

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 173

In the Matter of)

PACIFICORP,)

Application for Approval of A Power Cost)
Adjustment Mechanism.)
_____)

SURREBUTTAL TESTIMONY

OF THE

CITIZENS' UTILITY BOARD OF OREGON

October 17, 2005



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1 My name is Bob Jenks, and my qualifications are listed in my Opening
2 Testimony, CUB Exhibit 101.

3 **I. Introduction**

4 There is a sense of déjà vu in addressing PacifiCorp's proposal for a power cost
5 adjustment just as the docket addressing PGE's proposed power cost adjustment winds
6 down. Though the two proposed mechanisms were different in their technical details,
7 they both aimed to fundamentally change the risk balance between customers and the
8 utility. Likewise, our fundamental recommendation in these two proceedings is that there
9 is a place in regulation for an extreme-event power cost adjustment mechanism, which
10 acts in the place of deferred accounting for such events, and that such a strategy has
11 benefits both for the utility and for customers. While we acknowledge that the risk of

1 extreme price swings seems to have grown over the past decade, the utilities' customers-
2 bear-all-risk approach seems to be an over-reaction to the strain of the Western Energy
3 Crisis and the ensuing chaos. CUB's proposal is specifically designed to address such
4 events, as well as low hydro and other circumstances that push power costs beyond a
5 reasonable range of variation and have a material impact on a utility.

6 **II. PacifiCorp's Credit Rating & Its Proposed PCAM**

7 The basis for PacifiCorp's argument that it needs a power cost adjustment
8 mechanism to protect its credit rating is a single Standard & Poor's research article
9 included as Exhibit 101 in the Company's opening testimony. That article draws a
10 connection between a utility's credit rating and whether or not the utility has some sort of
11 fuel and purchased-power cost adjustment mechanism.

12 **A. PacifiCorp's TAM Solves The Company's Credit Concern**

13 That very same article, however, describes PGE's Resource Valuation
14 Mechanism (RVM) as a "quasi-[fuel purchased-power adjustment]" in that "rates are
15 updated annually," and that is combined with the ability to request a deferral when costs
16 vary from that annual update. Despite the fact that PGE's RVM is designed to facilitate
17 direct access, and regardless of whether or not one agrees that such a mechanism should
18 be applied to residential customers, the Commission granted PacifiCorp a Transition
19 Adjustment Mechanism (TAM) in its order in UE 170. Therefore, Oregon has adopted
20 the necessary regulatory mechanisms to satisfy the credit rating concerns cited as
21 evidence by PacifiCorp. In light of this, an argument that the Company needs an
22 additional power cost adjustment mechanism for credit quality would ring hollow. The
23 question remains whether an extreme event PCAM that would essentially act to

1 preauthorize a deferral application is useful. That question, however, is now unrelated to
2 the credit rating issue raised by the Standard & Poor's research article.

3 **B. CUB's Proposal Has Already Been Viewed Favorably By Rating Agencies**

4 The Company asserts that, without its proposed mechanism, its credit rating
5 would suffer because rating agencies will impute long-term contracts as debt. However,
6 as described above, those concerns have largely been taken care of. Interestingly, the
7 power cost adjustment mechanism we propose is essentially the same recovery
8 mechanism used by the Commission for recovery of costs from the Western Power
9 Crisis, and credit rating agencies found that mechanism to be supportive of credit
10 stability. The only modification in CUB's proposal from that mechanism is an
11 asymmetrical deadband and sharing bands designed to balance the asymmetry of power
12 cost variations.

13 [T]he Oregon Public Utilities Commission approved an agreement
14 allowing PacifiCorp ... to recover \$137 million, or 82% of its deferred
15 \$167 million ... This follows recovery orders ... all of which represent
16 support for credit stability at the utility.

17 CUB Exhibit 111 – Standard & Poor's Bulletin, July 18, 2002.

18 Clearly, the credit rating agencies take comfort in protections from extreme power
19 cost fluctuations. Though PacifiCorp's power cost overruns during the Western Power
20 Crisis were severely aggravated by the Hunter outage, Utah load underestimation, and
21 prudence disallowances, the Company's ability to recover costs from such an event
22 reassured the rating agencies. CUB's proposed mechanism would lay a foundation under
23 that reassurance by automatically activating such a deferral mechanism via a power cost
24 adjustment mechanism.

