BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 173

In the Matter of PACIFICORP (dba Pacific Power & Light Company) Application for Approval of Power Cost Adjustment Mechanism	STAFF'S RESPONSE TO PACIFICORP'S OPENING BRIEF

I. PacifiCorp Mischaracterizes Staff's Testimony

PacifiCorp repeatedly mischaracterizes Staff's testimony in its opening brief.

1. Staff supports a PCAM as the best response to increased net power cost-related earnings risk.

PacifiCorp incorrectly states:

> Staff is opposed to the Company's proposal because it believes that the bulk of volatility in net power costs should be captured through stochastic net power cost modeling in the context of a general rate case… Moreover, if Mr. Galbraith's "wait and see" approach were adopted, parties representing customer interests would have little or no incentive to agree on a stochastic approach to modeling net power costs.

PacifiCorp Opening Brief at 18. In fact, Staff does not recommend stochastic power cost modeling as a method of capturing volatility in net power costs:

> **Q. DOES SIMPLY SWITCHING TO STOCHASTIC POWER COST MODELING OBVIATE THE NEED FOR A SUPPLEMENTAL AUTOMATIC ADJUSTMENT CLAUSE?**
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> A. No. Stochastic power cost modeling does not represent a ratemaking response for treating the volatility of power costs around the baseline forecast. In other words, it does not address the earnings risk associated with power cost variability. Staff believes a properly designed PCA mechanism can be a reasonable means to mitigate PacifiCorp's earnings risk posed by large NVPC excursions.

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Staff/100, Galbraith/16. Staff recommends stochastic power cost modeling because it can provide a distribution of net power costs that can be used to develop a PCAM that satisfies the reasonable risk reduction and neutral cost recovery criteria. Staff/100, Galbraith/13-14. Moreover, Staff does not recommend a "wait and see" approach to addressing volatility in net power costs:

> **Q. IF STAFF IS NOT CONVINCED THAT THE COMPANY HAS AN ASYMMETRIC RECOVERY PROBLEM, THEN WHY DOES IT RECOMMEND ADOPTION OF INTERIM AND LONG-TERM PCA MECHANISMS?**
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> A. Staff supports the use of PCA mechanisms to mitigate the financial impact of extreme differences between actual and normalized NVPC. It can be unreasonable to rely solely on regulatory lag to offset an extreme deviation over the long run. Supplemental ratemaking can provide more timely recovery of excess power costs. However, supplemental power cost ratemaking should be consistent with normalized power cost ratemaking and not bias expected recovery over the long run.

Staff/300, Galbraith/8-9.

2. Staff supports using a deadband to exclude a reasonable range of normal variation from triggering the PCA mechanism.

PacifiCorp asserts that Staff does not recognize an important distinction between the deferred accounting process and the automatic adjustment clause process. PacifiCorp Opening Brief at 10. According to PacifiCorp, the deferred accounting process tends to be one-sided; therefore, "deadbands can be a reasonable means of restoring symmetry to the ratemaking process." PacifiCorp Opening Brief at 11. On the other hand, with an automatic adjustment clause the "rules of the game" are established ahead of time and, "a deadband is not necessary to assure fairness." PacifiCorp Opening Brief at 11. Staff understands this important procedural distinction, but disagrees with PacifiCorp that this ends the discussion on fairness.

Predetermining the "rules of the game" may be necessary to assuring fairness, but Staff's testimony in this case indicates that it is not sufficient to designing a fair PCA mechanism. Staff has emphasized that the purpose of a deadband is to exclude a reasonable range of normal

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variation from triggering the PCAM. PacifiCorp has historically been a bearer of NVPC risk and, according to Staff, should retain a significant portion of this risk. In explaining the rationale behind its reasonable risk reduction criterion, Staff emphasized that the level of risk reduction to achieve through a PCAM depends on the amount of risk compensation provided through return on equity. Staff/100, Galbraith/8-9. A large deadband serves several purposes: it allocates power cost risk between customers and shareholders; it keeps the Company focused on managing power cost risk; and it keeps the PCAM from becoming the primary form of power cost ratemaking. These considerations are also important when it comes to designing a fair PCA mechanism.

The Commission used this same distinction in Order No. 05-1261 to set the standard for deadbands around expected net power costs under hydro-related PCA mechanisms. Order 05-1261 at 9. We discuss the implications of Order No. 05-1261 for Docket UE 173 in the final section of this brief.

3. Staff supports reflecting any asymmetry in the distribution of PacifiCorp's power costs in the deadband of a permanent PCAM in order to preserve the equal risk of the company over-collecting or under-collecting power costs in rates.

