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Division of Public Utilities

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DIVISION MEMORANDUM

To: Utah Public Service Commission
Ric Campbell, Chair
Ted Boyer, Commissioner
Ron Allen, Commissioner

From: Division of Public Utilities
Constance White, Director
Energy Section
Artie Powell, Acting Manager, Utility Technical Consultant
Ron Slusher, Utility Technical Consultant

Date: Tuesday, August 23, 2005

Subject: Docket No. 05-035-47, In the matter of the Application of PacifiCorp for Approval of a 2009 Request for Proposals for Flexible Resource

Division's Recommendations

The Division recommends a lower risk factor (15% instead of 30% or 50%) proposed by PacifiCorp in determining the amount of debt to impute to a bidder's proposal during the screening evaluation. Of note, depending on receiving a timely response from PacifiCorp on an outstanding data request, the Division may have further recommendations in regards to the screening evaluation at a future time under this docket.

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Division's Comments on PacifiCorp's Proposed RFP-2009

The Division of Public Utilities (Division) has reviewed PacifiCorp's 2009 Request for Proposals for Flexible Resource (RFP-2009) document along with recommendations of Navigant Consulting (Navigant), which acted as the Independent Evaluator in Docket No. 03-035-29 (Currant Creek), and the recommendations of Merrimack Energy Group, Inc. (Merrimack), the Division's consultant in Docket No. 04-035-30 (Lake Side). In its final report to the Commission, Navigant made 16 recommendations intended to improve future utility (i.e., PacifiCorp) requests for proposals (RFP's);[1] Merrimack offered six recommendations. It appears that PacifiCorp has incorporated all of these recommendations in its RFP-2009. Therefore, the Division believes that the current RFP is superior to PacifiCorp's 2003-A RFP in that it more fully fulfills the objectives of achieving an open, fair, and reasonable process. Nonetheless, the Division has two concerns about the current RFP.

The Division's concerns are in regards to the screening evaluation proposed by PacifiCorp to arrive at a short list of bids. In particular, PacifiCorp proposes to include "all relevant … inferred and/or direct debt costs in this stage of the evaluation in order to arrive at a short-list."[2] The Division sponsored testimony on this topic in Docket No. 03-035-14 and would direct the Commission's attention to the Division's arguments contained in the direct testimony of Division witness Dr. William (Artie) Powell.

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[1] See, "Navigant Consulting's Final Report on PacifiCorp's RFP 2003-A," February 11, 2004.

[2] Application of PacifiCorp, Docket No. 05-035-47, p.5.

In brief, the Division argued that, while rating agencies view certain contracts as imposing costs on the utility and impute[3] debt to the utility's balance sheet for rating purposes, the actual impact or affect of this action on the utility's cost of capital is uncertain. Indeed two reports cited by the Division in its testimony conclude that little or no empirical evidence exists to support the hypothesis that the utility's cost of capital is adversely affected by the debt imputation. Furthermore, both Moody's and Standard & Poor's indicate that mitigating factors could result in a lower debt imputation. For example, Standard & Poor's indicates that the passage of SB26 may result in a lower risk factor – 30% instead of 50% – being applied in determining the amount of debt to impute. Based on these two factors, little or no empirical support and the stated rating policies of Moody's and Standard & Poor's, the Division recommended the use of a conservative 15% risk factor. We restate this recommendation for use in the screening evaluation of bids in the current RFP.

Additionally, the Division is concerned about the effect of a self-build option. Several of the sources cited by the Division in its testimony in Docket No. 03-035-14 conclude that a utility's self-build option poses more risk in terms of the utility's cost of capital than does power purchase agreements. For example, in the report prepared at the Lawrence Berkeley Laboratory the authors conclude, "At least as far as the cost of equity capital is concerned, we find more evidence to support the notion that utility construction raises the

[3] The Division's comments were primarily restricted to the case when a contract is determined to be a capital lease for which the rating agency imputes a portion of the capacity payment to the utility as debt.

cost of capital than that NUG [non-utility generation] purchases do."[4] One potential solution to this dilemma is offered by the Electric Power Supply Association:

> [An] approach is to apply a risk premium to the cost-plus offer in the evaluation of bids. The risk premium could be based on historical experience on cost pass-throughs [i.e., cost over-runs] with similar technologies. For example, if cost pass-throughs raised rate base by 20 percent in the past, the capacity related price in the cost-plus bid would be raised by 20 percent for purposes of bid evaluation.[5]

In this regard, the Division has asked PacifiCorp for a variance analysis of major capital projects over the last five years. PacifiCorp is currently working on a response to this question, which the Division may use to make a final recommendation in this area at a future time under this docket (Docket No. 05-035-47). With regards to the Division's first concern, the imputation of debt as a screening factor in developing a short-list of bidders, the Division recommends that the Commission instruct PacifiCorp to adjust its methodology to incorporate the lower risk factor of 15%.

[4] Edward Kahn, Steven Stoft, and Timothy Belden, "Impact of Power Purchases from Nonutilities on the Utility Cost of Capital," Lawrence Berkeley Laboratory (LBL-34741), March 1994, p. 30.

[5] "Getting the Best Deal for Electric Utility Customers: A Concise Guidebook for the Design, Implementation, and Monitoring of Competitive Power Supply Solicitations," Electric Power Supply Association, (prepared by Boston Pacific Company Inc.), 2004, p.16.