

**BEFORE THE PUBLIC UTILITY COMMISSION  
OF OREGON**

**UM 1182**

In the Matter of an Investigation  
Regarding Competitive Bidding.

STAFF'S OPENING COMMENTS

**Introduction**

The Public Utility Commission of Oregon, in Order No. 91-1383, adopted goals that a competitive bidding regime for Oregon's investor-owned electric utilities should satisfy. The Commission decided that competitive bidding should complement the Integrated Resource Planning process and assist the utilities in obtaining the optimal mix of power resources. The Commission indicated that competitive bidding was one of many acquisition options available to the utility and decided that competitive bidding should not unduly constrain the utilities' ability to use other options. The Commission supported a flexible competitive bidding approach that would allow contracting parties to negotiate mutually beneficial exchange agreements. Finally, the Commission decided that the competitive bidding process should be understandable and fair. Staff believes these goals for competitive bidding are still appropriate.

In Order No. 91-1383, the Commission also adopted competitive bidding guidelines that when taken together comprised a competitive bidding regime that the Commission believed would satisfy its goals. The Commission indicated that it intended to monitor the competitive bidding process and that it would modify its guidelines to adapt to changing circumstances. Staff believes that Docket UM 1182 should be viewed as a process check. The goal of this docket should be to update the Commission's competitive bidding guidelines as needed to create a regime that will continue to satisfy the Commission's goals.

Staff has developed a proposal that would update the Commission's competitive bidding process and achieve the competitive bidding goals adopted by the Commission in 1991. See Staff Opening Comments, Attachment A. Staff developed the proposal with significant input from parties to this proceeding. On September 26, 2005, staff distributed its proposal to the UM 1182 service list and encouraged parties to respond to the proposal in their opening comments. The remainder of staff's opening comments is devoted to more fully explaining and justifying our proposed guidelines.

## Staff's Proposed Competitive Bidding Process

**1. RFP after IRP:** Staff recommends that the competitive bidding process follow the IRP process.

The Commission's Integrated Resource Planning (IRP) requirements are currently being revisited in Docket UM 1056. For example, staff recommends updating the primary goal of IRP to be "the selection of a portfolio of resources with the best combination of expected costs and associated risks and uncertainties for the utility and its ratepayers." See UM 1056 Staff Reply Comments, Proposed Requirements and Guidelines, page 1. Other parties to UM 1056 have recommended a similar goal. Whether the Commission decides to adopt staff's recommendation, the recommendation of another party, or to simply retain the primary goal as stated in Order No. 89-507, the competitive bidding process should align with the primary goal of IRP. A utility Request for Proposals (RFP) is a means to promote and improve the resource actions identified in the utility's IRP Action Plan. Staff recommends that the competitive bidding process follow the IRP process to establish consistency between resource planning and resource acquisition.

**2. RFP Requirement:** Staff recommends that the Commission establish a guideline requiring electric utilities to use an RFP process for all Major Resource acquisitions. Staff defines Major Resources as those with durations greater than 5 years and quantities greater than 50 MW.

In 1991, the Commission directed each electric utility "to obtain at least a portion of its new power resources through the competitive bidding process." See Order No. 91-1383, page 1. Industry use of competitive bidding has expanded since 1991. Today, competitive bidding is a proven method of utility resource acquisition. Staff believes an RFP requirement for Major Resource acquisitions is justified given the widespread acceptance of RFP processes and its benefits.

As to the Major Resource definition, staff's review of the energy risk management policies of Oregon's investor-owned electric utilities shows maximum transaction terms for front office power purchases ranging from 18 months to 48 months. That is, transactions with delivery terms greater than 48 months generally require prior approval by senior management. In addition, transaction risk limits are also defined using a combination of transaction term and notional transaction value, incremental value-at-risk, or counterparty credit score. For example, a risk limit might require prior Board of Directors approval of transactions with delivery terms greater than 5 years and notional transaction value greater than \$100 million. A 5-year 50-MW transaction with flat delivery would trigger Board review at a transaction price greater than \$46 per MWh (i.e.,  $\$100 \text{ million} / (50 \text{ MW} * 8,760 \text{ hours} * 5 \text{ years}) = \$45.66 \text{ per MWh}$ ). A 5-year

100-MW transaction would trigger review at \$23 per MWh. Since larger transaction volumes are associated with longer-term deals, a 5-year 50-MW definition of a Major Resource seems reasonable.

**3. Exceptions to RFP Requirement:** Staff recommends that the RFP requirement not apply to Major Resource acquisitions, other than self-build resources, in emergencies or in situations where there is a time-limited resource opportunity of unique value to customers. Staff also recommends that a reporting requirement accompany this recommendation. See Attachment A.

