Oregon

Theodore R. Kulongoski, Governor

Public Utility Commission
550 Capitol St NE, Suite 215
Mailing Address: PO Box 2148
Salem, OR 97308-2148
Consumer Services
1-800-522-2404
Local: (503) 378-6600
Administrative Services
(503) 373-7394

October 17, 2005

Via Electronic Filing and U.S. Mail

OREGON PUBLIC UTILITY COMMISSION
ATTENTION: FILING CENTER
PO BOX 2148
SALEM OR 97308-2148

RE: **Docket No. UE 173** - In the Matter of PacifiCorp (d/b/a Pacific Power & Light Company) Application for Approval of Power Cost Adjustment Mechanism.

Enclosed for filing in the above-captioned docket is the Public Utility Commission Staff's Supplemental Testimony. This document is being filed by electronic mail with the PUC Filing Center.

/s/ Lois Meerdink

Lois Meerdink
Regulatory Operations Division
Filing on Behalf of Public Utility Commission Staff
(503) 378-8959
Email: Lois.Meerdink@state.or.us

cc: UE 173 Service List - parties

PUBLIC UTILITY COMMISSION
OF OREGON

UE 173

STAFF SUPPLEMENTAL TESTIMONY OF

Maury Galbraith
Bill Wordley

In the Matter of PacifiCorp (d/b/a Pacific Power & Light Company) Application for Approval of Power Cost Adjustment Mechanism

October 17, 2005

CASE: UE 173
WITNESS: Maury Galbraith

PUBLIC UTILITY COMMISSION
OF
OREGON

STAFF EXHIBIT 300

Supplemental Testimony

October 17, 2005

Introduction

Q. PLEASE STATE YOUR NAME.

A. My name is Maury Galbraith.

Q. DID YOU PREVIOUSLY FILE TESTIMONY IN THIS PROCEEDING?

A. Yes. I sponsored Staff/100. My witness qualifications were provided at Staff/101.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of this testimony is to respond to the issues raised in the rebuttal testimony of PacifiCorp witnesses Christy A. Omohundro and Mark T. Widmer in this docket.

Q. DOES STAFF PRESENT ANY OTHER WITNESSES IN THIS FILING?

A. Yes. Bill Wordley, Senior Economist in the Economic Research and Financial Analysis Division addresses the issues raised in the rebuttal testimony of PacifiCorp witness Gregory N. Duvall in this docket and clarifies Staff's recommended PCAM allocation methodology. *See* Staff Exhibit 400.

Q. PLEASE SUMMARIZE STAFF'S OVERALL TESTIMONY.

A. Staff's primary arguments are:

- Contrary to PacifiCorp's assertion, staff's recommendations in this proceeding address the potential asymmetry of the Company's net variable power costs (NVPC). Staff proposes that the Company use stochastic power cost modeling to reflect any asymmetry in NVPC in base rates, as well as the deadband of a long-term PCA mechanism.

- Contrary to PacifiCorp's assertion, staff's recommendations in this proceeding address the issue of credit rating agency debt imputation related to long-term purchase power agreements. Staff recommends that the Commission make a long-term commitment to the allocation of NVPC risk by adopting an interim PCA mechanism as a first step towards a more permanent long-term PCA mechanism.
- Contrary to PacifiCorp's assertion, the data shown at Exhibit PPL/201 and the Company's comparison of average differences between actual and normalized NVPC are not sufficient to conclude that PacifiCorp has an asymmetric recovery problem.
- The Commission should not use a PCAM that lacks a deadband to mitigate the perception of bias in current normalized NVPC ratemaking. PacifiCorp's proposed PCAM would supplant normalized test year ratemaking by dulling the incentive for the Company to improve the normalization of power costs in rate cases.
- The Commission should use the SE allocation factor, based 100 percent on the actual energy loads that occurred during the PCAM year, to allocate excess NVPC.

<u>Response to PacifiCorp</u>

Q. PACIFICORP WITNESS MS. OMOHUNDRO ASSERTS THAT STAFF'S PROPOSED PCA MECHANISM DOES NOT EFFECTIVELY ADDRESS THE

TWO PRINCIPAL ISSUES THE COMPANY SEEKS TO ADDRESS IN THIS PROCEEDING. *SEE* PPL/102, OMOHUNDRO/6. PLEASE SUMMARIZE THESE ASSERTIONS.

A. First, PacifiCorp asserts that staff's proposed PCA mechanism does not effectively address the extreme asymmetry of the Company's NVPC, and therefore would fail to provide the Company with a fair opportunity to earn its authorized return on equity over the long-term. Second, PacifiCorp asserts that staff's proposed PCA mechanism would fail to avoid debt imputation by the major credit rating agencies related to long-term purchase power agreements. *See* PPL/201, Omohundro/6.

Q. DO STAFF'S RECOMMENDATIONS IN THIS PROCEEDING ADDRESS PACIFICORP'S FIRST ISSUE – THE NEED TO CONSIDER THE POTENTIAL ASYMMETRY IN THE DISTRIBUTION OF NET VARIABLE POWER COSTS WHEN SETTING THE COMPANY'S RATES?

A. Yes. In direct testimony, staff recommended that PacifiCorp use stochastic power cost modeling in its next general rate case. Staff supported this recommendation on two grounds. *See* Staff/100, Galbraith/13-14.

First, stochastic power cost modeling can improve the normalization of NVPC in general rate cases. This modeling can provide a realistic representation of any asymmetry in the distribution of the Company's NVPC. By setting normalized NVPC equal to the mean of the distribution of NVPC, the Commission could reflect any asymmetry in net variable power costs in the Company's base rates. Reflecting any asymmetry in base rates would provide a fair opportunity for the Company to recover its costs on an expected basis and to earn its authorized return on equity over the long-term, without relying on supplemental ratemaking to achieve these goals.

Second, stochastic power cost modeling can be used to design a PCA mechanism that satisfies the reasonable risk reduction and expected value recovery criteria. 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.

Contrary to Ms. Omohundro's assertion, staff's recommendations in this proceeding address the potential asymmetry of the Company's net variable power costs and the need to provide a fair opportunity for the Company to recover its expected costs over the long-term.

Q. DO STAFF'S RECOMMENDATIONS IN THIS PROCEEDING ADDRESS PACIFICORP'S SECOND ISSUE – THE NEED TO AVOID DEBT IMPUTATION BY MAJOR CREDIT RATING AGENCIES RELATED TO LONG-TERM PURCHASE POWER AGREEMENTS?

A. Yes, in part. Staff does not believe the goal is to avoid any debt imputation. A reasonable goal is to mitigate the effects of imputed debt on the Company's credit rating. If a long-term purchase power agreement does not put downward pressure on the Company's ratings, the amount of debt imputed by Standard and Poor's (S&P) or the other ratings agencies is irrelevant. Given staff's more holistic view of debt imputation and ratings, staff recommends that the Commission make a long-term commitment to the allocation of NVPC risk by adopting an interim PCA mechanism as a first step towards a more permanent long-term PCA mechanism. *See* Staff/100, Galbraith/23. Staff expects that a long-term commitment would be viewed favorably by the major credit rating agencies. However, Staff is not convinced that major credit rating agencies need further indication of the Commission's commitment to the utility's timely recovery of net power costs.

In a Memo Regarding Debt Imputation and Power Purchase Agreements, dated June 6, 2005, Staff emphasized that S&P's formula for balance sheet debt imputation for long-term purchase power agreements is heavily influenced by its perception of the likelihood of the utility being able to receive timely recovery of their costs. *See* Staff, Staff/301. S&P has emphasized that PCA mechanisms are not a substitute for supportive regulation, and therefore are not necessarily the "Holy Grail of utility credit quality" that PacifiCorp is seeking. *See* PPL/101, Omonhundro/5.

However, the Commission's regulation of PacifiCorp, which has not included the use of a PCA mechanism, can be fairly characterized as supportive. The Commission's regulation of PacifiCorp during the western energy crisis of 2000 – 2001 is a case-in-point. *See* Order No. 02-469. The Commission's recent approval of PacifiCorp's request to annually update its normalized NVPC included in rates as part of its Transition Adjustment Mechanism is further indication of the Commission's support for timely recovery of net variable power costs. *See* Order No. 05-1050. The Commission's current regulation of PacifiCorp may already be sufficient to avoid debt imputation by major credit rating agencies related to long-term purchase power agreements. By adopting staff's recommendations in this case, the Commission can provide even further indication of its commitment to timely recovery of net variable power costs.