PacifiCorp incorrectly asserts that Staff has provided little explanation for its position that, "if the Company's risk of net power cost variability is asymmetrical, the deadbands also need to be asymmetrical." PacifiCorp Opening Brief at 11. In fact, Staff has repeatedly put forward its rationale for reflecting any asymmetry in the distribution of PacifiCorp's power costs in the deadband of a permanent PCAM:

> By reflecting any asymmetry in the distribution of NVPC in the deadband of a long-term PCA mechanism, the Commission could preserve the equal risk of the company over-collecting or under-collecting NVPC in rates, while simultaneously excluding a reasonable range of normal power cost variation from triggering the PCA mechanism.

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Staff/300, Galbraith/4. Moreover, Staff has cautioned that a symmetrically designed PCA mechanism that tracks asymmetric financial impacts can be expected to produce a balancing account balance that favors PacifiCorp. Staff/100, Galbraith/10.

4. Staff's recommendations in this case emphasize the need to provide PacifiCorp a fair opportunity to recover its expected net power costs over the long-term.

PacifiCorp suggests that Staff has lost track of this first principle of ratemaking and complains:

> Staff and intervenors seem to be suggesting that any proposal that creates even a possibility of the Company recovering all of its prudently incurred net power costs is somehow unfair or undesirable.

PacifiCorp Opening Brief at 10. It is important to notice that in PacifiCorp's Opening Brief the principle of providing a fair opportunity to recover expected costs is repeatedly stated as the principle of providing a fair opportunity to recover actual prudently-incurred costs. For example, PacifiCorp states:

> The [Company's] proposed PCAM will ensure that, in the future, PacifiCorp's prices more accurately capture the Company's actual prudently incurred costs of providing service to its customers.
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> *****
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> As observed by all parties to this proceeding, an assurance of full cost recovery would not provide PacifiCorp with appropriate incentives to effectively manage its net power costs. However, in the context of a PCAM, any deadband or sharing mechanism should be evaluated on the basis of whether it provides sufficient and appropriate incentives, while permitting the Company a fair opportunity to recover all its prudently-incurred costs.

PacifiCorp Opening Brief at 4 and 11. While these two principles may converge in the long-run, they are nonetheless two separate ratemaking principles. In the short-run it is reasonable for the Company to experience periods when recovering its expected net power costs results in under-recovery (or over-recovery) of its actual prudently-incurred net power costs. This exact point underlies Staff's recommendation that the Commission use reasonable risk reduction and neutral cost recovery criteria when evaluating PCA mechanisms. According to Staff, the Commission

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1 should preserve the equal risk of the company over-collecting or under-collecting NVPC in rates,
2 while simultaneously excluding a reasonable range of normal power cost variation from
3 triggering a PCA mechanism.

4
5 **5. The Commission should not use PacifiCorp's proposed PCAM to mitigate a perception of bias in traditional normalized power cost ratemaking.**

6 PacifiCorp has emphasized throughout this case that its actual power costs exceeded its
7 normalized power costs included in rates by more than $675 million over the period 2000-2004.
8 The company has also emphasized that the average annual excess power costs over this period is
9 $135.5 million. PacifiCorp states:

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> This experience has caused the company to conclude that there is a greatly increased variability in net power costs from the level projected in general rate cases and that this variability is not symmetrical. Absent a PCAM, PacifiCorp does not have an opportunity to earn its allowed rate of return.

13 PacifiCorp Opening Brief at 3-4.
14 PacifiCorp derides Staff's suggestion that results from 2000-2004 might simply reflect a
15 run of bad luck:

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> To put it bluntly, it appears other parties know the Company is losing a lot of money and wish to avoid shifting those costs to customers for as long as possible. Otherwise, one must ask… Why would Mr. Galbraith state that there is "considerable uncertainty" as to whether the Company faces an asymmetric recovery problem, but then express considerable certainty the proposed PCAM will result in a "large risk shift to customers?"

20 PacifiCorp Opening Brief at 8-9.
21 First, Staff reviewed the data shown at PPL Exhibit/201 and indicated that it is not
22 sufficient to conclude, one way or the other, whether the increase in the average difference
23 between actual and normalized power costs reflects the onset of an asymmetric recovery problem
24 or simply reflects a run of bad luck. Staff/300, Galbraith/6-7. Staff believes its approach to this
25 issue is more reasonable than the Company's:
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Q. WHY IS STAFF'S APPROACH TO ADDRESSING PACIFICORP'S ASYMMETRIC RECOVERY PROBLEM BETTER THAN PACIFICORP'S APPROACH?

A. Staff's approach is better because: (1) It explicitly recognizes that there is considerable uncertainty as to whether the Company actually has an asymmetric recovery problem; and (2) It addresses the issue head-on by attempting to improve the normalization of power costs in general rate cases.

