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May 31, 2007

***Via Electronic and US Mail***

Public Utility Commission
Attn: Filing Center
550 Capitol St. NE #215
P.O. Box 2148
Salem OR 97308-2148

Re: In the Matter of PUBLIC UTILITY COMMISSION OF OREGON STAFF'S Request to open an investigation regarding performance-based ratemaking mechanisms to address potential build-vs-buy bias
**Docket No. UM 1276**

Dear Filing Center:

Enclosed please find the Opening Comments of the Industrial Customers of Northwest Utilities in the above-referenced docket.

Thank you for your assistance.

Sincerely,

*/s/ Christian Griffen*
Christian W. Griffen

Enclosures
cc: Service List

## CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing Opening Comments of the Industrial Customers of Northwest Utilities upon the parties on the service list, shown below, by causing the same to be deposited in the U.S. Mail, postage-prepaid, or via electronic mail to those parties who waived paper service.

Dated at Portland, Oregon, this 31st day of May, 2007.

*/s/ Christian Griffen*
Christian W. Griffen

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**BEFORE THE PUBLIC UTILITY COMMISSION**

**OF OREGON**

**UM 1276**

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| In the Matter of<br><br>PUBLIC UTILITY COMMISSION OF OREGON STAFF'S<br><br>Request to open an investigation regarding performance-based ratemaking mechanisms to address potential build-vs-buy bias | )<br>)<br>)<br>)<br>)<br>)<br>)<br>)<br>) | THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES' OPENING COMMENTS |

## I. INTRODUCTION

Pursuant to Administrative Law Judge ("ALJ") Power's April 30, 2007 Memorandum, the Industrial Customers of Northwest Utilities ("ICNU") submits these Opening Comments regarding the Public Utility Commission of Oregon's ("OPUC" or the "Commission") investigation into mechanisms to address the utilities' bias to build rather than purchase new generation resources. ICNU applauds the Commission for initiating the investigation and considering options to eliminate the long-standing and difficult problem of utilities favoring their own generation resources. In the past, ICNU believes that this utility bias has increased the cost of power to ratepayers and harmed the development of a competitive electric generation market.

ICNU recommends, however, that the Commission should not attempt to mitigate this bias by adopting the utilities' own proposals, which would provide them with economic incentives to enter into purchase power agreements ("PPAs"). Each of



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these proposals provides additional income opportunities to the utilities, but would not provide any guarantee that the utility bias will be eliminated. The result is to simply increase costs to ratepayers. Providing economic incentives is the wrong response to the utilities' failure to purchase lower cost market resources. Adoption of these proposals would be akin to accepting the fox's recommendation regarding how to construct a better hen house. If the Commission, however, decides to adopt any of the utilities' proposals, then a corresponding adjustment to their return on equity ("ROE") should be made to hold ratepayers harmless and ensure that earnings are not increased above a reasonable level.

Instead of adopting the utilities' proposals, ICNU recommends that the Commission review whether the new integrated resource planning rules and competitive bidding requirements have been able to successfully mitigate the utilities' bias. The Commission should also reaffirm that the utilities are required to serve customers with the least cost, least risk resources regardless of ownership. In future rate proceedings, any utility claims that owned resources are a better value for ratepayers should be viewed with a healthy skepticism that recognizes the utilities' biases. Finally, ICNU finds merit in the recommendation of the Northwest & Intermountain Power Producers Coalition ("NIPPC") to explicitly remedy the utility bias through an adjustment in the competitive bidding process. If these measures prove insufficient to remedy the utilities' bias, then ICNU recommends that the Commission revisit this issue in the future.



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## II. BACKGROUND

In August 2006, the Commission opened an investigation regarding performance-based ratemaking ("PBR") mechanisms to address the build vs. buy bias in electric utility resource procurement. This PBR proceeding is intended to complete the Commission's investigation into regulatory policies affecting new resource development that was opened in the fall of 2002 (Docket No. UM 1066). Docket No. UM 1066 reviewed how new generating resources should be treated for ratemaking, which customers the utilities should plan to serve, and whether the utilities should engage in competitive bidding. Re an Investigation into Regulatory Policies Affecting New Resource Development, Docket No. UM 1066, Order No. 02-872 (Dec. 12, 2002). The Commission is also considering whether to amend or repeal its rule that requires these new resources be included in rates at market prices. Re an Investigation into Regulatory Policies Affecting New Resource Development, Docket No. UM 1066, Order No. 05-133 (Mar. 17, 2005).

