BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1276

In the Matter of THE PUBLIC UTILITY COMMISSION OF OREGON An investigation regarding performance-based ratemaking mechanisms to address potential build-vs.-buy bias.	ORDER

DISPOSITION: DOCKET CLOSED; DOCKET UM 1182 REOPENED

I. INTRODUCTION

We opened this docket in August 2006 to address the bias inherent in the utility resource procurement process that favors utility ownership of generation assets over Power Purchase Agreements (PPAs) with third parties. We took this action as part of a series of major policy investigations to address resource planning and acquisition.[1]

In its report that initiated this proceeding, the Commission Staff identified four factors that it believes may contribute to the perceived bias. These include: (1) utility concerns over the treatment of PPAs in credit scores; (2) counterparty risk associated with PPAs; (3) utilities' inability to earn any return on equity from PPAs, and (4) utility "empire building" aspirations.[2]

All three regulated electric utilities—PacifiCorp, dba Pacific Power (Pacific Power), Portland General Electric Company (PGE), and Idaho Power Company (Idaho Power) intervened in the proceeding, as well as the Industrial Customers of Northwest Utilities (ICNU), the Citizens' Utility Board of Oregon (CUB), Northwest and Intermountain Power Producers Coalition (NIPPC), the Northwest Energy Coalition (NWEC) and the Renewable Northwest Project (RNP). Through an extended collaborative process, parties

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[1] Prior proceedings include Docket UM 1182, in which we updated guidelines for competitive bidding; Docket UM 1056, in which we updated guidelines for integrated resource planning; and Docket UM 1066, in which we considered the rate treatment of new generation (market price or cost of service).
[2] Staff Report for August 22, 2006 Public Meeting at 1.

held numerous workshops and meetings to discuss possible mechanisms to address the perceived bias.

II. DISCUSSION

Most of the parties in this proceeding accept the premise that a bias exists in the utility resource procurement process that favors utility owned resources over PPAs. While the magnitude of the bias is difficult, if not impossible, to quantify parties identified two primary sources for the bias. First, owned resources offer a utility an opportunity to earn a return, while PPAs do not. If a utility is faced with the choice of building a generating plant or entering into a PPA—and there is no difference in cost between the two options—the utility will likely choose to build the plant because of the opportunity to earn a return on its investment. Second, rating agencies may consider PPAs as long-term commitments that have debt-like obligations. As a result, the rating agencies may impute debt equivalency amounts to a utility's balance sheet, which could negatively impact the credit ratios of a company.

To mitigate this bias, parties have filed numerous proposals for our consideration. Following a Commission workshop, we directed the parties to confer and refine two proposals: (1) Pacific Power's Conservation Incentive Mechanism for Purchased Power (CIM/pp); and (2) NIPPC's risk avoidance discount for PPAs in competitive solicitations. This led to the filing of new proposals and counter-proposals, including an incentive proposal by Staff that was offered as a compromise between Pacific Power's and NIPPC's proposals.

At the end of this proceeding, we are left with two primary proposals: (1) the CIM/pp; and (2) Staff's incentive proposal. We address each proposal separately, followed by the parties' comments. We then provide our decision.

A. Pacific Power's CIM/pp

The CIM/pp is based on this Commission's prior decision to allow the utilities to capitalize Demand Side Management (DSM) expenditures to eliminate the utilities' disincentive to invest in conservation. Pacific Power explains that the CIM/pp is designed to allow the utility the ability to earn a return on a PPA similar to how a utility would earn a return on a utility-owned resource.

In basic terms, the CIM/pp proposes to allow utilities to capitalize the net present value of the capacity costs of PPAs—subject to certain caps—calculated using the utility's cost of debt. The utility would then amortize this capitalized amount over the life of the PPA, with a return based on the utility's authorized rate of return, calculated on a pre-tax basis. During the course of the proceeding, Pacific Power revised the proposal to address concerns raised by other parties, such as limiting the mechanism to only new contracts with a minimum duration of three years and 25 megawatt (MW) in size.

B. Staff's Incentive Proposal

Staff's incentive proposal contains elements of the CIM/pp and NIPPC's proposal and would have given PPAs a risk avoidance discount in competitive solicitations. Staff's proposal provides utilities with a 10 percent pre-tax adder on the forecasted costs of qualifying PPAs, excluding fuel costs. The incentive would be trued-up annually based on differences between forecasted and annual costs of the PPA for the previous year. To qualify, the PPA must be selected in a competitive bidding process with a minimum duration of three years and 25 MW in size. The PPA must also be in lieu of a utility ownership option and be shown that it will absorb costs or risks that a utility's customer would otherwise be required to absorb. Staff recommends that an independent evaluator (IE) be used to provide a recommendation to the Commission about the eligibility of a PPA for the incentive, and that the total incentive paid be limited to one percent of the utility's authorized retail revenues. Finally, like the NIPPC proposal, Staff's incentive proposal also requires utilities to include in the final request for proposals (RFP) short-list all PPAs with prices that do not exceed 110 percent of the forward price curve and which otherwise do not qualify.

