BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1909

In the Matter of the Application of: PUBLIC UTILITY COMMISSION OF OREGON Investigation of the Scope of the Commission's Authority to Defer Capital Costs	JOINT OPENING BRIEF OF THE OREGON CITIZENS' UTILITY BOARD, THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES, AND NORTHWEST INDUSTRIAL GAS USERS

I. INTRODUCTION

The Public Utility Commission of Oregon ("Commission") initiated this proceeding to investigate the scope of its authority to defer capital costs for later inclusion in rates. As described more fully below, the Oregon Citizens' Utility Board, the Industrial Customers of Northwest Utilities, and Northwest Industrial Gas Users (collectively "Joint Intervenors") agree with Commission Staff that the Commission does not have the authority under ORS 757.259(2)(e) to defer the revenue requirement necessary to recover a return on capital investment, because return on investment is not a "revenue" or "expense" under the statute. If, however, the Commission finds that it does have the legal authority to authorize deferrals of the return on capital investments, the Joint Intervenors join Staff in recommending that the Commission adopt a policy against such deferrals for the reasons provided in Staff's brief as well as those discussed below. With respect to the return of capital investments, for which the Commission may have authority to allow deferrals, Joint Intervenors request that the Commission, as a matter of policy, not allow those amounts to be deferred, because those amount are more appropriately recovered through the traditional ratemaking process.

II. BACKGROUND

On July 29, 2016, Portland General Electric Company ("PGE") filed an application in docket UM 1791 to defer for later rate-making treatment the incremental revenue requirement associated with the Carty Generating Station beyond what was approved in PGE's 2016 general rate case, UE 294. According to PGE, it incurred significant cost overruns associated with "extraordinary events" that occurred after its rates were set. The revenue requirement for which PGE seeks a deferral consists of depreciation expense for a return of its investment, a return on the associated capital investments, utility income taxes, and increases in revenue sensitive costs.

After questioning whether PGE's request was lawful under ORS 757.259(2)(e) and determining that the Commission's authority to defer capital costs is an issue that will affect all Oregon utilities, Staff requested that the Commission open a generic docket to investigate the issue and to establish a formal policy going forward. On November 21, 2017 the Commission approved Staff's "request to open a docket to investigate the scope of the Commission's authority to defer capital costs for later inclusion in rates." As noted by Staff, the Commissioners clarified that the investigation should go beyond mere legal authority analysis to include a discussion of policy considerations surrounding deferring the return of and the return on capital investment.[1]

The scope of this brief matches the intended scope of the docket contemplated by the Commissioners at the November 21, 2017 public meeting. That is to say that it will include both legal arguments regarding the Commission's authority to defer capital costs, as well as policy rationale for why the Commission should adopt a general policy against deferral of capital investments.

[1] UM 1909 – Staff's Opening Brief at 1, citing November 21, 2017 public meeting at 51:45, accessed at http://oregonpuc.granicus.com/MediaPlayer.php?view_id=1&clip_id=252.

III. ARGUMENT

A. The Commission Does Not Have The Legal Authority To Defer The Return On A Utility's Capital Investments For Later Inclusion In Rates.

In 1987, the Legislature enacted ORS 757.259 to provide the Commission with authority to grant certain types of deferrals. Among other things, subsection (2)(e) of the statute provides the Commission with the limited authority to authorize the deferral of "identifiable utility expenses or revenues, the recovery or refund of which the commission finds should be deferred in order to minimize the frequency of rate changes or the fluctuation of rate levels or to match appropriately the costs borne by and the benefits received by ratepayers."[2] Staff's brief includes a thorough analysis of the language and legislative history of this statute, which the Joint Intervenors will not repeat. This analysis demonstrates that "expenses or revenues" does not include, and was not intended to include, a return on capital investment, which is a different component of the revenue requirement calculation, R=E+(V-D)r.[3]

As explained in Staff's brief, the Commission's authority to defer revenue requirement associated with capital investments, which includes a return on capital investment, turns on whether the revenue requirement is considered a "revenue" or an "expense" under the statute. Courts apply a two-step process when determining the legislature's intended meaning for statutory terms.[4] First, the court examines the statute's text and context.[5] The court may also consider any pertinent legislative history, if useful to its analysis.[6] Finally, if the legislature's

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[2] ORS 757.259(2)(e) (emphasis added).

