BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1276

INVESTIGATION INTO PERFORMANCE-BASED RATEMAKING MECHANISMS	STAFF'S OPENING COMMENTS

BACKGROUND

Docket UM 1276 was opened in August 2006 in order to look at mechanisms to address the potential bias inherent in the utility resource procurement process ("the bias".)[1] That decision was based in part on Staff's June 9, 2006 memo which detailed four potential barriers to the purchase of "power purchase agreements" (PPAs):

1. Utility concerns over the treatment of PPAs in credit scores;
2. Counterparty risk involved in entering into PPA contracts;
3. Utility-owned power plants earn a return as part of the utility's rate base, whereas PPAs do not; and
4. The concept that a utility would want to engage in empire building.

As a result of the workshop discussions, staff is convinced that the primary barrier to PPA procurement is that utilities do not earn a return on PPA contracts. The logic is simple: under cost of service regulation, a utility's "profit" is the opportunity to earn a return on the rate base,[2] and by purchasing a PPA in lieu of building a power plant it is forgoing the potential to earn some amount of profit. Short of eliminating rate base as part of a regulatory overhaul and allowing a utility to cut costs under a revenue or price cap mechanism, there is not a tremendous amount a utility can do to significantly boost its profits outside of the return on rate base.

Staff identified three potential regulatory regimes to address the bias:

1. Reduction of regulatory risk only;
2. Monetary incentives; and
3. Elimination of rate base.

[1] As directed by the Commission, for the purposes of this docket, the parties assumed the existence of the bias. As such, staff will refer to the "potential bias" as simply the "bias" in the remainder of these Comments.
[2] In UM 1066, staff also noted a utility's ability to earn profits through operational benefits of owned plants.

One or more options were discussed for each regime, ranging from simple mechanisms to broad regulatory reforms. A version of one option, the power cost adjustment mechanism (PCAM), was approved for PGE in Order No. 07-015, though it is too early in its implementation to determine if it has made any difference in PGE's resource procurement preferences.

THE PROCESS

The parties held four workshops to discuss possible mechanisms to address the bias. Parties operated with two parameters in mind. First, as directed by the Commission, the parties assumed that the bias exists. Second, the resulting mechanism could and most likely would provide an incentive to utilities to choose PPAs over utility-owned resources during the procurement process.

The parties also agreed that any party could make a proposal and would not be expected or required to advocate for that proposal. Using this assumption allowed for a more robust discourse during the workshops and allowed ideas to come to light that may have been withheld otherwise.

The parties submitted the following final straw proposals on May 16, 2007:

1. PacifiCorp: Incentives for New PPAs Based Upon Oregon Conservation Incentive Model (CIM/pp);
2. PGE: Income Opportunities with Contracts;
3. PGE: Income Opportunity by Portfolio;
4. PGE: Debt Imputation Straw Proposal;
5. NIPPC: NIPPC Straw Proposal; and
6. ICNU: Return on Equity Adjustment Straw Proposal.

DISCUSSION

PacifiCorp's CIM/pp

Staff concludes that PacifiCorp's CIM/pp is the strongest of the submitted straw proposals and has the greatest potential to address the bias while still holding true to the precepts and processes of least cost resource procurement and just and reasonable customer rates.

The strength of the CIM/pp is its ability to address the primary barrier to PPA procurement (i.e. the lack of an opportunity to earn a return on PPAs) and its basis in a framework that the Commission has used in the past. The capacity portion of a PPA would be capitalized, subject to a cap described below, which is similar to how a power plant is accounted for in the rate base. Additionally, the proposal's built-in regulatory discipline through the use of prudence reviews is both a responsible and necessary addition.

It is important to consider that, through the Integrated Resource Planning and Request for Proposal processes and through general rate cases, the Commission has a number of opportunities to address resource choices and ultimately decide if a procured resource is prudent and if the costs of that resource will be allowed in rates.

During the final workshop, CUB raised a concern about how the costs to be amortized would enter rates, because contracts are generally structured so that multiple capacity payments are made over the life of the contract. Capitalizing all of the capacity costs upfront would most likely result in questions regarding what was used and useful. Staff's understanding of the fourth bullet point in the CIM/pp[3] alleviates that concern, as capacity payments only enter the rate base as they are incurred.

Concerns were raised during the discussion of the CIM/pp that utilities would be motivated to structure PPA contracts towards capacity as opposed to energy in order to maximize the portion of the PPA that would earn a return. PacifiCorp's solution is the CIM/pp's proposed 50 percent cap on the capacity portion of the PPA. The value of 50 percent is derived from the S&P method of determining a proxy capacity component for 100 percent energy contracts, which essentially assumes that energy-only contracts have a capacity component of 50 percent.

Staff is concerned that the CIM would apply to new PPAs having a minimum contract length of one year or longer in duration, as opposed to having a minimum duration of three or five years. However, staff recognizes that S&P recently changed their imputed debt determination criteria, and shorter contracts are now taken into account in their analysis. Ultimately, staff is not opposed to the proposed minimum contract length of one year, to the extent that the CIM/pp can achieve its goal of eliminating the bias, improving the results of the S&P calculations, and potentially improving utility credit scores and reducing associated financial costs.

