

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

Order Instituting Rulemaking to Promote  
Consistency in Methodology and Input  
Assumption in Commission Applications  
of Short-run and Long-run Avoided Costs,  
Including Pricing for Qualifying Facilities.

Rulemaking 04-04-025

**PRE-WORKSHOP COMMENTS OF  
INDEPENDENT ENERGY PRODUCERS ASSOCIATION**

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Pursuant to the Notice of Workshop distributed electronically on May 17, 2004 (revised on May 27, 2004), the Independent Energy Producers Association (IEP)<sup>1</sup> respectfully submits these comments preliminary to the initial workshops scheduled “...for the purpose of soliciting public input and facilitating a discussion of the California Public Utilities Commission’s (Commission) methodology for developing and subsequent usage of avoided costs in various rulemakings.” Among those various rulemakings, of which there are thirteen (13) referenced in the caption of the workshop notice, it is the application to qualifying facilities (QFs) with which IEP primarily is concerned.

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<sup>1</sup> IEP is a nonprofit trade association representing the interests of California electric generators and certified independent power marketers. IEP’s membership consists of the owners and operators of projects using cogeneration, solar-thermal, wind, biomass and geothermal technologies, as well as the purchasers of fossil facilities voluntarily divested by the California investor-owned public utilities. IEP’s membership collectively own and operate more than 20,000 MW of installed generating capacity participating in California’s competitive markets, and many are actively developing approximately 9,500 MWs, about 70% of new generating capacity under development as identified by the California Energy Commission. (See, [http://www.energy.ca.gov/maps/siting\\_cases.html](http://www.energy.ca.gov/maps/siting_cases.html).)

## INTRODUCTION

IEP supports the OIR's goal of developing "...a common methodology, consistent input assumptions and updating procedures for avoided costs across our various proceedings, and for adopting avoided cost calculations and forecasts that conform to those determinations." OIR at 2. A common methodology for the determination of avoided costs is important to ensure that non-utility resources that serve load (whether from the supply- or demand-side) be acquired at just and reasonable prices equal to that incurred if the utility served the same load itself through whatever means are available to it. Avoided costs are defined in Federal law as

[t]he incremental costs to an electric utility of energy or capacity or both which, but for the purchase from the qualifying facility or qualifying facilities, such utility would generate itself or purchase from another source.

18 C.F.R. 292.101(b)(6); cf. OIR at 7. The Commission has never deviated from this definition for QF pricing and, to date, it has priced power purchased from QFs in a manner consistent with this Federal mandate. On the other hand, the first matter of business in the instant rulemaking is the consideration of an approach for determination of avoided cost for energy efficiency. The Commission has directed parties' attention to a draft report<sup>2</sup> that will be the focus of the initial set of workshops in this rulemaking. The Commission has asked parties to discuss the applicability of this proposed approach to other applications of avoided costs, including QF pricing. Such consideration is appropriate not only from the perspective of reducing administrative burden but also from

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<sup>2</sup> "A Forecast of Cost Effectiveness Avoided Costs and Externality Adders" (January 8, 2004), by Energy and Environmental Economics, Inc. (E3).

the perspective of developing a consistent approach for the side-by-side valuation of different resource options.

While the application of avoided cost theory to energy efficiency lacks the imprimatur and strictures of Federal law, it also invites consideration of a broader array of beneficial attributes than traditionally have been included by this Commission in the determination of avoided cost QF pricing. Stated another way, while determinations for QF pricing must be “just and reasonable” under the Federal requirements (a test which is met, by definition, when that determination is based upon utility avoided cost) such determinations also must not discriminate against QFs. OIR at 4; cf. D. 82-04-071 and 18 C.F.R. 292.304(a)(2).

The challenge for the Commission in this proceeding will be to harmonize its policy goals related to the assessment of avoided costs for use in evaluation of demand-side resources with the legal requirements that underlie the determination of avoided costs as they are used for QF pricing.

### **PRELIMINARY RESPONSES TO THE WORKSHOP QUESTIONS**

By the terms of the workshop notice, the first step in this rulemaking is to determine the appropriateness of the E3 methodology to the determination of avoided costs related to the energy efficiency proceeding (for which the E3 methodology was originally developed). Accordingly, the workshop notice and the OIR, ask:

- 1. Should the Commission adopt the methodology for updating avoided costs presented in the consultant’s report for the purposes of evaluating the resource value of DSM/EE programs? If not, what aspects of that methodology should be refined or modified?**

In IEP's view, there are two reasons that the Commission should adopt the E3 methodology, at least for use as the basis for going forward with this OIR. Those two reasons are 1) it is committed to "...develop a transparent and fully documented methodology using readily or publicly available data, so as to allow independent review by numerous stakeholders" (E3 Report at 6) and 2) it embraces the concept of total avoided cost, incorporating within that concept non-direct generation costs such as environmental, transmission/distribution and reliability attributes of energy efficiency. E3 Report at 2.0, generally.