1 PacifiCorp's proposed mechanism, with its recovery of 70¢ for the first dollar of
2 power cost variation, is a different animal altogether, and, rather than being designed to
3 manage wide swings in power costs, is instead designed to remove almost all swings in
4 earnings caused by variations in power costs; PacifiCorp's proposed PCAM would be a
5 lottery jackpot for shareholders. PacifiCorp's proposed mechanism should get the
6 Company a diamond-studded, platinum credit rating with a free club membership on the
7 side.

8 **III. Revised Protocol & Mechanism's Mechanical Issues**

9 **A. Revised Protocol And Non-Normalized Hydro**

10 PacifiCorp agrees that the Revised Protocol allocates normalized power costs; that
11 this docket concerns variation from normal conditions or "non-normalized" power costs;
12 and that the MSP did not consider non-normalized costs. PPL/301/Duvall/1. Yet, the
13 Company cannot stop itself from arguing that somehow testimony by CUB and other
14 parties in support of that agreement was related to the costs at issue here.

15 Oregon parties did not suggest that any additional hydro-related costs
16 should be shared system-wide. On the contrary, there was an express
17 recognition by the Oregon parties that departing from a rolled-in method
18 and allocating a greater share of hydro resources to Oregon customers
19 could increase the cost and price volatility to Oregon customers.
20 Representatives of CUB and the Oregon Staff regularly assured other MSP
21 participants that this was a risk they were willing to take in order to obtain
22 a hydro endowment.

23 PPL/301/Duvall/6.

24 Let us be clear. The Multi-State Process did not deal with non-normalized costs;
25 it only dealt with the allocation of the normalized costs that one sees in a rate case. The
26 risk of non-normalized hydro was not an issue in the Multi-State Process (MSP). CUB

1 could not have assured other MSP participants that we would take the risk of non-
2 normalized hydro. Under the traditional Oregon system, the risk on non-normalized
3 hydro falls on the Company, not customers. Why would we assure other states that
4 Oregon customers would take on a risk that we felt properly belonged to shareholders? It
5 is time for the Company to stop taking quotes from MSP out of context and applying
6 them to a situation where they clearly do not apply.

7 In the testimony concerning the Revised Protocol, we could only find one
8 statement that concerned non-normalized hydro conditions and that was the statement by
9 Marc Hellman that we cited in our Opening Testimony. See CUB/100/Jenks/11. It
10 concerned hydro variation which is the definition of non-normalized hydro, and it
11 supported the approach that such costs are a system cost.

12 We must again note that the Revised Protocol did not grant Oregon customers the
13 full benefits of the Northwest's hydro. We did not receive the benefits of hydro as they
14 relate to providing reserves for the system or as a protection from Utah load growth. The
15 Company uses the hydro system for reserves, and this makes sense from a power supply
16 function, but it reduces the volume of hydro that is available to serve load. The value of
17 this reserve function is not picked up by the Embedded Cost Approach to the Hydro
18 Endowment. Under the Revised Protocol, as Utah grows, the cost of that load growth is
19 allocated to Oregon based on our share of the overall system (rolled in) without taking
20 into account the Northwest hydro. If Oregon were 28% of the overall system, and the
21 hydro were truly dedicated to us then our share of the non-hydro system must be less than
22 28%. This can be represented by the following formulas:

$$\frac{\text{Oregon Load}}{\text{System Load}} = 28\% \qquad \frac{\text{Oregon Load} - \text{Oregon Hydro}}{\text{System Load}} < 28\%$$

1 We must recognize that, in exchange for the normalized benefits of hydro that
2 were assigned to Oregon through the Hydro Endowment, Oregon agreed to pay the costs
3 of historic QFs. There was not a good reason to directly assign these QF costs, other than
4 to offset some of the benefits of the Hydro Endowment. The Revised Protocol was a
5 negotiated settlement that attempted to balance interests. Adding additional hydro-
6 related costs, which were not part of that settlement threatens to upset the delicate
7 balance of the Revised Protocol. It took several years of discussion among PacifiCorp
8 states to finally achieve a negotiated settlement to cost allocation among PacifiCorp
9 states. It is surprising to see the Company propose to change that balance before the ink
10 is even dry on the Revised Protocol.

