<u>BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH</u>

In the Matter of the Application of Rocky Mountain Power for Approval of Its Proposed Energy Cost Adjustment Mechanism	**))))))))))**	**DOCKET NO. 09-035-15** **Exhibit No. DPU 1.0SR** **Surrebuttal Testimony for Phase I of** **Charles E. Peterson**

FOR THE DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE
STATE OF UTAH

Surrebuttal Testimony for Phase I of

Charles E. Peterson

January 5, 2010

Surrebuttal Testimony of Charles E. Peterson

Q. Have you previously filed testimony in this docket?

A. Yes, I filed direct testimony on behalf of the Division of Public Utilities (Division, or DPU) as DPU Exhibit 1.0 with attached Exhibits on November 16, 2009. Subsequently, on December 10, 2009 I filed rebuttal testimony for the Division in this matter (DPU Exhibit 1.0R).

Q. What is the purpose of your surrebuttal testimony in this matter?

A. My surrebuttal testimony is in response to the rebuttal testimony filed by Ms. Michele Beck, in behalf of the Office of Consumer Services (Office); and by Mr. Gregory N. Duvall, Mr. Frank C. Graves, and Dr. Karl A. McDermott representing PacifiCorp d.b.a. Rocky Mountain Power (Company).

Q. Please summarize your surrebuttal testimony.

A. As discussed at some length in my rebuttal testimony, the intervening parties, including the Office, confuse the acceptability of the Company's proposed ECAM in its initial filing with the threshold question of whether or not some form of ECAM for PacifiCorp in Utah may be in the public interest. The Division believes that the public interest issue is the over-arching issue in Phase I of this Docket. Ms. Beck's rebuttal testimony regarding the Division's position in this matter does little more than highlight that the Division basically agrees with the Office that the Company's proposed ECAM is seriously wanting. However, her rebuttal testimony does not significantly and persuasively address the Division's position that some sort of ECAM for PacifiCorp may be in the public interest. I will comment further on her claim that my testimony "lacks any explanation of how a power cost adjustment mechanism could be 'in the interest of both the Company and ratepayers. . .'" (Ms. Beck at lines 27-29).

In their rebuttal testimonies, Messrs. Duvall, Graves, and McDermott made a few comments on my direct testimony. Their comments regarding my testimony range from favorable, noting that the Division accepts that this Docket should move on to the design phase, to criticism of my earnings analysis under the Company's proposed ECAM (Mr. Duvall at lines 458-499), my statements that the Company's hedging program mitigates the risks that an ECAM should cover (Mr. Graves at lines 52-54), advocating a "non-comprehensive ECAM" (Dr. McDermott at lines 360-381), and risk-shifting from the Company to ratepayers (Dr. McDermott at lines 445-534). I will comment on these criticisms as well as address one or two issues raised by the Company's witnesses in their rebuttal testimony.

I want to emphasize that there are many statements made by the above mentioned witnesses throughout their sometimes lengthy rebuttal testimonies that I am not commenting on. This lack of comment should not be interpreted as either agreement or disagreement with those statements.

Q. In your direct testimony did you provide "any explanation" supporting that a power cost adjustment mechanism could be in the interest of both the Company and ratepayers, that is, in the public interest?

A. Yes. First, I discussed that it is in the public interest to have a financially strong and stable utility. In this regard I mentioned the weakening of the Company's stand-alone bond ratings over recent years, and I stated that if the Company continues to be unable to earn its allowed rate of return—its cost of capital—that this would be detrimental to the Company and eventually to ratepayers: higher than expected power costs are plausibly one source of the Company's difficulty in earning its allowed rate of return.

