UNITED STATES OF AMERICA

DEPARTMENT OF ENERGY
BEFORE THE
BONNEVILLE POWER ADMINISTRATION

Proposed Methodology for Determining the Average System Cost of Resources for Electric Utilities Participating in the Residential Exchange Program Established by Section 5(c) of the Pacific Northwest Electric Power Planning and Conservation Act	)))))))	BPA File No. ASCM-08

COMMENTS OF THE
PUBLIC POWER COUNCIL AND
NORTHWEST REQUIREMENTS UTILITIES

I. Introduction

The Public Power Council (PPC) is a non-profit trade association, which represents the interests of the over one hundred publicly- and consumer-owned utilities in the Pacific Northwest that purchase power as preference customers of the Bonneville Power Administration. Northwest Requirements Utilities (NRU) is a non-profit trade association comprised of over fifty member utilities that are preference customers of BPA, which rely primarily on BPA as their wholesale power and transmission supplier.

Because the member utilities of PPC and NRU pay for the costs of the Residential Exchange Program through their BPA rates, they have long had an interest in the BPA Average System Cost (ASC) methodology. Indeed, BPA instituted the 1984 ASC Methodology in response to a PPC request that BPA address the numerous abuses that arose from the 1981 ASC Methodology. *Administrator's Record of Decision, Average System Cost Methodology* (June 1984), p. 15-16.

In many respects, BPA's proposed new ASC Methodology represents a reversion to the 1981 ASC Methodology. In particular, BPA proposes including return on equity (ROE)

and Federal income taxes in the new ASC Methodology, despite abuses that occurred under the 1981 ASC Methodology, stating that "BPA finds that enough changes have occurred in the PNW regulatory environment to reasonably ensure that terminated plant costs will not be included with allowable costs under the ASC Methodology." 73 Fed. Reg. 7270, 7277 (Feb. 7, 2008).

The problem is, however, that ROE can serve as "a catch-all" for utility costs that a utility commission wants to grant a regulated utility, whether or not such expenses are intended to be allowable under the ASC Methodology. In the 1980's, the abuse was a utility commission trying to give a return on terminated nuclear plant via an excessively high rate of return to a regulated utility – in the future, there may well be other issues where a utility commission facilitates the exchange of inappropriate costs via an excessive rate of return. Given the unavoidably arcane procedure for determining an ROE for a regulated utility, BPA's contention that "the risk that Regulatory Bodies will include inappropriate costs in the ROE has diminished significantly since 1984" (ibid.) and that outside parties can "likely determine" whether such abuse is taking place is wishful, but not likely accurate, and may serve as a basis for considerable contention in the future.

One of the principal reasons why PPC protested the 1981 ASC Methodology was the fact that numerous consumer-owned utilities had higher residential rates than adjacent privately owned utilities, putting consumer-owned utilities in the position of paying subsidies to neighboring private utilities with lower residential rates. This problem recurred under the invalid Subscription Settlement contracts where again across the Northwest consumer-owned utilities paid subsidies to adjacent private utilities with lower residential rates. The proposed ASC methodology runs the risk of having this irrational situation recur a third time, through

overly generous ASC determinations for private utilities. While we are confident that a properly functioning rate test would blunt the impact of the new ASC methodology, the operation of the rate test should not serve as an excuse for adopting a flawed ASC methodology.

II. Tiered Rates And The ASC Methodology

A significant issue with the ASC Methodology, and the Residential Exchange generally, is that BPA is moving to a system of tiered power rates. Many preference customers will be developing resources on their own in lieu of purchasing power to meet load growth from BPA, so the PF rate or rates will not accurately reflect the total cost of generation used to meet preference customers' retail loads. BPA's proposed revision to the ASC Methodology does not address this problem, and so is seriously deficient. Any revisions to the ASC Methodology must take into account the fundamental change expected in the way BPA does business with its preference customers. In an extreme case, preference customers could be acquiring resources on the margin to meet all of their own load growth (and to replace all of their retired resources), while at the same time subsidizing the acquisition of all new resources by the IOUs. This was not a result contemplated by the Northwest Power Act, and it would be an extremely unstable outcome politically because preference customer residential rates could be rising more rapidly than IOU residential rates concurrent with a subsidy. For this reason, PPC and NRU recommend that any changes in the existing ASC Methodology at this time be modest and temporary.

