State of Utah

DEPARTMENT OF COMMERCE
Committee of Consumer Services

To: Public Service Commission of Utah

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1 SUMMARY

The Committee of Consumer Services (Committee) continues to believe that consideration of any interjurisdictional cost-allocation method should be evaluated using the criteria developed by the Utah parties and circulated with the 3 July 2003 and the 10 September 2003 memoranda from Utah parties. In particular, an allocation method must meet three key principles:

- Assignment of cost and burdens on the basis of cost causation;
- Maintenance of the benefits of single system operation and planning;
- Long-term durability of the solution.

The Committee considers the *Utah Dynamic Alternative: An Integrated Basis for Cost Recovery,* with modifications to include a state resource category, to be an alternative to the Protocol. It provides for a time-limited hydro endowment. In the short run the Committees' first principle of cost causation would not be met, but it would consider this near-term cost for the long-run benefit of the assurance of a universal rolled-in method of cost allocation.

2 DISCUSSION

This Commission provided the Company clear direction regarding its interjurisdictional cost allocation expectations in its 28 September 1988 merger order and has spoken with a principled, clear, and consistent voice in all subsequent cases addressing interjurisdictional cost allocation. In April of 1998, after a full evidentiary hearing and careful consideration, the Commission formally adopted a traditional, rolled-in cost-allocation method.

In the spring of 2002, the Committee agreed to actively participate in the Multi-state Process (MSP) in order to address cost-recovery concerns raised by Oregon's restructuring legislation and the need for new resources on the east side of PacifiCorp's system that the Company was reluctant to build or acquire because of concern that western jurisdictions

would not share in the cost recovery of those new resources. In agreeing to participate in the process, the Committee never intended to revisit the settled interjurisdictional allocation case.

However, despite this early intention, Committee representatives did collaborate with other Utah parties in proposing a hydro endowment calculated as a fuel cost adjustment. This was an effort to be responsive to western parties' declared political need for a hydro endowment.

Because the fuel adjustment calculation includes only Company-owned hydro and pre-merger thermal plant rather than all thermal plant as is included in the Modified Accord calculation, it is anticipated that this hydro adjustment will result in a Utah revenue requirement that is smaller than the revenue requirement that results from the use of Modified Accord. The outcome should, therefore, approach a "fair sharing" of the allocation hole created by some jurisdictions using rolled-in and others Modified Accord. As specific hydro plants are relicensed and thermal plants retired, they would be removed from the calculation. Thus, this hydro endowment is limited in time.

The Committee was willing to consider this approach, because the ultimate result was a merged cost allocation method for a merged system. The Committee believes that a rolled-in allocation method best achieves results that are cost-based and therefore equitable; best promotes efficient single-system planning and operation; best provides rate stability and administrative ease, and is least likely to result in unintended consequences. It is therefore the most durable. The Committee was willing to consider a short-run subsidy to achieve the benefit of an equitable and sustainable long-run solution. The Committee is still willing to consider a modest, time-limited hydro endowment and still supports the detail included in the *Utah Dynamic Alternative: An Integrated Basis for Cost Recovery*.

The Committee believes that the MSP has been mostly successful in addressing the two issues that originally concerned the Committee. Parties are in agreement in principle with how to address direct access in Oregon or in any other state that might deregulate, and substantial progress has been made in investigating the cost impact of a fast growing state on relatively slower growing states at a time of system shortage. Studies reveal that with a rolled-in cost allocation method, between 95% and 111% of the cost of a reasonable new resource is absorbed by the growing state, depending on the resource choice. Thus, the question of who will pay for the cost of new resources appears clear, the customers of the growth state.

The heart of the controversy among the states, and thus the heart of the Company's concern regarding its ability to have the opportunity to recover 100% of its prudently incurred costs, dates back to the time of the merger and appears to color the new resource issue. From the Committee's perspective, the treatment of existing (premerger) resources is the real issue. Despite language in the Oregon merger order that anticipated merged costs for a merged system, Oregon parties (and Washington parties) asserted their claim to a permanent hydro endowment from the first days of the PacifiCorp Interjurisdictional Taskforce on Allocations (PITA) immediately following the merger. In the current process, they have reasserted and expanded their claim to include the Mid-C contracts. They have characterized these demands as "must haves" in order to achieve a single agreement among the states. The expansion of the hydro

endowment from that embodied in Modified Accord appears to be a direct response to the Utah Commission's decision to complete the transition to conventional, average-cost ratemaking, which is viewed by these parties as Utah having broken the PITA deal.

During the course of the MSP, the concept of a Hybrid was introduced, and the Oregon and Washington parties embraced it. The Hybrid artificially demerges the Company along control area boundaries for the purpose of assigning resources and allocating costs. It directly assigns all plant to one of two divisions based on PacifiCorp's control area boundaries and then dynamically allocates the costs of that plant within each division. The western division would include PacifiCorp's California, Oregon and Washington service territories, and the eastern division would include its Idaho, Utah and Wyoming service territories. The reserve margins in the two control areas are dramatically different. See Confidential Exhibit A.