Contrary to Ms. Omohundro's assertion, staff's recommendations in this proceeding address the issue of credit rating agency debt imputation related to long-term purchase power agreements.

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.

Q. PACIFICORP IS CONVINCED THAT THE COMPANY HAS AN ASYMMETRIC RECOVERY PROBLEM. WHY DOES STAFF QUESTION THE CERTAINTY OF THE PROBLEM?

A. PacifiCorp relies on Exhibit PPL/201 to establish that the Company has an asymmetric recovery problem. Exhibit PPL/201 shows the difference between actual NVPC and the normalized NVPC included in rates for the period 1990-2004. PacifiCorp compares the average difference for the period 1990-1999 to the average difference for the period 2000-2004 and concludes that the Company developed an asymmetric recovery problem starting in calendar year 2000. *See* PPL/205, Widmer/2 and PPL/200, Widmer/3. PacifiCorp's comparison does not support its conclusion because: (1) the data from the period 2000-2001 were impacted by the western energy crisis and reflect anomalous market behavior and should not be used as evidence of an on-going problem with normalized ratemaking; and (2) the data from the period 2002-2004 could simply reflect a run of back luck instead of a systematic change to the company's recovery risk. More specifically, during the three-year period 2002-2004, the average difference between actual and normalized net power costs was 10 percent. During the period 1990-1999, the average difference was 2.62 percent. A comparison of these averages is not sufficient to conclude, one way or the other, whether the increase is attributable to the onset of an asymmetric recovery problem or attributable to chance. Staff does not deny that significant under recovery is possible going forward, we simply cannot conclude that it should be expected. Staff presented these issues to PacifiCorp in Staff Data Request No. 3. See Staff/301, Galbraith/1. PacifiCorp's responses are not persuasive.

Q. YOU STATED THAT STAFF'S PCAM RECOMMENDATIONS ARE PREFERABLE TO PACIFICORP'S PCAM RECOMMENDATIONS BECAUSE THEY DO NOT ASSUME THE EXISTENCE OF AN ASYMMETRIC RECOVERY PROBLEM. PLEASE ELABORATE ON THIS STATEMENT.

A. As I stated earlier, Staff recommends that the Company use stochastic power cost modeling in its next general rate case. This modeling can provide a realistic representation of any asymmetry in the distribution of the Company's NVPC. By calculating normalized NVPC as the mean of the distribution, the Commission could reflect any asymmetry in NVPC in the Company's base rates. 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 and provide timely recovery of excess power costs, while simultaneously excluding a reasonable range of normal power cost variation from triggering the PCA mechanism. Of course, PacifiCorp's stochastic power cost modeling could indicate little or no asymmetry in the Company's NVPC. Symmetry, or lack of symmetry, is a matter of degree. Whatever the result, it could be reflected in both base rates and the long-term PCA mechanism.

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?

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.

Q. PLEASE CONTRAST PACIFICORP'S APPROACH TO THE ASYMMETRIC RECOVERY PROBLEM WITH STAFF'S RECOMMENDATION?

A. In contrast, PacifiCorp would have the Commission act on the supposition that the distribution of PacifiCorp's net power costs has become "very" or "extremely" asymmetric. *See* PPL/200, Widmer/3 and PPL/102, Omohundro/6. PacifiCorp recommends that the Commission "fix" the Company's asymmetric recovery problem by adopting its proposed PCAM. *See* PPL/205, Widmer/2. PacifiCorp recommends that the Commission act as though the issue of the symmetry of PacifiCorp's power cost distribution is a settled matter, when in fact it is not.

Q. IS THE COMPANY OPPOSED TO CONSIDERING THE USE OF STOCHASTIC POWER COST MODELING TO INFORM THE COMMISSION OF ANY ASYMMETRY IN THE DISTRIBUTION OF PACIFICORP'S NET POWER COSTS AND TO IMPROVE NORMALIZED RATEMAKING IN ITS NEXT RATE CASE?

A. Not entirely. The Company has indicated that probabilistic modeling of net power costs for rate-setting purposes is not the norm in the industry and that it is premature to adopt it at this time. *See* PPL/205, Widmer/2 and Staff/301, Galbraith/2. On the other hand, the Company has also indicated that:

> Probabilistic modeling of net power costs may be another alternative for fixing the [asymmetry] problem. *See* Staff/301, Galbraith/2.

The Company has also indicated that:

> [A]t such time as the general rate case process is adjusted so that the Company no longer faces substantial asymmetrical risk, the Company would support wider dead bands that would cause a PCAM to be triggered less frequently. *See* Staff/301, Galbraith/3.

Q. IS PACIFICORP SUGGESTING THAT INCLUDING A LARGE DEADBAND IN A PCA MECHANISM IS ONLY APPROPRIATE AFTER NORMALIZED POWER COST RATEMAKING HAS BEEN ADJUSTED TO ADDRESS ANY ASYMMETRY IN THE POWER COST DISTRIBUTION?

A. Yes. PacifiCorp has proposed a PCAM that lacks a deadband in order to correct a perceived flaw in normalized power cost ratemaking. In order to effectively fix the perceived asymmetric recovery problem, a PCAM must either lack a deadband or have an asymmetric deadband. PacifiCorp recommends the first alternative; if needed, staff recommends the second.

Q. ARE YOU CONCERNED THAT IF THE COMMISSION ADOPTS PACIFICORP'S APPROACH, THEN THE INCENTIVE FOR THE COMPANY TO FIX ANY PROBLEM WITH NVPC NORMALIZATION IN ITS GENERAL RATE CASE PROCESS WILL BE REDUCED?

A. Yes. As I stated earlier, Staff's approach to addressing the asymmetry problem is better than PacifiCorp's because it would take the issue head-on in the general rate case process. This is also what I meant in my direct testimony when I stated that it is important that a PCAM not become the primary form of ratemaking. *See* Staff/100, Galbraith/9, Lines 8-13. More specifically, I indicated:

> The PCAM deadband should serve to exclude a reasonable range of normal variation from triggering the mechanism. For example, a PCAM with a deadband set at the 10th and 90th percentiles of the NVPC distribution can be expected, on average, to provide supplemental ratemaking in 1 out of every 5 years. Supplemental ratemaking should complement normalized test year ratemaking, not supplant it. Staff/100, Galbraith/18, Lines 10-15.

A PCAM that lacks a deadband, and therefore produces frequent power cost accruals, can supplant normalized test year ratemaking, by dulling the incentive to improve power cost normalization. A utility may be willing to accept normalization bias as long as it has a PCAM to fix the problem. *See* for example, Docket UE 165, PGE/300 Niman – Tinker/ 32 and PGE/100 Lesh/4.

Q. MR. WIDMER INDICATES THAT NET POWER COSTS ARE APPROXIMATELY 25 PERCENT OF PACIFICORP'S OVERALL REVENUE REQUIREMENT IN OREGON AND CONCLUDES THAT IT IS UNREASONABLE FOR STAFF TO SUGGEST THAT THE COMPANY'S PROPOSED PCAM WOULD LIKELY BECOME THE PRIMARY FORM OF RATEMAKING IN OREGON. *SEE* PPL/205, WIDMER/1. IS MR. WIDMER'S ARGUMENT WELL FOUNDED?

A. No. Mr. Widmer misconstrues the phrase “primary form of ratemaking” to mean “contribution to overall revenue requirement.” First, consistent with the subject matter of this docket, staff has focused solely on the ratemaking treatment of PacifiCorp's net variable power costs. Second, staff identified the frequency of supplemental power cost ratemaking, not its contribution to overall revenue requirement, as an important criterion for evaluating alternative PCA mechanisms.

Q. SHOULD THE COMMISSION USE THE ABSENCE OF A DEADBAND IN PACIFICORP'S PROPOSED PCAM TO MITIGATE THE PERCEPTION OF BIAS IN CURRENT NORMALIZED POWER COST RATEMAKING?

