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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

POST-HEARING BRIEF

OF

WESTERN RESOURCE ADVOCATES

December 16, 2010

Western Resource Advocates (WRA) submits this post-hearing brief in accordance with the request of the Public Service Commission of Utah (Commission) at the completion of the hearing in this docket held November 1 and 2, 2010. This brief provides a review of key issues and evidence supporting WRA's policy positions in this docket.

INTRODUCTION

The record in this proceeding is extensive, consisting of PacifiCorp's original application, ten sets of prefiled testimony filed by multiple witnesses, and three hearings. However, despite the length and complexity of this proceeding, the policy considerations are relatively straightforward. First, PacifiCorp must meet its evidentiary burden in proving need for an ECAM. Second, the proposed change in the method of cost recovery of net power costs must serve the public interest. Third, if there is potential harm to the public from adopting an ECAM, that harm should be mitigated through design or other measures. Therefore, if the Commission first determines that PacifiCorp met its burden in proving need for an ECAM and therefore decides an ECAM is needed, the ECAM must be designed to serve the public interest, and mitigation measures should be established to address any concerns not rectifiable through ECAM design.

ARGUMENT

I. The Company Has Not Provided Sufficient Evidence In Support Of Its Claimed Need For An ECAM

PacifiCorp first filed its ECAM application March 16, 2009 with supporting testimony from two witnesses, Mr. Gregory N. Duvall and Mr. William R. Griffith. On May 26, intervening parties filed comments regarding the scope of issues to be addressed. Because of the

paucity of evidence included in the initial application and testimony, both the Office of Consumer Services (Office) and the Utah Association of Energy Users (UAE) recommended to the Commission that it dismiss the Company's application. The Commission determined to proceed with the case, but concurred with parties that it is the Company's "burden to prove a change in rate-making treatment for net power costs is appropriate and in the public interest." The Commission provided guidance to the Company and intervenors regarding the record to be developed. (Docket No. 09-035-15, Commission, Notice of Scheduling Conference and Procedural Order, June 18, 2009) PacifiCorp filed the supplemental testimony of four witnesses August 17 2009.

Mr. Gregory N. Duvall, supplemented by Dr. Karl A. McDermott and Frank C. Graves, provide testimony regarding the Company's need for an ECAM.[1] Company witnesses offer two essential arguments that could constitute evidence of need.[2] First, they note the fact that wholesale power, natural gas, and, increasingly, coal, commodity markets are highly volatile. Second, they claim that factors outside of their control increasingly subject the Company to the volatility of these markets. They argue that as a result, actual net power costs significantly exceed net power costs in rates. Mr. Duvall provides an exhibit that purports to demonstrate the year-by-year magnitude of the shortfall in net power cost recovery. (Phase 1: Duvall

[1] Mr. Bruce N. Williams' supplemental testimony addresses the possible financial benefits to the Company from the adoption of an ECAM; his testimony does not address need, per se.

[2] Dr. McDermott and Mr. Graves testify extensively to the situations of other utilities. However, these are not demonstrations of PacifiCorp's need. We would note that this comparative testimony does not address whether other states have single item ratemaking for Major Plant Additions as does Utah.

Of significance, Mr. Graves's comparative testimony actually demonstrates that PacifiCorp has less of a need for an ECAM than other states. He says "For 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." (Phase 1: Graves Supplemental at 232-240)

Supplemental, ln 83) Finally, Division witness, Charles E. Peterson, notes that the Company has been unable to earn its authorized rate of return in Utah and offers under recovery of net power cost as a "plausible" explanation, although he emphasizes that the Company has not demonstrated "to what degree the effect on profits has actually been from rising and volatile net power costs." (Phase 1: Peterson Direct, ln. 133-138)

