

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 165 & UM 1187

In the Matter of)
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PORTLAND GENERAL ELECTRIC,)
)
Application for a Hydro Generation Power)
Cost Adjustment Mechanism, &)
Application for Deferral of Costs and)
Benefits Due to Hydro Generation)
Variance.)
_____)

OPENING BRIEF
OF THE
CITIZENS' UTILITY BOARD OF OREGON

September 9, 2005



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I. Introduction

The Citizens' Utility Board opposes the Stipulation presented by Portland General Electric and the Commission Staff in these dockets, because the Power Cost Adjustment (PCA) mechanism agreed to in the Stipulation: 1) flies in the face of longstanding Commission policy; 2) contradicts the Commission's order in a similar, recent case; 3) deviates significantly from Staff's own policy positions both generally and as stated in this case; and 4) is replete with theoretical and practical flaws. We are disappointed that PGE and Staff have presented a mechanism that is so flawed and unbalanced, and that seemingly ignores basic principles of fairness. We are tired of opposing deferrals followed by PCAs followed by a combination of the two. We would much rather work toward a resolution of the issue, but when presented with proposals that are this defective, we have no choice.

This proceeding combines a request for a hydro deferral (UM 1187) and a request for a hydro-related power cost adjustment (UE 165). These dockets have essentially merged, in part because they implicate similar policy matters, but also because one is being used as a vehicle for the other. This is not unreasonable. Given the controversy over what constitutes an appropriate deferral filing in recent years, we think establishing a Power Cost Adjustment as an ongoing proxy for periodic deferral filings is an efficient and sensible way to establish appropriate cost-recovery boundaries, and to reduce the flurry of deferral-related paperwork that we have seen lately. With this in mind, the PCA mechanism should be designed with the same basic policy framework and regulatory treatment that the Commission has applied to recent deferrals.

Instead of accepting the Stipulation, we recommend that the Commission adopt a 2005 Hydro Deferral that is consistent with its recent deferral orders. As in UM 1008 and UM 1009, the Commission should establish a deadband equivalent to a 250 basis point impact on the Company's return on equity, an intermediate 50/50 sharing band for a financial impact between 250 and 400 basis points, an outer 90/10 customer/company sharing band for a power cost impact that is greater than 400 basis points of return on equity, and, last but not least, a prudence review.

If the Commission opts to establish a PCA here, and we have come to think that it should, the mechanism should not only be consistent with the elements above, but should also recognize the asymmetrical nature of power cost variations, which have been testified to by both PGE and CUB in this docket. PGE/100/Lesh/9-10, CUB/100/Jenks-Brown/20. To reflect the asymmetrical effect of hydro variance and its effect on market prices, the PCA mechanism should have a deadband when the financial impact to the

Company is between -125 to +250 basis points of return on equity, intermediate 50/50 sharing bands when the financial impact is from -200 to -125 basis points or from +250 to +400 basis points of return on equity, and outer 90/10 sharing bands when the financial impact is beyond -200 or +400 basis points of return on equity.

II. The Stipulation Is Seriously Flawed

The proposed mechanism has any number of fatal flaws. It uses retroactive ratemaking when it is entirely unnecessary to do so, its deadband is completely inadequate and represents an anomaly in Staff's position on the issue of power cost variability, and it has other technical flaws that make the mechanism unworkable.

A. Retroactive Ratemaking

Even though PGE's 2005 Hydro Deferral and the Company's application for a PCA have combined in this docket, they are not the same mechanism and they do not serve the same purpose. One is to address the low hydro conditions in 2005. The other is an ongoing regulatory mechanism to capture large power cost variations in either direction.

The PCA proposed in the Stipulation attempts to take the place of, or piggy-back upon, the 2005 Hydro Deferral that PGE filed in UM 1187. It does this by making the PCA, which could not be adopted by the Commission earlier than September 2005, retroactive to January 1, 2005. However, the PCA would be a rate mechanism all by itself, regardless of how the Commission treats PGE's 2005 deferral application.