The Methodology clearly will need to be revisited again in the very near future in order to make adjustments necessary to ensure that tiered rates do not lead to inequitable

outcomes. The major changes that BPA is proposing now should not be enacted, but should be deferred to the debate over the relationship between ASC and tiered rates. On the assumption, nonetheless, that BPA will move forward with changes to the Methodology, PPC and NRU offer the following comments.

III. Changes Proposed by BPA

In its Federal Register Notice (FRN) in this proceeding, BPA proposes several changes to the ASC Methodology, which collectively serve to increase the IOUs' ASC compared with the 1984 Methodology, and thus to increase the subsidy that would be paid by BPA's preference customers (except to the extent overall benefits are limited by the rate test). In proposing these changes, BPA has provided either inadequate or no justification; in some cases, the proposed changes contradict the purposes and limitations on the program as established in the Northwest Power Act.

A. Transmission Costs

When the 1984 Methodology was written, BPA's wholesale rates were still "bundled": a single PF-Preference rate included both generation and transmission costs. In 1996, BPA opted to unbundle its transmission and power rates, in order to comply with national energy policy at the time. Thus, there is now a PF-Preference rate that excludes transmission costs, and separate transmission rates designed to recover only transmission costs. Nevertheless, BPA now proposes to include transmission costs as resource costs for purposes of calculating the IOUs' ASC.

It is noteworthy that in 1984, several IOUs used the fact that, at that time, the PF rate was bundled to argue for the inclusion of transmission costs in ASC: "BPA's half of the

exchange includes both transmission and generation, and . . . a utility's ASC must include both transmission and generation costs in deference to 'wholesale rate parity'." See BPA, *Administrator's Record of Decision, Average System Cost Methodology*, June 1984 at 37 ("1984 ROD"). Now, however, even without the inclusion of transmission costs in BPA's rates, BPA is proposing to include transmission costs in ASC determinations. In support of its proposal in this matter, BPA observes that certain "changes in industry structure" have occurred since 1984, including the development of wholesale power markets, the creation of Regional Transmission Organizations (RTOs), and FERC's Order 888. These observations are either irrelevant, or actually work against BPA's proposed changes in ASC Methodology.

First, wholesale power markets existed since before 1980, and before the 1984 methodology. They have not arisen since 1984, although they have become more sophisticated and liquid. Utilities have relied on wholesale power markets both before and after 1984 to sell surplus power, to buy incremental power supplies, and to displace more expensive resources. This does not provide a justification for changing the ASC Methodology in 2008.

Second, even though some parts of the country have RTOs, the Northwest pointedly does not. The existence of RTOs in the Eastern Interconnection can hardly be used to justify a change in BPA's rate-setting processes in the Northwest.

Third, although it is true that BPA and IOUs have separated their generation and transmission functions as a result of Order 888, this separation actually argues against the inclusion of transmission costs in ASC, as noted above. Separation of functions has led to separation of costs and thus separation of rates.

Fourth, these changes are irrelevant to any revised methodology in 2008 because all of the options for integration of new resources listed in the FRN (at 7276) were also available in 1984. Some utilities relied then on "coal-by-wire", while others chose "coal-by-rail" (see the 1984 ROD at 37). This option still exists, and is not fuel-dependent.

Finally, including transmission costs in ASC could bias utilities toward the development of more distant resources, because BPA's preference customers would effectively be picking up part of those costs through the Residential Exchange program. This could lead to greater reliance on distant resources rather than distributed generation, which could have reliability impacts on the Northwest transmission system. This proposal would also bias investments against conservation, because it would make (distant) generation appear to be less expensive than it really is, due to the subsidies provided by BPA's preference customers. At a time when national policy is moving to recognize the externalities associated with the generation of power, BPA should not be taking steps to decrease the incentive to conserve.

For all of the reasons above, the ASC Methodology should not allow inclusion of transmission costs as resource costs in determining utilities' ASCs.

B. Energy Audits

Regarding conservation resources, BPA proposes including the costs of energy audits in ASC. This appears to be a reasonable change, because expectations for performance of conservation resources are not always matched by actual performance in the field. Audits of conservation resources perform a function similar to "O&M" of generation resources, which is included in ASC. Thus, energy audits should be included in ASC.