Another of staff's concerns is that the CIM/pp proposal does not specify a minimum contract size applicable to the mechanism. If a goal of the mechanism is to ultimately promote a robust wholesale power market in the region, the incentives need to focus on PPAs that will result in the building of new IPP plants or the expansion of plants currently in operation, essentially replacing a utility's need to build its own plant. It is unclear at this time if allowing a return on smaller contracts will have a similar result or merely replicate the market today with an

[3] "In rate case or annual net variable power cost update, allow utilities to amortize prudent PPA capacity expenditures, plus AFPPA for capacity portion of PPA, over life of PPA."

unnecessary incentive for utilities. Staff does not have a suggestion for a minimum contract size at this time.

Staff recommends adding the following two requirements to the CIM/pp:

First, there should be an ongoing accounting of how the mechanism affects the financial metrics of the utility engaged in one or more PPAs under the CIM/pp. Tracking the financial metrics will assist in determining if the incentives are having the desired effect on utility imputed debt calculations, credit ratings, and rates of return. Tracking financial metrics will also assist in determining if the incentives provided are excessive. Staff recommends that the metrics be reported annually.

The second requirement, as proposed by NIPPC, should be an appraisal of the CIM after it has been in effect for five years in order to judge how well the mechanism is working and whether any changes need to be made. Staff recommends that the appraisal be presented at a public meeting.

PGE Income Opportunities with Contracts

PGE's Income Opportunities with Contracts proposal comes from the same theoretical neighborhood as the CIM/pp. The essential difference between this proposal and the CIM/pp is that PGE commendably attempts to tailor the reward, in the form of an adder, for each PPA to the risk and length of the contracts.

The tailoring of the risks and rewards is the proposal's greatest asset. There is certainly great value in tailoring the risk and reward of the mechanism, as it may ensure that a utility is correctly compensated for its entry into a given PPA. The utility's regulated rate of return may be overpaying for a contract that requires little in the way of management. Additionally, the rate of return may overcompensate for a shorter contract that the utility can take off of its books after a few years.

Conversely, the tailoring of the risks and rewards is also the proposal's greatest liability. PGE does not propose a method by which the adder is objectively determined and the adders used in the proposal itself are arbitrary. Staff has two concerns regarding the potential process for determining the adder. First, it is not appropriate to use an arbitrary adder. While administratively simple, it does not represent the real risks and rewards of a particular PPA. Second, should the Commission desire to attempt to calculate the real risks and rewards of a particular PPA, the potential calculations, assuming some sort of option value methodology is used, are complex and open to interpretation. This problem is compounded if more than one PPA is under consideration, as each PPA would most likely require its own adder calculation.

In fairness, it can be argued that the CIM/pp is also arbitrary in its use of a utility's regulated rate of return for all contracts and overcompensates for the risks of many PPAs. However, the benefit of using the regulated rate of return is that the value is argued in front of and approved by the Commission in general rate case proceedings, which not only provides validity for the value but minimizes the potential for additional litigation in the resource selection process.

Ultimately, there is the potential that the Income Opportunities with Contracts proposal is self-sabotaging, as the potential computational complexity and process time necessary to determine the adder will provide a disincentive to utility PPA purchases.

PGE Income Opportunity by Portfolio

PGE's Income Opportunity by Portfolio proposal suffers from a similar problem as the Income Opportunities with Contracts proposal; the determination of the incentive, which for this proposal is the management fee, is completely arbitrary. PGE does not include any proposal on how to calculate the management fee.

The proposal also does not specify whether only new PPAs are included and what the size and term requirements are for inclusion. If the mechanism is retroactive to include all PPAs in a utility's portfolio, PGE would stand to earn a substantial amount of money without even purchasing a new PPA, let alone a PPA that would offset the building of a new power plant. PacifiCorp and Idaho Power, which do not have the same portfolio makeup as PGE, would not achieve the same instant gains.

Additional potential issues with this proposal arise because it includes the energy portion of PPA costs in the calculation.

The first issue is that the proposal's inclusion of energy costs may overcompensate a utility. Overcompensation can happen for two reasons. First, S&P only considers capacity costs in its debt imputation calculations, so it is not correct to propose compensation based on energy costs to deal with debt equivalency problems. Second, utilities do not earn a return on energy costs for their own plants, so the mechanism is not premised on an apples-to-apples basis with the utility's opportunity cost associated with building.

The second issue is that the mechanism, through the inclusion of energy costs, may inappropriately influence a utility's operational economics. Income based on energy costs may create situations in which a utility has an incentive to ramp down a lower-cost utility-owned resource in order to capture the additional income provided via the mechanism. For example, assuming equal treatment of capacity portion of both utility-owned resource and PPA:

Utility-owned resource energy cost: $30.00/MWh
PPA energy cost: $30.01/MWh
PPA energy cost plus 3% management fee: $30.91

Without necessarily appearing imprudent, this example shows that the utility would earn almost a $1/MWh by ramping down the more economic, but utility-owned, resource. The Commission does not monitor the hourly resource decisions made by a utility and so may be unaware of such inappropriate utility actions taken under the mechanism.