The second point was that it is reasonable for the Company to recover costs that are significant, unpredictable, and otherwise outside the Company's control. The cost recovery mechanism that is primarily used in Utah is the general rate case. This mechanism does not appear to be a good forum for the recovery of unpredictable power costs. The Division believes that it is reasonable that a mechanism be put in place to protect the Company especially from large, unpredictable power cost fluctuations.[1]

I accepted examples Mr. Duvall presented in his direct testimony as being illustrative of actual situations the Company could face in which it could not protect itself through hedging.[2] Later, I concluded that "[t]he Division accepts that spot prices have been more volatile in recent years and that, to a large extent, such volatility cannot[3] be anticipated or mitigated, especially for the hourly and daily balancing needs of the Company."[4] I did go on to say that, longer term, there are strategies the Company might employ to reduce some of this volatility.

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[1] Charles E. Peterson, Direct Testimony, pp. 6-7.
[2] Id., lines 229-230.
[3] In my original testimony I incorrectly left in the word "not" following the word "cannot." This quotation corrects my statement to its intended meaning.
[4] Peterson, op. cit. lines 311-313.

Finally, I alluded to the idea that better price signals would benefit ratepayers by giving them more information with which to make decisions regarding their own particular situation. Shortening the time between true-ups in an ECAM might give ratepayers some of this benefit.

Q. Dr. McDermott is critical of your and intervenors' comments regarding shifting risk from the Company to ratepayers. What are your comments on Dr. McDermott's position?

A. Dr. McDermott's rebuttal testimony on this issue is essentially a restatement of Mr. Duvall's direct testimony[5] that the issue is not about risk shifting but about customers paying for the Company's "prudently incurred costs." Dr. McDermott goes on to imply that ratepayers are to blame when he states that "the base rate case process in Utah has failed because Utah customers have underpaid prudently-incurred NPC by over $300 million. (Duvall, Reb.) Calling this risk shifting is, at best misleading and distracting."[6] What Dr. McDermott, and other Company witnesses fail to note is that over the eight years in question there has been only one litigated rate case completed and several stipulated rate case settlements that the Company agreed gave it a reasonable opportunity to earn its allowed rate of return.[7] Indeed the Company proposed and filed with the Commission in 2005 what it called then a power cost adjustment mechanism (PCAM), and then voluntarily withdrew it.[8] The Company must maintain at least a significant share of the responsibility for its own past and future

[5] For example see, Gregory N. Duvall, Pre-Filed Direct Testimony, lines 111-114.
[6] Rebuttal Testimony of Karl A. McDermott, lines 466-469.
[7] 08-035-38 Stipulation. On revenue requirement. March 23, 2009 Paragraph 25
[8] Docket No. 05-035-102.

management decisions and forecast errors.[9] Dr. McDermott argues that there remains some risk to the Company between ECAM true-ups due to regulatory lag.[10] However, this concern is significantly mitigated when one considers that under the Company's proposed ECAM, the Company will earn its cost of capital on the ECAM balances while waiting for the true-up.[11]

Without question, the proposed ECAM will unburden Company management of much of the risk, as measured by volatile costs and earnings, and transfer that volatility to ratepayers. The question of whether the complete transfer of the NPC volatility to ratepayers is just, reasonable, and in the public interest is a significant one. In my direct testimony I suggested that the Company is being compensated at least for some of the volatility that comes from operating a for-profit business.[12]

Q. Dr. McDermott is critical of you and other intervenors for suggesting something short of an ECAM that was "comprehensive." Do you have a response to his criticisms?

A. Yes. Dr. McDermott's criticism basically is that if not all aspects of net power costs are included in an ECAM, then perhaps undesirable or even perverse incentives could be created. He gives the example of treating fuel and purchased power equally.[13] The Division recognizes that unintended consequences may occur whenever something new is tried. However, the Division rejects the notion that ratepayers should be solely responsible for any variation in the costs of items that are within the control and discretion of Company

[9] Dr. McDermott, himself, seems a little puzzled that net power costs have been under-forecasted by the Company for eight years running. See Rebuttal Testimony of Karl A. McDermott, lines 200-202.
[10] Rebuttal Testimony of Karl A. McDermott, p. 16.
[11] Exhibit RMP-GND-2, line 20, shows the "interest rate" is 8.36 percent, which is the current Utah allowed rate of return.
[12] Peterson, Op. Cit. lines 335- 338, and 558-562.
[13] Ibid. lines 377-381.

management. There are also policy reasons for limiting the scope of an ECAM. The Commission may not want to treat fuel and purchased power equally, to use Dr. McDermott's example, if, as a policy matter the Commission wants the Company to reduce its purchased power from current levels.