The Commission kept the existing market price rule in effect (subject to waiver in specific proceedings), but found that there were numerous valid reasons for including new generation resources in rates at cost rather than market. Id. The Commission was concerned that returning to "cost standard will cause a utility to favor its own proposed resources." Id. at 2. The Commission decided to hold Docket No. UM 1066 in abeyance until the completion of three proceedings to address the

utilities bias to favor its own projects: 1) a revision to the competitive bidding guidelines to ensure resources are considered on an equal basis; 2) a modification to the least cost planning rules to foster timely and efficient resource acquisition; and 3) a PBR investigation to review utility bias in favor of its own resources. Id. at 2-3.

On August 10, 2006, the Commission issued its final order in its investigation into new competitive bidding guidelines. Re an Investigation Regarding Competitive Bidding, Docket No. UM 1182, Order No. 06-446 (Aug. 10, 2006). The Commission modified the original 1991 competitive bidding rules to require a more rigorous competitive bidding process. A request for proposals ("RFP") is required for all new resources with durations greater than five years and over 100 MW, and an independent evaluator is required to evaluate the bids. Id. at 3-4, 6-7. 9-14. Resources must be considered on an equal basis, but the utilities retain the final authority to select a resource. PacifiCorp's current RFP is the first that has been subject to these new requirements.

The Commission also recently adopted new guidelines regarding integrated resource plans ("IRP"). Re Public Utility Commission of Oregon Investigation into Integrated Resource Planning, Docket No. UM 1056, Order No. 07-002 (Jan. 8, 2007). The Commission reaffirmed its 1989 IRP guidelines, but adopted new substantive requirements regarding additional information and analysis that the utilities must provide to obtain acknowledgement of an IRP. Id. at 3. The goal of an IRP continues to be to identify those resources with the lowest overall cost and risk for ratepayers. Id. at 1.



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The Commission opened this PBR docket after the Commission Staff originally identified four potential barriers to utilities entering into PPAs. These include: 1) regulatory treatment of PPAs; 2) counter party risk associated with PPAs; 3) utility owned plants earn a return on rate base; and 4) utility "empire building" and attempts to accumulate assets. The Commission directed the parties in this PBR investigation not to debate whether the utilities are biased in favor of their own resources, but to review potential solutions.

The parties have held five workshops to explore solutions to the problem of utility bias, four of which ICNU and the Citizens' Utility Board were invited to participate in. With some input from workshop participants, Portland General Electric Company ("PGE") and PacifiCorp separately developed four different straw proposals that attempt to mitigate the utility bias by providing the utilities with economic incentives to enter into PPAs.[1/] NIPPC has proposed to reopen the competitive bidding docket to explicitly acknowledge the benefits PPAs provide to ratepayers in the RFP process, and a modified version of PacifiCorp's straw proposal. ICNU opposes all of the utility proposals on the basis that they unfairly shift costs and risks to ratepayers. ICNU has proposed that, if the Commission adopts one of the incentive-based straw proposals, then the utilities' ROE should be adjusted to hold ratepayers harmless and ensure the utilities do not earn excessive returns. Staff has not separately developed its own proposals.

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1/ ICNU's opening comments address the straw proposals that were circulated with the parties on May 16, 2007. The final versions of some parties' straw proposals are being filed simultaneously with the opening comments in this proceeding and may differ from those that were circulated earlier.



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## III. COMMENTS

### 1. The Commission Should Not Require Customer Paid Incentives In Order For the Utilities to Do Their Jobs

The utilities' proposals should not be adopted because they provide them with additional income opportunities to do what they are already required by law to do: acquire the least cost and least risk resources for ratepayers regardless of ownership. See, e.g., Re Public Utility Commission of Oregon Investigation into Integrated Resource Planning, Docket No. UM 1056, Order No. 07-002, Guideline 1(c) (utilities must plan to acquire the least cost, least risk resources); Re Juniper Util. Co. for Water Serv., Docket Nos. UW 65 and UW 68, Order No. 00-543 at 8-9 (Sept. 14, 2000). There is no guarantee and little support that these utility proposals will change their behavior, eliminate their bias, or promote the development of the wholesale power markets. In fact, the only certainty associated with the utility proposals is that they will increase the costs to ratepayers and provide additional income to the utilities, even if they do not enter into additional cost-effective PPAs.