While the deferral statute specifically allows for inclusion of costs that are applied retroactively, *i.e.*, tracked from the initial filing of the deferral application (ORS

757.259), that statute provides a number of limitations and security measures regarding retroactively applied costs. The retroactive PCA included in the proposed Stipulation is not a deferral under that statute; it is, rather, a form of Automatic Adjustment Clause under ORS 757.210, which does not provide any explicit exceptions to the general prohibition on retroactive ratemaking. PGE and Staff should not be allowed to violate Commission policy by inappropriately confusing statutory devices.

There is no justification for introducing retroactive ratemaking when long-held Commission policy disfavors collecting past costs in rates that have been established on a forward-looking basis. Customers need to know that current rates actually reflect the cost of serving them, and not the cost of serving previous generations of customers. The general prohibition on retroactive ratemaking is not irrational. A cavalier use of retroactive ratemaking would open the door to new complaints about past utility costs and ratemaking decisions, thereby necessitating even more retroactive ratemaking.

CUB/200/Jenks-Brown/21.

B. The Deadband

The Stipulation provides for a deadband of \$15 million for power costs that are greater than forecast, and \$7.5 million for power costs that are below forecast. Stipulation, p.3. This deadband is not appropriately sized, it diverges from past Commission decisions on deferral mechanisms, and it inexplicably deviates from Staff's otherwise consistent position on deadbands both in this, as well as other dockets.

In a rate case, the shareholder is compensated through an authorized return on equity (ROE) to accept certain financial risks that accompany normalized utility ratemaking. Deferrals and PCAs are mechanisms that allow recovery for the shareholder

when certain costs reach a level not anticipated in normal ratemaking. However, before customers pay additional money to the shareholders to cover those extreme costs, we need to make sure that the shareholders have absorbed the normal financial risk that customers pay for in rates. Otherwise, the deferral or PCA is simply a way to achieve a ROE that is higher than authorized by the Commission, the upshot of which is that shareholders would be overcompensated for the risks we assume they are taking. The deadband is the way that we account for the expected financial risk that must be absorbed by the shareholder before customers pay more in rates. The Commission recognizes this as a matter of course, stating recently in UM 1071:

The magnitude of the financial effect on the utility is also a factor in our consideration under the discretionary stage of the decision process. For a stochastic risk to justify deferred accounting, the financial impact must be substantial. . . . In UM 995, for instance, we established a deadband around PacifiCorp's baseline of 250 basis points of return on equity. We allowed no recovery of costs or refunds to customers within that deadband, reasoning that the band represented risks assumed, or rewards gained, in the course of the utility business.

Order No. 04-108, UM 1071, March 2, 2004, p.9, footnote omitted.

Indeed, Staff, in its Opening Testimony in UE 165, echoed their understanding of this regulatory treatment. Staff said:

Staff has consistently argued in recent cases that a PCA mechanism should be used to protect the company from extreme fluctuations in NVPC. (See Staff Testimony in Docket UE 137 and Staff Closing Comments in Docket UM 1071.) Staff believes an extreme event PCA is a reasonable way to mitigate PGE's NVPC-related earnings risk. A large deadband serves several purposes. First, it serves to keep PGE focused on managing the financial impacts of varying hydro conditions. Staff believes PGE is better positioned to manage hydro-related financial risk through wholesale market activities than are customers through response to annual price signals. Second, a large deadband serves to keep supplemental ratemaking, such as a PCA, from becoming the primary form of ratemaking. Supplemental ratemaking should complement normalized test year ratemaking, not supplant it. Staff posits that a deadband that leaves the company with all of the NVPC risk except for plus and minus the

projected over most ten percent of NVPC distribution achieves these goals.

Staff/100/Galbraith/11.

Staff inexplicably departs from both its own otherwise-consistent position, as well as the Commission's precedent. Instead of supporting the 250 basis point deadband, which equals approximately \$40 million, Staff agreed to a deadband of only \$15 million when hydro costs are higher than anticipated in rates. By way of explanation, Staff says the smaller deadband is justified by the exclusion of certain cost factors from the PCA mechanism. Staff/300/Galbraith/10.