Company witness Mr. Frank Graves discusses at length what amounts to a "non-comprehensive" ECAM when he focuses on net short-term power sales revenues and natural gas costs in apparent contradiction to Dr. McDermott.[14] The Division likely could agree to support an ECAM structured around these items, since the Company may not be able to forecast and hedge these items well.

Q. What is the Division's understanding of the system balancing issue that Mr. Graves highlights, and other Company witnesses have mentioned?

A. The Division understands that from one hour to the next, the load on the Company's system may vary significantly from the expected or forecast load in unpredictable ways. This variation requires that the Company acquire additional power or reduce excess power. These variations add an additional cost to net power costs. The Company may not be in a position to economically hedge or otherwise mitigate this variability. This is why the Division, in principle, may support an ECAM structured around these hourly load variations.

Q. Do you have an example of the load balancing issue?

A. Yes. For illustrative purposes only, I have compiled the hourly system load data for the third week in July of 2006 and 2007. For this illustration, the 2006 data, which are actual 2006

[14] Rebuttal Testimony of Frank C. Graves, pp. 5-15.

data, are assumed to be the Company's forecast for the same period in 2007,[15] the 2007 data are the actual results. DPU Exhibit 1.1SR, sets forth graphically the hourly load for the third week in July 2007, supplemental graphs show the variations from the "forecast." The hourly differences between the actual load and the "forecast" could result in the Company acquiring additional power, or disposing of excess power. The added costs of this load balancing activity could be the subject of an ECAM.[16]

Q. Mr. Graves argues that the Company cannot hedge against all power cost fluctuations and implies criticism of your statement that the Company has "substantially shielded" itself from spot market volatility as a result of its hedging practices. Do you still believe that the Company has "substantially shielded" itself from spot market volatility?

A. Yes. The Company's current practice is to hedge virtually 100 percent of its expected electric market and natural gas market purchases.[17] However, the operative word is "expected." To the extent that the load demands and consequently net power costs inevitably vary somewhat from what the Company forecast, the Division agrees with Mr. Graves that not all volatility can be hedged away, which I believe was Mr. Graves' main point.

Q. Mr. Duvall criticized your analysis of the Company's return on equity as if the proposed ECAM had been in place in recent years and in all of the PacifiCorp states. What are the main points of his criticism?

[15] This type of forecast is sometimes referred to as "naïve" forecasting: that is, the next period is forecast to be the same as the previous period. The Company's actual forecasts should be able (on average) to do noticeably better than this type of forecast.

[16] The Division understands that there are other factors contributing to short-term power cost variability than just load variability, but that load variability is a place to start analyzing the cost variability.

[17] PacifiCorp 2008 SEC Form 10K, p 11.

A. Mr. Duvall believes I should have used regulatory financial statements, such as the Company's semi-annual reports to the Commission instead of the Company's SEC financial statements, because his total Company net power cost short-fall amounts were calculated assuming that Utah regulation was operative throughout the PacifiCorp system and does not account for the differences in state regulation including, apparently, that some of the NPC shortfall was actually collected through other states' ECAMs. However, Mr. Duvall does not provide what he believes to be the correct returns. Mr. Duvall is correct that there are differences between the regulatory reports filed in Utah and the SEC filings.

I believe for this kind of analysis the SEC-based financial statements would have been better for Mr. Duvall to have used because they are closer to the actual results of the Company in that they provide the actual capital structure of the Company and not an assumed capital structure and because there are normalizing and other adjustments that may have a valid regulatory purpose, but do not provide the return on capital data as it is viewed by investors.