The evidence in this case does not support the Company's claim of need. First, intervenors who address the issue agree that the fact of wholesale electricity and natural gas price volatility does not constitute need, nor does it demonstrate that net power costs are uncontrollable. (Phase 1: Peterson Direct, ln. 103-104, Peterson Surrebuttal ln. 143-147; Chernick Direct, ln. 210-259, Chernick Surrebuttal, ln. 177-182; Higgins Direct, ln. 195-310, Higgins Surrebuttal 103-209; Kelly Direct, page 8, ln. 9-18, Kelly Surrebuttal, 248-258; January 12 TR, pg 124, ln. 17-25 pg 125 ln. 1-2)

Second, the Company provides no explanation of how the factors PacifiCorp identified as outside its control contributed to the deviation between actual net power costs and net power costs in rates reflected in Mr. Duvall's exhibit. (Phase 1: Peterson Direct, ln. 234-235; Chernick Direct, ln. 187 and 202-204, Chernick Surrebuttal 28-36; Kelly Surrebuttal, ln. 224-247) In addition, Office witness, Mr. Paul Chernick, and Division witness, Mr. Peterson, identified shortcomings with the derivation of these deviations and reveal that the magnitude of the system losses the Company claims are overstated. The Company calculated the deviation as if rates in Utah applied to the entire system and did not account for net power costs that were recovered through ECAMs active in other states. (Phase 1: Peterson Surrebuttal, ln. 152-159) Additionally, the exhibit was not adjusted to remove the SMUD revenue imputation to reflect

Utah regulatory terms. (Phase 1: Chernick Direct, ln 445-447) Most significantly, the Company excluded the revenue offsets to cost that it receives from retail sales to customers when actual load exceeds forecasted load. Says Mr. Chernick: "If sales are greater than forecast, NPC should be greater than forecast, but PacifiCorp revenues would be greater as well. That situation would not be problematic for PacifiCorp; if anything, earnings would likely be increased by the higher sales level." (Phase 1, Chernick Direct, ln. 430-435) Mr. Peterson states, "the Company's proposal includes offsetting costs by third-party revenues as part of the NPC calculations, but does not include changes in revenues from its native load customers." (Peterson Direct, ln. 378-380) The effect according to Mr. Chernick is that "in some years in which Mr. Duvall reports that RMP under-collected NPC, the Company actually over-collected NPC." (Phase 1, Chernick Direct, ln. 428-429) Mr. Peterson testified that with these revenue additions, if the Company's ECAM had been in place during the years included in the exhibit, the Company would have over earned, raising "questions about the accuracy of the NPC data that has been supplied." (Phase I: Peterson Direct, ln. 239-254, Peterson Surrebuttal, ln 167-175)

UAE witness, Mr. Kevin C. Higgins, offered testimony at the November 2, 2010 hearing that provides an explanation for at least some of PacifiCorp's failure to earn its authorized return and is an alternative to the "plausible" but unproven notion that shortfalls in net power cost are the cause of PacifiCorp under earning. Mr. Higgins testified that even if actual net power cost exactly matched forecast net power cost, the Company would show under earning in Utah because of the way in which earnings are reported. The Company uses the Revised Protocol interjurisdictional allocation method for reporting earnings rather than the interjurisdictional allocation method that is used to set rates in Utah. (Nov 2 Tr, p. 519 ln. 22 – p. 521 ln. 11)

It appears that PacifiCorp's desire for an ECAM results from its underlying dissatisfaction with the Commission's rate case determinations and the results of negotiated settlements. Mr. Duvall states "Under the current Utah regulatory treatment of net power costs, the level of net power costs in rates reflects the Commission's assessment of the competing forecasts and forecast adjustment in contested cases, or reflects the joint view of the parties and the Commission in cases where net power costs are determined as part of a settlement. Regardless of whether a case was litigated or settled, the outcomes have varied significantly from the cost of providing service to Utah customers." (Phase 1: Duvall Rebuttal ln. 120-126) He further states: "RMP believes that all parties and its customers would be best served by revising the regulatory process to allow the Commission to judge the prudence of the net power costs incurred in a historic period rather than perpetuate the current process in which the Commission is forced to act as a referee in the battle of competing forecasts of volatile power cost—forecasts that may be reasonable but are admittedly inaccurate." (Phase 1: Duvall Rebuttal ln. 141-146)