**4. Waiver of RFP Requirement:** Staff recommends that the utilities be able to request Commission acknowledgment of an alternative acquisition method for a Major Resource in their IRP. Staff also recommends that the utilities be able to request a waiver of the RFP requirement outside the IRP process. Staff recommends a timely public comment process associated with waiver requests. See Attachment A.

The 1991 Commission was aware that in designing a competitive bidding regime there is a trade-off to be made between establishing a flexible approach and establishing important process requirements and limits. See Order No. 91-1383, page 4. Staff supports appropriate exceptions to the RFP requirement for Major Resource acquisitions, as well as a waiver process, in order to promote a flexible approach. Staff favors the 5-year 50-MW definition of a Major Resource, as opposed to a 5-year 100-MW definition, due in part to the flexibility provided by the recommended exceptions and waiver process. Sections 2 through 4 of staff's proposal should be considered together. Staff believes that taken together these bidding guidelines strike a reasonable balance between establishing a flexible approach and establishing firm regulatory rules.

**5. Affiliate Bidding:** Staff recommends that utility affiliates not be prohibited from participating in a utility RFP. However, the Commission should require the use of an Independent Evaluator (IE) if the utility decides to allow affiliate bidding in an RFP.

In Order No. 91-1383, the Commission limited participation in electric utility RFP to PURPA Qualifying Facilities, independent power producers, and outside utilities. See Order No. 91-1383, page 14. The Commission decision was based, in part, on staff's argument that affiliate participation in the utility's own RFP could damage the perceived credibility and fairness of the bidding process and that there are sufficient independent sellers of energy services for a successful competitive bid to occur without affiliate participation. Staff continues to be concerned about the perceived credibility and fairness of the competitive bidding process. Staff continues to believe that there are sufficient independent sellers of most energy services to successfully complete an RFP without affiliate participation. What has changed is an awareness among staff, and possibly industry-wide, that an IE can be used to

help prevent self-dealing and to help ensure a fair bidding process. As the Commission indicated in 1991, both the perception of fairness and fairness itself matter. See Order No. 91-1383, page 6. Staff recommends that the Commission not prohibit affiliate bidding in order to promote a flexible competitive bidding process. At the same time staff recommends that the Commission require the utility to use an IE to safeguard fairness.

**6. Utility Ownership Options:** Staff recommends that the Commission allow electric utilities to use a self-build option in an RFP to provide a cost-based alternative for customers. Staff also recommends that utilities be allowed to consider ownership transfers within an RFP. However, if the utility chooses to consider these ownership options in an RFP, then the Commission should require the utility to use of an Independent Evaluator.

Before ordering Docket UM 1066 to be held in abeyance the Commission opined:

The comments submitted provide numerous valid reasons for including new generating resources in a utility's revenue requirement at cost, rather than at market price. We are still concerned, however, that the use of a cost standard will cause a utility to favor its own proposed resources. Order No. 05-133, page 2.

The Commission then indicated that one purpose of Docket UM 1182 is to revise the competitive bidding guidelines to ensure resources are considered on an equal basis. As a first step to ensuring a fair comparison of cost-based and bid-based resources, Staff recommends the Commission require the use of an Independent Evaluator whenever a utility ownership option is under consideration. Sections 5-7 and 9-14 of staff's proposal develop the role and function of the Independent Evaluator. Taken together, these guidelines can reasonably be expected to achieve the goal of ensuring a fair comparison of cost-based and bid-based resources.

**7. Independent Evaluator:** Staff recommends that the IE be selected by the utility and Commission staff from a qualified list of candidates. The IE should not be providing, or recently have provided, consulting services to participants in western energy markets. Staff recommends that the IE report to the Commission staff and be paid by the utility through assessments of the bidders and the utility if it includes a Benchmark Resource in the RFP. Bidding fees should be based on the anticipated costs of the IE's services as established between the IE, the utility and the Commission staff.

The purpose of the IE is to provide assurances to all of those involved in the RFP that the process was fair. Technical competence and independence should be paramount concerns when hiring the IE. Of course, many technically competent individuals work for consulting firms that provide services to energy

market participants. This presents a potential dilemma. Staff believes it is reasonable to limit the hiring of the Independent Evaluator to individuals who have not recently, and are not currently, providing consulting services to participants in western energy markets, including Oregon's investor-owned electric utilities, their affiliates and independent power producers doing business in the western markets.

#### **8. Bid Scoring and Evaluation Criteria:**

- a. Staff recommends that selection of an initial short-list of bids be based on price and non-price factors. The utility should use the initial prices submitted by the bidders to determine each bid's price score. The price score should be calculated as the ratio of the bid's projected total cost per megawatt-hour to forward market prices using real-levelized or annuity methods. This methodology allows comparison of bids with unequal delivery periods. For example, for a 10-year bid the real-levelized ratio of unit costs to forward market prices would be calculated over 10 years. For a 20-year bid the calculation would cover 20 years. The proposal with the lower cost-to-market ratio is the better choice and should receive a better price score. Staff recommends that the non-price score be based on the resource characteristics identified in the utility's IRP Action Plan (e.g., resource duration, dispatch flexibility, portfolio diversity, etc.) and conformance to the standard form contracts attached to the RFP.

