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June 27, 2005

Public Utility Commission of Oregon
Attn: Filing Center
550 Capitol Street, NE
Suite 215
PO Box 2148
Salem, Oregon 97308-2148

Re: UE 167

Dear Filing Center:

Enclosed for filing, please find the Staff Reply Brief in Docket No. UE 167, *In the Matter of the Application of Idaho Power Company for Authority to Increase its Rates and Charges for Electricity Service to Customers in the State of Oreogn.*

Thank you for your attention.

Very truly yours,

Stephanie S. Andrus
Assistant Attorney General

Enc.

c. Service list

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UE 167

In the Matter of the Application of
Idaho Power Company for Authority to
Increase its Rates and Charges for
Electricity Service to Customers in the
State of Oregon.

STAFF REPLY BRIEF

As discussed in the parties' opening briefs, most issues presented in this docket have been resolved by stipulation. The only revenue requirement issue not resolved by stipulation is the appropriate level of net variable power costs (NVPC) to include in Idaho Power Company's ("Idaho Power") rates. Staff of the Public Utility Commission ("staff"), the Citizens' Utility Board ("CUB") and the Oregon Industrial Customers of Idaho Power ("Industrial Customers") believe Idaho Power has significantly underestimated the revenue it would receive from wholesale sales of surplus generation under normalized conditions, and thus, has overstated its NVPC. As explained in staff's opening brief, Idaho Power's understated projections for wholesale sales revenue stem from flawed modeling. Idaho Power input unrealistically low natural gas prices into its power cost model, which produced unrealistically low market-clearing prices for electricity. As a result, Idaho Power's NVPC is based on projected wholesale sales of surplus energy at unrealistically low prices.

Idaho Power does not attempt to defend its power cost modeling. Rather, Idaho Power asserts that the Commission should adopt its proposed NVPC because its proposal is consistent with historic NVPC and because adopting any of the NVPC levels proposed by staff or the intervenors would not allow Idaho Power to recover its actual power costs or earn its authorized rate of return. The crux of Idaho Power's argument is found in the introductory portion of its brief:

History, along with knowledge of current drought conditions, demonstrates that the projections of NPSE proposed by Staff, CUB, and OICIP cannot reasonably be expected to occur during the period of time that rates will be in effect. As a result, if Staff, CUB or OICIP's recommendations for net power supply expenses are adopted by this Commission, Idaho Power will have no realistic opportunity to recover its reasonably incurred power

expenses or earn its rate of return. For these reasons, this Commission should reject the recommendations for NPSE made by Staff, CUB, and OICIP. Instead, Idaho Power's recommended NPSE should be adopted for inclusion in rates by this Commission. (Idaho Power Company's Opening Brief at 2.)

Idaho Power's reliance on historical data and arguments regarding its chance of full cost recovery in a drought year is misplaced. Neither historic comparisons nor arguments regarding cost recovery establish by a preponderance of the evidence that the NVPC level proposed by Idaho Power would result in just and reasonable rates.

In contrast, staff's proposed NVPC is based on forward market prices that are consistent with prices that are likely to be in effect during the rate period. Further, staff's methodology is one that has been allowed by the Commission in several previous rate cases.

A. Historic comparisons are not persuasive evidence of the reasonableness of Idaho Power's proposed NVPC.

As a general matter, the Commission does not determine a utility's projected power costs by backcasting historic operations and power cost results. If power cost normalization consisted of replicating the past, the Commission would simply need to average the actual results of the past 21 years to determine the appropriate level of NVPC to use in this rate case. However, market conditions, utility resources and utility loads of the distant past are not likely to reoccur in the future. The goal of power cost normalization is to determine how the utility will operate its system in the future, given normal conditions.