11 Finally, it should be noted that the existence of a Hydro Endowment is not new.
12 Such a mechanism has existed since the Pacific Power-Utah Power merger. The
13 existence of a Hydro Endowment has never affected the allocation of non-normalized
14 hydro. For example, in UM 995, PacifiCorp did not propose that Oregon bear a greater
15 share of hydro replacement costs because a Hydro Endowment was in existence at that
16 time.

17 *i. PCAM Over-Allocates Costs To Oregon*

18 By assigning non-normalized hydro-related power costs to Oregon, but assigning
19 non-normalized Utah load-related power costs to the system, the PCAM over-assigns
20 costs to Oregon. As an example, assume that PacifiCorp's TAM, in projecting costs for
21 the following year, is exactly right for all variables except for hydro and Utah load.
22 Assume hydro is 5% below forecast and Utah load is 5% above forecast. Under
23 PacifiCorp's proposed PCAM, Oregon ratepayers would pay the majority of the cost of
24 replacing the low hydro, because we receive the majority of the hydro endowment.

1 However, Utah would not pay the full cost of serving its unanticipated load, even though
2 the incremental load is 100% Utah's. Instead it would be a system cost, and Oregon
3 would pay 28% of it. This makes no sense. Hydro-related costs are our responsibility,
4 but Utah-related costs are system costs!

5 The Company also seems to claim that adopting CUB's recommendation to use
6 monthly allocation factors based on load solves this Utah subsidy problem.
7 PPL/301/Duvall/7. It doesn't.

8 As an example, if PacifiCorp's system load were forecast to be 300 MWh and
9 Utah's load were forecast to be 100 MWh or 33% of that system load, but Utah's load
10 were 5% greater than forecast, then the system load would be 305 MWh and Utah's load
11 would be 105 MWh or 34% of the system load. PacifiCorp's proposed PCAM would
12 track the cost of serving that additional 5 MWh, the entirety of which was caused by
13 Utah. However, because that additional load is treated as a system cost, even if it is
14 allocated in proportion to actual load, Utah would still only pay 34% of those costs,
15 because Utah load represented 34% of actual system load. Oregon and the other states
16 would pay the rest.

17 CUB is not recommending that the non-normalized cost of meeting Utah's load
18 be directly assigned to Utah. Instead, we recommend that the costs of load variation, like
19 the costs of hydro variation, be allocated system-wide based on actual monthly load.
20 This means that allocation factors are more accurate, but they are still system-wide
21 allocation factors.

1 **IV. Appropriateness of Mechanism in OR's Regulation**

2 **A. Regional Precedent For Adjustment Mechanisms**

3 *i. Existence of deadband*

4 PacifiCorp challenges our examples of other utilities with significant deadbands.
5 PPL/205/Widmer/12. This makes little sense. Other utilities in the region do not have a
6 Transition Adjustment Mechanism to update power costs annually. In PacifiCorp's TAM
7 update, 100% of the cost of the forecasted change in power costs is allocated to
8 customers with no deadband. PacifiCorp wants a TAM to update power costs every year,
9 which no other state in the region does, and then assign to customers 70¢ of every dollar
10 in power cost variation from what their annual mechanism projects. Neither Avista nor
11 Puget, which have no TAM and do have significant deadbands, offer a precedent for such
12 a mechanism.

13 As we stated, having an RVM or TAM and allowing a deferral meets the needs of
14 the rating agencies. Therefore we believe that the purpose of a power cost adjustment
15 mechanism in addition to the Company's TAM is to substitute for the deferral
16 mechanism. Essentially, it allows for pre-approval of a deferral. This benefits the
17 company significantly, because it removes the regulatory lag associated with a deferral.
18 Low hydro is not a sudden event, but is a circumstance that builds over time. Using the
19 deferral process, the Company must absorb some of the costs of a hydro shortfall,
20 because hydro conditions must drop to the point that they warrant a deferral application,
21 and a deferred account does not begin tracking costs until the date the deferral application
22 is filed. CUB's proposed mechanism would protect the Company from this regulatory
23 lag, and reduce all parties' paperwork by eliminating the deferral application.

1 **B. Qualifying Facilities**

2 The Company offers three arguments defending its choice to not include
3 Qualifying Facilities in the mechanism's sharing bands: 1) QFs are not a discretionary
4 resource; 2) QFs may deliver irregular power; and 3) future QF rates may be indexed to
5 natural gas prices. PPL/205/Widmer/3. These are weak arguments.