Staff/300, Galbraith/6.

Second, there is no ulterior motive or logical infirmity to Mr. Galbraith concluding that there is considerable uncertainty as to whether the company faces an asymmetric recovery problem and at the same time concluding that PacifiCorp's PCAM would result in a large shift of net power cost risk to customers. The two conclusions are independent. Staff made this exact point in direct testimony:

> An automatic adjustment clause transfers risk previously borne by investors to customers. Whenever the company, staff, or any other party uses the phrase "risk reduction" to describe the effect of an automatic adjustment clause, they are viewing the risk from the company's perspective. From the customers' perspective, the NVPC risk is increased. Even if the expected value of the mechanism is zero, customers face more risk because they are exposed to significant swings in rates.

Staff/100, Galbraith/7.

Finally, to put it even more bluntly, if PacifiCorp has concluded that it is losing a lot of money due to asymmetry in net power costs it should file a rate case to reset normalized net power costs. Despite PacifiCorp's contrary assertion, a PCAM should be designed to have expected payments to shareholders and customers equal out over time.[1] According to Staff, the purpose of a PCAM is to provide timely recovery of extreme differences between actual and

[1] PacifiCorp incorrectly stated Staff's contention as, "to have payments to the Company and shareholders equal out over time." PacifiCorp Opening Brief at 11. Staff argues that to satisfy the neutral cost recovery criterion it may be necessary for a PCAM to result in more frequent but smaller surcredits that offset less frequent but larger surcharges.

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normalized net power costs. It can be unreasonable to rely solely on regulatory lag to offset an extreme deviation over the long run. However, supplemental power cost ratemaking should be consistent with normalized power cost ratemaking and not bias expected recovery over the long run. Staff/300, Galbraith/8-9. PacifiCorp's proposed PCAM is not the best response to its alleged under-recovery of net power costs.

II. PacifiCorp's Hypothetical Cases Are Not Part of the Record in this Case and Fail to Support PacifiCorp's Assertions

PacifiCorp asserts that seven hypothetical cases demonstrate that Staff's interim PCA mechanism: (1) would fail to provide PacifiCorp with a fair opportunity to recover its net power costs on an expected basis; (2) would not be viewed favorably by rating agencies; and (3) would give rise to bizarre results and poorly aligned incentives. PacifiCorp Opening Brief at 16. In fact, PacifiCorp's hypothetical cases fail to support these assertions.

First, notice that in each of the seven cases there are two annual net power cost outcomes that occur with same frequency. For example, in Case 1 the annual deviation from projected net power costs is positive 200 in odd numbered years and negative 100 in even numbered years. Does PacifiCorp consider the expected power cost deviation to be positive 50 per year (i.e., .5*200 + .5*-100 = 50) and positive 500 over the 10-year period? Does Staff's interim PCA mechanism fail the expected recovery test because it would fail to provide recovery of positive 500 over the 10-year period? Why should anyone believe that the hypothetical distribution of excess net power costs shown in Case 1 represents reality? Why is the symmetrical distribution shown in Case 5 not a better test of expected recovery? Is it because Case 1 is more likely to occur than Case 5? PacifiCorp's hypothetical cases cannot demonstrate whether Staff's interim PCA mechanism provides a fair opportunity to recover excess net power costs on an expected basis because the distributions are hypothetical and are not representative of PacifiCorp's actual power cost variability. Or was it the point of these hypothetical cases to demonstrate that Staff's

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interim PCA mechanism would fail to provide full recovery of all of PacifiCorp's prudently-incurred costs?

Second, it is difficult to discern how these hypothetical cases demonstrate anything with respect to the rating agencies' comfort with Oregon regulation. As Staff indicated in its rebuttal testimony, Standard & Poor's does not consider a PCA mechanism to be a substitute for supportive regulation and is comfortable with automatic adjustment mechanisms that are not used regularly, but rather under certain extreme circumstances. Staff/300, Galbraith/5 and Staff/301, Galbraith/20.

Finally, the results of PacifiCorp's hypothetical cases only appear "bizarre" to those who are mistaken enough to think that the cases represent real power cost variability. In other words, it is PacifiCorp's choice of cases that is bizarre. What makes Case 4 an "extreme case?" Is it the positive 400 deviation in odd numbered years? Is it the expected annual deviation of positive 150 (i.e., .5*400 + .5*-100 = 150) or the 10-year deviation of positive 1,500? By what standard is the 75 percent recovery of excess costs under the Staff interim proposal bizarre?

Why is Case 7 a "stable" case? Is it because the 10-year deviation is positive 250, or is it because each of the 10 annual deviations is a deadband result under the Staff interim proposal?

