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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Approval of its Proposed Energy Cost Adjustment Mechanism	Docket No. 09-035-15

SURREBUTTAL TESTIMONY OF NANCY L KELLY

ON BEHALF OF

WESTERN RESOURCE ADVOCATES

January 5, 2010

I. INTRODUCTION

Q: Please state your name, employer and present position.

A: My name is Nancy L Kelly. I am employed by Western Resource Advocates (WRA) in its Energy Program as a Senior Policy Advisor.

Q: Have you previously filed testimony in this docket?

A: Yes. I filed direct testimony on November 16, 2009.

Q: What is the purpose of your current testimony?

A: To correct misrepresentations of my direct testimony as well as to respond to issues raised in rebuttal testimony filed December 10, 2009 by Mr. Gregory N. Duvall, Professor Karl A. McDermott, and Mr. Frank C. Graves on behalf of PacifiCorp and by Mr. Charles E. Peterson on behalf of the Division.

Q: Please summarize the issues you will cover.

A: First I explain the relevance of Docket No. 90-035-06 to this case. I then address risk shifting and long-run planning incentives. Finally I respond to the analysis of need.

II. RELEVANCE OF DOCKET NO. 90-035-06, THE ENERGY BALANCING ACCOUNT (EBA) CASE TO THE CURRENT ECAM DOCKET

Q: Which witnesses address the relevance of Docket No. 90-035-06 wherein PacifiCorp requested elimination of the Energy Balancing Account (EBA)?

A: Mr. Duvall addresses this in his rebuttal testimony referencing Mr. Peterson's direct testimony.

Q: What position do they take?

A: Mr. Duvall and Mr. Peterson both assert that the case is not relevant to this case because the facts and circumstances have changed. The implication of Mr. Duvall's rebuttal testimony is that my testimony and that of Ms. Beck of the Office of Consumer Services (OCS) related to that case is irrelevant. (Duvall Rebuttal at 69-78)

Q: How do you respond?

A: I agree with Mr. Duvall and Mr. Peterson that the facts and circumstances have changed from 1990 when the Company requested elimination of the EBA. Both the industry and the Company have changed from what they were in 1990.

Significantly, PacifiCorp had a large surplus in 1990. It desired to be a competitive seller of wholesale power and reap the rewards of those sales, which it could not if it had to pass the revenues back to customers through the EBA. Now, however, as a result of past management planning decisions, PacifiCorp has become a net buyer, and an ECAM is once again attractive to the Company.

While I agree with Mr. Duvall and Mr. Peterson that the circumstances are different, I disagree that the EBA case is made irrelevant by changed facts and circumstances. Testimony in that case identified a number of public interest benefits from using a normalized approach including rate stability, appropriate price signals to customers, placing the risk of fluctuating prices on those best able to manage them, operational efficiency, elimination of retroactive ratemaking issues,[1] and appropriate placement of risk and rewards. In 1990 Mr. Duvall testified as follows:

> "The results of the production cost model are not intended to match actual costs on a year by year basis, but are intended to provide results which are fair and reasonable and simulate the operation of the system under normal conditions. The fundamental difference between using normalized and actual net power costs is the placement of risks and rewards associated with over running and under running net power costs. Using actual information places the risks and rewards on retail customers, while using normalized information places the risk and rewards on the Company and its shareholders. In deciding the fate of the EBA, the Commission should carefully consider which group it believes should properly bear the risk."[2]

My primary purpose in referencing testimony from the EBA case was not to reestablish these public interest benefits of the current approach or to debate the merits of the Company's claimed need for an ECAM by comparing past circumstances with current circumstances. My purpose was to demonstrate that the choice of regulatory recovery mechanism influences management decisions when selecting resources. Mr. Topham's testimony in the EBA case establishes that management considers the regulatory cost recovery mechanism when undertaking long-run resource acquisition. The use of an ECAM does affect long-run planning incentives. I discuss the actual affect on long-run planning incentives later in this testimony.