Transparency is essential to ensure legitimacy in the process of fairly determining avoided costs. As has been seen with QF pricing since 1996, transparent means for determination of avoided costs tend to rely on publicly available information, have the benefit of being self-effectuating without ongoing utility or regulatory manipulation, and are not prone to constant protests from one side or the other.

The E3 concept of total avoided cost is consistent with federal regulations regarding the determination of avoided cost. These require, to the extent practicable, consideration of a wide range of factors, such as availability during peak periods, reliability, outage coordination, availability during system emergencies including separation from the grid, individual and aggregate energy and capacity value, smaller increments and shorter lead times to availability, deferral of new utility generation and displacement of fossil fuel use and costs or savings with respect to line losses. 18 C.F.R. 292.304(e). IEP notes that the E3 report correctly identifies some, but not all, of these factors in its proposed avoided cost methodology. While incomplete, it is clearly on the

right path with respect to an approach for the determination of avoided cost that is applicable to more than just energy efficiency. These and other factors undoubtedly will prove relevant and applicable to the determination of total avoided costs.

**2. Which components of the proposed methodology could be applicable to other avoided cost applications, such as short-run avoided costs (SRAC) for QF pricing, evaluation of RPS bid proposals, cost-effectiveness evaluation of demand-response programs, distribution generation, renewables, and other supply-side resources? Which components do not appear to be applicable, and why not?**

As noted, E3's goal of identifying and quantifying, to the extent possible, all possible avoided costs, is the cornerstone of its methodological proposal. The degree to which any particular non-direct generation attribute meaningfully applies to a particular supply- or demand-side resource will depend on the specific resource being considered. For example, the ability to coordinate availability during outages or system emergencies, including shedding generation, or to dispatch up during high demand periods may be an attribute uniquely characteristic of a generation alternative such as a QF. The ability to defer utility generation and avoid fossil emissions is probably, in some degree, an attribute of any resource option. The value of pure, non-schedulable capacity/reliability value is probably similar between alternatives. The determination of which individual proposal represents the best fit and appropriate cost will depend upon the load serving entity's particular circumstances at the time of procurement. Flexibility on the part of the prospective supplier to meet those requirements is the greatest value of them all.

**3. With regard to QF pricing, parties are encouraged to carefully review existing avoided cost pricing methodologies applicable to QFs which determine (1) SRAC energy payments, and (2) As-**

**Delivered Capacity Prices. Parties should comment on the need for, and difference between, short-run and long-run methodologies or considerations thereof, as well as any appropriate methodological (and thus appropriate pricing) differences between firm and as-available power. Parties should also concisely address any practical constraints that arise from any associated legal requirements and the degree of latitude and discretion available to the Commission under the circumstances, as well as prior Commission direction provided in D.03-12-062 and D.04-01-050. Parties should also be prepared to address whether the formula mandated by Section 390 either inhibits or prevents us from assuring just and reasonable rates for the power provided by QFs, such that Section 390 should be modified or rescinded.**

IEP is familiar with existing and prior avoided cost methodologies applicable to QFs. While these methodologies have varied, each has proven to be viable and fair. Recognizing the mandatory obligation for the Commission to determine as reasonably as possible the utilities' short-run and long-run avoided costs, it has, in the past, adopted a small number of alternative approaches for determining avoided costs. Historically, the avoided cost methodology with the longest tenure has relied on production simulation models. These determined the probable mix of utility resource options over a forecast year to calculate what changes to that mix, and concomitant savings, would likely occur with the substitution of QFs for other options. The use of production simulations not only simulated the operation of an individual utility's generating facilities but it also accounted for non-generation options such as economy energy purchases from other utilities and suppliers to the extent such options were available and of lower cost. In short, on a forecast basis using the best information available at the time the forecasts were developed, this methodology ensured procurement of QF energy at the lowest cost in comparison with known utility alternatives.

The use of production simulation models was contentious and litigious. The proceedings to determine the Incremental Energy Rate (which was the result of multiple simulation model runs) were highly technical and often resulted in settlements between parties. However, even with settlements related to Incremental Energy Rates, there was still contention regarding short-run avoided energy costs, primarily because they relied on utility declarations of their supposed cost of natural gas fuel in any particular QF pricing period. To avoid those disputes, to make the process more transparent and self-effectuating, and to reduce administrative burden, the Commission approved of the current approach for determination of short-run avoided energy costs. This methodology adjusts a base energy price against observed changes in natural gas fuel prices measured at the California border. This is the methodology codified in Section 390 as referred to in the workshop question. The common feature of both approaches, of course, is the dominance of natural gas fuel as the key determinant of utility avoided cost. IEP believes that natural gas prices will continue to be the primary driver of utility avoided costs in the foreseeable future.

The workshop notice also makes the distinction between short-run and long-run avoided cost methodologies. By definition, short-run avoided costs are costs that can be avoided by displacing some existing alternative operational or purchased cost (i.e. energy) from an existing arrangement. Long-run avoided costs include both the deferral or avoidance of capital expenditures associated with the provision of energy as well as the change in operating costs that result from the alternate resource plan. Long-run avoided costs can be separated into avoided capacity costs and avoided energy costs.

Existing QF contracts provide utilities with both products, namely energy and capacity, with each product having a separate pricing structure.