In rebuttal testimony, staff witness Galbraith explained why Idaho Power's historic comparisons are invalid:

The comparisons shown in Idaho Power Exhibit 201 [an exhibit showing a “22 Year Range of Net Power Supply Expenses”] and Idaho Power Exhibit 302 [a graph showing “actual,” “modeled,” “IPC” and “Staff” Normalized Net Power Costs] are invalid because the AURORA NVPC projections assume current WSCC [Western System Coordination Council] loads and resources, whereas the actual NVPC results reflect the WSCC conditions that prevailed, for example, during 2001, during 1990, and during 1983. The purpose of the AURORA projections is not to replicate actual results from 1983-2003, but to project the results that would occur, given the current WSCC loads and resources, and given, for example, 2001 water conditions, 1990 water conditions, and 1983 water conditions. (Staff/300, Galbraith/6.)

Furthermore, there has been a fundamental shift from a coal-based to a natural gas-based electricity market. This fundamental shift makes Idaho Power’s comparisons of its proposed NVPC to historic NVPC even less persuasive. As CUB explained in its opening testimony:

Today, a gas-fired combined-cycle turbine is typically the marginal resource whose cost drives prices. While Idaho Power now uses a small amount of gas for peaking, the Company is in the unusual position of having no gas-fired base-load generation. This creates a growing spread between the Company’s cost to produce power with hydro and coal and the market value of power based on gas. This spread is worth millions of dollars in revenue from sales for resale. (CUB/100, Jenks-Brown/3.)

The following testimony from staff witness Galbraith echoes CUB’s testimony on this point:

- Q. Are the utility loads and generating units that comprise the current WSCC significantly different from the utility loads and generating units that comprised the WSCC in the past?
- A. Yes. There have been significant resource capacity additions in the WSCC since the Western Energy Crisis of 2000-2001. The vast majority of these additions have been natural gas-fired resources. Over this same period of time, natural gas prices have significantly increased and become more volatile. In addition, Northwest natural gas prices now more closely track the prices set in the integrated North American natural gas market. * * * (Staff/300, Galbraith 36.)

B. Idaho Power's power cost modeling is unreliable.

Rather than relying on historic averages, the Commission generally relies on power cost production models, such as AURORA, to normalize power costs included in rates. The Commission relies on accurate inputs (e.g., natural gas prices), accurate generating unit parameters (e.g., capacity, heat rates, forced outage rates), and economic dispatch logic to normalize power costs. If the model is accurately parameterized the Commission has confidence that the model will accurately normalize power costs

In this case, however, Idaho Power did not provide accurate power cost modeling. Contrarily, Idaho Power's power cost modeling is flawed by unrealistically low natural gas price inputs and also, by Idaho Power's assumption of a deterministic relationship between natural gas prices at the Henry Hub in Louisiana and Northwest hydro conditions.

In theory, one of the flaws in Idaho Power's modeling, the unrealistically low gas price inputs, may have been corrected by substituting more realistic prices. In fact, at one point in its investigation, staff sought to have Idaho Power re-run its power cost model with more realistic inputs. (*See Staff/200, Galbraith/13.*) However, the second flaw, the assumption that there is a deterministic relationship between Henry Hub natural gas prices and Northwest hydro conditions, does not reasonably reflect the actual relationship between these variables. For this reason, staff was unable to resuscitate Idaho Power's power cost modeling and accordingly, proposed adjustments to Idaho Power's NVPC based on a methodology that has been used in several previous dockets. (*See Staff/200, Galbraith/13.*)

C. Staff's proposed NVPC is an accurate representation of Idaho Power's NVPC under normalized conditions.

Staff proposes that the Commission determine Idaho Power's normalized wholesale sales revenues assuming the conditions of a single average water year and using prices obtained from the April 30, 2004 forward price curves for the year 2005. The forward price curves include monthly prices for on-peak and off-peak energy. Under staff's proposal, all Idaho Power's projected monthly sales and purchases are re-priced using a weighted average of these monthly on-peak and off-peak prices.

Staff's proposal results in an NVPC that is reasonably certain to occur under normalized conditions. First, the water conditions used by staff are in fact average conditions taking into account 76 years of streamflow data.