6 With respect to the first argument, serving load is not discretionary either, but it is
7 part of the framework within which the utility operates. Should all costs of serving load
8 be exempt from the sharing bands because serving them is not discretionary? The
9 discretionary argument is based on circular logic. In addition, QF purchases may not be
10 discretionary, but customers rely on the Company to negotiate the terms of the QF
11 contract, and PacifiCorp should have an incentive to negotiate a sound agreement.

12 Second, while QFs may provide irregular power, customers may provide irregular
13 load. Every resource has its own risk profile and its own complications. It is
14 PacifiCorp's job to meet customers' unpredictable load with the resources it has
15 available, and this includes QFs; welcome to the utility business. Finally, the Company
16 will forecast load, power delivery, market prices, and natural gas prices annually under its
17 Transition Adjustment Mechanism. The Company will include in its forecasts the
18 forecasted cost of a QF contract based on forecasted natural gas prices. Again, welcome
19 to the utility business; although the Company may want customers to absorb all risk of
20 power cost variations if the Company projections are wrong, this is not a reasonable
21 policy.

1 **C. Prudence Review**

2 The Company argues that contracts and resources that have been in proceedings
3 before this Commission before should not be subject to a prudence review. This is not a
4 rational or reasonable proposal. Under such a framework, Staff, CUB, and other
5 intervenors would have to analyze every variable in excruciating detail, as we would
6 never have another chance to question that variable. This is absurd, no one can
7 reasonably be expected to review every single contract or utility decision involved in a
8 filing. Simply because we do not make an imprudence argument about a contract in a
9 docket, does not mean we have analyzed it completely and come to the conclusion that it
10 is prudent.

11 When we feel it is appropriate and when we have gathered the evidence to support
12 a claim of imprudence, CUB will present it to the Commission, and we expect that the
13 Commission will consider our argument and the evidence at that time. PacifiCorp's
14 attempt to structure its PCAM in a way that denies CUB and other parties the opportunity
15 to address the Company's prudence is inappropriate. CUB will not agree to having its
16 hands tied when presenting evidence and argument to the Commission.

17 **V. Power Cost Exposure & Risk Allocation**

18 For the purpose of his testimony, Widmer defines net power cost exposure as "the
19 variance between actual and authorized net power costs." PPL/200/Widmer/2. This
20 variance, however, is part and parcel of what the Company is paid a rate of return to
21 manage. The suggestion that the Company's proposed mechanism with no deadband and
22 draconian sharing bands somehow produces "a risk allocation between customers and
23 shareholders that is more in line with historic levels," is absurd. PPL/102/Omohundro/2.

1 There is little historical precedent in Oregon for assigning customers 70¢ of the first
2 dollar of increased power costs.

3 **A. The “Historic” Level Of Risk Allocation**

4 While we do not disagree with the Company that the risk of extreme power cost
5 variations seems to have increased over the past decade, and that the magnitude of those
6 variations may also have increased, the Company fails to demonstrate that its proposed
7 mechanism somehow brings the customer-Company risk balance back to historic levels.
8 Historically, customers have not shared the costs or benefits of minor power cost
9 variations with the Company, as the Company is proposing.

10 Historically, when the Company experienced a material variation in power costs,
11 it would apply to the Commission for a deferral. Given the Company’s not-unreasonable
12 concern about wide swings in net power costs, we are comfortable providing a
13 mechanism that is automatically triggered by extreme power cost variations, such that the
14 Company knows it will get recovery in those circumstances, will not have to apply for a
15 deferral, and will not suffer from the regulatory lag associated with filing a deferral
16 application. It is our proposed mechanism, not the Company’s, that respects historic risk
17 sharing between customers and the Company.

18 **B. Technical Problems With PacifiCorp’s Risk Analysis**

19 The Company’s presentation of its “risk exposure” and the asymmetry of that
20 exposure is misleading at best. In rebuttal testimony, Omohundro reiterates that the
21 Company’s net power cost exposure has increased by “over 1200 percent” from 1990 to
22 2004. PPL/102/Omohundro/3.

1 That is a huge, impressive number and one might think we are bankrupting the
2 Company. There are a number of problems with this analysis, however.