[1] Prefiled Direct Testimony of Verl R. Topham, Docket No. 90-035-06, May 1990.

[2] Prefiled Direct Testimony of Gregory N. Duvall, Docket No. 90-035-06, May 1990, p. 20, 2-17.

Mr. Duvall's rebuttal testimony does not rebut my demonstration that the choice of regulatory mechanism for recovering costs directly influences management's resource acquisition decisions.

III. RISK SHIFTING AND LONG-RUN PLANNING

Q: Which witness responds to intervenors testimony regarding the risk shifting effect of an ECAM?

A: Professor McDermott.

Q: What is his position?

A: He says he refutes the notion that an ECAM would somehow shift risk from utility shareholders to customers. He says the risk shifting argument is a distraction or a decoy that cannot withstand careful scrutiny and should be rejected by the Commission. He further says that the term risk is a "nebulous imprecise term" that has not been defined carefully in testimony. (McDermott Rebuttal at 443 to 475)

Q: How do you respond?

A: I will use the testimony of Mr. Verl Topham from the EBA case to respond. Mr. Topham was President of Utah Power and Light and Executive Vice President of PacifiCorp Electric Operations Group at the time. He defines the risk of an ECAM as "the risk of fluctuating power costs." He believes an ECAM places this risk, as well as inappropriate rate volatility which thereby distorts price signals, on customers. The following is taken from his testimony.

> "Q: The EBA is a mechanism which places the risk of fluctuating power costs on the customer. If the EBA were terminated, the risk of fluctuating power costs would be placed on the Company. Why is the Company willing to accept this risk?"

I previously quoted Mr. Topham's response in my direct testimony:

> "A: The Company is willing to accept this risk because we believe it is manageable. The Company believes in placing the risk of management practices on those that make the business decisions – management – not customers." [3]

Q: Does who bears the risk for fluctuating power and fuel prices matter to long-run resource acquistion?

A: Yes. Who bears this risk affects whether Company management prefers capital intensive or fuel and market intensive resources. Mr. Graves explains the affect on resource acquisition well, although I disagree with his perception regarding the direction of the incentive effect.

> This no-ECAM approach implicitly encourages a utility to favor, utility-owned assets or fixed-cost supply contracts over resources and procurement strategies with more variable costs, even if the latter might be less expensive, on average. This incentive arises because the utility is exposed to risks from fuel and short term power costs that are quite volatile, difficult to forecast, and largely uncontrollable. There is less risk and more financial certainty from assets put into ratebase with an allowed return, compared to operating costs that must be forecasted with inevitable variances from forecasts (often large, as was demonstrated in section 1 of this rebuttal testimony). **This bias towards lower risk assets that results from lack of an ECAM** is different

[3] Prefiled Direct Testimony of Verl R. Topham, Docket No. 90-035-06, May 1990, p. 13, 17-26.

> than the bias sometimes noted for utilities of increasing the investment in ratebased assets. [emphasis added] (Graves Rebuttal at 27)

While Mr. Graves characterizes a lack of an ECAM as causing an inappropriate incentive favoring long-term fixed contracts and Company-owned generation, and I characterize an ECAM as distorting planning by inappropriately favoring resources with volatile prices and uncertain cost consequences, the effect we are discussing is the same. When the Company's shareholders share the risk of fluctuating power costs through regulatory lag and the risk of missed forecasts, Company management is not biased toward riskier resources. When customers bear the full risk of fluctuating prices through an ECAM, a bias towards resources with less certain costs is introduced.[4]

Q: Do other Company witnesses discuss this effect?

A: Yes. Professor McDermott recognizes the "input bias" effect of an ECAM. He says, "Mr. Chernick's citation of studies from the academic literature does not show that any particular ECAM *will necessarily* distort input choices *in a manner that will reduce efficiency*." [emphasis added] (McDermott Rebuttal at 347-349) In attempting to rebut Mr. Chernick's review of the literature his emphasis was on operational efficiency not on long-run resource acquisition decisions. He clearly recognizes that the literature demonstrates that an ECAM causes an input bias.