CUB witnesses Jenks and Brown explain why this justification is nonsense. CUB/200/Jenks-Brown/18-19. The deadband is not determined by how many cost components are included in a deferral or PCA. The deadband represents the financial risk that shareholders absorb before customers are expected to shoulder an increased burden. In a deferral, for example, extreme hydro conditions may cause increased costs, but other factors may reduce costs, thus balancing out the financial impact on the utility. If the reduced costs outweigh the costs of the extreme hydro event such that the Company's earnings are within the range of its authorized rate of return, then customers should not have to further compensate the shareholders. It is the overall financial impact on the utility that dictates the appropriateness of sharing additional cost burdens with customers, not the impact of one, isolated variable.

Now, consider the above example with a different set of cost variables, but in a PCA mechanism instead of a deferral; the result is exactly the same. The deadband creates a proxy for the shareholders' expected financial risk, to which they are exposed in

exchange for an authorized rate of return, irrespective of the cost elements in the PCA mechanism.

C. Staff's Position In UM 1071

Speaking of UM 1071, Staff's position in that docket highlights its deviation from past Staff positions in this docket. In its UM 1071 order, the Commission states that "Staff estimates PGE's excess NVPC attributable to poor hydro conditions at \$17.5 million..." Order No. 04-108, p.5. In UM 1071, Staff took the position that PGE's application for a deferral should be denied in part because the hydro cost did not deviate sufficiently from the variability built into rates. Staff's recommendation to the Commission included an alternative that took the \$17.5 million hydro-related cost and applied a \$39.6 million deadband. UM 1071, Staff Opening Comments Attachment C. At that time, Staff did not believe that the exclusion of non-hydro power costs justified a smaller deadband!

Yet in this proposed Stipulation, Staff settles for customers absorbing excess costs at only \$15 million. Has the Staff's consistent position that deferrals and PCA mechanisms should be used to protect the company from extreme fluctuations in Net Variable Power Cost morphed into a position that these mechanisms should be used to protect utilities from modest fluctuations? No. As recently as August 19, 2005, Staff again recommended a 250 basis point deadband in PacifiCorp's Power Cost Adjustment Mechanism. UE 173, Staff/100/Galbraith/3. Staff's position in the Stipulation in this case is an unexplained anomaly when compared to Staff's previously consistent position in cases involving both PGE and PacifiCorp.

D. Flaws In The Mechanism

i. Mechanism Assumes Imprudent Behavior

The proposed mechanism calculates a representation of actual power costs by using actual on-peak and off-peak market electricity prices from the Dow-Jones Mid-Columbia Daily Electricity Firm Price Index and the hourly price shape from the Dow-Jones Mid-Columbia Daily Electricity Firm Price Index. Stipulation, p.2. In other words, the proposed Stipulation assumes that, in pricing the replacement power for the lost hydro, PGE would wait until the power is needed, and then purchase power on what could be the most expensive -- or at least most volatile -- market: the day-ahead market. It seems safe to assume that, under most circumstances, PGE would never actually take such an imprudent approach to replacing lost hydro power, despite a misleading assertion in the Company's Sursurrebuttal Testimony:

The result is a "back-cast" power cost forecast; in other words, the forecast we would have used for ratemaking had we known exact hydro production and electric and natural gas prices for that year.

UE 165/PGE/1100/Lesh-Tinker/3.

Unfortunately, the proposed mechanism's use of day-ahead market purchases to replace lost hydro power is exactly NOT what PGE would have done had the Company known exact hydro production and electric and natural gas prices. When it becomes clear that hydro conditions are poor, any prudent utility would begin making longer-term arrangements specifically to avoid the volatility of day-ahead market. This is exactly what the utilities told the Commission at the April 5, 2005 special public meeting on the developing drought conditions, as they described their strategy for replacing their lost

hydro power. CUB/200/Jenks-Brown/13-14. This strategy, as described at that meeting, did not rely heavily on day-ahead market purchases.