3 *i. Analysis Includes Power Crisis & Hunter Failure*

4 It doesn't make a whole lot of sense to include an event such as the Western
5 Power Crisis when measuring average volatility or average price variation. The Power
6 Crisis was an extreme event, and one not likely to be repeated. Every business is at risk
7 for such quakes which happen from time to time, but they are not the sort of event one
8 should address with everyday ratemaking as in the mechanism proposed by PacifiCorp.
9 The Company portrays steroidal growth of its risk exposure over the past decade;
10 however, if one were to normalize Widmer's analysis in PacifiCorp Exhibit 201, and
11 remove the impact of the Power Crisis, it would paint a very different picture.

12 Compounding the misleading inclusion of Power Crisis data is the fact that the
13 Power Crisis data also includes the Hunter Failure which would have had a considerable
14 impact at any time, but happened at the worst possible moment. The cost variability and
15 risk exposure portrayed by the Company as a general phenomena, actually represents a
16 period of time which includes a statistical anomaly, a massive spike in the data, which
17 completely distorts the overall picture.

18 *ii. Analysis Includes Massive Load Underestimation*

19 As if the above factors didn't distort the Company's conclusion enough, it turns
20 out that PacifiCorp's load projection for 2001 was horrendously below its actual load, as
21 well as being completely out of synch with the Company's load forecasts for 2000, 2002,
22 2003, and 2004. CUB/105/Jenks/1. The situation the Company was in during the Crisis,
23 when markets were insane, Hunter was out, and loads were far above projections, was
24 about as bad as they get (we hope), and it is exactly these situations that CUB's proposed

1 mechanism would address. It is disingenuous for the Company to make claims about its
2 general risk exposure using data which includes such a drastic combination of events.

3 *iii. Analysis Includes Prudence Disallowance*

4 In addition, issues of prudence also played a role in the Company's recovery of
5 Power Crisis costs. Though Widmer does include PacifiCorp's deferral recovery in
6 Exhibit 201, his analysis fails to mention that the power cost variation he describes
7 includes a 15% prudence disallowance which the Company stipulated to in UM 995.
8 UM 995 Order No. 02-469 page 72.

9 **VI. Asymmetry**

10 All the parties seem to agree that power cost variations tend to be asymmetric;
11 power cost variations above baseline tend to be of a larger magnitude than power cost
12 variations below baseline. This asymmetry is a risk the Company carries in exchange for
13 a rate of return paid by customers. Given this understanding that power cost variations
14 around baseline are asymmetric, and given that this dynamic is part of what the Company
15 gets paid a rate of return to manage, any automatic adjustment mechanism must have a
16 proportionally asymmetric deadband and sharing bands such that the mechanism itself is
17 not asymmetric.

18 There is no "asymmetry problem" with regulation as it currently stands; the only
19 potential asymmetry problem arises from a mechanism with a deadband and sharing-
20 bands of equal magnitude above and below baseline. Such a mechanism completely
21 ignores the asymmetry of power cost variations that is an integral part of what a utility is
22 paid a rate of return to manage. As we know that power cost variations are not
23 symmetric, a deadband and sharing-bands of equal magnitude above and below baseline

1 are clearly wrong. Where exactly they should be in reference to baseline is open to some
2 debate, but that they should not be symmetric is clear.

3 **VII. Conclusion**

4 The Company's proposed PCAM is ridiculously generous, even without
5 consideration of its annual Transition Adjustment Mechanism. When considering the
6 Company's annual TAM, PacifiCorp's proposed PCAM overshoots absurd.

7 CUB's proposed mechanism has not only been seen by credit rating agencies as
8 supportive of the Company's credit rating, but also balances the asymmetry of power cost
9 variations with an asymmetric deadband and sharing-bands. It has the added benefits of
10 removing the need for the Company to file for a deferred account when power cost
11 variations become material, saves the Company from a concern over regulatory lag in
12 regard to when it files its deferral application, and gives the rating agencies further
13 assurance that the utility will recover a reasonable share of its prudently incurred power
14 costs when circumstances warrant.

CERTIFICATE OF SERVICE

I hereby certify that on this 17th day of October, 2005, I served the foregoing Surrebuttal Testimony of the Citizens' Utility Board of Oregon in docket UE 173 upon each party listed below, by email and U.S. mail, postage prepaid, and upon the Commission by email and by sending 6 copies by U.S. mail, postage prepaid, to the Commission's Salem offices.

Respectfully submitted,



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