C. Oregon Public Purpose Charge

BPA's proposal on the Oregon Public Purpose Charge (OPPC) is somewhat ambiguous: "BPA proposes that the OPPC . . . should be considered in determining ASC" (FRN at 7276) and that BPA must be able to "review and audit [the] costs and programs of an OPPC-recipient organization" (FRN at 7277). There are several problems with this proposal. First, it is not clear that BPA has the authority to audit the recipients of funds from the OPPC, which are not IOUs, but are instead the Energy Trust of Oregon, Education Service Districts, and the Oregon Department of Housing and Community Services. Second, it is not clear what standards BPA's auditors would use to determine what is an "allowable" expense for the purposes of the ASC Methodology.

Instead of an audit right, BPA should adopt a simpler approach. A specific portion (63 percent) of the OPPC is required by statute to be allocated to (a) the acquisition of "new cost-effective conservation and market transformation". The remainder is obligated to (b) explicitly non-cost-effective renewable resources (19 percent) and (c) transfer payments between utility ratepayers (i.e., the low-income weatherization and low-income bill payment assistance, 18 percent). The ASC should not include market transformation costs, non-cost-effective resource costs, or transfer payments. These are not costs of IOU resources that were intended to be subsidized by preference customers under the Northwest Power Act's establishment of a Residential Exchange Program.

Because cost-effective conservation and market transformation are combined into one category, a simple rule-of-thumb is necessary to distinguish costs that should, and should not, be included in ASC. PPC and NRU recommend that one-half of the 63 percent of the OPPC be includable in ASC, unless the IOU makes an affirmative filing that some greater percentage is actually being spent on cost-effective conservation. Such an affirmative filing

should include sufficient documentation that BPA will not need to audit the organizations actually receiving the OPPC funds.

D. Return on Equity

In contrast to its decision in 1984, BPA now proposes to include return on equity (ROE) in ASC. PPC felt that including ROE in the residential exchange was inappropriate in 1984 and continues to think that there are good reasons why ROE should continue to be excluded. In 1984, the major concern addressed by BPA was the possibility that the costs of terminated plant could be included in ASC via an upward adjustment by state regulatory commissions in the allowed ROE. As justification for the currently proposed change, BPA observes changes that have taken place in state regulation of IOU rates. Although changes may have taken place that reduce the risk that costs of terminated plant will be included in ROE, those changes cannot and do not address other risks that BPA's proposal would create.

First, regulatory commissions face the challenge of balancing the costs imposed on ratepayers with the returns on investment to shareholders. This is a delicate operation, and is not exact science. If a state regulatory commission knew that increasing the allowed ROE would be offset, even in part, by an increase in the subsidy paid by BPA's preference customers, it would be reasonable to assume that this would lead commissions to lean in favor of higher ROEs. All else equal, this proposal would thus tend to increase ROEs over what they otherwise would be. This "excess ROE", however, cannot be easily extracted from the complex decision-making process surrounding IOU rates, and thus cannot be easily excluded from ASC. State commissions can be expected to take into account the net impact on residential ratepayers from allowing a higher ROE that is offset by subsidies provided by BPA's preference customers.

Making this problem even worse is that there are a plethora of issues, including exclusions from rate base, expenses that are judged as imprudent, and the utility's cost of capital that are related to the financial return to an investor-owned utility. The utilities' return on equity is only one of literally dozens of moving parts that are interrelated in the resolution of any rate case. Under BPA's proposed Methodology, utilities, commissions, and consumer advocates will have strong incentives to increase the ROE, and offset that via the many other possible financial rate case adjustments, in order to have as high of a stated ROE as possible. This is made even more likely by the fact that many IOU rate cases end in settlements, rather than fully litigated rate cases, which makes it easier to simply include a high stated ROE as part of the settlement.

Furthermore, it is even possible that state commissions could explicitly adopt an ROE structure that differentiates among customer classes, depending on the availability of subsidies from preference customers. For example, the allowed ROE on residential customers could increase, with the expectation that the increase would lead to higher subsidies from BPA's preference customers. Including ROE in ASC will actually create or increase the risk of such an incentive. Also, by allowing ROE, BPA is inappropriately interfering in state regulatory decision-making processes. This is not meant to suggest that regulatory oversight has not improved since the mid-1980s, but merely recognizes that regulatory commissions are likely to take into account the full impact of their decisions, including indirect impacts through the ASC methodology.