In Order No. 91-1383, the Commission adopted a weighting system for calculating a bid's total score from its price score and non-price score. The Commission was persuaded that:

By providing ranges over which the utility can rank price and non-price factors, the proposed weighting system will not unduly constrain process flexibility while simultaneously keeping the bid evaluation procedure understandable and fair. Order No. 91-1383, page 19.

The Commission also adopted an environmental damage factor system for calculating the environmental component of a bid's non-price score. The Commission indicated that:

Assigning numbers representing damages imposed on society by sources of electrical power involves analysis of the types of resources available and requires a healthy dose of judgment. Experience in doing that is not extensive... If actual experience suggests different numbers or a different approach, the Commission will again address the issue. Order No. 91-1383, page 21.

Actual experience has indicated that the environmental damage factor system is difficult to implement and explain to bidders. Staff recommends allowing the utilities to propose environmental scoring based on the environmental analysis included in its acknowledged IRP. This approach is not new and was discussed in Order No. 91-1383. See Order No. 91-1383, page 22. Staff recommends that the Commission adopt environmental scoring based on IRP analysis as the standard approach.

Actual experience also has indicated that the weighting system for price and non-price scores is overly rigid. Staff recommends that the Commission allow the utilities, with input from interested parties and the Independent Evaluator, when needed, to propose an appropriate weighting system. The Commission would be able to review the proposed weighting system as part of its approval of the proposed RFP. See Attachment A, Paragraph 11.

- b. Staff recommends that selection of the final short-list of bids be based on total system portfolio analysis using the utility's production cost and risk models to identify the best combination of resource additions. The portfolio modeling and decision criteria used to select the final short-list must be consistent with the modeling and decision criteria used to develop the utility's IRP Action Plan. If the RFP requires an Independent Evaluator, then the IE must have full access to the utility's production cost and risk models.

This set of recommendations should be adopted to improve the alignment of the IRP and RFP processes. Recent experience has brought to light an inconsistency in planning for resource additions on a least-cost, least-risk basis but acquiring resources additions solely on a least-cost basis. Staff notes that this portfolio approach may work best with all-source or simultaneous single-source RFP. The Commission will need to continue to monitor the competitive bidding process to determine if this portfolio approach works well with staggered single-source RFPs.

Staff also recommends that the utility and the Independent Evaluator evaluate the unique risks and advantages of any utility self-build or ownership options, including the regulatory treatment of construction costs, equipment failures and outages, and the costs of replacement capacity, energy, and ancillary services. See Attachment A, Paragraph 13(b)(ii). This is another step towards ensuring a fair comparison of cost-based and bid-based resources. Staff provides further justification of this recommendation later in these comments.

- c. Staff recommends that ratings agency debt imputation be reserved for the selection of the final bids from the initial short-list of bids. The utility should be willing to obtain an advisory opinion from a ratings agency to

substantiate its analysis and final decision, if requested by the Commission. Staff supports this recommendation largely based on two findings. First, regulated utilities appear to receive favorable treatment by Standard & Poor's with respect to power purchase agreements. Second, because power purchase agreements can be structured in unlimited ways, there is no "one size fits all" approach to determining the balance sheet effect of a bid. Staff's Memo Regarding Debt Imputation and Power Purchase Agreements, dated June 6, 2005, elaborated on these and other justifications. See Attachment B.

**9. RFP Design:** Staff recommends that the Commission allow the utility to design a Standard RFP, without input or oversight by an Independent Evaluator, if the utility will not consider affiliate bids or ownership options in the competitive solicitation. Alternatively, staff recommends that the Commission require the electric utilities to design a Non-Standard RFP, with input and oversight by an Independent Evaluator, if the utility will consider self-build, affiliate, or other ownership options in the competitive solicitation. Staff also recommends that the Commission require utilities to provide at least 60 day advance notice of their intention to conduct an RFP. Advance notice of a Non-Standard RFP is essential for the utility and IE to develop a rapport and to work collaboratively on the design of the RFP.

**10. Minimum Bidder Requirements:** Staff recommends that the utility be allowed to establish minimum bidder requirements on the basis of creditworthiness and professional competence. Staff recommends that the Commission require IE involvement in the development of bidder requirements for a Non-Standard RFP. Finally, minimum bidder requirements should be subject to public comment and to Commission approval of the proposed RFP. The Commission specifically addressed this issue in Order No. 91-1383:

In order to protect itself and ratepayers, the utility should require assurances that a proposed project has a reasonable probability of successful construction and operation. In determining this probability, such factors as the developer's control over the site where the project is to be located, project engineering, project financing, management expertise, and the likelihood of obtaining necessary government licenses should be considered. Order No. 91-1383, page 11.

