwritten signature in cursive script, appearing to read "Kenneth J. Deremer".

KENNETH J. DEREMER

Director of Financial Analysis and Assistant Treasurer
San Diego Gas & Electric Company