[3] Where "R" is the revenue requirement; "E" is the utility's operating expenses; "V" is the gross value of the utility's property; "D" is the accumulated depreciation of utility property; and "r" is the utility's authorized rate of return. Expenses and revenues, as discussed in ORS 757.259(2)(e), are included in "E". Capital investments are included in "V".

[4] *Blachana, LLC v. Bureau of Labor and Industries,* 354 Or 676, 687-688 (2014) (referring to *State v. Gaines,* 346 Or 160 (2009)).

[5] *State v. Gaines,* 346 Or 160, 171 (2009).

[6] *Id.* at 177.

intent remains unclear, the court will resort to general maxims of statutory construction.[7] "Whether any possible meaning comes within the intended meaning depends upon the policy which the word or phrase is intended to convey."[8]

Staff's brief persuasively argues that a return on capital investment is not authorized by either the plain language or legislative history of the statute, because it is not an "expense or revenue."[9] The Joint Intervenors add that, as a consequence, it is irrelevant whether deferral of a "return on" would violate the rule against retroactive ratemaking. That is because "[i]t is a fundamental principle of administrative law that an administrative body possesses only those powers that the legislature grants, and that it cannot exercise authority that it does not possess."[10] In other words, rate setting is a legislative function, which the legislature has delegated to the Commission and, therefore, the Commission cannot set rates in a manner the legislature prohibits.[11] While, consistent with its legislative mandate, the Commission undoubtedly has broad discretion to set rates generally, the legislature has circumscribed this discretion in the context of deferrals by establishing explicit statutory criteria for granting a deferral. "The inclusion of specific matters in a statute implies a legislative intent to exclude related matters not mentioned."[12] By limiting the items eligible for deferral to "expenses or revenues," the legislature necessarily excluded a return on capital investments. Consequently, even if the Commission would otherwise have authority to defer a return on capital investment under its general ratemaking powers, the legislature has removed that authority through ORS 757.259.

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[7] *Id.* at 171.
[8] *Springfield Educ. Ass 'n v. Springfield School Dist. No. 19,* 290 Or 217, 225 (1980).
[9] Staff Brief at 2-8.
[10] *Coquille School Dist. 8 v. Castillo*, 212 Or. App. 596, 607 (2007).
[11] *Gearhart v. Commission*, 255 Or. App. 58, 61 (2013).
[12] *Roseburg Forest Products v. Wilson*, 110 Or. App. 72, 76 (1991); *Gantenbein v. Public Employees Retirement Bd.*, 33 Or. App. 309, 319 (1978).

B. The Commission Should Adopt A General Policy Against Deferral Of Capital Investment.

The Commission has determined that deferred accounting is a "discrete and exceptional ratemaking process,"[13] that "deferrals should be used sparingly[,]"[14] and has further referred to the use of deferrals as "extraordinary" on several occasions.[15] In exercising its discretion to utilize deferred accounting, the Commission considers two interrelated factors: the type of event that caused the deferral; and the magnitude of the event's effect.[16] The Commission "will consider whether there are other, more appropriate regulatory tools to address recovery of identified costs or revenues."[17] This includes considering whether a general rate proceeding would be more appropriate.[18]

The Commission also has limited application of the deferral statute "to the recovery of discrete expenses that might affect a utility's earnings on a short-term basis,"[19] and has held that the "statute cannot be used to authorize the deferral of general expenditures that a utility incurs in an ongoing and continuous manner."[20] Capital investments are just that—general expenditures that a utility incurs in an ongoing and continuous manner. Allowing deferral of depreciation of a capital investment (i.e. return *of*) and a rate of return *on* that investment does not comport with

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[13] *In re Oregon Public Utility Commission*, OPUC Docket No. 1147, Order No. 06-507 at 4 18 (Sept. 6, 2006) ("Deferred accounting is a discrete and exceptional ratemaking process...").

[14] OPUC Order No. 05-1070 at 10.