Second, the forward market prices used by staff, which range from \$30.62 to \$51.55 per MWh on-peak and from \$24.73 to \$43.38 per MWh off-peak, are prices the electricity market actually expected to be in effect in 2005, under average conditions. (Staff/302, Galbraith/2.) The conclusion that these prices can reasonably be expected to occur in the future is buttressed by CUB's testimony that the Northwest Power and Conservation Council projects average on-peak power prices for the Southern Idaho Region between \$44 and \$58 per MWh in 2006 and off-peak power prices between \$33 and \$52 per MWh through 2008. (CUB/100, Jenks-Brown/3.)

Idaho Power argues that a comparison of actual annual transaction prices for purchases and sales in 2003 to annual transaction rates obtained under staff's normalized scenario shows that staff's proposed NVPC is not an accurate representation of NVPC under normalized conditions. According to Idaho Power, the annual transaction rate for purchases and sales under staff's proposed adjustment must be lower than that actually

experienced by Idaho Power in 2003 if staff's adjustment is truly representative of average conditions. (Idaho Power Company's Opening Brief at 9.) Idaho Power's argument is without merit because many factors (e.g., system load and thermal unit outage rates), not simply poor hydro conditions, influenced Idaho Power's actual transaction rates in 2003. It is possible that the normalization of these other factors is behind the result that Idaho Power asserts is anomalous. (See Tr 35.) Notably, neither Staff nor Idaho Power attempted to normalize Idaho Power's actual 2003 results of operations in this docket.

In testimony and again in its brief, Idaho Power complains that staff's methodology is inappropriate because it 1) returns the Commission to a pre-1982 approach to computing variable power expenses using a single average water year that was abandoned more than twenty years ago; 2) ignores the asymmetric nature of the relationship between hydro expenses and water supplies; and 3) relies on forward-price curves that are representative of the power market's expectation of drought, rather than average, water conditions. Idaho Power's complaints are not well taken.

First, Idaho Power is mistaken that staff's proposed methodology has been abandoned by the Commission. In fact, this forward price curve methodology was used to determine NVPC in Docket Nos. UE 115 (2001), UE 116 (2001), UE 139 (2002), UE 149 (2003), UE 147 (2003) and UE 161 (2004).

Second, Idaho Power is also mistaken that the April 30, 2004 forward price curves for calendar year 2005 delivery anticipated drought conditions. In its testimony, staff demonstrated that there was a pronounced increase in forward prices in early 2005 for the months of May, June and July of 2005. In comparison, for nearly all of calendar

year 2004, the forward on-peak prices for delivery during May, June and July of 2005 were significantly lower than the prices for delivery during the remaining months of 2005. In early 2005, the forward on-peak prices for May, June and July converged on the higher price level associated with the other months. This increase indicates that electricity markets did not begin to anticipate poor hydro conditions for the months of May, June and July until early 2005. (Staff/300, Galbraith/13.)

To the extent that Idaho Power argues that “it is unlikely power marketers would have ignored autocorrelation * * * in determining the April 30, 2004 forward price curves[,]” the argument is not well taken. First, no evidence supports the conclusion that the April 30, 2004 forward price curves were influenced by autocorrelation, which is the assumption hydro conditions tend to remain below and above historical means for period of more than a year at a time. Idaho Power’s testimony that it is “unlikely” power marketers did not consider autocorrelation is not in and of itself sufficient to establish that autocorrelation impacted the April 30, 2004 forward price curves. Further, the marked increase in early 2005 for May, June and July prices contradicts the suggestion that the April 2004 forward price curves were affected by autocorrelation. If in fact this was the case, the marked increase in 2005 would not have occurred.

Finally, with respect to Idaho Power’s argument that staff’s methodology ignores the asymmetrical relationship hydro conditions; staff accepts the premise that there is such a relationship. However, no reliable modeling in this case captures that relationship. As discussed above, Idaho Power’s modeling is flawed and unreliable. Accordingly, staff’s methodology is superior to that of Idaho Power’s even though it may not fully capture the asymmetric relationship between hydro conditions and power prices.