The Company's proposed Protocol, the subject of its 30 September 2003 filing, was intended to be a compromise between the Hybrid and Utah's rolled-in cost allocation method. The Protocol creates three categories of generation resources: seasonal, regional, and state.

Seasonal resources would be allocated using modified allocation factors. The MSP parties from Oregon and Washington requested this category to address their concern that Utah's peak load growth is imposing unfair costs to other jurisdictions. The Committee is not opposed to a properly defined seasonal resources category, if it is considered essential to gaining an agreement that is perceived as fair. However, we note that it seems to add unnecessary complication for a small and unexpected change in revenue requirement (the use of actual data indicates seasonal allocation lowers Utah's revenue requirement).

The Regional resources category would include the northwest hydro and the Huntington coal plant which would be assigned to the former Pacific Power & Light (PPL) and Utah Power & Light (UPL) states, respectively, and then allocated among them. PacifiCorp created this category of plant in response to the northwest's demand for a hydro endowment. The coal endowment is created as a cost-offset.

The Committee has a number of concerns with methods that assign costs to a region without a cost-causal basis. However, we note here that the Protocol, like all methods that include a hydro endowment, increases Utah's costs in the early years for a benefit in the later years. If enough years are considered, Utah would be expected to experience a benefit in net present value, while the PPL jurisdictions would have a net cost of the endowments compared to a rolled-in allocation. It appears that the Protocol has a NPV close to that of rolled-in around year 15, although PacifiCorp has not yet provided 15 years of data. The Committee believes that this distribution of costs and benefits repeats Utah's unfortunate history of being promised long-term benefits in exchange for near-term costs, is not cost based, nor is it currently needed to achieve merger fairness (as it may have been in the past).

The state resource category was created to address situations in which the resource acquisition decisions of a state might impose costs upon other jurisdictions. The State resources are limited in the Protocol to Demand Side Management Programs and Portfolio Standards. The Committee supports the principle that resource decisions that are driven by state policy should not "unfairly burden other states." We recommend that future Qualifying

Facility contracts also be included in this category.

In addition, the Protocol addresses Oregon's direct access, the situs treatment of special contracts and it proposes a single method for responding to other existing and potential areas where states might take a different approach. Finally, it proposes a future method of resolving disputes among states.

In producing a single agreement, the Protocol appears to have been a failure, particularly in the regional plant category. No party liked the concept of a coal endowment or a coal opt-out, although reasons have varied among parties. And, Oregon parties have further stated that the Protocol does not respond to the risk imposed on it by Utah load growth. As has been the case throughout the MSP, the situation has continued to change, and it is no longer clear that the Protocol is the relevant alternative for further analysis. However, should it again become relevant, the Issues List that the Committee provided 11 November 2003 would be pertinent.

In their 6 February 2004 Issues Paper, Oregon parties advocate using a variant of the Hybrid to allocate their costs, and Washington staff has made its first Hybrid data request in the ratecase docket in Washington. As a fall-back to a Hybrid, Oregon parties advocate a dynamic model with important modifications favorable to Oregon—a hydro load decrement (including Mid-C) and tiering of new resources by vintage—plus two offsets (situs allocation of QFs and seasonal allocation of the APS exchange). Either approach could cause significant harm to the Company should Utah continue to allocate its costs using rolled-in.

It appears to the Committee that by significantly increasing the possibility of a revenue shortfall, the Oregon parties are trying to force Utah to abandon its adopted allocation approach to avoid financially harming the Company, and if the shortfalls are large enough, ultimately its customers.

Because of the unusual nature of this proceeding where Utah Commissioners will meet face-to-face with Commissioners from other states, the Committee believes that two categories of issues become pertinent; the legal basis for not fully merging the costs of a merged system, and the nature of the cost allocation methods the Oregon parties are advocating.

3 ISSUES

3.1 Merger Issues / Basis for a Hydro Endowment or Hybrid

The 1989 merger of Utah Power & Light with PacifiCorp Maine, a Maine Company, to form PacifiCorp, an Oregon Company, was approved by all the relevant state commissions and is not formally challenged by any party to the MSP. Cost allocation was not addressed as part of the merger. Applicants assured Commissions that the project merger-related cost savings were large enough that all could benefit under any reasonable cost allocation method. The applicants made quite clear that shareholders accepted the risk of any shortfall.

Following a 10-year transition period, and a lump-sum fairness adjustment that was calculated to decline from $72 million to $0 over a 20-year period (the midpoint of 10 year and a 30 year transition period), Utah has treated the PacifiCorp system as fully merged. Idaho is completing a transition to rolled-in, and Wyoming is rumored to be

considering it. Oregon and Washington have never accepted the full merger of power supply, and the Oregon coalition parties (and the Washington UTC staff) have proposed to artificially de-merge the power-supply system by advocating the use of the Hybrid.

The normal assumption in a merged utility serving multiple jurisdictions is that the generation and transmission systems will be treated as merged, while distribution, being a local cost, is assigned geographically. The Committee sees the central issue in this case as being one of whether there is any reasonable basis to not fully merge or to demerge PacifiCorp's generation and transmission system.