#### A. The Utility Proposals

Although they differ in details, each of the utilities' four proposals attempts to provide them with additional income to encourage additional PPA acquisitions and reduce investment in rate base generation resources. PGE has proposed to impute equity to offset the debt equivalence of the capacity component of its PPAs. PGE Debt Imputation Straw Proposal at 1. The utilities would be allowed to earn a



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return on "phantom" common equity capital which was not provided by utility investors or retained utility earnings. PGE proposes that the amount of phantom equity would be determined in the utility's general rate case. Id.

PGE has also proposed that the utilities should be allowed additional income from a portfolio management fee. PGE Income Opportunity by Portfolio at 1. The management fee would be similar to the fee earned by a manger of a mutual fund or stock portfolio. Id. The utilities would simply earn a fee based on the percentage of the net costs of its contracts. Id.

PacifiCorp and PGE have each proposed different methods to allow the utilities to include PPAs in their rate base and thus earn return on power contracts. PGE Income Opportunities with Contracts; PacifiCorp Incentives for New PPAs. Both PGE's and PacifiCorp's proposals would include PPAs in rate base based on the capacity component of the PPA. The utilities would essentially earn a return without making any investment. PacifiCorp modeled its proposal based on conservation incentives that were implemented by the Commission in the late 1980s and early 1990s, which attempted to encourage demand side management. It has not been shown that these conservation incentives were successful or what their costs to ratepayers were.

These proposals are not fully developed and face many practical implementation issues. For example, the Commission would be required to establish clear requirements regarding how the capacity portion of a contract is determined and



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which contracts can be partially or fully rate based. Similarly, standards would need to be developed to calculate the phantom equity associated with debt imputation.

The only clear aspect of PGE's and PacifiCorp's proposals to rate base PPAs is that they would increase the costs to ratepayers for each new PPA that a utility enters into. A PPA is simply not a rate base item and to characterize it as such is contrary to decades of Commission precedent. ICNU's review of the contract examples included in PGE's straw proposal shows that the costs to ratepayers for each PPA would be increased by 1.1 to 3.3%. Actual cost increases to ratepayers could be much higher.

Providing these economic incentives could also result in unintended negative consequences, in addition to the increased power costs that would be charged to ratepayers. For example, if the utilities are provided a return on the capacity portion of their PPAs, then the utilities may enter into more capacity based PPAs than are beneficial to ratepayers. In addition, the actual substantive details of the PPAs may not change, but the PPAs may be structured in unique fashions in order to maximize the ability to rate base the contract.

The utilities' proposals could also provide an incentive to enter into above market transactions. Currently, PPAs are passed on to customers based on actual costs, subject to a prudence review, and the utilities have an economic incentive to enter into the most cost-effective PPAs. PGE's portfolio income opportunity proposal would allow the utilities to impose a management fee on the net cost of its contracts and offer the utilities an economic incentive to enter into more expensive PPAs to increase their



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management fee. Similar perverse incentives could result from the proposals to rate base PPAs.

Another significant flaw in the utilities' proposals is that they do not guarantee any change in the utilities' resource procurement, or that the overall lowest cost resources will be acquired for ratepayers. For example, PGE's portfolio income opportunity may simply provide more income to the utilities without any change in behavior. PGE already meets about 50% of its energy requirement needs with power purchase contracts, and this proposal would simply provide PGE with additional revenues regardless of the actions it takes. Properly designed economic incentive mechanisms should not apply to all contracts or even all new contracts, but be limited to only those contracts which the utilities would not otherwise enter into due to their bias.

### B. The Utilities Should Not Be Rewarded for Failing to Fulfill Their Statutory Obligation to Serve Customers with the Least Cost Resources

The utility proposals acknowledge that they are biased in favor of owning resources and that this bias should be reduced to make them more receptive to additional PPAs. E.g. PGE Debt Imputation Proposal at 4. PGE asserts that many of the positive benefits associated with PPAs "might be lost" without the opportunity for the utilities to earn additional income. PGE Income Opportunities with Contracts at 1. The utilities are essentially admitting that the financial rewards associated with rate basing their owned generation resources has resulted in decisions not based on what is the best option for ratepayers, but the potential returns to shareholders. The Commission should penalize



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the utilities for deciding not to acquire the most cost-effective resources for ratepayers instead of providing the utilities economic incentives to just do their jobs.

### C. The Commission Should Penalize the Utilities When They Fail to Acquire the Least Cost Resources

The Commission should utilize the regulatory tools already available to address the utilities' bias to build new generation resources. Any prudence review of a new generation resource should recognize this bias exists, and require the utilities to demonstrate that this bias did not prevent them from acquiring the least cost resource.