**11. RFP Approval:** Staff recommends that the Commission continue to require electric utilities to submit a draft RFP for Commission approval. The Commission should solicit public comment on the utility's draft RFP, including the proposed minimum bidder requirements and bid scoring and evaluation criteria. After reviewing the draft RFP and the public comments the Commission may approve the RFP with any conditions and modifications deemed necessary. Staff also recommends that the Commission consider the impact of multi-state regulation including requirements imposed by other states for the RFP process, such as the

timing of the process and the selection and use of an IE, when considering approval of an RFP. Finally, staff recommends a timely decision process once the utility has filed a final proposed RFP. See Attachment A.

In Order No. 91-1383, the Commission emphasized the importance of preserving the basic roles of the Commission and the utility in the regulatory process and clearly delineated the role of the Commission in the competitive bidding process:

The purpose of Commission involvement in competitive bidding is to establish a fair bidding process and to determine whether a proposed project is consistent with the soliciting utility's least-cost plan and complies with the bidding guidelines established by the Commission. Order No. 91-1383, page 7.

Staff recommends that the Commission continue to review draft RFP for compliance with the adopted competitive bidding guidelines and consistency with the utility's IRP.

**12. Benchmark Score:** Staff recommends that the Commission adopt the following guidelines to help ensure a fair comparison of cost-based and bid-based resources. The proposed guidelines would apply only if the utility has a self-build option that it intends to use as a Benchmark Resource in a Non-Standard RFP. First, staff recommends that the Commission require the utility to submit a detailed Benchmark Score, with supporting cost information, to the Commission and IE prior to the opening of bidding. The Benchmark Score should be assigned to the Benchmark Resource using the same price and non-price scoring that will be used to score market bids. Information provided to the Commission and IE must include any transmission arrangements, and all other information, necessary to score the Benchmark Resource. Second, if during the course of the RFP process, the utility and IE determine that bidder updates are appropriate, staff recommends that the Commission allow the utility to make a concurrent cost update and submit a revised Benchmark Score.

**13. RFP Process/ Analysis:** Staff recommends that the Commission allow electric utilities to conduct a Standard RFP without input or oversight by an Independent Evaluator. However, staff recommends that the Commission require electric utilities to conduct a Non-Standard RFP with input and oversight by an Independent Evaluator, whenever the utility intends to consider self-build, affiliate, or ownership options in the solicitation.

In both the Standard and Non-Standard RFP, the utility will score the bids, select the initial and final short-lists, and undertake negotiations with bidders. In the case of the Non-Standard RFP, the IE will validate the utility's Benchmark Score and independently score an appropriate number of bids, at the discretion



of the IE and the Commission. The utility and the IE will compare resource scores and work to reconcile and resolve any scoring differences.

Finally, the Commission should require the utility and the IE to evaluate the unique risks and advantages associated with the Benchmark Resource, including the regulatory treatment of construction costs, plant efficiency, equipment failures and outages, and costs of replacement capacity, energy and ancillary services. The utility and the IE should propose methods for making a fair comparison between the Benchmark Resource and the bid-based resources. For example, one possible approach is to model likely variation in construction costs, plant efficiency, plant outages, and operation and maintenance costs and assign a risk premium to the Benchmark Resource. Another possible approach is to propose to restrict cost recovery for the Benchmark Resource to an appropriate range. For example, recovery of construction costs could be limited to 110 percent of the utility's initial cost estimate; plant efficiency could be limited to 102 percent of the utility's initial estimate; and so on. At this time, staff believes a flexible approach is the best way to address this fair comparison issue. The Commission can watch for progress on this issue and revisit its bidding guidelines if the competitive bidding regime needs to be updated to achieve the fairness requirement.

**14. IE Closing Report:** Staff recommends that the Commission require that the IE prepare a Closing Report once it has completed its involvement in the RFP process. In addition, the IE should make its detailed bid scoring and evaluation results available to the utility, Commission staff, and non-bidding consumer advocates for use in RFP acknowledgment or cost-recovery proceedings in which the RFP resources are at issue.

**15. Confidential Treatment of Bid and Score Information:** Bidding information, including the utility's cost support for its Benchmark Resource and any detailed scoring and evaluation results should be made available to the utility, Commission staff, and non-bidding intervenors under protective orders that limit use of the information to RFP acknowledgment or cost-recovery proceedings in which the RFP resources are at issue.

**16. RFP Acknowledgment:** Staff recommends that the utility be allowed to request Commission acknowledgment of the utility's selection of the final short-list of RFP resources. RFP acknowledgment should have the same legal force and effect as IRP acknowledgment in any future cost-recovery proceeding in which the selected resources are at issue. Acknowledgment should have the same meaning as assigned to that term in Order No. 89-507. If an Independent Evaluator has participated in an RFP, staff recommends that the IE participate in any associated RFP acknowledgment proceeding.