A. No.

Q. MS. OMOHUNDRO USES MR. WIDMER'S CONTRIBUTION TO TOTAL REVENUE REQUIREMENT CALCULATION TO REBUT YOUR ASSERTION THAT PACIFICORP'S PROPOSED PCAM WOULD SHIFT NEARLY ALL OF THE COMPANY'S NVPC RISK TO CUSTOMERS. IS MS. OMOHUNDRO'S ARGUMENT WELL FOUNDED?

A. No. The issue in this case is the allocation of any difference between actual and normalized NVPC to customers and shareholders. Mr. Widmer's demonstration that the cost differences addressed by the PCAM are a small percentage of the Company's total revenue requirement says nothing about the allocation of those costs. The simple fact is that the Company's proposed PCAM allocates at least 70 percent of any difference between actual and normalized power cost to customers. For example, PPL Exhibit 204 shows a scenario where customers would be allocated 76 percent of excess power costs. Without supplemental ratemaking, traditional regulatory lag would allocate 100 percent of excess power costs to shareholders. Changing the allocation from 100 percent to shareholders to at least 70 percent to customers is a large shift in risk to customers.

In addition, because PacifiCorp's PCAM lacks a deadband, it would trigger monthly balancing account accruals. In contrast, staff recommends that the

Commission include a deadband in any adopted PCA mechanism to exclude a normal range of variation from triggering deferral of excess power costs. Staff's recommendation appears to be in-line with a recent S&P statement, made by Associate Director Dimitri Nikas, that automatic adjustment clauses should not be used regularly, but rather under extreme circumstances. *See* Staff/301, Galbraith/20. Staff suggests that deferral in 1 out of every 5 years could be a reasonable allocation of NVPC risk. *See* Staff/100, Galbraith/18.

Q. MR. WIDMER STATES THAT MANY OF THE LONG-TERM CONTRACTS AND RESOURCES THAT WILL BE IN EFFECT DURING THE PERIOD OF THE PROPOSED PCAM ALREADY RECEIVED A PRUDENCE REVIEW IN DOCKET UM 995 AND THAT FURTHER REVIEW ASSOCIATED WITH THE PCAM WOULD BE UNNECESSARY AND WASTEFUL. *SEE* PPL/205, WIDMER/ 4. DO YOU AGREE WITH THIS ASSESMENT?

A. No. In UM 995, the Citizens' Utility Board of Oregon (CUB) and the Industrial Customer's of Northwest Utilities (ICNU) challenged whether PacifiCorp had prudently managed certain long-term sales contracts and prudently maintained the Hunter 1 generating unit. The Commission reviewed each of these specific challenges and concluded, on each issue, PacifiCorp was not imprudent. The Commission also found that PacifiCorp's overall power supply strategy, during the deferral period, was prudent. *See* Order No. 02-469 at page 74. The Company actions reviewed by the Commission in UM 995 are not likely to impact the period of the proposed PCAM. The long-term sales contracts challenged in UM 995 have all expired. The Company's maintenance of the

Hunter 1 unit prior to November 24, 2000, and the Company's power supply strategy during the UM 995 deferral period, are not likely to impact future power costs. Mr. Widmer seems to believe that the Commission made a blanket prudence determination in Order 02-469 covering all long-term contracts and resources that contributed to the UM 995 deferral balance. The Commission's determinations in UM 995 were more limited in scope.

Q. MR. WIDMER INDICATES THAT STAFF HAS PREVIOUSLY TAKEN THE POSITION THAT PRUDENCE REVIEWS ARE NOT NECESSARY IF THEY HAVE OCCURRED IN PREVIOUS DOCKETS. DO YOU AGREE WITH THIS ASSESMENT?

A. No. First, there is an important distinction to be made between a Commission determination that certain long-term contracts and resources contribute to an overall revenue requirement that results in just and reasonable rates and a Commission determination that the long-term contracts and resources were prudently acquired or managed. Neither one of these Commission determinations necessarily implies the other. This distinction was the crux of staff's position in UM 1039. Second, although I agree with Mr. Widmer that a prudence determination is based on information from the time of the decision to acquire the resource, I disagree with his assertion that once a Commission has made a prudence determination that it is impossible for new information from the decision period to come to light. Nothing in Mr. Wordley's statement from UE 170 contradicts this position. For these two reasons, it may be necessary to conduct a prudence review of certain long-term contracts and resources even if the contracts and resources have been reviewed in previous dockets. The Commission should not adopt PacifiCorp's recommendation in this docket to exempt contracts and resources previously included in rates from future PCAM prudence reviews.

Q. WOULD PRUDENCE REVIEWS BE LESS FREQUENT WITH STAFF'S PROPOSED PCAM OR PACIFICORP'S PROPOSED PCAM?

A. It is unclear. Under PacifiCorp's proposal a prudence review would occur whenever the cumulative Oregon allocated deferral balance exceeded plus-or-minus $15 million. This could take 1 year, 5 years, 10 years, or more. Presumably, any prudence review would cover the entire deferral period. In contrast, under staff's proposal a prudence review would only occur whenever the annual deferral balance exceeded or was near the deadband boundary. Furthermore, any prudence review would only cover the annual deferral period. A PCA mechanism with a large deadband can limit the frequency of prudence reviews and mitigate the need for earnings tests.

Q. MR. WIDMER HAS PROVIDED THREE REASONS WHY 100 PERCENT OF ANY NVPC VARIATION RELATED TO QUALIFYING FACILITY (QF) CONTRACTS SHOULD BE ALLOCATED TO CUSTOMERS. ARE HIS REASONS WELL FOUNDED?

A. Not at this time. Mr. Widmer argues that QF contracts should receive different treatment because: (1) the purchases are required by PURPA; (2) the Company has no control over the output of QFs; and (3) Oregon QFs now have the option of charging the utility a rate that is indexed to natural gas prices. *See* PPL/200, Widmer/7 and PPL/205, Widmer/3.

Citizens' Utility Board of Oregon (CUB) witness Mr. Jenks has persuasively rebutted the first two arguments. *See* CUB/100, Jenks 24-25. The QF name is not enough to justify different regulatory treatment. Similar resources should receive similar regulatory treatment. The Company's lack of control over the output of a QF contract is not a condition unique to QF contracts. The Company lacks control over the output of certain hydroelectric and wind generating plants not under PURPA contract. Furthermore, the Company negotiates non-standard avoided cost rates and other contract terms and conditions for QFs with output greater than 10 MW to reflect, among other considerations, the ability of the utility to dispatch the Qualifying Facility, as set forth by 18 C.F.R. § 292.304(e) and Commission Order No. 05-584. Mr. Jenks rightly points outs that regulatory lag provides good incentive for the company to negotiate the best deal on behalf of customers and that the Company is compensated for absorbing risk between rate case through its return on equity. See CUB/100, Jenks/25.

Mr. Widmer's third argument might have merit in the future. The combination of lack of control over QF output and a QF rate that is indexed to natural gas prices has the potential to increase QF related NVPC variation above the level currently experienced by the Company. This combined risk, and the prudent hedging of this risk, may warrant Commission consideration in future rate cases or in future PCA mechanisms.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

CASE: UE 173
WITNESS: Maury Galbraith

PUBLIC UTILITY COMMISSION OF OREGON

STAFF EXHIBIT 301

Exhibits in Support of Supplemental Testimony

October 17, 2005

UE-173/PacifiCorp
June 9, 2005
OPUC Data Request 3

OPUC Data Request 3

At PPL/200 Widmer/2 Lines 15-17, Mr. Widmer defines net power cost exposure as the variance between actual and authorized net power costs. At PPL/200 Widmer/3 Lines 3-7, Mr. Widmer compares the average annual net power cost exposure from 1990 through 1999 (positive $10.7 million) to the average annual net power cost exposure from 2000 through 2004 (negative $135.5 million).

a. Is the division of the period 1990-2004 into two separate time periods arbitrary?
b. Is it reasonable to include the period 2000-2001 in this comparison of averages?
c. Is the apparent increase in net power cost exposure attributable to a systemic change or simply a run of bad luck?
d. Is this analysis sufficient to conclude that normalized ratemaking will result in systemic under recovery of net power costs on a going-forward basis?