The Commission has the regulatory tools to address the utilities' decisions to make resource decisions based on what is best for shareholders instead of ratepayers. In procuring resources to serve their customers, the utilities must make prudent and reasonable investment decisions. Re PGE, Docket No. UE 139, Order No. 02-772 at 11-14 (Oct. 30, 2002). Costs which are excessive, unaccounted for, or caused by lack of proper foresight or mistakes are imprudent and disallowed. Re Northwest Natural Gas Co., Docket No. UG 132, Order No. 99-697 (Nov. 12, 1999). Similarly, if a utility decides not to enter into a lower cost option to provide service to customers, the Commission should disallow any costs associated with the higher cost decision as imprudent. See Re Juniper Util. Co. for Water Serv., Docket Nos. UW 65 and UW 68, Order No. 00-543 at 8-9 (Sept. 14, 2000).

The Commission should be especially critical if the utilities' resource costs exceed market, a self build option exceeds its estimated costs in an RFP, or a utility selects a self build option that is somehow more expensive than a competing bid. Even if



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a utility is not biased in favor of rate basing resources, the cost estimates for a utility's benchmark resource in an RFP can be lower than a comparable IPP because the utility has the potential to include cost overruns in customer rates while an IPP typically must absorb any cost overruns. Thus, the costs of a benchmark resource can appear lower in the RFP because the utility may assume that certain risks will be borne by ratepayers. This particular problem was noted by the Oregon independent evaluator in PacifiCorp's current RFP, which recommended that PacifiCorp's benchmarks be held to the same guarantees made by the bidders that propose pay for performance PPAs. Oregon IE's Assessment of PacifiCorp's 2012 RFP at 22-24 (Apr. 13, 2007). If the utilities are unwilling to stand behind the cost estimates for their benchmark resources, then the Commission should take appropriate action to protect ratepayers and disallow the higher costs of a utility-owned resource.

The adoption of the new integrated resource planning and competitive bidding requirements may provide the Commission with additional tools to review whether the utilities are fulfilling their obligation to serve customers with the least cost resources. More transparent and rigorous IRPs and RFPs could limit the ability of the utilities to claim that a higher cost, company-owned generating resource is actually the prudent, least cost option. The Commission should determine if these rules are successful in lowering power costs and promoting the development of a competitive generation market before adopting incentives that would encourage additional PPAs.



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ICNU also generally supports NIPPC's proposal to explicitly recognize in the competitive bidding process the positive benefits that PPAs provide to ratepayers. NIPPC has proposed that the risk avoidance benefits to ratepayers that are provided by PPAs should be recognized by applying a 10% discount in the net present value of delivered power in any independent power producer bid in a utility RFP. Although ICNU is not certain that a single, broad discount in the net present value is the best method, ICNU agrees with NIPPC that the competitive bidding process should be adjusted to reflect the benefits of PPAs and to explicitly mitigate the utility bias.

NIPPC's proposal is similar to a recommendation by the Oregon IE that is reviewing PacifiCorp's current RFP. The Oregon IE concluded that PacifiCorp's RFP does not fully account for differences in risk between utility-owned and independent power producer bids, which could bias the bidding process in favor of PacifiCorp's benchmark resources and invalidate the entire bidding process. Id. The Oregon IE suggested that the potential bias in favor of the utility ownership could be addressed through using adders in the bidding process to account for the bias. Id.

Fundamentally, ICNU believes that it may be premature to adopt economic incentives to eliminate the utility bias when the Commission has not ascertained whether the new integrated resource planning and competitive bidding rules will work, and has not exhausted other, less costly, options. This does not mean that ICNU is not concerned with the utility bias, how it has increased power costs, and the harm it causes to the development of a competitive generation market. ICNU simply



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recommends that the Commission first rely upon less radical measures to remedy this problem before significantly altering the manner in which Oregon utilities are regulated.

**2. An ROE Adjustment Is Necessary if the Commission Adopts the Utilities' Incentive Proposals**

The Commission should adopt an adjustment to the utilities' ROE if it provides them with economic incentives to enter into PPAs. An ROE adjustment should hold ratepayers harmless, prevent the utilities from earning excessive returns, and mitigate the utilities' bias to build their own resources. ICNU's ROE adjustment would reduce the utilities' overall ROE by an amount that would be equivalent to the additional income the utility expects to obtain during the test period in which the economic incentive mechanism is in place. Such an adjustment would be appropriate for all of the income opportunity straw proposals that have been made in this proceeding, but should not be made if the Commission accepts NIPPC's recommendation to explicitly address the bias in the competitive bidding process.