There are other problems with including ROE as a component of ASC. Pacific Northwest IOUs have had and currently have non-electric and non-regulated subsidiaries that can affect a utility's ROE. For example, Puget Sound Energy and Avista are both gas and

electric utilities. The significant wave of mergers that has occurred in the Northwest, and is continuing with the recent acquisition of Puget Sound Energy, also affect ROE in ways that have little to do with the provision of electric service.

There have been times, such as in the mid-1990s, where the cost of capital has been declining, and some of the region's IOUs chose not to file rate cases, allowing them to keep their return on capital above market levels. If these conditions recur, BPA will be overcompensating the IOUs for their cost of capital under the proposed Methodology.

Also, as noted in the introduction, ROE can still be used to include costs that are impermissible under the ASC Methodology. Although one would hope that future regulation will always be perfect, or at least improved, and that future regulators will not respond to pressures to use ROE as a mechanism for including impermissible costs, it is always a possibility, and it will be extremely difficult and contentious to distinguish "permissible" from "impermissible" ROE under these circumstances.

For all of the reasons above, ROE should be excluded from ASC.

E. Federal Income Taxes

Again reversing course from 1984, BPA now proposes including federal income taxes in ASC (FRN at 7277). As BPA noted in the 1984 ROD (at 63), taxes are simply transfer payments from some individuals in society to others. They are not "costs" as defined in the Northwest Power Act. The simple passage of time has not changed the fundamental nature of this. Taxes were transfer payments in 1984, and are still transfer payments.

BPA's proposal to include Federal income taxes invites BPA to become involved in the various methods by which IOUs defer and/or avoid payment of income taxes, and to make judgments about the appropriateness of such decisions. This will clearly complicate the

process of determining ASCs. Additionally, IOUs actually fund the acquisition of new generation resources with a number of different revenue sources, including bonds and equity. To determine the actual tax burden of any specific generation resource, or the tax burden of generation resources in general, is impractical.

Inclusion of Federal income taxes in ASC is even more problematic than it was when the Regional Act was passed. In 1981, the region's investor-owned utilities were stand-alone companies. Since then, regional IOU's have passed through a succession of mergers, a trend which is likely to continue into the future.

Enron, of course, became the poster child for abuse of the tax system through its use of "phantom taxes" – charging ratepayers for taxes that were never paid to governmental bodies. The OPUC proved unable to address the "phantom tax" issue in any meaningful fashion. With Northwest IOUs increasingly being part of larger, highly sophisticated holding companies who are trying to minimize their overall tax costs, it will not pass unnoticed that BPA will pick up a portion of the holding companies' tax burden, if a greater share of the larger holding company Federal tax obligations are passed onto a Northwest IOU.

In response to the Enron abuses, Oregon did pass SB 408, which hopefully will curb some potential tax abuses. SB 408 will not stop holding companies from trying to shift their Federal tax burden to Northwest IOUs however (so long as taxes are actually paid to the Federal government), and past performance makes one question whether state regulatory commissions can reliably keep larger holding companies from doing so.

It should also be noted that SB 408 faced ardent opposition, and it would be reasonable to assume that SB 408 could be repealed or weakened in the future. BPA should

therefore not take as a given that SB 408 will continue to operate in the future as it is currently intended. Also, other Northwest states have no equivalent to SB 408.

For all of the above reasons, BPA's ASC Methodology should not allow inclusion of Federal income taxes.

F. Regulatory Assets and Liabilities

The issue of whether Regulatory Assets and Liabilities (RALs) should be included in ASC is a new issue, because RALs did not exist in 1984. (See FRN at 7278.) In this case, BPA's proposal may or may not adequately mitigate the potential that RALs will be allowed (and adjusted) by state commissions in light of the ability of the net costs of such assets to residential ratepayers to be reduced by an increase in subsidies from BPA's preference customers. Thus, RALs create the same incentive problems as inclusion of ROE in ASC. It is not simply a matter of functionalization, although that is important. Commissions will perceive incentives to allocate regulatory assets and liabilities in ways that maximize ASCs for purposes of the Residential Exchange Program, irrespective of whether such assets and liabilities are actually included in residential rates. The proposed changes in the methodology create such incentives. Thus, BPA should retain the ability to exclude RALs, based on direct analysis.

