

**BEFORE THE PUBLIC UTILITY COMMISSION**

**OF OREGON**

**UM 1276**

In the Matter of )

THE PUBLIC UTILITY COMMISSION )  
OF OREGON, )

Staff request to open an investigation )  
regarding performance-based )  
ratemaking mechanisms to address )  
potential build-vs.-buy bias. )  

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OPENING COMMENTS  
OF THE  
CITIZENS' UTILITY BOARD OF OREGON

May 31, 2007



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_____	)	

**I. Premise**

This docket presumes that, from a utility’s perspective, a bias exists for building and owning a resource, as opposed to procuring a comparable resource through a power purchase agreement (PPA). Customers stand to benefit from a vibrant and competitive wholesale market in general, and specifically from the risk-mitigation characteristics that a PPA can bring. Thus, as utilities have a bias toward self-build resources, customers may not be enjoying the benefits that independent power producers (IPP) can offer. The Commission has requested that the parties propose mechanisms to counterbalance the utilities’ build-vs.-buy bias, in order to, ultimately, make customers better-off through appropriate use of power purchase agreements.

While quantifying the value that power purchase agreements could bring to a utility’s portfolio would be a formidable, if not impossible, task, there is, nonetheless,

room to assume that there is value that can be brought to the table. An appropriate mechanism to counterbalance a utility's build-vs.-buy bias would share that value between shareholders and customers, thus providing an incentive for shareholders to enter into power purchase agreements, and, thereby, serve customers more reasonably and reliably.

## **II. Theory – An Evaluation Framework**

Before addressing the mechanisms that have been proposed, we describe the general framework we use to evaluate the mechanisms.

### **A. Advantages Of Power Purchase Agreements**

In order to gauge the currently-foregone value of the benefits of power purchase agreements and a healthy wholesale market, it is important to at least qualify those benefits. Power purchase agreements, in contrast to utility-built resources, have two primary counterparties, the utility and the independent power producer, and so can contain a number of risk-sharing provisions that are not available for a unilateral self-build resource.

Typically, it is the IPP who takes the risk that construction costs may be greater than projected, that timelines may be delayed, or that other, unexpected problems increase the cost of the resource. An IPP can also take the risk that the plant may not perform to its specifications. Depending upon the circumstances, it could be the IPP or the utility that is in the better position to manage some of these risks. More abstract, but also important, is the competitive edge that an active wholesale market can bring to a regulated utility. It provides the utility with more options with which to serve customers, and it also acts as a benchmark against which a utility's performance can be measured.

## **B. Reasons For The Buy Vs Build Bias**

Discussions in workshops have circled primarily around two sources for a utility's bias for a self-build resource as opposed to a PPA. The first is that the utility's shareholders earn a rate of return on the capitalized cost in rate base of building a generating plant, but not on the cost of a PPA. The second is that credit rating agencies, when evaluating the creditworthiness of a utility, impute debt in a utility's capital structure for the capacity portion of a PPA.

The first of these sources seems relatively clear-cut and straightforward; shareholders make money on a self-build resource, whereas they do not on a PPA. When a utility builds a resource, the capitalized cost is added to the utility's rate base, the amount of which is multiplied by the utility's authorized rate of return and added to customer rates. The second source of bias, debt imputation, is less clear, and the disincentive it provides, if any, is not readily qualified or quantified. Credit rating agencies, when calculating a utility's credit rating, impute debt for the capacity portion of a PPA, thereby increasing the appearance of debt in a utility's capital structure, and possibly contributing to a credit rating downgrade. The question to address in the context of this docket is how, or if, this contributes to a utility's build-vs.-buy bias.

On its face, any increased cost of debt resulting from the contribution of debt imputation to a ratings downgrade would be minimal, as these costs would flow to customers through rates. There may be, however, a number of other considerations influencing a utility shareholder's preference to avoid the risk of debt imputation contributing to a downgrade, including the ability to issue dividends under merger

conditions, the impact of the credit rating on any unregulated portions of the business including access to capital, or the impact of credit rating upon stock price.

The impact of debt imputation on a utility's credit rating and the following impact of credit rating on the above considerations is neither immediate nor clear-cut, but may, nevertheless, be a consideration for a utility. In addition, if rating agency debt imputation contributes to a utility's build-vs.-buy bias, the significance of that contribution is also unclear. Rating agency debt imputation is formulaic only to a point, a subjective risk factor is used in the debt imputation calculation, the impact of that calculation on a utility's credit rating as a whole is unknown, and a utility's credit rating is based on any number of other subjective factors. It is unclear if even the rating agencies themselves could tease out the impact of debt imputation on a utility's credit rating, in light of everything else that impacts a utility's credit worthiness in the eyes of the rating agencies.

Given the questionable contribution of debt imputation to a utility's build-vs.-buy bias, we focus on mechanisms that target bias resulting from the utility's opportunity cost associated with increasing rate base.