Response to OPUC Data Request 3

a. No. As stated on PPL/200 Widmer/3 at lines 2-3, "beginning in 2000, with the start of the 2000-2001 energy crises, the exposure has become very asymmetric toward losses". The division of the 15 year period is done to show the volatility in Net Power Cost exposure that PacifiCorp has faced over the last 5 years compared with the first 10 years.

b. Yes. The purpose of the comparison is to show the timing and magnitude of the changes experienced by the Company.

c. The increase in Net Power Cost exposure is attributable to the asymmetric nature of Net Power Costs, the increase in price level and volatility of market prices for electricity and gas, and variability of the Company's system.

d. The analysis shows that significant under recovery is possible and provides justification for a PCAM.

OPUC Staff Data Request 10

At PPL/205 Widmer/2, Mr. Widmer stated that:

> "As demonstrated in Exhibit PPL 201, recovery of net power costs through the general rate case process is not symmetrical ... As long as the Company is subject to recovery asymmetry, it is not likely that it will be able to earn its authorized rate of return over the long run."

Assuming the asymmetric recovery shown in Exhibit PPL 201 is the result of the current power cost normalization methodology used in the general rate case process:

a. Please identify the flaw or flaws in the power cost normalization methodology that make it unlikely that PacifiCorp will be able to earn its authorized rate of return over the long run;
b. Please indicate any changes to the power cost normalization methodology that would fix the asymmetric recovery problem;, and
c. Please indicate why PacifiCorp did not to pursue changes to the power cost normalization methodology in Docket No. UE 170 and instead decided to pursue a PCAM in Docket No. UE 173?

OPUC Staff Data Request 10

a. As explained in Mr. Widmer's testimony, the current net power cost normalization approach does not allow the Company to recover costs on an expected basis. As shown on Exhibit PPL 201, the asymmetry of cost recovery has lead to the Company significantly under recovering costs.
b. Power cost adjustment mechanisms (PCAM) are the most common method of dealing with the recovery of volatile net power costs. The adoption of a PCAM such as the one proposed by the Company should fix the asymmetry problem. Probabilistic modeling of net power costs may be another alternative for fixing the problem. However, probabilistic modeling of net power costs for rate setting is not the norm in the industry and has not been evaluated by the Company at this point in time.
c. See the Company's response to OPUC Staff Request 10b.

OPUC Staff Data Request 12

Dimitri Nikas of Standard & Poor's Ratings Services, in a February 17, 2005 presentation at the Managing the Modern Utility Rate Case conference in Las Vegas, Nevada, stated that fuel adjustment mechanisms are:

> "Not to be used regularly, but rather under certain extreme circumstances." (See Attachment A at page 17.)

a. PacifiCorp's proposed PCAM lacks a dead band and would result in monthly power cost accruals. Does PacifiCorp's proposed PCAM satisfy the test of not being used regularly?
b. Would the Company characterize Mr. Nikas' statement as an endorsement of "catastrophic insurance" mechanisms? Please explain why or why not.

OPUC Staff Data Request 12

Ms.Omohundro was not present at Mr. Nikas' presentation and is reluctant to speculate on what Mr. Nikas might have said based upon a few lines of text in a Power Point presentation. However, it appears from the slides that Mr. Nikas' basic premise is that general rate cases ought to be resolved in a manner that permits a utility a reasonable opportunity to recover its allowed rate of return and that excessive reliance on other cost recovery mechanisms can jeopardize -credit quality. Ms. Omohundro agrees with both these propositions. As indicated by Mr. Widmer's rebuttal testimony, at such time as the general rate case process is adjusted so that the Company no longer faces substantial asymmetrical risk, the Company would support wider dead bands that would cause a PCAM to be triggered less frequently.

STANDARD
&POOR'S

Cost of Capital – What is Wall Street Saying

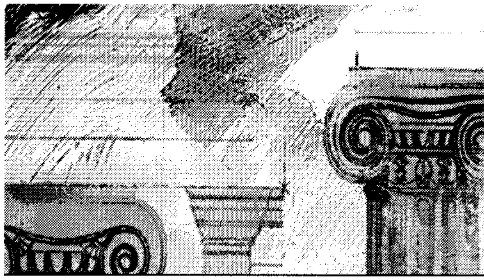
Dimitri Nikas

Associate Director

Utilities, Energy & Project Finance

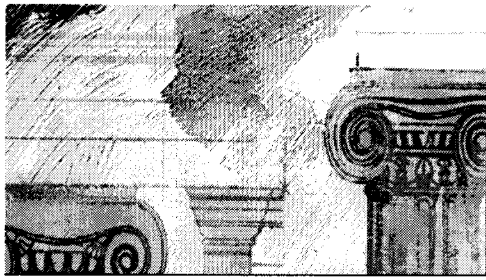
Standard & Poor's Ratings Services

The McGraw·Hill Companies



Agenda

- **The trend in authorized ROEs**
- **Why are authorized returns declining?**
- **How do authorized returns affect:**
  - Company financing structures
  - Ability to raise capital
  - Credit quality
- **What are the prospects for new investment?**



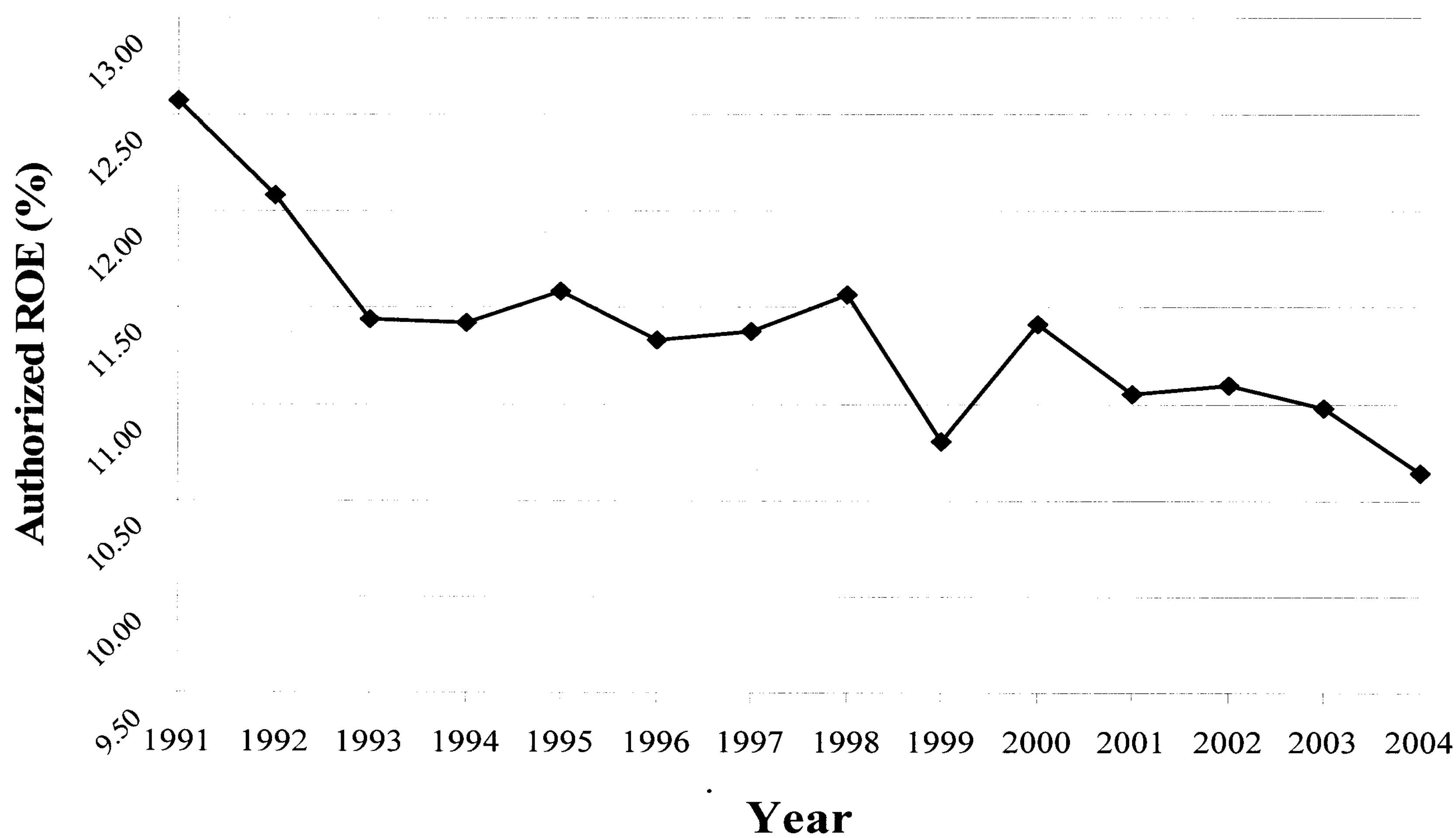
Recent Examples of ROE Determinations

Some examples of reductions in recent ROE determinations during 2004 include:

	Approved	Requested
❖ Nevada Power (NV)	10.25%	12.40%
❖ Madison Gas & Electric (WI)	11.50%	12.00%
❖ Idaho Power Co. (ID)	10.25%	11.20%
❖ Sierra Pacific Power (NV)	10.25%	12.40%
❖ Kentucky Utilities (KY)	10.50%	11.25%
❖ Avista Corp. (ID)	10.40%	11.50%
❖ Aquila (CO)	10.25%	10.75%
❖ Georgia Power Co. (GA)	11.25%	12.50%
❖ Louisville Gas & Electric (KY)	10.50%	11.25%

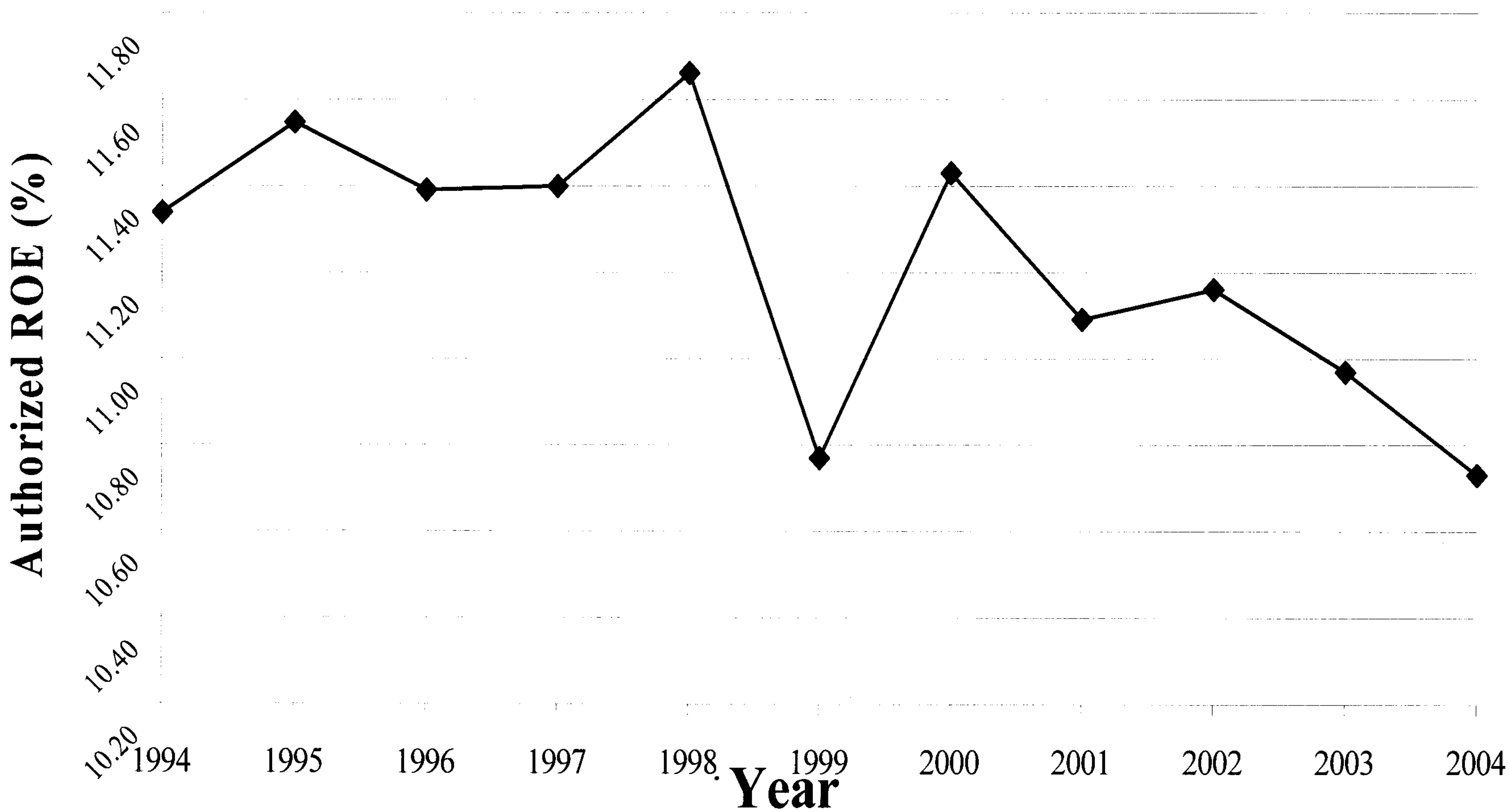
Source: Regulatory Research Associates – Major Rate Case Decisions – January 1990 – December 2004, Regulatory Focus, January 31, 2005

Authorized ROE Trend – All Utilities



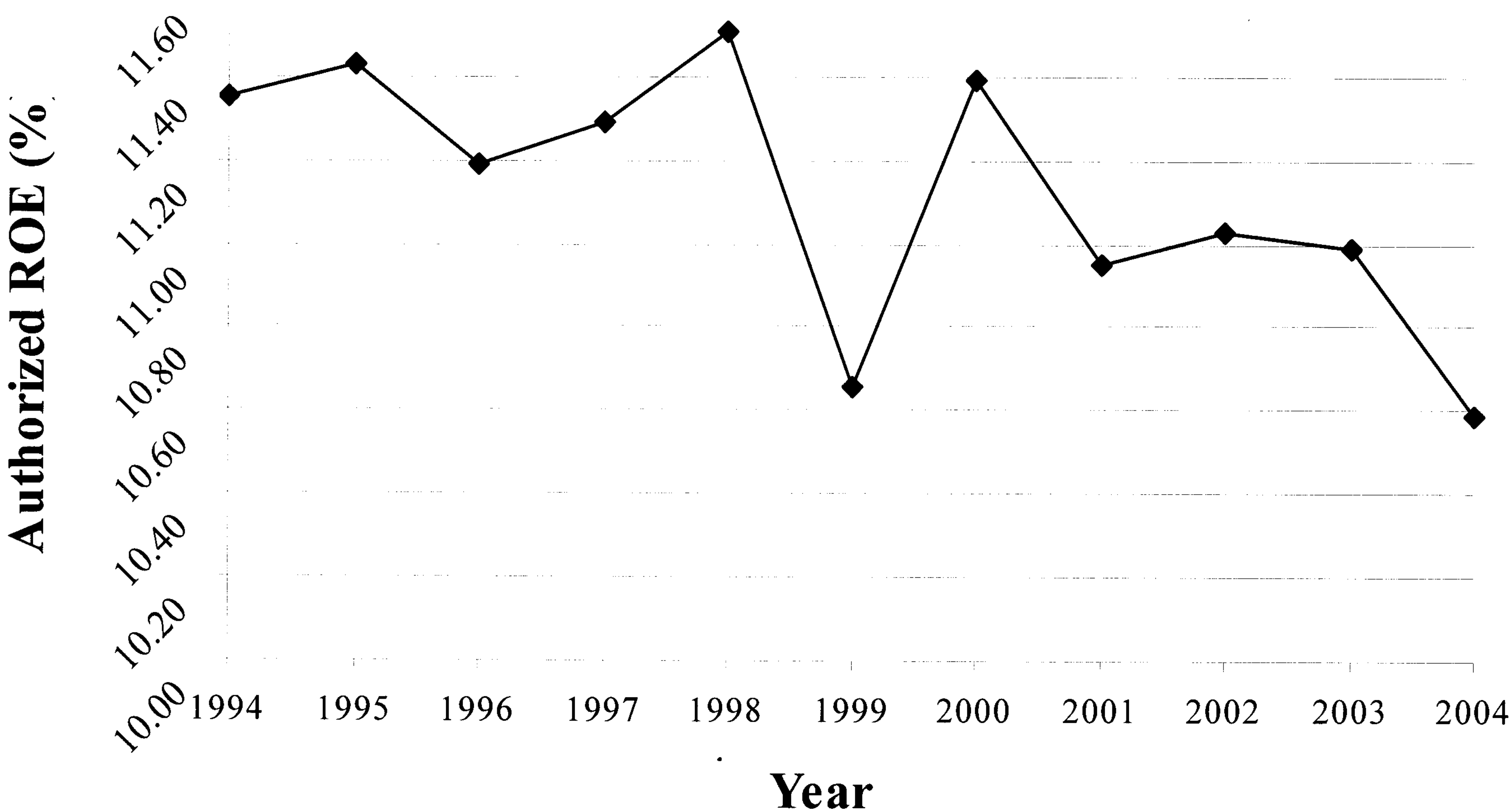
Source: Regulatory Research Associates – Major Rate Case Decisions – January 2003 – December 2004 Supplemental Study, January 14, 2005