The Commission could adopt an ROE adjustment to directly eliminate the utilities' bias. The Staff Report which recommended this investigation be opened noted that eliminating rate base could end the bias problem associated with utility power plants earning a return. Staff Report at 2 (Aug. 14, 2006). The elimination of rate base combined with price cap regulation would level the playing field for PPAs. Id., Attachment A at 9. Similarly, an ROE adjustment that simply lowers the utilities' ROE to the lowest point of the zone of reasonableness could significantly mitigate this bias by reducing the utilities' incentives to favor their own generation resources.



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ICNU is not recommending the elimination of rate base, or a punitive ROE adjustment, although ICNU's ROE proposal would likely have a positive effect of reducing utility bias. ICNU's proposal is designed to ensure that the utilities have an opportunity to earn fair, but not excessive, earnings, which is consistent with the fact that rates for Oregon's utilities are set to provide them an opportunity to earn a reasonable rate of return on their investment. See American Can Co. v. Lobdell, 55 Or. App. 451, 454 (1982); Op. Att'y Gen. No. 6076 at 3-4 (Mar. 18, 1987).

The incentive proposals may result in the utilities earning an excessive level of compensation because the utilities would be earning more income than the amount the Commission found to be reasonable when it set the utility's rate of return. ICNU's ROE proposal would ensure that the utilities continue to earn fair overall compensation and that rates are no higher than necessary to provide adequate and reliable service. The combination of an ROE adjustment to rate base resources and the allowance of incentive compensation for entering into PPAs should provide the utility with an overall fair, but not excessive, compensation.

An ROE adjustment is also intended to maintain the current balance of risk and reward between shareholders and ratepayers. PGE's and PacifiCorp's incentive proposals reduce the risk to the utilities and transfer those risks to customers. For example, PGE's phantom equity imputation to offset the debt imputation issue would provide the utilities with a return on this phantom equity and increase their rate of return on the actual amount of common equity. Not only would this produce excessive returns,



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but it will shift the risks associated with debt imputation from shareholders to ratepayers. It would be appropriate to compensate customers for bearing this risk with a lower return on the utility's investments.

ICNU's ROE adjustment would also protect ratepayers from the additional costs that they would be required to pay under the utilities' incentive proposals. PGE currently acquires about half of its energy needs from market transactions. Allowing PGE to charge a management fee or rate basing a portion of all, or even only the new, contracts would increase customer rates. An ROE adjustment would allow the Commission to adopt this new regulatory experiment in a manner that does not significantly increase rates.

It is important to note that ICNU's proposal would not fully insulate ratepayers from the cost increases associated with the utilities' incentive proposals. ICNU's proposal would adjust the utilities' ROE in the next general rate case in which an incentive mechanism is expected to be in place. PGE's and PacifiCorp's power costs, however, are set on an annual basis. Thus, if the utilities enter into more PPAs than expected in the last general rate case, then they would retain these earnings until the next time their ROE is adjusted.

The utilities are likely to argue that ICNU's ROE proposal will have the practical impact of eliminating the incentives that would be provided by their proposals. As mentioned above, even under ICNU's ROE proposal, the utilities would have an opportunity to earn excessive compensation. More importantly, the adoption of the



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incentive proposals and an ROE adjustment would attempt to hold utility earnings at the similar overall fair level. This would occur by simultaneously reducing the attractiveness of rate basing resources and making PPAs more attractive. The goal of this proceeding is to mitigate the utility bias to own resources—not to provide the utilities with additional income.

## IV. CONCLUSION

ICNU recommends that the Commission mitigate the utilities' bias to own new generation resources by relying upon a more rigorous prudency review, the new competitive bidding requirements, and the new integrated resource planning rules. ICNU also supports revising the new competitive bidding rules to explicitly acknowledge the potential benefits of PPAs and mitigate the utility's self build bias. The Commission should allow these measures to be implemented before adopting more radical regulatory proposals like economic incentives or the elimination of rate base for generation assets.

The Commission should not adopt the utilities' incentive based proposals because they are likely to increase utility earnings at the expense of ratepayers without any guarantee that they will mitigate the utilities' bias. However, if the Commission decides to provide the utilities additional income in order to enter into PPAs, then the ratepayers should be held harmless with an adjustment to the utilities' ROE.



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Dated this 31st day of May, 2007.

Respectfully submitted,

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