The basis for paying SRAC energy was described above. Just as with avoided energy costs, the Commission has a long history of establishing avoided capacity costs. The Commission has consistently used the annual rental value of a combustion turbine as the basis for determining a utility's long-run avoided capacity cost, since parties generally agreed that a combustion turbine was the cheapest source of pure reliability (i.e. the cost of avoiding a shortage) available to a utility. The value of short-run avoided capacity costs (also known as as-delivered capacity) is also measured against that annual rental value but is paid only with delivery of energy. In contemporary conditions, these two products are perhaps better thought of as energy and reliability because as-delivered capacity, being an incident of energy delivery in real time, is a different product than a firm commitment to be available, which has value whether or not energy is actually delivered or dispatched at any particular time.

The difference between firm capacity and energy is perfectly analogous to paying a taxi a fixed charge to wait and be available to you and then paying for mileage if, as and when actually used. A contemporary procurement approach is consistent with Federal requirements positioning potential sellers to offer both a reliability component and an energy component, irrespective of their categorization as energy or capacity.

Based upon these observations, IEP finds completely baseless the assertions, made without any theoretical let alone analytical underpinning, of the two Commission decisions called out for comment in the workshop notice. Describing the SRAC energy

formula as “out of date” and the add-on comment that the applicability of separate capacity payments exaggerates some inequity in current SRAC pricing reveals a startling misunderstanding of the avoided cost pricing system currently in place in California.

As noted above, most QF contracts provide for the sale and purchase of two separate commodities: energy and capacity. With regard to energy, payments are made based on periodically determined estimates of avoided utility operating costs based on changes in the cost of natural gas. Such indexing is appropriate since the prices of power and natural gas are related and, as a result, utilities’ short-run avoided energy costs would move with changes in gas prices.

It is generally agreed that the price of natural gas fuel can be volatile and, as a result, basing SRAC energy prices on a volatile index would result in volatile SRAC prices. This problem is not new and the Commission has addressed this concern in the past by adopting fixed energy pricing for periods of years. In any event, IEP is unaware of any basis for concluding that changes, and specifically increases, in available natural gas costs are anything other than what the utilities would have experienced and therefore are consistent with avoided cost.

With respect to firm capacity payments, the Commission decisions simply misunderstand the product that is being purchased from QFs. Unlike SRAC energy prices which are determined from time to time, firm capacity payments compensate QFs for the deferral, and saved costs, of capital investment in new utility-owned reliability units at the time the contracts were signed. Provided the QFs maintain the requisite contractual performance standards, those firm capacity payments are made to ensure the availability

of the QF to meet reliability needs. The idea in the decisions that the prices of these two products may sensibly be blended is a *non sequitur*.

The workshop notice inquires into limitations on the Commission’s determinations in this proceeding based on the existence of Section 390; specifically whether Section 390 “inhibits or prevents us from assuring just and reasonable rates for power provided by QFs...” It is clear that Section 390 defines how SRAC energy prices are to be determined – importantly, that prescription is precisely the methodology adopted by the Commission for determination of SRAC before Section 390 was enacted. Because the Commission methodology reasonably determines SRAC energy costs, that methodology results in just and reasonable rates by definition. Thus, the premise of the workshop notice’s question does not obtain. In the absence of any evidence, and there is none, that the current methodology requires modification, IEP sees no reason to adjust it. As a result, IEP does not agree that Section 390 “inhibits” the Commission from determining just and reasonable rates for QF power.

#### **4. What should be the next procedural steps in this proceeding?**

IEP does not understand the Commission’s apparent enthusiasm for modifying SRAC by virtue of perceived, but unexplained, deficiencies in the current methodology as codified in Section 390. Nevertheless, IEP welcomes the opportunity to collaborate on developing new and potentially better and more creative ways to measure, determine and fix avoided cost to better capture all avoided costs, as attempted in the E3 Report. The extensive workshop schedule in advance of any hearings that might be required is the best way to go. IEP believes that the workshops will be most helpful in framing more

precisely what matters should be brought before the Commission and what precise direction is to be asked of the Commission. In addition, bringing together and making consistent to the degree possible the key assumptions for determining avoided costs is clearly valuable. Also, comparing the ability of different resources to avoid utility costs (e.g., QFs can provide coordination of their operation with utility generation and many can provide dispatchability while energy efficiency might only be able to provide pure reliability; the ability of different resources to displace fossil generation) is fantastically interesting and long overdue. Moreover, this proceeding is precisely the right venue to ensure that Commission-adopted definitions of avoided costs for energy efficiency in no way discriminate against QFs.

IEP looks forward to full participation in the process, hopes these initial comments are helpful in framing some discussion and thanks the Commission for the chance to weigh in.

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Respectfully submitted,

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## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served a copy of the “Pre-Workshop Comments of Independent Energy Producers Association” on all known parties to R.04-04-025 by transmitting an e-mail message with the document attached to each party named in the official service list.

Executed on June 4, 2004 at Sacramento, California.

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Eric Janssen

**R.04-04-025**

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June 4, 2004

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