[15] *See, e.g., in re Northwest Natural Gas Company*, OPUC Docket Nos. UM 1635 and UM 1706, Order No. 15-049 at 14 (Feb. 20, 2015) ("In exercising this discretion, we use a flexible, fact-specific approach that acknowledges the wide range of circumstances underlying a deferral and the decisions made to authorize this extraordinary rate treatment."); *see also in re Portland General Electric Company*, OPUC Docket No. UM 1234, Order No. 07-227 at 7 (June 8, 2007) ("We limited the deferral, however, to extraordinary outage costs only—*i.e.*, those costs deemed beyond the level of costs expected to be within the measure of normal risk."); *see also in re Portland General Electric Company*, OPUC Docket No. UE 324, Order No. 17-482 (Nov. 28, 2017) (Referencing the "general ratemaking principle that a utility is responsible for operating within a fixed level of rates, and should only be allowed to recover amounts through deferred accounting in extraordinary circumstances.").

[16] *In re Public Utility Commission of Oregon,* OPUC Docket No. UM 1147, Order No. 05-1070 at 3 (Oct. 5, 2005).

[17] *Id.* at 10.

[18] *Id.*

[19] *In re Portland General Electric*, OPUC Docket No. UE 115, Order No. 01-988 at 8 (Nov. 20, 2001).

[20] OPUC Order No. 01-988 at 8.

this definition. As explained more fully below, to allow these costs to be eligible for deferred accounting would fly in the face of past Commission precedent, and would erode the policies and practices for implementing deferrals in the first place.

Accordingly, if the Commission finds that utilities may lawfully defer capital investments (either a return of, a return on, or both), then the Commission should nevertheless adopt a policy that generally prohibits such deferrals on policy grounds.

i. Enabling Deferral of Capital Costs Fundamentally Alters the Regulatory Lag Risk Profile and Creates an Incentive to Over-Utilize this Extraordinary Ratemaking Mechanism.

The return of a capital investment is recovered as a depreciation expense in a rate case proceeding. Pursuant to ORS 757.140, depreciation expense increases the revenue requirement and represents the portion of the cost of a utility's capital investment that is allocated over its useful life.

Depreciation expense is traditionally recovered in a rate case without a deferral. Further, a utility can time general rate cases such that capital investment can be included when setting base rates. A utility can substantially recover capital investments over the remaining life of the asset as a depreciation expense when it files its rate case, even if such amounts are not included in rates from the outset or subject to deferred accounting. Although the depreciation expense may only be recovered for the remainder of the capital asset's useful life, the entire capital investment is not lost without a deferral. Utilities have an incentive to manage costs and time capital investments and general rate cases to minimize losses through depreciation. The fact that utilities control the timing of capital investments, and can recover substantial amounts of capital investments without deferred accounting, differentiates return of utility capital investments from other categories of deferred expenses and revenues.

Capital costs incurred by a utility are traditionally brought forth in a general rate case proceeding and are subject to regulatory lag. The Commission has defined regulatory lag as "'the delay between rate cases and within a rate proceeding where rates remain frozen until a new rate is approved.'"[21] There, the Commission noted that "utilities typically bear the risk of increased costs between rate cases."[22] Due to this risk, regulatory lag provides an incentive for utilities to plan and manage costs between rate cases. A utility's Commission-approved return on equity ("ROE") is the mechanism that traditionally compensates the utility for this risk. Natural delays in recouping capital investment are absorbed by the utility's authorized earnings.

If a utility is permitted to file a deferral every time a capital investment becomes used and useful—but before its next general rate case—regulatory lag is effectively eliminated, while the utility retains the benefit of an authorized ROE intended to compensate for that impact. In that instance, all of the risk associated with regulatory lag is shifted to customers on the back end of the capital investment's depreciation curve, while all of the benefit is shifted to the utility on the front end. The utilities would improperly benefit from dollar-for-dollar recovery of capital investments, but customers would be forced to continue to pay the price set during a prior rate case for a capital investment that is continuously depreciating. An illustrative example provides insight into the inequity.