Q. Have you calculated the Company's return on equity using the financial statements Mr. Duvall recommends?

Yes. In order to assuage Mr. Duvall's concerns, DPU Exhibit 1.2SR parts a, b, c and d set forth the analysis of Company profitability for 2007 and 2008 for both the total Company and Utah only based upon the Company's semi-annual filings. As this exhibit shows, the Company's return on equity with the ECAM in place ranges from 10.75 percent to 12.30 and in particular the Utah unadjusted returns are 12.30 percent for 2007 and 11.50 percent for

2008. These results support my direct testimony conclusion that under the proposed ECAM the Company would have likely earned over its allowed rate of return for those years.

Q. Mr. Duvall implies that you erred by not considering that some of the NPC recovery would have been deferred to later years. Is this an error?

A. No. As I specifically pointed out in my direct testimony under the Company's proposed ECAM, the present value of any deferrals are equal to the amount of the under-collection in the year of under collection because the Company earns its cost of capital on the amounts under-collected until those amounts are refunded to the Company by ratepayers. Therefore the correct amount of under-collection of NPC to apply in this analysis is the amount under collected in that particular year.

Q. You indicated earlier that you had one or two additional comments; could you give us those comments now?

A. Yes. Dr. McDermott attaches to his rebuttal testimony tables summarizing ECAM activity and programs for other utilities in other states. These tables show the diversity of such programs, which suggests that discussion of prudence and regulatory oversight in other states needs to be placed in the context of the mechanisms actually put in place in those other jurisdictions. The determination of prudence and the viability of regulatory oversight in these other states cannot necessarily be extended to the Company's proposed ECAM in Utah.

Moreover, the information in these tables implicitly contradict some of the points that he and other Company witnesses make with regard to risk shifting and the supposed necessity that an ECAM equally cover all aspects of NPC. For example, several entries in the table entitled "Examples of Sharing and Performance Based Incentives" show companies whose approved mechanisms treat some costs differently than others (e.g. Southwestern Electric Power, Florida Power & Light, and Northern States Power). And most, if not all, of the entries show various forms of risk-sharing. If, indeed, the idea of risk shifting is a "straw man" as Dr. McDermott states, it would appear as if many commissions have nevertheless sought to protect ratepayers from it. As the examples in the table illustrate, an ECAM need not necessarily cover either all aspects of NPC nor shift responsibility for 100% of any costs or category of costs onto ratepayers.

Mr. Duvall seems to propose that additional revenues could be considered as a possible offset to additional net power costs, but only to the extent net power costs were built into the rates charged. That is, if in the development of a given rate, 30 percent of that rate was attributed to net power costs, and then only 30 percent of the revenue should be used to offset any additional net power costs. While Mr. Duvall did not directly refer to my testimony in his discussion, this is an issue I specifically raised. If my understanding of Mr. Duvall's proposal is correct, then I disagree with it. An example should illustrate why I disagree. Suppose the Company had originally forecast (i.e. the "in-rates" amount) that system load would be 10 MW and instead it turned out that to 11 MW. The Company could acquire the additional 1 MW either by increasing its own generation, reducing wholesale sales, or making wholesale purchases that in some combination would add up to the 1 MW. Naturally this would incur higher power costs than were "expected." However, the Company would not sell the additional MW (technically MWh) for 30 percent of its tariff rate; it would sell it for its full tariff rate. At the margin, all of the Company's non-power costs are, or very nearly are, fixed and the only variable cost is power cost. The non-power costs, including rates of return, were covered by the rates charged for the first 10 MWs. The only cost that needs to be recovered for the additional MW is power cost and that cost is mitigated, if not completely covered, by the additional revenue collected. In some instances the Company very likely earns additional profits through these additional sales, while in other instances it is possible that the additional costs are higher than additional revenues, the difference plausibly being the subject of an ECAM.

Q. Have you altered any of your conclusions since your direct testimony?

A. No. I continue to believe that there are good reasons to believe an ECAM may be in the public interest and that the Commission should move this Docket to Phase II, the design phase.

Q. Does this conclude your testimony?

A. Yes.