Q: Please explain what is meant by an "input bias."

A: Quoting from Mr. Chernick's direct testimony:

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[4] Customers always bear risk for these resource choices. With an ECAM, short of a prudence disallowance, they carry the full risk. When net power costs are normalized, the Company shares the risk between rate cases.

> Atkinson and Halverson (1980), and Scott (1985) find that under certain conditions the FAC [fuel adjustment clause] may induce the utility to bias its selection of inputs towards those whose costs are covered by the FAC pass-through. (Chernick Direct at 911-914)

> Suspicions that fuel adjustment mechanisms distort input choices are justified. In the case of no fuel cost uncertainty, there is an incentive for utilities to invest in relatively more fuel-intensive technologies than would be employed by a firm producing the same output. (Chernick Direct at 922-925)

> At the same time, they tilt the playing field in favor of high fuel cost options. (Chernick Direct at 939-940)

Q: The literature characterizes the input bias as being caused by an ECAM while Mr. Graves provides the opposite view. Has any testimony been submitted that would assist in correctly characterizing the direction of distortion?

A: I believe Professor McDermott's rebuttal testimony is helpful. In discussing the need to assure that an ECAM, if implemented, is comprehensive, he states the following:

> "if some costs were treated one way, and other costs another, perverse incentives could be created. Comprehensive and symmetrical treatment provides an assurance that fuel and purchased energy are treat equally, meaning that a utility would not have an incentive to favor one over the other."

The introduction of an ECAM causes some costs to be treated one way and other costs another and introduces the type of perverse planning incentives Professor McDermott warns us of. An ECAM incents the acquisition of riskier resources.

Q: Did Professor McDermott provide an opinion as to whether an ECAM would distort long-term planning?

A: Yes. He sees no reason why an ECAM "would be harmful from a resource planning perspective relative to the status quo approach of dealing with NPC in base rate case proceedings—this is because the utility's incentives to procure least-cost resources would be unchanged."

Q: What do you make of this response?

A: The assertion contradicts the concept of an input bias, which he recognizes as legitimate. It also contradicts the principle he stated above that treating categories of costs differently introduces perverse incentives.

Q: What reasons does he give for stating that the utility's long-run planning incentives would be unchanged?

A: He says that with our without an ECAM, PacifiCorp "would strive to avoid prudence-related disallowances, which would lead it to have the proper incentives to procure resources on a least-cost basis." Apparently he believes the incentive to avoid a prudence disallowance is stronger than any other incentive.

Q: Do you agree with that?

A: No.

Q: In the quote which you cited previously regarding the incentive effect of No-ECAM, Mr. Graves implied that lack of an ECAM causes harm to customers by incenting lower risk but possibly more costly resources. Do you agree with that?

A: While this is theoretically possible, this does not describe the current planning environment. The resources that best manage risk also have lower expected costs despite higher capital costs.

I have prepared an exhibit, NLK-1, that compares the performance metrics of two Portfolios studied in the most recent IRP, IRP 2008.

Portfolio 5 is the portfolio the Company initially chose as its Preferred Portfolio.[5] Portfolio 8 is a more capital-intensive portfolio that performed better on the cost and risk metrics. As previously discussed in my direct testimony, it includes more renewables, more energy efficiency, less natural gas-fired resources and fewer front office transactions than Portfolio 5. (Kelly Direct p. 11 at 4-21, and p. 12 at1-7)

Metrics are provided for three CO2 tax levels. The shaded boxes indicate the lower (better) value. With no tax on carbon dioxide emissions, Portfolio 5 has a lower expected cost and lower risk adjusted cost. However, Portfolio 8 is less risky. It has a lower upper tail risk, lower production cost deviation, and lower net power costs. It also has the lowest emissions. However, it has the higher capital cost and customer rate impact. In terms of metrics counting, the two portfolios are tied four to four.