### **C. When Does The Buy Vs Build Bias Come Into Play?**

A utility's bias toward self-build resources comes into play when the utility must choose between its resource options. Given this, it is important to tailor any mechanism designed to mitigate the build-vs.-buy bias to the decision point where the utility is considering a self-build option. The more cleanly a mechanism targets the build-vs.-buy bias, the more effective it will likely be, and the less likely it will be to have unintended consequences.

### **III. Practice – The Proposals**

Here we address the individual proposals, the incentives they provide, and the precision with which they target the build-vs.-buy bias. We do not address PacifiCorp's suggestion that utilities be able to propose utility-specific mechanisms in the future, but are always open to working with a utility to develop mechanisms that bring value to the utility and its customers.

#### **A. Quantify PPA Value in RFP Bid Evaluation [NIPPC]**

NIPPC's first proposal is to re-open UM 1182, and require that the benefits of a PPA be explicitly and quantitatively included in a utility's bid evaluation. As described earlier, customers stand to benefit generally from a vibrant wholesale market, and specifically from the protections that a PPA can bring to a diversified portfolio. Though utility shareholders also stand to benefit from the lower risk of a PPA, the premise of this proposed mechanism is that shareholder bias toward a self-build option colors its RFP process and bid evaluation accordingly, thereby making it difficult for an independent power producer to compete. NIPPC proposes balancing the build-vs.-buy bias, that tips a utility's bid evaluation in favor of a self-build option, by adding a comparable counterweight to value the benefits that customers would enjoy through a PPA.

A major selling point of this mechanism is the precision with which it targets the utility's build-vs.-buy decision point. Another selling point is that this mechanism does not involve any rate change, and so does not fundamentally alter the financial balance between risk and reward that has been established in past rate-setting. The downside of this point, however, is that the mechanism, therefore, provides no financial incentive to actively encourage utility shareholders to enter into a PPA.

A concern that we have with this proposal is that the contract terms of a PPA are negotiated and established for each individual PPA, and so the risk protections included in one contract might not be included in another. For example, one PPA might put the risk of construction delay on the IPP, while another might put it on the utility.

If a quantitative value is to be added to a PPA when evaluating bids, then the benefits that this value is based upon need to be clearly stated, and the mechanism should only capture a PPA if it includes those benefits. NIPPC suggests the following criteria for a PPA to be eligible for its second proposed mechanism (paraphrased):

- The unit availability must be pre-established on an annual basis;
- The IPP must take the construction risk;
- The IPP must take the operation and maintenance risk; and
- The IPP must be responsible for compliance with all relevant permitting requirements.

This proposed mechanism has the potential to address the build-vs.-buy bias, but in order for it to do so in a way that brings value to customers, it must be limited to those power purchase agreements that reduce risk or otherwise provide a benefit to customers. As contract terms can be negotiated in any number of ways, it is necessary to clearly define the conditions a PPA must contain for it to be eligible for this incentive.

#### **B. Rate Base The Capacity Portion Of PPA [NIPPC, PacifiCorp]**

PacifiCorp and NIPPC both propose a mechanism whereby the capacity portion of a PPA would be included in a utility's rate base, thereby allowing the utility to earn a return on a portion of its PPA costs. PacifiCorp proposes that this mechanism apply to any new PPA of one-year or longer in duration. Though this mechanism would provide a

financial incentive to actively encourage utilities to enter into a PPA of a year or longer, it is less precisely tailored to a utility's build-vs.-buy decision.

A utility uses power purchase agreements to meet various needs in its resource portfolio, but only some of those needs would be appropriately met with a self-build resource. As the purpose of this docket is to address the build-vs.-buy bias, it only makes sense to provide the utility an incentive to enter into a PPA that competes with a self-build option. One way to do this would be to limit the mechanism to major resources that are selected through an RFP process that includes a self-build option. In RFP Guideline 1, the Commission defines a "major resource" as one with a duration of greater than 5 years and quantity greater than 100 MW. UM 1182 Order No. 06-446 at 3.

A potential problem with this mechanism is that, in providing the utility a financial incentive to enter into a PPA, it would increase the cost of a PPA to customers, and this cost must be accounted for in the RFP bid evaluation. Increasing the cost of a PPA would disadvantage it in the RFP bid evaluation. Unlike the proposal to quantify PPA value in RFP bid evaluation, which can stand on its own, this proposal may need to be combined with the PPA value proposal in order to offset the bid-evaluation impact of the now-higher cost of the PPA.

### **C. Equity Imputation [PGE]**

PGE proposes to impute equity into a utility's capital structure to counterbalance the debt that credit rating agencies impute for the capacity portion of a PPA. While this proposed mechanism may address concerns about debt imputation by allowing a utility to earn a higher rate of return, it is unclear if this incentive would be specific enough to overcome the build-vs.-buy bias. The equity imputation mechanism would increase the

percentage of equity in a utility's capital structure for ratemaking purposes. This would increase a utility's overall rate of return by weighting its capital structure more heavily toward equity, as a utility's cost of equity is typically considerably greater than its cost of debt. The higher rate of return would bring a utility higher profits, which would, in turn, make a utility look more creditworthy in proportion to the amount a PPA capacity payment would make a utility look less creditworthy in the eyes of the credit rating agencies.