C. Party Comments

Pacific Power, PGE, and Idaho Power prefer the CIM/pp proposal. They contend that the CIM/pp is superior in numerous respects, including its use of clear and objective standards. The utilities express concerns about many details of Staff's proposal. For example, because Staff's proposed 10 percent adder is not grossed up for taxes, the utilities contend that the incentive would provide a return lower than a rate base return and likely not change a utility's behavior. They also fear that the prospect of using the IE to evaluate whether a PPA has shifted risk away from a utility will cause uncertainty in utility planning.

NIPPC favors Staff's incentive proposal. NIPPC notes that it contains key elements of its own straw proposals submitted in this proceeding, and recommends the Commission adopt it with only certain modifications. Among other things, NIPPC agrees with the utilities that the incentive should be awarded on a post-tax basis to provide the utilities the full ten percent value on eligible PPAs. NIPPC also does not favor the requirement that the PPA be chosen "in lieu of ownership," explaining that the provision might unintentionally require utilities to mock-up hypothetical resources in order to secure the incentive.

RNP also supports Staff's incentive proposal. RNP contends that Staff's proposal is appropriately tailored to narrowly target the bias toward owned resources, and will provide incentives for utilities to select PPAs while protecting ratepayers. RNP also believes the incentive should be calculated on a post-tax basis, explaining that utilities should receive the full value of the credit and noting that other elements—such as limiting the incentive to one percent of the utility's revenues—provide adequate protection for ratepayers.

NWEC does not believe the Commission has sufficient information to adopt any PPA incentive proposal. NWEC maintains that, before crafting a mechanism to eliminate a bias or its effects, the Commission must have more information about the bias and where and how it might be acted upon. Rather than simply adopting a mechanism that would essentially throw ratepayer money at the problem, NWEC recommends the Commission put this docket on hold until further analysis is performed—most likely in an integrated resource planning (IRP) setting—to better quantify the risk mitigation value of PPAs as compared to utility-owned resources.

CUB is also concerned about the adoption of either proposal. CUB accepts that there is a bias toward utility-owned resources, and that this bias increases customer rates. CUB maintains, however, that the mechanisms presented simply provide money to utilities in an attempt to modify behavior without offering any certainty that rates would decrease. In fact, CUB contends that the only certainty offered by both proposals is that utilities will receive additional revenues for entering into certain PPAs—even if the utilities would have purchased the power without the incentive.

If the Commission adopts an incentive mechanism, CUB offers various modifications to the proposals. Most significantly, CUB recommends the incentives be awarded on a case-by-case basis and be limited to contracts of ten years or longer. In addition, the utilities should be required to show that the PPA has reduced utility risk, and agrees with Staff that an IE should be used for this purpose. Finally, CUB agrees with Staff's proposal that the total amount of incentives should be capped at one percent of the utility's revenue requirement.

ICNU contends both proposals are inconsistent with Oregon law and Commission regulatory policies because they would allow the utilities to earn excessive profits that are not based on any actual costs. ICNU recommends the Commission reject the proposals because, if adopted, they would result in unjust and unreasonable rates. ICNU claims that the focus in this proceeding has shifted from developing solutions to eliminate utility bias to simply providing the utilities with monetary rewards to enter into certain types of PPAs.

ICNU criticizes the proposals for failing to include symmetrical mechanisms that provide penalties as well as rewards to help ensure a change of utility behavior. ICNU also faults the incentives for not including any meaningful guidelines or benchmarks to evaluate whether the incentives have been successful in mitigating the utility bias. If any proposal is adopted, ICNU urges the Commission to make a corresponding adjustment to the utility's return on equity (ROE) to hold ratepayers harmless and to ensure that utility earnings are not increased above a reasonable level.

Staff favors its incentive proposal over the CIM/pp. Staff explains that its incentive recommendation is based on prior Commission decisions related to the incentives for conservation, and allows the utility to receive an incentive in rates. Staff adds that the 10 percent adder recognizes the resource diversity and flexibility that PPAs provide in resource planning and acquisition.

Staff opposes most of the utilities' and NIPPC's proposed revisions to the incentive proposal. Among other things, Staff rejects the recommendation that the 10 percent incentive be applied on a post-tax basis, consistent with rate-making for utility owned resources. Staff shares NWEC's opinion that the incentive should be lower, and also be determined on a utility-specific basis. Staff also maintains that the incentive should only apply when the PPA competes against a utility self-build option and is selected through a request for proposal (RFP) process, and that an IE should provide a recommendation whether the PPA should be eligible for the incentive.

Staff contends that the CIM/pp is flawed in several respects. For example, Staff contends that the rationale for the CIM/pp capitalization approach is wrong. It assumes the utility, in addition to receiving the full cost recovery of the PPA, also should receive a return on the PPA up to 50 percent of the percent value of the contract payments, even though the utility has not invested its own capital.