Authorized ROE For Electric Utilities



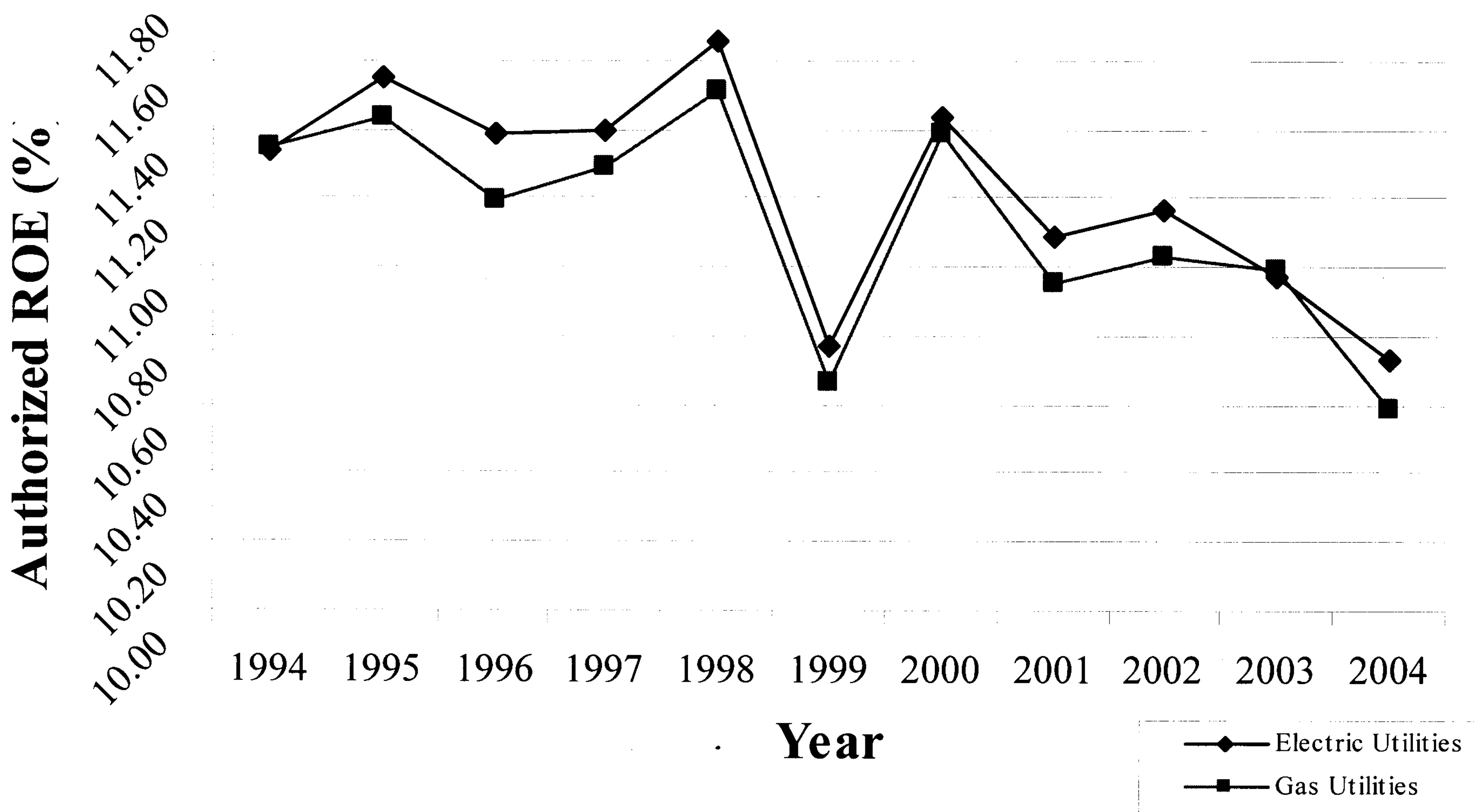
Source: Regulatory Research Associates – Major Rate Case Decisions – January 2003 – December 2004 Supplemental Study, January 14, 2005

Authorized ROE For Gas Utilities

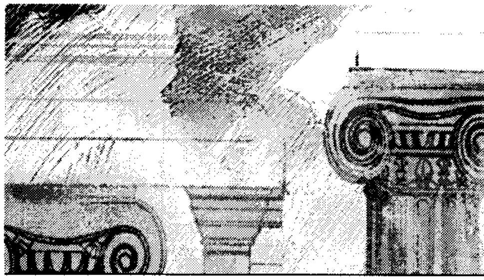


Source: Regulatory Research Associates – Major Rate Case Decisions – January 2003 – December 2004 Supplemental Study, January 14, 2005

Combined Authorized ROE Trend



Source: Regulatory Research Associates – Major Rate Case Decisions – January 2003 – December 2004 Supplemental Study, January 14, 2005



Why are Authorized Rates of Return Declining?

Authorized ROEs are declining for a number of structural reasons, including:

- **Protracted period of low interest rates and benign inflation**
  - Adjustments are made to reflect current economic environment
  - But adjustments are sticky!
- **Industry restructuring has separated utilities into T&D operators (regulated) and generators (merchant/un-regulated)**
  - T&D operators have lower operating risk
- **Utilities have demonstrated ability to generate healthy cash flow and remain profitable in the absence of rate cases despite additions to asset base**
  - Accomplished through cost savings and technological innovation
- **Performance-based regulation may challenge some utilities to meet cost reductions**

Lower Authorized ROEs and Effect on Company Financing Structures

- **ROE is determined in conjunction with an approved equity layer, motivating utilities to adhere to a particular capital structure**
  - Declining authorized ROEs have in some instances been accompanied by lower authorized levels of equity
- **Low interest rates and declining authorized rates of return make debt financings appear cheaper and may increase leverage**
- **Utility capital structure may not mirror that of the parent, leading to double leverage**
- **Capital structure is often viewed in the context of business model, i.e. Integrated utility (more conservative capital structure) vs. T&D (more relaxed capital structure)**
- **Trend towards lower authorized ROEs has not materially affected company financing structures – Utilities manage their capital structure with regard towards the capital structure embedded in rates but also with regard to reducing financing costs**
  - Capital structures have deteriorated for reasons other than low authorized rates of return, prompting severe rating actions

Lower Authorized ROEs and Ability to Raise Capital

- **Utilities compete for capital with other companies**
  - Therefore, regulators cannot authorize a low enough ROE to make utility investments unattractive and deprive the company of necessary funds
  - Regulators must balance access to capital markets among other issues
  - But then, how do you punish a poorly performing utility?
- **Lower authorized ROE may influence issuance costs (i.e. higher interest expense), which combined with lower implied cash flows may lead to weaker financial profile over long-term**
- **Even with lower authorized ROEs, utility investments are appealing due to stability and predictability of cash flows**
- **No examples of adverse of low authorized ROEs affecting ability to raise capital**