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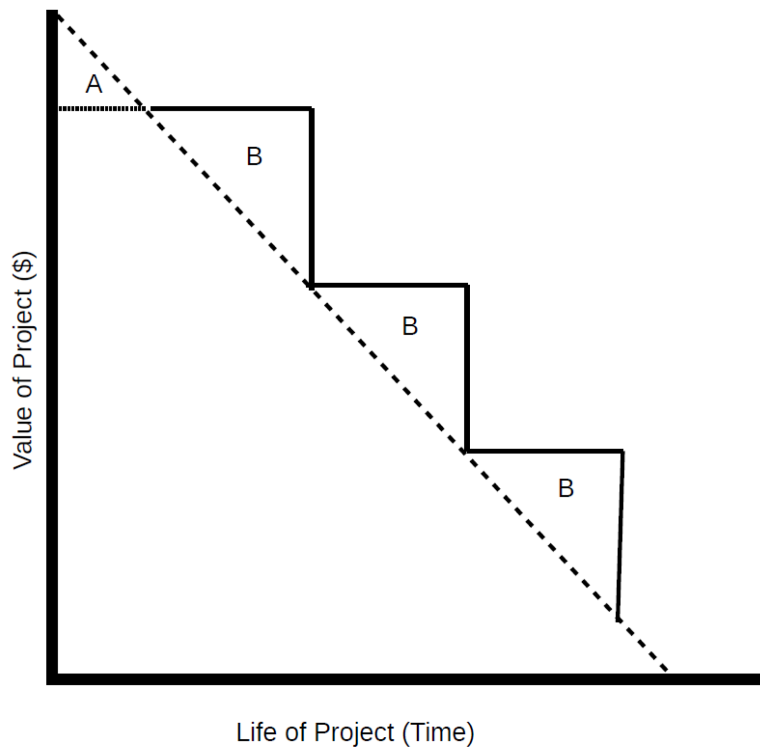
[21] *In re PacifiCorp, dba Pacific Power Request for a General Rate Revision*, OPUC Docket No. UE 246, Order No. 12-493 at 15 (Dec. 20, 2012), citing Leonard Saul Goodman, *The Process of Ratemaking* (Vol. I), 44 (Pub. Util. Rpts., Inc. 1998).

[22] OPUC Order No. 12-493 at 17.



[23]

This figure indicates how a utility recovers the value of a capital investment. In this hypothetical example, the solid line indicates how much the utility recovers in rates. The diagonal dashed line represents the revenue requirement associated with a capital investment. It is important to recognize that utility investments are not recovered in a manner similar to a home mortgage, where the monthly payment is the same throughout the life of the mortgage. Instead, utility investment recovery declines each month as more plant is depreciated and the return on the undepreciated investment shrinks. This means that a rate case will establish a new revenue requirement for a capital investment, but does not capture the decline in the revenue requirement associated with that investment between rate cases. Therefore, while Triangle A is the regulatory lag traditionally borne by the utility, Triangle B is the regulatory lag borne by customers. The points where the solid line intersects with the dashed line indicate the timing of a general rate

[23] This figure assumes a $500 million capital investment depreciated on a straight line over a 40 year useful life. It uses a 50/50 capital structure, 9.5% ROE plus 21% tax reform upgrade, and a 5.5% cost of debt.

case. Because utilities control the timing of rate case filings, a utility already has the ability to file a rate case soon after a major capital investment, while staying out during periods of non-investment to avoid capturing a decline in revenue requirement associated with depreciation of prior investments.

The practical effect of enabling a utility to defer capital investments runs counter to Commission precedent recognizing deferrals as exceptional ratemaking tools used in limited, discrete circumstances. If a utility files a deferral each time a capital investment becomes used and useful in order to eliminate regulatory lag, why, then, would customer groups not also file deferrals to capture the depreciation in each of the following years? If one side of the coin is permissible, plain reason dictates that the other side should be too. This will result in a deluge of deferrals that will be administratively burdensome to all parties and would fundamentally alter the ratemaking process. As discussed above, the Commission can use its discretionary power to decide whether to grant a deferral application. Within that discretion, it considers "whether there are other, more appropriate regulatory tools to address recovery of the identified costs or revenues."[24] Here, such tools exist. The utility should bring the capital costs forward for prudence review in a general rate case subject to regulatory lag, as is tradition.

ii. Additional Policy Considerations Dictate that the Commission Should Decline to Exercise Its Discretion to Allow the Deferral of Capital Investments.

Aside from the inequity and perverse policy incentives that would result, additional policy considerations weigh against a Commission determination enabling utilities to defer capital investments. Although there may have been instances where the Commission has approved deferrals for capital investments in the past, it has been on individual occasions to

[24] OPUC Order No. 05-1070 at 10, *supra*, note 15.

facilitate a desired regulatory outcome, and not part of a broader overall policy.[25] Given the fact that there are more appropriate regulatory tools to address the recovery of capital investments, the Commission should adopt a general policy against deferring these costs.