This does not appear to be a precise way of addressing the build-vs.-buy bias for two reasons. First, it is not specific to those power purchase agreements that would compete with a self-build resource. As pointed out earlier, many power purchase agreements could not appropriately be replaced with a self-build resource, and are not, therefore, at issue when the build-vs.-bias comes into play. Second, by increasing the utility's rate of return it would also increase the profit a utility would make on the capitalized costs of a self-build resource, which appears contrary to the intent of the mechanism.

#### **D. Income Opportunity [PGE]**

PGE proposes two versions of an income opportunity mechanism to increase the appeal of power purchase agreements to utilities: 1) income opportunity on individual contracts, and 2) income opportunity on a portfolio of contracts. Like the rate base and equity imputation proposals, these mechanisms would allow utilities to earn money as a result of power purchase agreements, thereby increasing the appeal of a PPA when compared to a self-build option. Our primary concern with these income opportunity proposals is the same as that with the equity imputation proposal. The income

opportunity mechanisms do not precisely target the build-vs.-buy bias, because they would capture contracts that wouldn't compete with self-build resources.

The regulatory complexity of the income opportunity mechanisms is another drawback of this proposal. Both versions of the income opportunity proposal would involve designing a new framework to value either portfolios by their content or contracts by their terms. As compared to the rate base mechanism – which takes advantage of a regulatory mechanism that is already in place – the income opportunity mechanisms appear to offer no significant advantage while bringing some additional complexity.

#### **E. Return On Equity Adjustment [ICNU]**

ICNU's proposal does not directly address the build-vs.-buy bias, but instead provides a tool that can be used in conjunction with other proposed mechanisms. The return on equity (ROE) adjustment mechanism can be used to maintain or adjust the balance of risk and reward that has been established between shareholders and customers.

A premise of the ROE adjustment mechanism is that, as long as the utility is earning the same amount of money, it shouldn't matter where that money comes from. If the Commission wants a greater share of a utility's earnings to come from power purchase agreements, it can include appropriate power purchase agreements in rate base, which would increase earnings, and then lower the utility's ROE to bring the utility's earnings back to where they would have been absent the increase in rate base. Thus both the utility and customers would both be kept whole.

The problem with using an ROE adjustment in this manner is that it would negate the PPA incentive that the rate base mechanism is designed to provide. If the utility is allowed to add the capacity portion of a PPA to its rate base, but at the same time the

utility's ROE is decreased to make the rate base addition revenue neutral, the utility still would have been better off adding a self-build resource to rate base without having its ROE adjusted. Where an ROE adjustment may be more appropriate, as ICNU mentions, is to counterbalance any lessening of the risk a utility must manage. An ROE adjustment to reflect a change in a utility's risk profile, however, is more appropriately made in a rate case, and not here.

#### **IV. Customer Protections**

As we explore possible mechanisms to counterbalance utilities' build-vs.-buy bias, we should also be considering the customer protections that would be germane to any regulatory mechanism, as well as those that would protect customers from significant unintended consequences. As other parties have stated, it is important that, if a mechanism is adopted, the appropriate time be built into the process for prudence reviews. We should also consider initially limiting the number of contracts that qualify for an incentive, or the amount that may be added to rate base. In addition, the mechanism should be scheduled for review after it has been in place for a short time to allow for improvements or, if necessary, abandonment.

#### **V. Conclusion**

It is important that any adopted mechanism be specifically tailored to those power purchase agreements that would compete with a self-build resource, and be designed to come into play at the time a utility is choosing between a PPA and a self-build resource. With this in mind:

- A mechanism that quantifies the PPA value in the RFP bid evaluation is precisely targeted to the build-vs.-buy bias, has the advantage of leveling the playing field without affecting rates, and can stand on its own.
- A mechanism that adds an appropriate capacity value of a PPA to a utility's rate base would also precisely targets the build-vs.-buy bias. It would provide the incentive of allowing a utility to profit from a PPA, but would probably need to include the previous mechanism so that the increased PPA cost for rates does not further disadvantage a PPA during bid evaluation.
- The equity imputation and income opportunity mechanisms don't offer anything to address the build-vs.-buy bias that the rate base mechanism does not, and are less well tailored to the build-vs.-buy bias than the rate base mechanism. These mechanisms also bring additional regulatory complexity.

Respectfully Submitted,  
May 31, 2007



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Utility Analyst

**CERTIFICATE OF SERVICE**

I hereby certify that on this 31<sup>st</sup> day of May, 2007, I served the foregoing Opening Comments of the Citizens' Utility Board of Oregon in docket UM 1276 upon the parties listed below by email and by 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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