Staff believes an RFP acknowledgment process will improve future prudence reviews and provide an additional layer of regulatory certainty to the utility.

Commission acknowledgment of a final RFP short-list would require a utility showing that it had conducted a fair RFP process, consistently scored and evaluated a full range of resources, and selected a final short-list of resources consistent with achieving the primary goal of IRP. The utility would gain assurance that at the time of RFP acknowledgment, the Commission found the utility's plans to pursue negotiations with the final short-list bidders to be reasonable.

Commission acknowledgment of the final RFP short-list preserves the traditional roles of the utility and the Commission. Acknowledgment of a single bid or signed contract would constitute pre-approval of the resource and alter the traditional role of the Commission. In addition, Commission RFP acknowledgment should not impair the negotiation position of the utility. By acknowledging a final short-list that contains several options for putting together the preferred incremental portfolio, as opposed to acknowledging a single incremental portfolio, the Commission can avoid inadvertently weakening the negotiating position of the utility.

### **Conclusion**

In these opening comments, Staff has provided justification for a set of guidelines that would update the Commission's competitive bidding regime. Staff believes the updated bidding regime would:

1. Complement the Integrated Resource Planning process and assist the utilities in obtaining the optimal mix of power resources;
2. Not unduly constrain the utilities' ability to use other resource acquisition options;
3. Be flexible and allow contracting parties to negotiate mutually beneficial exchange agreements; and
4. Be understandable and fair.

**STAFF Straw Proposal**  
**Docket No. UM 1182**  
**Competitive Bidding Investigation**  
September 26, 2005

- 1. RFP after IRP:** The RFP process should follow the IRP process. If the utility's IRP shows new resources are needed, then the utility's IRP Action Plan should identify the preferred resource strategy, specifically describing the types of technologies and characteristics of each new resource in the utility's preferred resource portfolio. For each of the resources identified in its IRP Action Plan, the utility should indicate if it plans to consider a utility-owned resource. If the utility plans to consider a utility-owned site it should identify the transmission arrangements.
- 2. RFP Requirement:** Utilities must issue RFPs for all Major Resource acquisitions. Major Resources are resources with durations greater than 5 years and quantities greater than 50 MW.
- 3. Exceptions to RFP Requirement:** The RFP requirement does not apply to Major Resource acquisitions, other than self-build resources, in emergencies or in situations where there is a time-limited resource opportunity of unique value to customers. If a utility acquires a Major Resource under such conditions, it shall report the acquisition and the reason for acting outside of the RFP requirement to the Commission, within 30 days of the acquisition. Copies of the report will be served on all participants in the utility's most recent RFP and IRP processes as well as on parties to its most recent rate case.
- 4. Waiver of RFP Requirement:** A utility may request Commission acknowledgment of an alternative acquisition method for a Major Resource in the utility's IRP. A utility may also request a waiver outside the IRP process. Such request will be served on all participants in the utility's most recent RFP and IRP processes, as well as on parties to its most recent general rate case. The Commission will issue an Order addressing such requests within 120 days, taking such oral and written comments as it finds appropriate under the circumstances.
- 5. Affiliate Bidding:** Utilities may allow affiliates to submit RFP bids. If the utility allows affiliate bidding, then an Independent Evaluator must participate in the Non-Standard RFP. The utility must blind all RFP bids and treat affiliate bids the same as all other bids.
- 6. Utility Ownership Options:** Utilities may use a self-build option as a Benchmark Resource in an RFP to provide a cost-based alternative for customers. Utilities may also consider ownership transfers within an RFP

solicitation. If the utility intends to consider ownership options in an RFP, then an Independent Evaluator must participate in the Non-Standard RFP.

**7. Independent Evaluator (IE):** The utility and Commission staff select an IE from a qualified slate of candidates. The IE should not be providing, or recently have provided, consulting services to participants in western energy markets. The IE should report to the Commission staff. The IE should be paid by the utility through assessments of all bidders including the utility. The bidding fees will be based on the anticipated costs of the IE's services as established between the IE and the Commission staff.

**8. Bid Scoring and Evaluation Criteria:**

- a. Selection of an initial short-list of bids should be based on price and non-price factors. The utility should use the initial prices submitted by the bidders to determine each bid's price score. The price score should be calculated as the ratio of the bid's projected total cost per megawatt-hour to forward market prices using real-levelized or annuity methods. The non-price score should be based on resource characteristics identified in the utility's IRP Action Plan (e.g., dispatch flexibility, resource term, portfolio diversity, etc.) and conformance to the standard form contracts attached to the RFP.
- b. Selection of the final short-list of bids should be made on a system basis using the utility's production cost and risk models to identify the least-cost, least-risk combination of resources. The portfolio modeling and decision criteria used to select the final short-list of bids must be consistent with the modeling and decision criteria used to develop the utility's IRP Action Plan. If an IE is used, then the IE will have full access to the utility's production cost and risk models.
- c. Consideration of ratings agency debt imputation should be reserved for the selection of the final bids from the initial short-list of bids. The Utility should be willing to obtain an advisory opinion from a ratings agency to substantiate its analysis and final decision, if requested by the Commission.

