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May 8, 2008

Tracy Kirkpatrick
Administrative Law Judge
Public Utility Commission of Oregon
550 Capitol St NE – Suite 215
PO Box 2148
Salem OR 97308-2148

Re: UM 1360 – Submissions from the Oregon Independent Evaluators

Dear Judge Kirkpatrick:

Enclosed with this letter is a memorandum to staff on indexing of bids that staff is submitting in PUC Docket UM 1360 on behalf of the Oregon Independent Evaluators (Boston Pacific Company). The subject of Boston Pacific Company's memorandum is "Additional Comments on Indexing of Bids." This is a public document that contains no confidential or highly-confidential information. Please note that I am serving this document on the other UM 1360 parties via electronic mail only.

Sincerely,

Mike

Michael T. Weirich
Assistant Attorney General
Regulated Utility & Business Section

MTW:nal/GENX7961
Enclosure
C: All parties w/enc. via electronic mail only

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MEMORANDUM

May 8, 2008

TO: Lisa Schwartz
Oregon PUC

FROM: Craig Roach
Frank Mossburg

SUBJECT: Additional Comments on Indexing of Bids

The purpose of this memo is for the Oregon Independent Evaluator (IE) to provide additional commentary and recommendations on the proposed indexing requirements in PacifiCorp's current All Source RFP (the RFP). The conclusion is that the current indexing proposal is satisfactory so long as creative alternate proposals are considered and the risks of indexed prices and any proposed mitigation measures are appropriately evaluated. Specifically, (a) the maximum percent of capital costs indexed should remain at 40%, as was the case in the 2012 Base Load RFP, (b) all alternate indices proposed by bidders should be considered and evaluated, so long as they are transparent, easily forecastable, and independent, (c) indexed bids should be adjusted in the evaluation process to account for their inherent risky nature and (d) PacifiCorp should consider any creative risk mitigation measures, such as caps or bands on price, that a bidder may offer and include those measures in the bid evaluation process.

BACKGROUND

The RFP contains indexing options for multiple cost components, including energy price, operating and maintenance (O&M) costs, and capital costs. In general, bidders may fix these components on day one, or they may increase these components over time by a designated amount (e.g. 4% per year) or by tying them to certain public indices (e.g. the Consumer Price Index (CPI) for O&M costs, a specified gas index (e.g. Henry Hub) for energy costs (for gas-fired plants)). The latter method carries with it a certain degree of risk, since we do not know for sure what those indices will equal in the future.

For this memo, we will focus exclusively on the indexing options for capital costs for new facilities. We focus on these because capital costs are a large component of costs and because the indexing of capital costs during the construction period is a relatively new phenomenon.

In the past, bids to construct new generation were made based on a fixed-price basis; bidders were able to obtain firm quotes from suppliers and price out a bid based on those quotes. The current market environment, featuring high demand for commodities, labor, and equipment and long lead times, makes it difficult for a bidder to obtain fixed-price estimates from suppliers. To counter this, in its 2012 Base Load RFP, PacifiCorp offered bidders the opportunity to index up to 40% of the capital costs of new facilities up until the earlier of the signing of an Engineering Procurement and Construction (EPC) contract or financial close. Of that 40%, up to 25% could be indexed to the CPI and up to 15% to the Producer Price Index –Metals (PPI-metals). The Company is offering the same option in the current RFP.

Our original concern, voiced in the IE's initial report on RFP design (the Report), was that the indexing requirements were perhaps too restrictive given the current market environment and could be preventing bidders from offering supply into the RFP. We requested comment from bidders on the percentage of costs indexed and the use of alternative indices. One potential bidder, LS Power, did respond and proposed that up to 100% of capital costs be indexed and that bidders be allowed to use a "number of indices."

IE'S RECOMMENDATIONS

Because input from bidders has been scarce we feel that it would be appropriate to submit a more detailed discussion of indexing options. Given that we agree on the need for some indexing, we feel that there are three key questions that must be addressed; (a) What indices should be used? (b) What percentage of costs should be indexed? and (c) How should the risk of indexed bids be evaluated?

Indices to be Used

When deciding what indices to allow bidders to use there are two major routes the RFP can take. One route is to prescribe the indices that bidders can use *before the fact*. The second method is to invite bidders to use their own indices. Each method has benefits and drawbacks. The first method is more transparent, all bidders know exactly what indices will be used and what values will be forecasted. The second method allows for more creative proposals by bidders.

The RFP currently allows for the use of two indices, the CPI and the PPI-metals. Bidders may submit an alternate proposal which "may include a different index option" but the indices proposed must be "transparent and easily measurable." In our Report we mentioned other potential indices that might be of use to bidders such as the Bureau of Labor and Statistics Other Heavy Construction Index.