First, the Commission's current policy for ratemaking treatment for deferred amounts is that such amounts earn interest at the utility's regulated rate of return unless and until the Commission approves the amortization of deferred amounts into rates.[26] Once amounts are approved for amortization, the utility earns interest at the blended treasury rate.[27] Pursuant to this policy, if a deferral is allowed for depreciation expense associated with a capital investment between rate cases (which provides for a return of the utility's investment) the utility will earn its authorized rate of return on the deferred amount (a return on the investment) until such time the amount is amortized for inclusion in rates. This single issue ratemaking has all upside for a utility to the detriment of ratepayers, and reduces the utility's incentive to operate efficiently to manage costs between rate cases.[28] Even worse, if a utility is permitted to defer the revenue requirement associated with a capital investment between rate cases (which revenue requirement already includes a return on the capital investment) it will earn its authorized rate of return on amounts that already reflect that authorized rate of return until such time the amount is amortized for inclusion in rates. This approach is untenable, allowing the utility, without filing a rate case, to substantially bolster the return on an investment, and fails to meet the fair, just and reasonable standard this Commission applies.

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[25] UM 1909 – Staff' Opening Brief at 11.

[26] *In re Public Utility Commission of Oregon,* OPUC Docket No. UM 1147, Order No. 05-1070 at 14 (Oct. 5, 2005).

[27] *In re Public Utility Commission of Oregon,* OPUC Docket No. UM 1147, Order No. 08-263 at 15-16 (May 22, 2008).

[28] *See* Order No. 17-482, *supra*, note 6.

Second, a determination to disallow deferrals for capital investments would fit within the Commission's current policy regarding its exercise of discretion.[29] The Commission currently evaluates deferrals based on two interrelated factors—the type of event giving rise to the deferral and the magnitude of the event's effect.[30] As previously noted, within its discretion, the Commission considers whether there are other, more appropriate regulatory tools for cost recovery, such as general rate cases.[31] Allowing deferrals for all capital expenditures would tip the scale in the utility's favor in an inequitable manner. If their cost recovery risk were to be mitigated like this, the utilities' ROE should be reduced accordingly. The Commission should not allow deferral of capital costs.

Finally, allowing deferral of utility capital investment—rather than bringing the costs in a general rate case—would shift the risk of load forecasting onto customers in an inequitable manner. In a general rate case, rates, including capital investments, are forecasted into a test year using forecasted load. This forecasted load is weather normalized, and does not take into account weather-related (or other) variations that affect a utility's retail sales. As such, the risk of actual retail sales being either above or below the forecasted load is absorbed by the utility. If the utility sells less than forecasted, it under recovers its costs. If the utility sells more than forecasted due to extreme weather, it over recovers its costs. But deferred accounting removes this risk. If mild weather reduces sales and less of the deferral is recovered than forecasted, the remainder is rolled into the following year. The utility keeps amortizing the deferral, until each dollar is recovered, regardless of load forecasts. If deferred accounting is allowed for capital investments, utilities will have a significant incentive to utilize it, because the utility assumes less risk under deferred accounting than traditional ratemaking.

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[29] UM 1909 – Staff's Opening Brief at 12.
[30] UM 1909 – Staff's Opening Brief at 12, citing OPUC Order No. 05-1070 at 3.
[31] OPUC Order No. 05-1070 at 10, *supra*, note 15.

Similar to the regulatory lag risk borne by the utility and the depreciation risk borne by customers, the inherent risks of load forecasting are built into traditional ratemaking models. To allow a utility to defer capital investments mitigates that risk. A utility's ROE is the mechanism that compensates for risk, and enables it to withstand these fluctuations. Once again, if a utility's risk is mitigated through deferred accounting of capital investments, then its ROE should be reduced accordingly. Allowing a utility to defer capital investments is counter to traditional ratemaking principles. The Commission should adopt a broad policy against deferring capital investment.

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IV. CONCLUSION

For the foregoing reasons, the Joint Intervenors respectfully request that the Commission determine that ORS 757.259(2)(e) does not permit the deferral of revenue requirement associated with return on capital investment. If, however, the Commission finds that it does have the legal authority to defer capital investments, the Commission should nevertheless adopt a general policy against such deferrals because deferrals in general should be used sparingly and capital investments are properly recovered through general rate cases, the timing of which is completely in control of the utilities.

Dated this 16th day of March 2018.

Respectfully submitted,

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