**9. RFP Design:**

- a. Standard RFP: The utility designs and conducts a "Standard RFP" if it will not consider affiliate bids or ownership options in the RFP.
- b. Non-Standard RFP: If the utility intends to consider self-build, affiliate, or ownership options in the RFP it must conduct a "Non-Standard RFP" and use an Independent Evaluator.
- c. Public Process Regarding RFP Design: Not less than 60 days before the utility intends to conduct a Standard or Non-Standard RFP, the

utility should announce its intention to conduct an RFP. The utility should draft a “Standard RFP” proposal, including the scoring and bid evaluation criteria. If a utility self-build, affiliate, or ownership option is considered, the utility and the IE together should draft a “Non-Standard RFP.” The utility and the IE, as needed, may conduct workshops on the upcoming RFP and will submit its final proposed RFP, including bid evaluation and scoring criteria and standard form contracts, to the Commission for approval, as described in paragraph 11 below.

**10. Minimum Bidder Requirements:** The utility may propose minimum bidder requirements for credit and capability. If a Non-Standard RFP is used, then the IE should assist in the development of any minimum bidder requirements. Minimum bidder requirements will be subject to public comment during the design of the RFP and to Commission approval of the proposed RFP as described in paragraph 11 below.

**11. RFP Approval:** The Commission should solicit public comment on the utility’s draft RFP, including the proposed minimum bidder requirements and bid scoring and evaluation criteria. Public comment should focus on: (1) the alignment of the utility’s draft RFP with the utility’s IRP; (2) whether the draft RFP satisfies the Commission’s competitive bidding guidelines; and (3) the overall fairness of the proposed RFP process. After reviewing the draft RFP and the public comments the Commission may approve the RFP with any conditions and modifications deemed necessary. The Commission should consider the impact of multi-state regulation including requirements imposed by other states for the RFP process, such as the timing of the process and the selection and use of an IE. The Commission should act on the proposed RFP within a reasonable time, but no later than 45 days following the filing of the final proposed RFP, unless the utility requests additional time.

**12. Benchmark Score:** If a utility owns a site that it intends to use as a Benchmark Resource in a Non-Standard RFP, the utility must submit a detailed Benchmark Score, with supporting cost information, to the Commission and IE prior to the opening of bidding. The Benchmark Score should be assigned to the Benchmark Resource using the same bid scoring and evaluation criteria that will be used to score market bids. Information provided to the Commission and IE must include any transmission arrangements and all other information necessary to score the Benchmark Resource. If, during the course of the RFP process, the utility and IE determine that bidder updates are appropriate, the utility will also update the costs of the Benchmark Resource. The IE will review the reasonableness of the cost update and the revised Benchmark Score. The information provided to the Commission and IE will be sealed and held until the bidding in the RFP has concluded.

**13. RFP Process/ Analysis:**

- a. Standard RFP: The utility conducts the RFP process, scores the bids, selects the initial and final short-lists, and undertakes negotiations with bidders.
- b. Non-Standard RFP:
  - i. The utility conducts the RFP process, scores the bids, selects the initial and final short-lists, and undertakes negotiations with bidders.
  - ii. The IE validates the utility's Benchmark Score and may validate, sample, or independently score all bids, at the discretion of the IE and the Commission. In addition, the IE evaluates the unique risks and advantages associated with the Benchmark Resource, including the regulatory treatment of construction cost overruns, equipment failures and outages, costs of replacement capacity, energy and ancillary services, and other risks and advantages of the Benchmark Resource to consumers.
  - iii. Once the competing bids and Benchmark Resource have been scored and evaluated by the utility and the IE, the two should compare results. The utility and IE should work to reconcile and resolve any scoring differences.

**14. IE Closing Report:** The IE will prepare a Closing Report for the Commission once it has completed its involvement in the RFP process. In addition, the IE will make its detailed bid scoring and evaluation results available to the utility, Commission staff, and non-bidding consumer advocates.

**15. Confidential Treatment of Bid and Score Information:** Bidding information, including the utility's cost support for its Benchmark Resource, as well as any detailed bid scoring and evaluation results will be made available to the utility, Commission staff, and non-bidding intervenors under protective orders that limit use of the information to RFP acknowledgment or cost-recovery proceedings in which the RFP resources are at issue.