D. Whether Idaho Power will recover extraordinary costs associated with extreme hydro conditions is not pertinent to the appropriate NVPC for normalized conditions.

Idaho Power's arguments that the NVPC levels proposed by staff and the intervenors would not allow it to recover its actual power expense or earn its authorized rate of return in expected drought conditions are misplaced in this general rate case.

(Idaho Power Opening Brief at 12-13). As CUB states in its opening brief:

General ratemaking is designed specifically to exclude outlying circumstances. By normalizing costs, the Commission can set rates on an on-going basis and the Company can do better or worse than that baseline depending on the circumstances. Extreme and outlier hydro conditions become part of the normalization process as though water years are included in the averages, but the current conditions should not be allowed to swallow the normalization process and drive rates. (Opening Brief of CUB at 4.)

Idaho Power appears to suggest that the Commission should depart from its traditional normalization process because the rates set in this case will only be in effect for a short period of time. Idaho Power's suggestion is without merit. First, the Commission has no guarantee the rates set in this docket will be short-term. Second, even if the Commission could be assured the rates would be effective for a short period of time, there would still be no justification for departing from the Commission's traditional normalization methodology. The Commission has already provided a remedy to utilities in circumstances such as that presented to Idaho Power. If Idaho Power is unable to recover its actual power costs due to extreme conditions, it may seek deferred accounting or a power cost adjustment mechanism. Idaho Power has in fact filed an application to defer costs associated with extreme hydro conditions in 2005.

E. Idaho Power's argument that staff's alternate recommendations undermine staff's primary recommendation is without merit.

Idaho Power asserts that staff's alternate recommendations highlight the flaws in staff's suggested methodology. Again, Idaho Power's argument is not well taken. To fulfill its obligation to the Commission, staff often provides the Commission with a range of potential resolutions. Idaho Power's assertion that the integrity of staff's primary recommendation is shaken because staff has identified feasible alternatives is fundamentally at odds with staff's role in this and all dockets.

In any event, to the extent the Company argues that staff's alternate recommendations support the Company's case because they decrease staff's recommended change to NVPC, Idaho Power is mistaken. The impact of staff's offered alternatives do not prove anything. Or, if anything, the fact that staff's alternatives still do not obtain a NVPC that is close to Idaho Power's proposal supports the conclusion that Idaho Power's proposed NVPC is overstated.

The fact that staff's alternatives are not probative of the reasonableness of its primary recommendation is especially true with respect to staff's alternate recommendation pricing Idaho Power's sales using the Company's April 30, 2004 off-peak forward prices and its purchases using the Company's April 30, 2004 on-peak forward prices. The fact that staff's primary recommendation does not include such a distinction is due to the fact that Idaho Power declined to provide information that would substantiate Idaho Power's claim that it would sell surplus power in the off-peak hours and would purchase power during the on-peak hours. (*See* Staff/300, Galbraith; Staff/404; Idaho Power's Response to Staff Data Request No. 244.) Put more plainly, staff did not recommend pricing Idaho Power's wholesale sales of surplus generation at

off-peak prices because Idaho Power did not provide information establishing that it in fact would sell surplus generation at off-peak prices.

A similar point can be made with respect to staff's alternate recommendation that would normalize Idaho Power's test period NVPC by replacing Idaho Power's natural gas inputs with more reasonable inputs developed by staff. As stated in staff's testimony and opening brief, staff believes that any output of the AURORA model is unreliable, even when adjusted with more reasonable natural gas prices. Accordingly, the fact that staff's alternate recommendation based on adjusted AURORA results is more favorable to the Company is not probative of whether staff's primary recommendation, which does not rely on flawed AURORA results, is reasonable.