CUB Exhibit 207 shows actual purchases that PGE made for 2005 that the Company identifies as related to the low hydro conditions. Instead of including these actual hydro-related prudently-incurred costs, the Company advocates a mechanism that would use the daily market price to calculate the cost of replacement power. So, while PGE may not act imprudently, this mechanism makes customers pay as if PGE had acted imprudently. The difference between the cost incurred by an imprudent utility (as modeled in this proposed mechanism) and the actual cost that PGE incurs, flows to the Company, which, in effect, reduces or eliminates the already-narrow deadband.

ii. PCA Updates Some Costs But Not Others With No Rational Basis

The PCA mechanism proposed here picks and chooses which costs included are actual and which are modeled when updating power costs. Typically (and theoretically), the deferral or PCA is supposed to be a comparison of modeled (predicted or normalized) costs versus actual costs. In essence, this is the whole point of the mechanism: to identify and collect, if appropriate, the actual costs above those modeled in the rate case. Yet the proposed PCA mechanism in the Stipulation uses some actual costs and some modeled costs to calculate a representation of actual costs. For certain costs, therefore, the PCA becomes a comparison of modeled costs versus modeled costs. In the section above, we looked at one set of costs, hydro replacement costs, where the Company and Staff chose not to include the actual replacement cost. This omission flies against the principle underlying the purpose of an appropriate PCA.

Another prime example of this is load. The proposed Stipulation would not use actual load when calculating the power cost variation, but instead would use old RVM forecasts. Interestingly, at the time PGE was negotiating the Stipulation, PGE knew that load was down in the first part of the year due to the very dry and warm conditions that contributed to the poor hydro period. CUB/200/Jenks-Brown/8. When load is down, PGE will obviously need to purchase less power to replace lost hydro, but since the Stipulation would act as if load had not changed from the earlier forecast, the cost advantage of buying less power would not be included in the calculations of the proposed mechanism.

This artificial set of data would increase the likelihood that hydro-related costs exceed the deadband, and when they do, would tend to shift more of those costs onto customers. Quite clearly, should customers use less electricity than projected, this mechanism would charge customers for a power cost difference on energy that customers didn't use. This attribute should not become part of a Power Cost Adjustment mechanism, because it would give the Company an incentive to over-forecast load between rate cases in the RVM.

iii. PCA Distorts And Destroys The Conservation Incentive

As a result of the artificial phenomenon created by not updating loads, a PGE customer no longer has the same economic incentive to conserve energy. CUB/200/Jenks-Brown/10-11. CUB observed that PGE joined CUB, BPA, and others in a press release to tell customers that “saving energy will help reduce future rate increases,” and that customers should “combat the economic effects of dry weather by efficiently using electricity this spring and summer.” CUB/205/Jenks-Brown/1. Yet this

proposed PCA mechanism assures that customers will not fully benefit from any positive economic effect of conserving.

The proposed PCA would charge customers the same whether they conserve or not. Yes, customers who conserve will be charged for less kWh in the month they conserved, but the proposed mechanism ignores this conservation when setting next year's power cost surcharge. The Company's response to this criticism is that, if PGE customers conserve enough to change market prices, then those reduced market prices will be accounted for in the mechanism. First, it is extremely unlikely that PGE customers, by themselves, would move market prices; even PGE implicitly acknowledges this in the Company's Surrebuttal:

[I]f "everyone" in the region conserved, regional demand would decrease, and power prices would tend to decrease, putting a downward pressure on power costs.

UE 165/PGE/1100/Lesh-Tinker/10.

Second, this is not the common understanding of a monetary benefit when customers consider conserving electricity. We believe that customers' understanding is more closely aligned with what the BPA news release stated: that if customers chip in and use less, their conservation will be reflected not only in their current bills, but will reduce future rate increases. This is not because they think their actions have influenced market prices, but because they will have reduced PGE's need to replace lost hydro power, which is the basis of future surcharges. The proposed PCA would not support customers' conservation in this manner, and so undermines this understanding of customer conservation.

iv. The PCA Cannot Be Tested Before Implementation

We have already discussed the hodge-podge of actual costs and modeled costs, and the various theoretical flaws in the model of the mechanism proposed. This proposed PCA is ripe for road testing. Surprise. There is neither the intent nor the possibility of testing this PCA for performance. Monet has not yet been updated to run the back-cast necessary for the calculations that are to be used in the proposed PCA. CUB/200/Jenks-Brown/17. When we asked the Company to run the model to demonstrate how it would have worked in 2002 to 2004, we discovered that the model is not ready to run anything yet, much less set rates. CUB/210/Jenks-Brown. We don't know how well this model works, and PGE and Staff, the signatories to the Stipulation, don't know either.