At a $45/ton CO2 tax level, Portfolio 8 has the lower expected cost as well as lower risk metrics and emissions. However it continues to have the higher capital cost and higher rate impact.

With a $100/ton CO2 tax, Portfolio 8 wins across all metrics other than capital costs.

[5] 2008 Integrated Resource Plan Volume 1, PacifiCorp, May 28, 2009, p. 235.

Portfolio 8 is also superior to Portfolio 5 in scenario risk (a metric requested by Commission staff) and it ties for reliability.

The exhibit demonstrates that the Company already has a preference for a portfolio with riskier, but lower capital cost, resources.

Q: Mr. Peterson says that your "claim that the Company's ECAMs in other states make it reluctant to build new generation capacity is not proven and is not a compelling argument for an ECAM, per se." (Peterson Rebuttal at 108-109) How do you respond?

Although one might draw the conclusion from my discussion that Mr. Peterson drew, he has misrepresented my position somewhat. My understanding of my contribution to this case is to demonstrate that the Company already has a bias toward portfolios with lower capital costs but higher and more volatile operating costs. I do not know the reason for the current bias, I can only conjecture. As I stated in my direct testimony,

> "it may be due in part to the power cost-adjustment mechanisms already functioning in other of PacifiCorp's jurisdictions; it may be due in part to the potential for differing rate recovery treatment of other resource types by PacifiCorp's jurisdictions; and it may be due in part to calculations Company management has made regarding its ability to recover costs through the rate case process. However it may also reflect PacifiCorp's optimism that it will have a power cost adjustment mechanism in place in Utah as well as in other of its jurisdictions." (Kelly Direct, p. 12 at 14-21)

Further, while Mr. Peterson might not consider my demonstration of the current bias "proof," I believe this demonstration is compelling and hope the Commission will find it so. The Commission can draw its own conclusions regarding the reasons for the bias.

Q: Mr. Graves suggests that if any disincentives to least-cost planning arise from the implementation of an ECAM, they can be addressed through the integrated resource planning process. (Graves Rebuttal at 495-500) Do you agree?

A: No. I don't agree. Since Utah instituted integrated resource planning as part of its regulatory process, the Company has submitted nine integrated resource plans excluding updates.[6] Only three of those were fully acknowledged.[7]

Q: What do you conclude regarding the effect of an ECAM on long-run planning and cost?

A: The main point of my direct testimony remains unrebutted. An ECAM is not in the public interest because it introduces distorted long-run planning incentives that result in riskier and higher-cost resource acquisition.

[6] RAMPP is an acronym for Resource and Marketing Planning Program. RAMPP 1 was completed before the Commission undertook IRP as part of the regulatory process. RAMPP 2 was the first IRP in which the Commission participated. I did not count RAMPP 1.

[7] RAMPPs 1 and 2 were considered in docket no. 90-2035-01; RAMPP 1 was deemed reasonable; RAMPP 2 was acknowledged. RAMPP 3 was considered in docket no. 94-2035-05. It was acknowledged but the Action Plan was not acknowledged because of concerns that "managerial judgment" was overriding the results of planning studies in the resource selection process without adequate analysis or transparency between the study results and the action plan. RAMPP 4 was considered in docket no. 96-2035-01. It was acknowledged. RAMPPs 5 and 6 considered in docket nos. 97-2035-06 and 98-2035-05 were not acknowledged. The primary concerns of intervenors and the Commission were that the Company's strategic business plan was driving the IRP assumptions rather than IRP study results driving the Business Plan. IRP 2003 was considered in docket no. 03-2035-01 and was acknowledged. IRP 2004, considered in docket no. 05-2035-01, was acknowledged but its action plan was not. IRP 2007, considered in docket no. 07-2035-01 was not acknowledged. IRP 2008 was filed May 28, 2009 and is being considered in docket no. 09-2035-01. The Commission has not yet issued an order.