Staff/301
Galbraith/14

STANDARD
&POOR'S

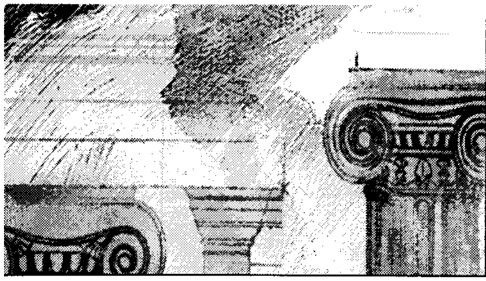
Authorized ROEs and Credit Quality

The McGraw·Hill Companies

Utility Credit Ratings Methodology

- Business profile (BP) scores are integral in assessing the credit quality of investor owned utilities
  - Provide a differentiation among business risk based on type of activity/business a company pursues
- BPs are assigned over a 10-point scale, with 1 being the strongest/less risky and 10 being the weakest/riskiest
- Examples of business profiles include:

	BP Range
Transmission & distribution	1-4
Transmission only	1-4
Integrated electric, gas & combination	3-7
Diversified Energy & Non-Energy	4-9
Energy merchants/developers/T&M	5-10



Utility Credit Ratings Methodology

Business Profile

Measured on a scale of 1 to 10.
From strongest to weakest
Five key qualitative characteristics
Each is given a different weight

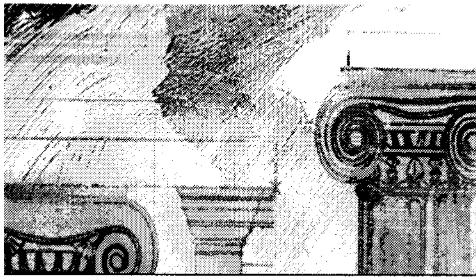
1. *Regulatory environment*
2. *Markets*
3. *Operational performance*
4. *Competitive position*
5. *Management's actions*

Financial Profile

Target indicators for business profile
Cash flow measures weighted heavily
More quantitative

BUT BENCHMARKS PROVIDE GUIDANCE, NOT DOGMA

1. *Profitability*
2. *Cash Flow*
3. *Capital Adequacy*
4. *Financial Flexibility*



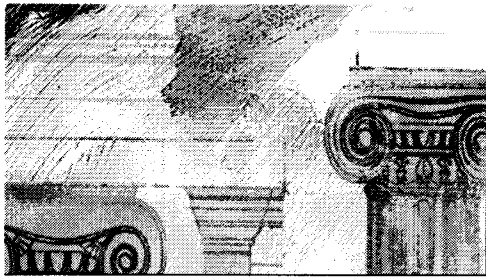
Assessing Regulation

In assessing the regulatory environment in which a utility operates, S&P analysis is guided by the following principles:

- Consistency & Predictability – The absolute necessities for regulatory environment to be considered supportive
- Efficiency & Timeliness – Eliminate/reduce regulatory lag
- Balance – Regulatory environment must balance interests of counterparties, with some deference towards timely cost recovery
- Political Insulation – Absent insulation from political pressures, bondholders' interests and credit quality may well be compromised

Evaluating The Rate Case Outcome

- **Regulators are legislators, hence, despite the existence of rate cases, testimony, rules of evidence and administrative law judges, regulators often emphasize compromise and political considerations**
- **Once a decision is reached, S&P evaluates the outcome in a number of ways:**
  - Does the decision address strictly a current topic or does the decision forewarn of the commission's thinking on long-term issues?
  - How does the rate case outcome affect the utility's financial profile over the intermediate term (3-5 year horizon) that is captured by the ratings outlook?
  - Do the new rates allow the utility to generate sufficient cash flow in order to preserve or enhance its financial profile and hence its credit profile? What do the new rates indicate about a commission's disposition towards credit quality?
  - Is the utility actually afforded the opportunity to earn the authorized rate of return? (To be addressed shortly)

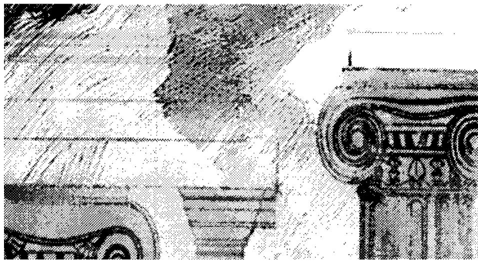


Recovering Expenses: The Significance of Fuel Clause Adjustment Mechanisms

- **By far one of the most important aspects of the rate case decision is the utility's ability to recover all expenses on a real-time or as close to real-time basis as possible**
- **Without full cost recovery, the earned ROE may appear unharmed, due to the ability to defer certain costs, while cash flow generation may suffer**
- **Expenses that must be recovered promptly include purchased power, fuel and gas costs**
  - These costs are often the largest ones a utility incurs
  - The utility funds these costs today with internal cash under the presumption that it will recover them all in the very near term to avoid a liquidity crunch
  - Fuel and purchased power clauses provide for recovery of these costs when rates are not sufficient

Fuel Clause Adjustment Mechanisms

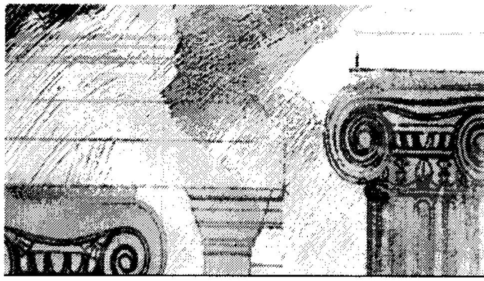
- **Fuel clause adjustment mechanism is a generic term for fuel clause, gas cost and purchased power adjustment mechanism**
- **Circumvents the need to file rate case in order to recover costs on a timely basis with minimal lag**
- **Useful for utilities that have significant exposure to cost swings through participation/ownership in gas fired generation and/or reliance on power purchases that are indexed to market prices**
- **Not to be used regularly, but rather under certain extreme circumstances**
- **Other examples of costs whose delayed recovery may prove detrimental include:**
  - Storm & hurricane costs
  - Pension and other post retirement costs
  - Various taxes and remediation costs



Regulation – Closing Thoughts

- In the end, while the authorized ROE level may affect how much cash a utility may generate in theory, it is the utility's ability to *actually* generate the authorized level of ROE and the associated level of cash flow that matters the most in determining credit quality

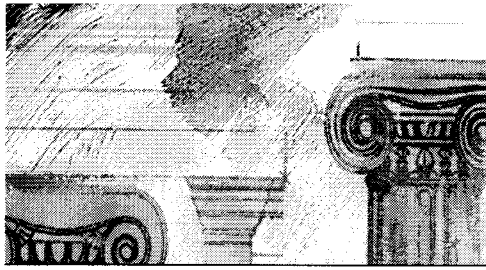
- In the absence of important safeguards, as discussed earlier, a utility's cash flow generating capability may be compromised and its financial profile may rapidly deteriorate, despite the existence of regulation and irrespective of what the authorized ROE is



What are the Prospects for New Investment?

Transmission Opportunities

- ❖ **Inadequate transmission capability,**
  - ❖ Causes congestion and higher prices of delivered power
  - ❖ Prevents the development of efficient wholesale power markets
- ❖ **New transmission investment is necessary to address:**
  - ❖ Reliability concerns
  - ❖ Connection for new generation
  - ❖ Reduction in congestion costs
  - ❖ Improved access to lower cost generation
  - ❖ Replacement of older transmission assets
- ❖ **Current framework for new transmission investment is favorable, but challenges remain i.e. siting, cost sharing, local opposition, etc.**



What are the Prospects for New Investment?