III. A Modest Proposal

There are reasonably simple solutions to the problems at hand: 1) PGE has a deferral for 2005 and can use it; and 2) if the Commission chooses to establish a PCA for 2006, prior to PGE's next rate case, it can do so using a simple and well-tested framework based on past deferral and PCA mechanisms. That framework, as set out in CUB/200/Jenks-Brown/29-32, is as follows.

A. 2005 Hydro Deferral

- A deadband for power cost variances representing 250 basis points of return on equity
- An intermediate sharing band of 50/50 for power cost variances representing an amount between 250 and 400 basis points of return on equity
- An outer sharing band of 90/10 customers/company for power cost variances representing an amount greater than 400 basis points of return on equity
- A prudence review

B. Power Cost Adjustment Mechanism

- An asymmetrical deadband for financial impacts between -125 and +250 basis points of return on equity
- An intermediate 50/50 sharing band for financial impacts between -200 and -125 and between +250 and +400 basis points of return on equity
- An outer 90/10 customer/company sharing band for financial impacts below -200 and above +400 basis points of return on equity
- A prudence review

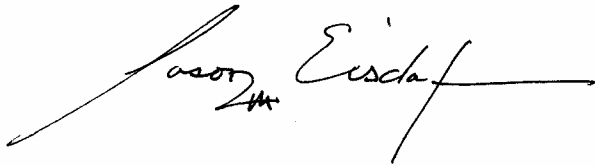
IV. Conclusion

The Stipulation between the Company and Staff should clearly be rejected. The mechanism is too technically flawed to be viable, and the use of retroactive ratemaking outside of the clearly defined boundaries provided in the deferral statute shows extremely poor judgment under the circumstances. PGE has filed for a deferral to cover the 2005 hydro conditions, and, should the impact of the hydro conditions this year prove to be financially material, the Company may seek recovery through that mechanism. There is no need, and certainly no rational reason, to turn to retroactive ratemaking in this case.

Our thinking on the appropriateness of a Power Cost Adjustment mechanism for PGE has evolved somewhat, not only as we have gone through multiple deferral and PCA dockets in recent years, but also as we have participated in the unfolding of this docket and proposals from other utilities. While establishing a PCA for one year doesn't seem to make much sense, we doubt that further discussions will bring us any closer and, without Commission guidance, we doubt that a PCA proposed by PGE in its next rate case will be a reasonable starting point for the parties to work towards a solution. Given our fatigue and frustration with this issue, we would like to see the Commission weigh in on the fundamental issue of the cost variances that a utility should absorb in exchange for the rate of return paid by customers.

Though we recommended the Commission not establish a mechanism for 2006 in our Surrebuttal Testimony in this docket, we now feel the Commission should establish the PCA described above (p.13) to capture those power cost variations that are outside of the range normally absorbed by the utility and for which the utility is compensated in its return on equity. In so doing, the Commission can bring some resolution to this controversy which has spanned a number of recent dockets.

Respectfully Submitted,
September 9, 2005

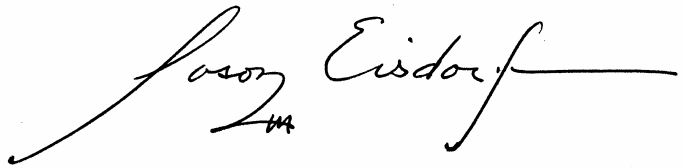
A handwritten signature in black ink, appearing to read "Jason Eisdorfer". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

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Attorney for the Citizens' Utility Board of Oregon

CERTIFICATE OF SERVICE

I hereby certify that on this 9th day of September, 2005, I served the foregoing Opening Brief of the Citizens' Utility Board of Oregon in docket UE 165 & UM 1187 upon each party listed below, by sending a copy via email and U.S. mail, postage prepaid, and upon the Commission by emailing a copy and by sending 6 copies by U.S. mail, postage prepaid, to the Commission's Salem offices.

Respectfully submitted,



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