IV. ANALYSIS OF NEED

Q: Mr. Duvall states that the only witness that attempted to respond to his analysis was Mr. Chernick and that no party raised any issues to its integrity. With respect to your testimony he states that you "expressed concern over incentives and disincentives with no comment on the Company's analyses." How do you respond?

A: What Mr. Duvall viewed as a lack of response should not have been considered agreement with the discussion provided in testimony. I was puzzled by what I considered to be lack of an analysis worthy of comment beyond the comment that I made, particularly since the Public Service Commission of Utah (Commission) had made clear in its June 18, 2009 Scheduling Order in this docket that the burden for providing an evidentiary record supporting a change in the regulatory cost recovery of net power costs lies with PacifiCorp. I did not think the testimony or supplemental testimony provided met this burden. [8]

By way of analysis of need, Mr. Duvall provided a historical chart in his supplemental testimony portraying a gap between actual net power costs and net power costs in rates, which he claims provides evidence that the current modeling of net power costs is unfair to the Company and requires redress through an ECAM. (Duvall Supplemental at 83) However, his testimony provided no information to explain how the calculations were made or how the factors PacifiCorp has identified as outside its control contributed to the

[8] Mr. Graves' analysis demonstrates that PacifiCorp has less "need" for an ECAM than other utilities. He says that "[f]or most utilities, fuel and net purchased power combined is the largest expense item they incur, often representing 35-45 percent of total delivered power costs per kWh." He says of PacifiCorp, "the Company's fuel and net purchases power have represented 20 to 30 percent of it average cost of power." (Graves Supplemental at 232-240)

alleged shortfall in each year. Neither was a convincing explanation provided for the systematic bias of actual net power cost exceeding net power cost in rates. Mr. Duvall indicated that the bias results from the increased volatility of prices in fuel and wholesale electricity markets. (Duvall Supplemental at 98-10) I found this explanation troubling. Volatility works in two directions and should not cause systematic bias. In short, I didn't consider this testimony to provide meaningful analysis.

The primary evidence cited by Company witnesses in support of an ECAM in direct testimony, supplemental direct testimony and repeated at length with supporting analysis in rebuttal testimony is the observation that prices in fuel and wholesale markets are volatile. Company witnesses then argue that factors outside the control of the Company increasingly expose the Company to the volatility of these markets thereby justifying the imposition of an ECAM.

Q: Did you address this analysis in your direct testimony?

A: I did. I agreed that prices in fuel and wholesale electricity markets are volatile and are likely to become even more so.[9] However I disagreed that this fact in and of itself establishes a need for an ECAM or that exposure to this volatility is entirely outside the control of the Company.[10]

[9] Professor McDermott includes my testimony as stating that markets are not "volatile enough" to justify an ECAM. (McDermott Rebuttal at 145) This is incorrect. I acknowledge the volatility; I do not agree that the fact of volatile markets establishes need.

[10] Since the primary concern of WRA with an ECAM is its affect on long-run planning incentives, I limited my response to the point that the Company can reduce its exposure and the exposure of its customers to this volatility through sound long-run planning. Mr. Chernick does an excellent job of outlining measures management takes that affect net power costs in the short-run. (Chernick direct at 1014-1028)

V. CONCLUSION

Q: What is your overall conclusion?

A: The Public Service Commission should deny PacifiCorp's application for an ECAM. A number of public interest benefits for using a normalized approach to net power costs were established in Docket No 90-035-06. These benefits have not been discredited, and the Company has not established a need for an ECAM. Given the benefits of a normalized approach, the perverse incentives that an ECAM would introduce, and the shifting of the risk of fluctuating net power costs from management to those least able to manage such risks, an ECAM is not in the public interest.

Q: Does this conclude your testimony?

A. Yes, it does.