Finally, Idaho Power believes that staff's alternate recommendation to use an average of the forward-price curves from January 2, 2004 to April 30, 2004 should be used because it results in an NVPC that is more favorable to Idaho Power, it does not explain why such an average in fact provides a superior methodology. Staff does not believe that it does. In general, today's forward price curve is more fresh (more up to date) than yesterday's. Today's curve reflects new information about the future price of electricity that yesterday's curve did not. Since the current curve reflects up-to-date information, it would not make sense to average today's fresh curve with stale curves from the past to predict the future price of electricity. The same is true with respect to the April 30, 2004 forward price curves. Averaging the January 2, 2004 to April 30, 2004 curves would in fact be redundant, because the April 30th curve reflects all the information reflected in the earlier curves.

As stated in its testimony, staff selected the forward price curves from April 30, 2004, because that price curve is consistent with the period the Company used to make adjustments for known ratebase additions in this case. Staff did not choose to use an average of forward price curves because staff believes that, for the reasons stated above, using price curves from a single day is superior for purposes of the adjustments proposed to Idaho Power's NVPC in this case.

Idaho Power offers no evidence or argument against staff's conclusion that using price curves from a single day is superior to using an average of price curves from multiple days for purposes of staff's proposed adjustments to Idaho Power's NVPC, other than to point out that using an average would be more favorable to the Company. This fact, in and of itself, is not sufficient to show that staff's proposed use of forward price curves from a single day is flawed.

F. Danskin plant.

The Industrial Customers argue that Idaho Power's Danskin plant should not be included in Oregon rates because it is not used and useful. Staff disagrees. In its 2000 Integrated Resource Plan (IRP), Idaho Power identified Danskin as one of the tools it would use to meet summer and winter peaking requirements for retail customers. Staff believes that the Danskin plant appropriately performs the role for which it was built and is used and useful. Further, Danskin provides benefits to Oregon customers by providing reliability in times of system emergencies and as an option to market purchases when market prices are high.

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G. Recommendations.

Staff recommends that the Commission adopt the Stipulation entered into by Idaho Power, staff, CUB, and the Industrial Customers resolving most revenue requirement issues presented in this docket. In that Stipulation, the parties agreed that the appropriate revenue requirement for Idaho power, excluding NVPC, is \$3,048,000, which would equal a 12.09 percent increase.

Second, staff recommends that the Commission adopt staff's proposed adjustments to Idaho Power's NVPC. Idaho Power proposes a normalized NVPC of \$47.7 million. Staff recommends an overall downward adjustment to NVPC of \$63.0 million, which results in a normalized NVPC at -\$15.3 million (\$3.1 million on an Oregon allocated basis. This downward adjustment to NVPC would reduce Idaho Power's revenue requirement by \$69,000, or negative 0.27 percent.

Third, staff recommends that the Commission include the Danskin plant in Idaho Power's rate base.

Fourth, staff recommends that the Commission adopt Idaho Power's proposal for time-of-use rates for industrial customers.

Fifth, staff recommends that the Commission reject Idaho Power's proposal for seasonal rates for residential customers.

Sixth, staff recommends that the Commission decline to direct Idaho Power to take any particular action with respect to distributed generation, and instead, acknowledge its (the Commission's) support for distributed generation programs.

Seventh, staff recommends that the Commission decline to direct Idaho Power to take any particular action with respect to its power supply quality.

Finally, as stated in its testimony, staff recommends that the Commission require Idaho Power to provide projected results of system operations on an hourly basis in their next rate filing. (Staff/200, Galbraith/5.) Idaho Power dispatches its system on a continuous real-time basis. The Company makes hourly purchases and sales in order to balance system supply and demand. Hourly NVPC results are a prerequisite for determining whether modeled results reflect actual system operations. (Staff/200, Galbraith/5.)

DATED this 27th day of June 2005.

Respectfully submitted,

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Attorney General

s/Stephanie S. Andrus
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Of Attorneys for Staff of the
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