**16. RFP Acknowledgment:** The utility may request that the Commission acknowledge the utility's selection of the final short-list of RFP resources. The IE will participate in any RFP acknowledgment proceeding. RFP acknowledgment should have the same legal force and effect as IRP acknowledgment in any future cost-recovery proceeding in which the selected resources are at issue. Acknowledgment shall have the same meaning as assigned to that term in OPUC Order No. 89-507.



# Memo

To: Lee Sparling  
From: Bryan Conway and Thomas Morgan  
CC: Marc Hellman  
Date: June 6, 2005  
Re: Debt Imputation and Power Purchase Agreements

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The issue of debt imputation for power purchase agreements (PPA) is in some sense a very old issue. The financial community, rating agencies, and other investor information services have been making similar decisions for many years. In fact, The Financial Accounting Standards Board developed the Financial Accounting Standard (FAS) 13, "Accounting for Leases" in November 1976.

Financial Accounting Standards are designed to require companies to convey material information to the users of the companies' financial statements. FAS 13 lays out the proper analytical framework, or "lease test", to determine whether a contract is properly classified as a capital lease or an operating lease.<sup>1</sup> The reason this is important is because capital leases are required to be included on a company's balance sheet, and are considered "owned assets" for accounting purposes. The capital lease is a financing tool and the treatment for accounting purposes generally mirrors that of an owned asset, financed with debt.

Operating leases, on the other hand, are not included on the balance sheet of the leasing company; however the impact of lease payments is included in the notes on SEC statements as "off-balance sheet" items. Therefore, debt imputation can be used to put operating leases and capital leases on equal footing.

Debt imputation is simply rating agencies' acknowledgement that required payments for a PPA may have the same look and feel as required interest payments on debt. In an attempt to demystify Standard and Poor's (S&P) treatment of required PPA payments,<sup>2</sup> S&P has made public a simple formula that it will use to evaluate PPAs.

The S&P formula applies to the required payments of the PPA and is laid out below:

1. S&P finds the NPV of the required payment stream discounted at 10%.

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<sup>1</sup> There are four primary tests that determine if a lease is a capital lease: (1) Ownership transfers to lessee at the end of the term of the lease; (2) there is a bargain purchase option at the end of the lease; (3) the term of the lease is at least 75 percent of the useful life of the underlying assets; and, (4) the net present value (NPV) of the fixed payments is greater than 90 percent of the assets fair value.

<sup>2</sup> Currently Fitch considers debt imputation in its ratings but has not made public a "debt imputation formula."

2. S&P then applies an arbitrary factor typically between 10%-75% of the NPV to determine what to impute as debt on the balance sheet. The arbitrary factor is proprietary and is heavily influenced by S&P's perception of the likelihood of the Company's ability to receive a timely recovery of the costs of the PPA.
3. S&P next calculates interest payments at 10% on the amount of debt imputed on the balance sheet for purposes of calculating its metrics such as interest coverage.

It is important to note that S&P looks at this from the exclusive perspective of the debt investor, not from the customer perspective. S&P's intent is to alert the debt investor to a company's off-balance-sheet obligations that could compete for payment with loan repayment at times of financial distress for the utility. Additionally, the final conclusion reached regarding the impact on overall credit ratings is subjective.

The credit rating is designed to measure the probability of default. As such, the overall range of the few credit metrics or ratios is relatively wide.<sup>3</sup> Even though each calculation is precise, the interaction among the variables requires a more "macro" view. Metrics may be outside the range for a specific rating category "notch" (or the "business ranking" subcategory) while not impacting the rating of a specific company.

Regulated utilities appear to gain favorable treatment by S&P with respect to PPAs. S&P states, "...most entities entering into long-term PPAs, as an alternative to building and owning power plants, continue to be regulated utilities. Observations over time indicate the high likelihood of performance on take and pay, or TAP commitments and, thus, the high likelihood that utilities must make fixed payments. However, Standard & Poor's believes that vertically integrated, regulated utilities are afforded greater protection in the recovery of PPAs, compared with the recovery of fixed tolling charges by merchant generators. There are two reasons for this. First, tariffs are typically set by regulators to recover costs. Second, most vertically integrated utilities continue to have captive customers and an obligation to serve. At a minimum, purchased power, similar to capital costs and fuel costs, is included in tariffs as a cost of service."<sup>4</sup>

Should the competitive bidding evaluation method and/or scoring criteria address the effect of debt imputation from a contract on the purchasing utility's balance sheet? Yes, to the extent the effect is present. However, because power purchase agreements can be structured in unlimited ways, there is no "one size fits all" approach. Each contract would likely need to be analyzed independently to ascertain the influence on a company's financial position. However, if the Commission feels that the evaluation or scoring is not correctly calculated, then the Company should be willing to pay the nominal fee required by S&P for an advisory opinion. (After all, the Company is trying to guess what S&P would do anyway.) Further, rather than a passive approach, utilities can work with S&P to help provide a better understanding of the terms and conditions of the PPA that are more likely to result in imputed debt. To the extent contracts can be structured so that no, or little, debt is imputed, the issue is mitigated.