PGE Debt Imputation Straw Proposal

PGE's Debt Imputation Straw Proposal addresses the first barrier to PPA purchases, which is a utility's concern over the treatment of PPAs in its credit score. As stated in the staff's June 9, 2006, memo, a debt equivalency mechanism can address the utility concern and is in place in at least one other jurisdiction:

> California adopted a process in 2004 in which debt equivalency would be considered as part of the resource selection process.[4] The CPUC recognized that "…as imprecise and subjective as it may be, DE [debt equivalency] is a real cost that needs to be considered when evaluating bids from a PPA vs. a utility-owned resource."[5]

PGE's approach is based on the S&P calculation and is fundamentally sound. One concern with the proposal is whether it is appropriate to use a specific risk factor for each company, per PGE's proposal, or whether it is appropriate to use a universal risk factor, which is the methodology used in California.[6] Staff does not currently have a position regarding this concern.

Staff outlined some concerns with this methodology in the June 9, 2006, memo and those concerns hold true today.

> Two other circumstances should also be recognized when looking at PPAs and debt imputation:
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> 1) Even though there may be a level of credit risk when entering into the PPA contract, the operating costs of a utility-owned resource vs. the PPA and the option value of the contract itself should be taken into consideration. The credit risk may be negated to an extent by the reduction in operating costs the utility incurs because they chose a PPA instead of building a plant.

[4] *See* California PUC Decision 04-12-048, Order Instituting Rulemaking to Promote Policy and Program Coordination and Integration in Electric Utility Resource Planning, December 16, 2004.
[5] *Ibid*. Page 144.
[6] *See* CPUC. Page 145.

2) Staff's 2005 memo[7] states that, at the time, staff was not aware of any cases in which a company had their credit rating downgraded due to entering a PPA. The rating process considers the future prospects of all material issues that affect a company, including other liabilities such as pensions and asset revaluations.

Additionally, the June 9, 2006, memo references the recommendations made by Bryan Conway in his 2005 memo:

> Staff addressed this issue as it relates to S&P in a 2005 memo by Bryan Conway. Staff recommended that if the Commission wishes to take action to mitigate the impacts of a PPA on a company's balance sheet, the Commission can:
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> 1) Increase the frequency of rate cases, which would reduce the uncertainty caused by regulatory lag;
> 2) Utilize a resource valuation mechanism process coupled with deferred accounting, which would decrease the likelihood of less than full and timely recovery; and
> 3) Securitize the capacity payments of a PPA to minimize the likelihood of less than full and time recovery of PPA expenses.[8]

Staff continues to have doubts about the specific credit rating impacts of entering a PPA, though any evidence that it does is worthy of consideration. Additionally, as stated previously, the primary barrier to PPA procurement is not debt equivalency, but the loss of the return the utility would have earned had it built its own plant. As such, staff recommends against utilizing a debt equivalency mechanism, not simply because the proposal is impractical, but because a securitization mechanism, such as the PacifiCorp CIM/pp, more directly and appropriately addresses the source of the bias.

NIPPC Straw Proposal

NIPPC's Straw Proposal primarily addresses the resource selection process, including a recommendation to re-open UM 1182 and apply a 10 percent discount to IPP bids to reflect the risk absorption benefits of PPAs. Staff would like to see more discussion of this proposal, including a robust accounting for how NIPPC derived the 10 percent value, before issuing a recommendation.

Staff agrees with NIPPC's recommendation that the PacifiCorp approach is worth pursuing and also previously stated that the CIM/pp should include NIPPC's recommendation of an appraisal of the mechanism after five years.

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[7] *See* Bryan Conway and Thomas Morgan's memo to Lee Sparling, June 6, 2005.
[8] *Id*.

ICNU's Return on Equity Adjustment Straw Proposal

ICNU's proposal correctly observes that, under each of the proposed mechanisms, there is some financial performance risk that is shifted from the utility to the ratepayers. Any of the implemented mechanisms should have a positive impact on how investors, creditors, and credit ratings agencies view the utilities, which should, to some extent, affect their financial metrics, such as credit ratings. As a result of each of the proposals, ratepayers will essentially pay to offset some amount of utility financial performance risk, though the benefits of improved utility financial standing and the long term benefits of a robust wholesale power market will provide an offset to the cost in the long-run.

However, ICNU's proposal is not an appropriate response to any implemented incentive mechanism because the process of holding ratepayers harmless will negate any incentive provided by any implemented mechanism. Even if the adjustment is not tied directly to the mechanism, the net result is still zero gain for the utility. Adding an ROE adjustment will only serve to continue a utility's bias towards building its own power plants.

CERTIFICATE OF SERVICE

I certify that on May 22, 2007, I served the foregoing upon all parties of record in this proceeding by delivering a copy by electronic mail and by mailing a copy by postage prepaid first class mail or by hand delivery/shuttle mail to the parties accepting paper service.

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