Interveners did not have an express preference for another index. However, given the rising cost environment, we feel that it would not be worthwhile to limit bidders to only the current two indices. The current environment demands creative solutions to the problems of rising cost and we believe that it could be potentially beneficial to allow bidders to submit creative proposals for managing this problem.

Four additional points must be made. First, as mentioned in the RFP, the indices proposed must be transparent and easily measurable, with reasonable forecasts readily available. Second, the indices proposed should be independent, in other words, bidders should not have control over the outcome of the index. Third, it should be clear that a bid using an index is still a binding bid. If a bidder's actual costs rise faster than the indices they will not be reimbursed for those costs above and beyond the indices. Fourth, for each index used, PacifiCorp should make it clear to bidders the forecast it is using as well as the volatility it assumes to derive the risk-adjusted value (discussed below). For the CPI and PPI-metals these values should be distributed to bidders prior to the submission of bids.

Percentage of Costs to be Indexed

The next issue to address is the percentage of capital costs to be indexed. As noted, bidders may currently index up to 40% of their capital costs. Traditionally, we prefer bids that are entirely fixed price. The reason for this is that the risk of changing prices is shifted from the consumer to the producer, who is in a much better position to do something about it. As noted above, current market conditions make it extremely difficult for bidders to obtain a complete set of fixed-price commitments prior to project approval.

In setting the percentage to be indexed there are two key effects that we must consider. The first effect is a "competitive" effect, in other words, the extent to which a more fixed bid requirement will prevent bidders from offering into the RFP. The second effect is a "price" effect. This refers to the fact that more "fixed" bids will, by necessity, incorporate some assumptions about cost increases into their price. In order to avoid losing money, bidders may factor in fairly large predicted cost increases into their final offer price. This extra cost would essentially serve as a risk premium paid by ratepayers in exchange for price stability.

The proper choice then is very much dependent on the views of regulators and the risk they are willing to subject ratepayers to. On the one hand, allowing more indexing puts more risk on ratepayers, but allows for the potential reward of lower costs and more bidders. One the other hand, a more fixed price bid will lower ratepayer risk at the expense of a risk premium and potentially decrease the pool of eligible bidders.

In terms of the competitive effect, the 2012 RFP, which featured 40% indexing, had adequate competition. Furthermore, we have not received word that any bidder would definitely *not* offer into the RFP under the current indexing proposal. In terms of the price effect, it is our understanding, based on conversations with Staff, that the Commission would likely prefer bidders to shoulder more risk, even if it results in a higher risk premium being paid. Furthermore, the competitive process itself will act as a check on excessive risk premiums, as bidders who place too high a risk premium in their bid risk not being selected in the RFP.

Since there is no direct evidence that the current percentage indexed would prevent bidders from participating, and since the Commission would prefer to see bidders bear more risk than ratepayers, we believe that it is best to keep the percentage indexed unchanged from the 2012 RFP's level of 40%.

Evaluating the Risks of Indexed Bids

Our final question is, how do we evaluate the risks of indexed bids? The goal of this exercise is to recognize the risk inherent in an indexed bid and assign credit to bidders who take that risk off of ratepayers by fixing their bids. All things being equal, a bidder with a lower risk profile (e.g. with a fixed bid) should be preferable to one with a higher risk profile.

To be consistent with our previous suggestions and with PacifiCorp's own methods, we would recommend that indexed bids for capital costs be evaluated using the same "risk-adjusted cost" that PacifiCorp uses in their bid evaluation. To be clear, this means that each bid using indexing will be increased in cost by the mean of the projected escalation *plus* the 95th percentile projection times the probability of occurrence (i.e. 5%). This method is the same method we suggested (as detailed in Staff's reply comments) for evaluating the risk of PacifiCorp's benchmark proposals.

As an example, say that the CPI was projected to escalate at 5% over the escalation period. Based on this current projection, and the past volatility of the index, we project with 95% confidence that the CPI will not escalate higher than 10% over the escalation period. The risk adjusted escalator would be 5% plus 0.05 times 10% or 5.5%. This escalator would then be applied to up to 25% of the capital cost of the bid. The same exercise would be done for the PPI-metals as well, except the index would be applied only up to 15% of the bid. Note that, in the case of the Company benchmark proposals we recommend indexing 100% of the costs, as those bids are not fixed in any way. By increasing bid costs in this manner, both via the index and the risk-adjustment for that index, we hope to encourage bidders to offer lower-risk fixed bids.

To be clear, bidders should not be discouraged from any other innovative risk management approaches. For example, if bidders wish to put a “cap” on capital costs, they should feel free to do so, and any evaluation should take such proposed risk mitigation measures into account. This holds true, not just for capital costs, but for any other costs as well. If bidders wish to mitigate their energy price (e.g. not letting the price go above a certain level) then that mitigation should be factored into the bid evaluation.

CERTIFICATE OF SERVICE

I certify that on May 8, 2008, I served the foregoing upon all parties of record in this proceeding by delivering a copy by electronic mail to:

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