Other prospects for new investment include:

- **Generation**
  - To address situations where new transmission investment may not be suitable or economical
  - In restructured states, investment may be purely merchant or rely on long-term contract
  - In states that remain regulated, new investment to be recovered in rates
  - Challenges will always include local opposition
- **Environmental Compliance**
  - Driven by state and federal mandates
  - Investment to be recovered in rates for regulated utilities, in power prices for merchant generators

STANDARD
&POOR'S

Dimitri Nikas
Associate Director
Standard & Poor's
U.S. Utilities, Energy & Project Finance
dimitri_nikas@standardandpoors.com
212.438.7807

The McGraw-Hill Companies

CASE: UE 173
WITNESS: Bill Wordley

PUBLIC UTILITY COMMISSION
OF
OREGON

STAFF EXHIBIT 400

Supplemental Testimony

October 17, 2005

Q. PLEASE STATE YOUR NAME.

A. My name is Bill Wordley.

Q. DID YOU PREVIOUSLY FILE TESTIMONY IN THESE PROCEEDINGS?

A. Yes. I sponsored Staff/200, my direct testimony. My witness qualifications were provided as Staff/201.

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?

A. In this testimony I will: 1) comment on PacifiCorp's witness Greg Duvall's rebuttal testimony regarding the Power Cost Adjustment Mechanism (PCAM) allocation methodology, and 2) clarify staff's recommended PCAM allocation method.

Q. PLEASE DESCRIBE THE COMPANY'S ARGUMENT REGARDING THE ALLOCATION OF HYDRO-RELATED POWER COST VARIATION FOR APPLICATION IN ITS PROPOSED PCAM.

A. Mr. Duvall suggests that the states that receive the benefits of the company's low-cost hydro resources should be assigned the costs related to those resources. This, the company maintains, would be consistent with the Revised Protocol. (See PPL/301, Duvall/3-4)

Q. WHAT DOES MR. DUVALL RELY ON TO SUPPORT THE POSITION THAT THE COMPANY'S PROPOSED ALLOCATION METHOD FOR THE PCAM IS CONSISTENT WITH THE REVISED PROTOCOL?

A. In his rebuttal testimony, Mr. Duvall includes several general statements made by Staff (Marc Hellman) and CUB (Bob Jenks) at the UM 1050 Oral Arguments referring to the Revised Protocol hydro endowment. Mr. Duvall then concludes: "It is clear from these representations that if

Oregon is to receive the benefits of the low cost hydro, it should also bear the costs." (See PPL/301, Duvall/3-4)

Q. UNDER THE REVISED PROTOCOL AS APPROVED AND IMPLEMENTED, DOES OREGON RECEIVE ALL BENEFITS FROM THE HYDRO RESOURCES?

A. No. Under the Revised Protocol Oregon does not receive all benefits of the hydro resources **and** it is not assigned all the hydro-related risks and costs. The hydro benefit for Oregon that is included in the Revised Protocol is the Embedded Cost Differential (ECD) credit, which reflects the lower cost of hydro resources compared to the cost of all other resources. Hydro benefits that Oregon does not receive, because they are **not** included in the Revised Protocol are the value of hydro operating reserves, the value of the flexibility to "shape" the generation output of hydro resources, and the value of additional generation from actual good hydro conditions. Hydro-related costs that Oregon does not incur because they were **not** included in the Revised Protocol are the cost of replacing the reduction in hydro resource output due to relicensing requirements, contract expiration, retirement or actual poor hydro conditions. All these hydro-related benefits and costs not explicitly assigned in the Revised Protocol are shared system-wide along with all other company costs and benefits not explicitly addressed in the Revised Protocol.

Q. WHY WERE THE HYDRO-RELATED BENEFITS AND COSTS THAT WERE NOT EXPLICITLY ASSIGNED IN THE REVISED PROTOCOL NOT ASSIGNED?

A. The final terms of the Revised Protocol were negotiated by the parties as a package. Staff testimony in UM 1050 explained and quantified all the benefits and costs that were considered in its evaluation of the Revised Protocol. Staff described which benefits and costs for Oregon were included and which were excluded, and concluded that those included represented a fair result for Oregon compared to the principles initially given by the Commission. (See UM 1050, Staff/200)

Q. DO THE PARTIES IN THIS CASE AGREE THAT ONE SET OF BENEFITS AND COSTS NOT ASSIGNED IN THE REVISED PROTOCOL IS THE IMPACT OF THE VARIATION IN ACTUAL HYDRO OUTPUT?

A. Yes. All parties agree that the Revised Protocol deals only with "normalized" power costs, and does not address operational hydro-related power cost variations. The Revised Protocol provides no guidance, directly or implied, as to how the impact on power cost of actual hydro output variation should be allocated to states.

Q. PACIFICORP HAS STATED THAT, FROM A JURISDICTIONAL ALLOCATION PERSPECTIVE, THE PRIMARY PRINCIPLE THAT THE COMPANY HAS FOLLOWED IN DESIGNING ITS PROPOSED PCAM IS TO ENSURE CONSISTENCY WITH THE REVISED PROTOCOL. IS THIS IMPORTANT?

A. No. What was negotiated and ultimately included in the Revised Protocol has nothing to do with the PCAM. As stated above the Revised Protocol deals only with normalized power costs. The PCAM, on the other hand, deals only with variations from normalized power costs, and has nothing to do with the Revised Protocol.

Q. WHAT DOES STAFF RECOMMEND IN THIS DOCKET AS THE METHOD FOR JURISDICTIONAL ALLOCATION OF ACTUAL VARIATIONS FROM THE NORMALIZED POWER COSTS INCLUDED IN BASE RATES?

A. As recommended in direct testimony, Staff still recommends a system-wide load-based allocation of actual total power cost variations. Staff modifies its recommendation only slightly in this testimony. In direct testimony Staff advocated use of the SG factor. Staff now recommends use of the actual SE factor. Both the SG and SE are load-based, however, while the SG is based on a 75% weighting of peak demand and a 25% weighting of energy loads, the SE is 100% energy based. Power costs are primary driven by energy levels, consequently the SE factor, based 100% on the actual energy loads that occurred during the year, is the most appropriate allocator of actual power cost variations.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes

CERTIFICATE OF SERVICE

UE 173

I certify that I have this day served the foregoing document upon all parties of record in this proceeding by delivering a copy in person or by mailing a copy properly addressed with first class postage prepaid, or by electronic mail pursuant to OAR 860-13-0070, to all parties or attorneys of parties.

Dated at Salem, Oregon, this 17th day of October, 2005.

David B. Hatton

David B. Hatton
Assistant Attorney General
Of Attorneys for Public Utility Commission's Staff
1162 Court Street NE
Salem, Oregon 97301-4096
Telephone: (503) 378-6322

UE 173
Service List (Parties)

LOWREY R BROWN CITIZENS' UTILITY BOARD OF OREGON 610 SW BROADWAY, SUITE 308 PORTLAND OR 97205 lowrey@oregoncub.org	DATA REQUEST RESPONSE CENTER PACIFICORP 825 NE MULTNOMAH, SUITE 800 PORTLAND OR 97232 datarequest@pacificorp.com
MELINDA J DAVISON DAVISON VAN CLEVE PC 333 SW TAYLOR, STE. 400 PORTLAND OR 97204 mail@dvclaw.com	JASON EISDORFER CITIZENS' UTILITY BOARD OF OREGON 610 SW BROADWAY STE 308 PORTLAND OR 97205 jason@oregoncub.org
RANDALL J FALKENBERG RFI CONSULTING INC PMB 362 8351 ROSWELL RD ATLANTA GA 30350 consultrfi@aol.com	MAURY GALBRAITH PUBLIC UTILITY COMMISSION PO BOX 2148 SALEM OR 97308-2148 maury.galbraith@state.or.us
DAVID HATTON DEPARTMENT OF JUSTICE REGULATED UTILITY & BUSINESS SECTION 1162 COURT ST NE SALEM OR 97301-4096 david.hatton@state.or.us	D DOUGLAS LARSON PACIFICORP ONE UTAH CENTER 201 SOUTH MAIN STREET, SUITE 2300 SALT LAKE CITY UT 84111 doug.larson@pacificorp.com
KATHERINE A MCDOWELL STOEL RIVES LLP 900 SW FIFTH AVE STE 1600 PORTLAND OR 97204-1268 kamcdowell@stoel.com	