Should the Commission take actions to mitigate the effects of a PPA on the utility's balance sheet? S&P states that PPAs are similar to fixed commitment leases. "When a utility enters into a long-term PPA with a fixed-cost component, it takes on financial risk. Furthermore, utilities are typically not financially compensated for the risks they assume in purchasing

<sup>3</sup> Ratio medians that Standard & Poor's has been publishing for more than a decade are merely statistical composites. They are not rating benchmarks, precisely because they gloss over the critical link between a company's financial risk and its business risk. Medians are based on historical performance, while Standard & Poor's risk-adjusted guidelines refer to expected future performance. Guidelines are not meant to be precise. Rather, they are intended to convey ranges that characterize levels of credit quality as represented by the rating categories. Obviously, strengths evidenced in one financial measure can offset, or balance, relative weakness in another.

<sup>4</sup> Standard & Poor's Utilities and Perspectives, May 12, 2003, Vol. 12, No. 19.



power, as purchased power is usually recovered dollar-for-dollar as an operating expense.<sup>5</sup> However, it is not clear if S&P is discussing a new issue or is simply referring to regulatory lag.

Between rate cases, if a utility were to enter into a new PPA that resulted in a large amount of debt imputation, they may not be compensated for that specific risk until after it is incorporated into rates through a general rate case or RVM. However, it is likely that other risks have also changed since the last rate case. To single out one risk without reviewing the other risks may not result in just and reasonable rates. Further, since the utility's cost of debt is calculated using its embedded costs, the interest it pays on debt should fully reflect the riskiness of the utility up to the test period involved. Finally, with respect to cost of equity, since the utility's cost of equity is based on a comparable sample group of companies, and it is unlikely that the sample group is not similarly impacted by PPAs and debt imputation, it is difficult to make the case that an ROE premium should be granted. If a utility were truly unique with respect to PPAs, then this would most appropriately be dealt with in a general rate case and would likely manifest itself in the authorized capital structure.

Importantly, Staff is not aware of any cases where a company has been downgraded solely due to entering into a PPA. The rating process considers the intermediate future prospects of all material issues that affect a company, including other liabilities, such as pensions and asset revaluations (asset impairment test, or mark-to-market accounting). The imputation of debt is important to be able to compare companies amongst themselves.<sup>6</sup> The treatment afforded public utilities for PPAs is not different than other industries that sign leases or other long-term commitments, and the credit rating agencies have not altered their approach for at least two decades.

If the Commission wishes to take actions to mitigate the impacts of a PPA on a company's balance sheet, there are many tools at its discretion. First, more frequent rate cases would reduce uncertainty caused by regulatory lag. Second, the RVM process coupled with deferred accounting would decrease the likelihood of less than full and timely recovery of the PPA costs. This would reduce or eliminate the amount of debt imputed by S&P and others. If necessary for unique situations, the Commission could, in effect, securitize the capacity payments of a PPA to minimize the likelihood of less than full and timely recovery of PPA expenses. All of these items should be viewed favorably from a ratings agency perspective. Securitization is likely only necessary in extreme circumstances since all utilities are being treated equally by S&P and others. For that reason, the Company's authorized rate of return already reflects the costs associated with the "imputed debt" borne by the comparable companies.

If the Company wishes to adjust a PPA bid to reflect debt imputation, it should be reserved for the selection of the final bid from among the short-listed bidders. If there is a reasonable argument that a short-listed PPA would impose other costs on the company through its capital structure, the analysis should be included. The debt imputation analysis would likely only be an issue with projects of similar costs. Finally, it may be reasonable to require a utility to obtain an advisory opinion from a ratings agency to substantiate its analysis and final decision.

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<sup>5</sup> Ibid.

<sup>6</sup> S&P 2002 Corporate Rating Criteria, Page 53, "Ratings are designed to be valid over the entire business cycle; ratios of a particular firm at any point in the cycle may not appear to be in line with its assigned debt ratings. Financial ratio medians are adjusted for unusual items and to capitalize operating leases. The operating lease adjustment is performed for all companies. Companies that buy all plant and equipment are put on a more comparable basis with firms that lease part or all of their operating assets. The lease adjustment impacts all ratios."

1 **CERTIFICATE OF SERVICE**

2 I certify that on September 30, 2005, I served the foregoing upon the parties hereto by  
3 sending a true, exact and full copy by regular mail, postage prepaid, or by hand delivery or  
4 shuttle mail, and by electronic mail to:

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Legal Secretary  
Department of Justice  
Regulated Utility & Business Section