D. Resolution

We too accept the premise that a bias exists in the utility resource procurement process that favors utility-owned resources over PPAs. This bias is really a logical inference drawn from an understanding of ratemaking practices and the effectiveness of incentives. As Staff explained in its opening comments about the lack of a return on PPAs:

> [U]nder cost of service regulation, a utility's "profit" is the opportunity to earn a return on the rate base and by purchasing a PPA in lieu of building a power plant, it is foregoing the potential to earn some amount of profit.[3]

The fact that credit rating entities impute debt equivalency amounts from PPAs to a utility's balance sheet similarly incents the acquisition of utility-owned resources.

Although we accept this premise, we share the concern raised by NWEC, CUB, ICNU, and others that, even after this lengthy proceeding, we know little about the scope and impact of this bias. We have identified its existence, but are not able to quantify its significance. We do not know whether the current regulatory process has, in fact, failed to prevent the utilities from acquiring higher cost, utility-owned resources.

Due to this uncertainty, we are unable to determine whether any of the proposals in this docket would mitigate the bias without improperly rewarding the utilities and unfairly harming customers. Both proposals address the self-build bias by providing utilities with monetary incentives to enter into PPAs. Because we have not quantified the impact of the bias on rates, however, the cost of the proposed incentives might greatly exceed whatever harm might otherwise be inflicted on customers. Moreover, as CUB and ICNU note, both proposals could provide utilities financial rewards for those PPAs that they would have entered into without the incentive.

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[3] Staff's Opening Comments at 1 (May 31, 2007).

Because of these unresolved questions, we decline to adopt any of the recommended proposals to address the preference of a utility to build new resources rather than buy power from third parties. Given our duty to serve the public interest by ensuring that rates are just and reasonable, we are unwilling to adopt any mechanism that would increase customer rates with no assurance of offsetting risks and costs to the ratepayer.

We do, however, take action to address the concerns raised about the self-build bias. First, with regard to the debt imputation issue, we allow the utilities to raise the impact on this practice on credit ratings and earnings in individual rate proceedings. We believe that this issue is more appropriately addressed in the context of an overall examination of a utility's cost of capital.

Second, we reopen Docket UM 1182 to further examine issues related to our competitive bidding guidelines. In Order No. 06-446, this Commission adopted comprehensive guidelines to improve competitive bidding for utility resource acquisitions. Utilities are now expected to issue an RFP for major resources with generating capacity greater than 100 MW. Utilities must also engage an IE to oversee the RFP process if they expect to receive Commission acknowledgement of the final short-list of RFP resources. Although these guidelines have greatly increased confidence that the utility RFP process is being conducted fairly and properly, we believe further improvements are needed to fully address utility self-build bias.

Under Guideline 11, the IE prepares its closing report after the utility has selected its final short-list of RFP resources. We invite comment on whether the role of the IE should be expanded by retaining the IE through the utility's negotiations and final resource selections to further address the utility preference to build its own resources.

Guideline 10(d) requires the IE to evaluate the unique risks and advantages of utility benchmark resources, including consideration of the regulatory treatment if construction costs and plant performance should differ from expected levels. In practice, the IE's evaluation of the comparative risks and advantages of utility benchmark resources has not met our expectations. When the benchmark has been a natural gas resource, the evaluation has primarily focused on the terms of the engineering, procurement, and construction (EPC) contract. When the benchmark has been a wind resource, the evaluation has tended to focus on the value of the site location after the plant's useful life. We want a more comprehensive accounting and comparison of all of the relevant risks, including consideration of construction risks, operation and performance risks, and environmental regulatory risks. We also want more in-depth analysis of all of these risks. We invite comment on the analytic framework and methodologies that should be used to evaluate and compare resource ownership to purchasing power from an independent power producer.

Finally, Guideline 1 establishes the expectation that the utilities will issue RFPs for major resources. Major resources are defined as having generating capacity greater than 100 MW and an operating life longer than five years. We invite comment on whether the threshold for a major resource should be lowered to include more projects in the competitive bidding process in order to further mitigate utility self-build bias.

We want to investigate whether these changes might help further ensure that the utility self-build bias does not result in the acquisition of higher cost utility-owned resources. We direct the Administrative Hearings Division to reopen docket UM 1182 and to convene a prehearing conference to establish a schedule to receive comments on these issues.

ORDER

IT IS ORDERED that:

1. Docket UM 1276 is CLOSED.

2. Docket UM 1182, regarding an investigation into Competitive Bidding, is reopened.

Made, entered, and effective JAN 03 2011.

Ray Baum
Chairman

John Savage
Commissioner

Susan K. Ackerman
Commissioner

A party may request rehearing or reconsideration of this order under ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-001-0720. A copy of the request must also be served on each party to the proceedings as provided in OAR 860-001-0180(2). A party may appeal this order by filing a petition for review with the Court of Appeals in compliance with ORS 183.480 through 183.484.]