Why should the Commission evaluate the Staff interim proposal on the basis of 10-year net recovery percentages and ignore the annual pattern of recovery/refund? In Cases 1 and 2, the deviation in bad years is positive 200 and the company recovers positive 45 (or 22.5 percent). The difference in 10-year net recovery percentages between these two cases is determined by the deviation in good years (i.e., negative 100 in Case 1 and negative 150 in Case 2). The only thing bizarre here is the repetitive pattern of these deviations.

Why is it that if the 10-year net deviation doubles (Cases 3 and 4) the company's losses should double? Under the Staff interim proposal, changing the annual positive deviation from positive 250 in Case 3 to positive 400 in Case 4, all other things constant, increased PacifiCorp's

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annual recovery in bad years from 36 percent to 56 percent, and increased PacifiCorp's 10-year recovery by 15 percent. Why is this irrational or directionally incorrect?

If PacifiCorp had included its hypothetical case analysis in testimony, Staff could have asked this long list of questions in a data request and responded in testimony. Unfortunately, PacifiCorp's hypothetical case analysis is an example of the kind of selective analysis that led Staff, at the beginning of this docket, to recommend the use of stochastic power cost modeling as a tool to help design and evaluate alternative PCA proposals.

III. Discussion of Order No. 05-1261

In Order No. 05-1261 the Commission established four design criteria for hydro-related PCA mechanisms: (1) Limited to Unusual Events; (2) No Adjustment if Overall Earnings are Reasonable; (3) Revenue Neutrality; and (4) Long-Term Operation. At this time, Staff makes two observations regarding this order and briefly discusses the implications for UE 173.

1. The purpose of a second deadband on return on equity is to override PCAM surcharges, when the company's earnings are above (below) the bottom (top) of a reasonable range.

In Order 05-1261, the Commission rejected the SD-PCAM, in part, because, "it could give PGE recovery of excess power costs even when its earnings are at a level we consider reasonable…" Order No. 05-1261 at 11. The Commission noted prevention of supplemental recovery when the Company's earnings are reasonable as a reason it favors a two-part mechanism (with one deadband on net power costs and another on overall earnings) over the conventional single-deadband approach. Order No. 05-1261, footnote 48, at 10.

Staff notes that the two deadbands serve different purposes. Staff has testified in UE 173 that the purpose of the deadband on power costs is to exclude a reasonable range of normal variation from triggering the PCA mechanism. Staff believes the purpose of a second deadband around return on equity is to override PCAM surcharges (surcredits) when the company's earnings are above (below) the bottom (top) of a reasonable range. Staff supports the use of a second deadband on return on equity to prevent unreasonable recovery or refund; however, Staff

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1 does not believe that adding a second deadband on return on equity means that the size of the
2 first deadband on net power costs should be reduced. In UE 173, Staff continues to recommend
3 that the deadband on net power costs be set to exclude a reasonable range of normal variation
4 from triggering the PCA mechanism. Staff continues to believe that a deadband set at the 10th
5 and 90th percentiles of the net power cost distribution would likely satisfy this criterion.

6 **2. Long-term PCAM operation allows offsetting events to be reflected in customers**
7 **rates, therefore a PCAM can be designed to provide more frequent recovery or refund than would be allowed under one-time deferred accounting.**

8 In Order 05-1261, the Commission made clear that the less strict unusual event standard
9 for hydro-related PCAs depends on the long-term operation of the mechanism. Order No.
10 05-1261 at 9 and 10. Long-term PCAM operation allows offsetting events to be reflected in
11 customer rates and, therefore, provides an opportunity for the Commission to use a more-
12 inclusive recovery standard. The Commission decided to adopt an unusual event standard for
13 hydro-related PCA's, at least in part, because "hydro availability is largely beyond the
14 company's control." Order No. 05-1261 at 9.

15 Staff supports long-term PCAM operation. Whether a more-inclusive recovery standard
16 should be used in the context of a net power cost-related PCA may depend on whether net power
17 costs are largely beyond the company's control. Staff's belief that company action can impact
18 net power costs is reflected in its deadband and sharing-band recommendations in UE 173.
19 Staff/100, Galbraith/18-19. Of course, if net power costs were largely within PacifiCorp's
20 control then Staff would not be recommending a PCAM in the first place. Staff believes that the
21 degree of company control over net power costs should be a
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secondary consideration used to adjust the deadband on net power costs and the sharing percentage on amounts falling outside the deadband. However, the degree of company control provides little guidance with respect to the primary allocation of power cost risk between customers and shareholders.

DATED this 17th day of January 2006.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 17th day of January 2006, I served the foregoing upon the parties, hereto by the method/s indicated below:

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