G. Cash Working Capital

BPA proposes to include one-eighth of total exchangeable O&M costs, less fuel and purchase power costs, as Cash Working Capital (CWC) in ASC. (See FRN at 7278.) This proposal, although apparently a continuation of the 1984 methodology, ignores the possibility that some CWC is normally attributable to the Transmission and Distribution functions.

Schedule 1-A in Endnote f/ to the ASC Methodology[1] clearly includes CWC for the Transmission and Distribution functions. CWC must be functionalized before it is included in ASC, and only CWC for the Production function should be allowed in ASC.

IV. Additional Issues

A. Cost of Debt

Some portion of the cost of debt incurred by IOUs is driven by the risk profile of the utility. In financial terms, there is a "risk-free" component of the cost-of-debt and a "risky" component that is utility-specific. This risk profile is not entirely exogenously determined, but results from actions taken by the utility and decisions made by its regulators. Some of these actions and decisions drive up the risk profile of the utility, and thus the cost of debt. The ASC Methodology should not encourage incremental risk-taking behavior because of the expectation that some of that risk will be "regionalized" via the Residential Exchange Program. In order to reduce the incentive for risky activities, the ASC should not include the actual cost of debt of an IOU, but rather BPA's cost of debt.

B. Investments in Associated Companies

The functionalization rules in the proposed ASC Methodology permit Investments in Associated Companies (Form 1, line 123) to be included in rate base. This raises concerns based on the region's experience with the combination of regulated and unregulated activities within the same company. Specifically, it appears that Associated Companies may be unregulated entities. If an IOU makes an investment in an Associated (but unregulated) Company, and such investments are allowed in rate base for the purposes of ASC, then BPA's

[1] Downloaded from http://www.bpa.gov/corporate/Finance/ascm.

preference customers will be subsidizing potentially risky activities of IOUs that have nothing to do with resource costs. There is no basis for subsidizing these activities because there is no nexus between these activities and generation assets. Thus, line 123 of Form 1 should not be subject to Direct Analysis, but rather should simply be excluded from rate base in the determination of ASC.

C. Derivative Instruments

IOUs also engage in markets for a variety of financial instruments, including puts, calls, swaps, and other "derivatives". BPA proposes that assets accumulated in "Derivative Instruments" (Form 1, lines 175-6) be included in rate base and functionalized to Production for the purpose of ASC. This assumes that such assets are necessarily related to Production, when they may be related to a number of other activities of the IOU. Thus, such assets should be subject to Direct Analysis, because it is not clear that these are associated in every case with generation costs. In the absence of data necessary for Direct Analysis, these assets should be excluded from rate base.

D. Income Accounts 411.6 and 411.7

FERC Form 1 Income Accounts 411.6 and 411.7, "Gain from Disposition of Utility Plant", should also be subject to Direct Analysis, because some of this income may be reasonably attributable to Generation.

D. Treatment of New Large Single Loads

Under §5(c)(7)(a), the average system cost shall not include "the cost of additional resources in an amount sufficient to serve any new large single load of the utility." BPA has indicated that it has made such adjustments in the past to exclude the impacts of NLSL on a utility's ASC.

Adjusting for the impact of a NLSL entails removal of the costs of serving a NLSL along with the associated megawatts. If the cost of serving that NLSL is higher than the utility's ASC, then the ASC would be less costly. The reverse is true, also; if the unit cost of serving that NLSL is less than the ASC, then the ASC would rise.

Practically speaking, there are two principal methods for making this adjustment: 1) Use vintaged resources somehow assigned at the time the NLSL was first served—tracking the costs of that resource over time, including capital additions, depreciation, etc.—in the amount of the NLSL. 2) Use a proxy NLSL assignment, such as current market prices, in the amount of the load.

Method 2, of course, is much simpler and would reflect the choices a utility would make if it had a) to purchase for that amount of load; or 2) to dispose of the NLSL power if it was making no off-system or market purchases. BPA should use Method 2 to correct for the impact of NLSLs on ASCs.

Respectfully submitted on May 2, 2008.