The most likely basis for not fully merging the system costs or demerging the costs would arise if one or more states had conditioned the merger on the retention of specific generation and transmission resources or benefits for the customers in that jurisdiction, and the other states had accepted the condition or allowed the merger despite that condition. The Committee's reading of the Oregon and Washington merger orders indicates that no such conditions were imposed. Neither order says anything about a hydro endowment or the permanent separation of UPL's and PPL's costs. In fact, Oregon's merger order allows for the possibility of merged costs within five years.

All orders require that customer rates will not be higher than they would have been without the merger, and PacifiCorp provided this assurance to the states.

The evidence in the MSP and in this proceeding indicates that Oregon and Washington customers, like other PacifiCorp customers, are better off with the fully merged system (including roll-in allocation) than without the merger. All states have benefited from increased useable capacity, sharing of seasonal peak capacity, and increased transmission access to markets. The PP&L states have also benefited from a decade in which Utah paid higher prices for power supply, even while its growth was assigning it an increasing portion of fixed costs and allowed PacifiCorp to average low-cost purchases into the mix. At the same time they were benefited by the rolled-in allocation of resources acquired to meet a winter peak.

PacifiCorp has estimated the effect of demerging the power supply system between divisions, and found that both divisions would be worse off in the future with separate power supply than with the rolled-in allocation of the merged supply. A study, 50.4 demonstrates that Oregon would pay $32.5 million more in 2005–18 without the merger.

Given the benefits of the merger, the Committee sees no reason to demerge the power supply. However, Oregon and Washington parties have presented an efficiency argument for a hydro endowment. They assert that the western states bear the non-energy costs and benefits of the hydro system, including the effects on irrigation, navigation, fisheries, endangered species, local employment, and local taxation. These western parties have expressed the desire to determine the fate of the hydro system, without the complication of PacifiCorp advocating for the economic interests of the other states as power consumers. While Utah parties may be as concerned about the environmental effects of the dams, and every state might be equally concerned about the employment and tax effects of its generating plants of every type, the desire of the western parties might be accommodated with limited complication of the rolled-in allocation method.

For example, the hydro resources might be priced at market value in the rolled-in cost allocation, with the difference between market and cost being credited (or charged) to particular states. If current projections indicate that the hydro-internalization adjustment would have significant effects on annual revenue requirements for the other jurisdictions, a series of fixed credits could be established today to minimize the expected net effect.

The Committee does not advocate this approach. This level of complication would only be justified if it would achieve consensus among the states and satisfy the interests of the western parties. As with other non cost-based adjustments, the Committee is concerned with the possibility of unintended consequences and, therefore, durability.

3.2 Questions regarding the Hybrid Allocation Methodology:

The benefits to Oregon and Washington from the use of the Hybrid as specified by Oregon over Modified Accord are dramatic. For example, using the updated gas and price forecast cases, Modified Accord lowers Oregon's revenue requirement from rolled-in by a 2005 three-year Net Present Value (NPV) of **Confidential**. The Oregon Hybrid lowers Oregon's revenue requirement from rolled-in by a 2005 three-year NPV of **Confidential**. And with the updated gas and price forecasts, the Hybrid that moves Cholla and the APS exchange to the West lowers Oregon's revenue requirement from rolled-in by a 2005 three-year NPV **Confidential**. (See Confidential Exhibit C)

However, those benefits are also very sensitive to forecasts and resource plans. Using the July gas and price forecasts, the Hybrid that includes Cholla and APS in the West *increases* Oregon's revenue requirement above rolled-in by a 2005 three-year NPV of **Confidential**. (See Confidential Exhibit B)

The revenue shortfall created by states using different allocation methods when one of those methods is the Hybrid is highly unstable. Compare the stability of Modified Accord to the Hybrid. (See Confidential Exhibit D)

We pose the following questions for investigation.

3.2.1 Why does the Oregon Hybrid method provide such large benefits to the PP&L jurisdictions:

- Exclusive use of the hydro;
- Insulation from Eastern load growth;
- Resource balance and reserve margin ;
- The price charged for spinning reserves?

3.2.2 If resources were reassigned to mimic, as closely as possible, the resource balance for the divisions at the time of the merger, what would be the interjurisdictional impact?

3.2.3 If resources were reassigned so that the reserve margin is the same for each side, what would be the interjurisdictional impact?

3.2.4 If resources were reassigned divisionally, with the post merger resources allocated based on use at the time that the resource was acquired, what would be the interjurisdictional impact?

3.2.5 Why should the APS contract, which has no benefits but only costs to the summer-peaking UP&L states, be assigned to them?

3.2.6 Shouldn't the UP&L states be assigned the hydro reserves and capacity that were freed up by addition of the UP&L system to PP&L?

3.2.7 How sensitive are the interjurisdictional results of the Hybrid to the following:

- Resource assignment;
- Fuel costs;
- Market prices;
- Environmental adders;
- Relicensing and clean-air costs.

3.2.8 Is the interchange accounting proposed in the Oregon Hybrid clear, unambiguous, fair, principled, and sustainable?

3.2.9 What is the basis for each feature of the Oregon Hybrid, as listed in the February 2004 Oregon Coalition paper, and is each feature unambiguously defined, sustainable, principled, and fair?