Diablo Deal Shifts Risk To PG&E Shareholders

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A Pacific Gas & Electric Co. lawyer said Monday's landmark settlement of four-year-old litigation over how to pay for cost overruns at the troubled Diablo Canyon nuclear plant was "not without pain" for the huge utility and its shareholders.

The settlement, which requires PG&E to write off about $2 billion it purportedly planned to charge customers for the overruns, was announced by Attorney General John Van de Kamp and representatives of the consumer advocacy arm of the state Public Utilities Commission as hearings were about to begin in the complex case before the PUC in San Francisco. The agreement, which must be approved by the PUC, also requires the oversight of an independent safety committee.

Believed to be the first agreement of its kind involving a major public utility — and certainly the first affecting a nuclear power plant — the settlement is based on an unusual method of utility price regulation called "performance-based pricing," which requires that rate payments be based strictly on plant performance and is expected to save customers billions of dollars. Without the agreement, said attorneys for the PUC and the attorney general's office, substantial rate hikes were inevitable.

The settlement provides for a 1.6 percent increase July 1, followed by 1.3 percent increases each Jan. 1 from 1989 through 1991 and "moderate increases" in future years, depending on plant operations.

"Under traditional rate making, consumers can be forced to pay enormous costs for construction of a plant that may produce relatively little power," Van de Kamp said at a San Francisco press conference announcing the agreement. "Under performance-based pricing, consumers pay for the power, not for the power plant."

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IRA ALDERSON: "It's a bold step for PG&E to take. It shows an entrepreneurial spirit, and they deserve some credit for that," said the assistant general counsel to the PUC.

Joseph Malkin, an O'Melveny & Myers partner who has been the lead attorney for PG&E in the Diablo negotiations, said the settlement "represented a

SEE **DIABLO** PAGE 7

Diablo Deal Shifts Risk to PG&E Shareholders

CONTINUED FROM PAGE 1

very fair balance between the interests of PG&E's shareholders and its customers." He said the settlement also removes "a cloud of uncertainty over the company's future" because of the lengthy litigation. He added that the settlement was "not without pain to the company."

Malkin described the performance-pricing agreement as "an innovative way of pricing [which] shifts more operating risk to the utility and off of the customer." Although used by some small power companies or those using alternate energy sources such as windmills, the pricing system has not been used by a major utility.

Describing the plant's notoriously "troubled history," Van de Kamp said construction of the San Luis Obispo County facility, begun in 1967, was "marked by inadequate responses to seismic hazards and sloppy design work." Because of design and construction errors — including reversed plans in some segments — the attorney general noted that "some parts of the plant have been built three times.

"As a result, PG&E spent $5.5 billion just to get Diablo Canyon into operation," he said. Under traditional utility rate regulation, PG&E would be permitted to collect rates to recover — and profit from — as much of the $5.5 billion as the PUC determined to be "prudently incurred." He said the $2 billion "disallowance" contained in the settlement is "far larger than any PUC in the United States has ever disallowed" and five times as large as the amount disallowed by the PUC last year for Southern California Edison's San Onofre project.

Under the agreement, if the Diablo plant performs "above average," PG&E can reduce the disallowance over time. The plant has been performing at 68 percent of capacity for the past three years.

If the plant performs poorly — if, for example, "it has the kind of dismal record the Rancho Seco plant in Sacramento has compiled" — Van de Kamp said PG&E will be subjected to even larger economic sanctions.

PG&E executives, who did not participate in the press conference, issued a press release and generally were supportive of the agreement.

"On the positive side, it establishes how PG&E will be compensated for our investment in Diablo Canyon," said Chief Executive Officer Richard A. Clarke in a prepared statement. "Also, it significantly reduces the uncertainties about when the case will be completed and how the complex issues will be resolved.

"On the negative side, the reduction in the dividend — our first reduction in 55 years — is painful for our 400,000 shareholders, many of whom rely significantly on their dividend for income," he added. The company said it would absorb a one-time charge of $500 million — effectively eliminating the company's 1988 earnings after taxes — and reduce cash dividends to shareholders — from $1.92 per share to a new annualized rate of $1.40 per share.

Clarke said the performance-based pricing system in the agreement "creates a strong economic incentive for us to operate Diablo Canyon safely and efficiently. If we don't, the plant won't run and PG&E won't get paid."

Van de Kamp and PUC attorneys praised PG&E for its decision to agree to the landmark settlement.

"It's a bold step for PG&E to take," said Ira Alderson, assistant general counsel to the PUC in San Francisco. "It shows an entrepreneurial spirit, and they deserve some credit for that."

Alderson said PG&E's agreement to a performance-pricing system means rate increases will be substantially less than they would have been under a traditional system.

Van de Kamp said the settlement would not have been possible "without the forward-looking leadership of PG&E's new management." Specifically naming Clarke and President George Manneatis, the attorney general said they were "willing to accept the risks of this agreement in exchange for the opportunities it presents if they manage the plant well."

The independent safety committee will consist of three persons — one each appointed by the governor, the attorney general and the chairman of the California Energy Commission — who will be selected from a list of candidates nominated by the president of the PUC, the dean of engineering at the University of California, Berkeley, and PG&E. All members must have knowledge, background and experience in nuclear facilities, and the cost of committee operations will be paid by PG&E.

According to an analysis of the agreement prepared by the attorney general's office, the performance-based rating will "likely" permit PG&E to receive 7.8 cents per kilowatt hour for Diablo generation, with the pricing rising according to a formula. With few exceptions [decommissioning costs pursuant to federal law, for example], when Diablo does not produce power, there is no cost to the customer.

The Associated Press contributed to this report.