Given PacifiCorp's failure to demonstrate a clear need for an ECAM; given PacifiCorp's dissatisfaction with the results of rate case outcomes and settlements based on forecasted test years; and given Mr. Duvall's statement that the Company would "prefer to judge the prudence of net power costs incurred in a historic period," WRA submits that a return to a normalized historical test year may be a sensible option for this Commission to consider. A return to a historical test year appears particularly reasonable in light of the enactment of the Major Plant Addition Statute during the 2009 General Session of the Utah Legislature, which allows the Company to begin recovering in rates large capital expenditures between rate cases. By allowing single-item ratemaking treatment for Major Plant Additions, this recent change in law addresses

the original purpose of implementing a forecast test year, thereby, eliminating the need to continue the practice of determining revenue requirement based on forecasts which, as Mr. Duvall states may be "admittedly inaccurate."

II. An ECAM Shifts Risk and Alters Management Incentives In A Manner That Is Not In The Public Interest

WRA's fundamental point throughout this proceeding has been that the method of cost recovery is intertwined with the financial incentives to which Company management responds. When the recovery method for any cost is altered from what it was previously, the incentive structure will change. Whether the change in incentives is in the public interest depends on the particulars. (Phase II, Part 2: Kelly Surrebuttal, ln 276-303) The change in incentives results from changes in the Company's perceived and/or real ability to recover cost. (Phase 1: Kelly Direct, p. 8, ln. 19 – p. 12, ln 21)

Under the current method for recovering the variable cost components of utility operation, Company management bears the risk between rate cases that wholesale electricity and natural gas prices are higher than expected. This provides the Company with an incentive to make every effort to manage these costs efficiently and to acquire the mix of resources over the long-run that that will best manage risk and uncertainty for customers and shareholders alike, since customers and shareholders share the risk that the future does not evolve as expected when resource decisions are made. Shareholders bear the risk of price volatility between rate cases; customers bear the risk that the mix of resources over time will be more costly than necessary.

PacifiCorp's ECAM, as proposed, would shift the full risk of fluctuating power and fuel costs from shareholders fully onto customers. (Phase II, Part 2: Kelly Surrebuttal, ln. 148-186)

This shift in risk is not in the public interest for three reasons. First, to impose the full risk of fluctuating prices on those who have the least ability to manage the risk is inequitable. And, if the shift in risk promotes a costlier and riskier system over time, this is particularly the case. (Phase II, Part 2: Kelly Rebuttal, ln. 196-204) Second, the shift in risk removes the Company's financial incentive to operate its system efficiently and control operating costs, resulting in an erosion of cost control over time. (Nov. 2, Tr. Peterson) Third, the shift in risk results in a resource acquisition bias toward wholesale market and natural gas resources and away from energy efficiency and renewable resources. Given the current economic and climate conditions, this resource bias is not in the public interest.

Even if the Commission should determine a change in the method of regulatory net power cost recovery is warranted by need, these public interest failings of an ECAM must be addressed through design or some other measure for an ECAM to be in the public interest.

III. To Address the Erosion of Operational Efficiency Over Time, A Strong Financial Sharing Mechanism is a Necessary ECAM Design Component; Prudence Review is an Insufficient Incentive

PacifiCorp's ECAM as proposed would shift 100% of the risk of prices exceeding forecasts to customers providing Company management with no financial incentive to control costs and would likely erode efficient cost control over time. A sharing mechanism, that keeps the Company at risk for a significant portion of net power costs, provides the Company with a financial incentive to control costs. This is the case both when average market prices are increasing as well as decreasing.

In her Phase II, Part 2 Surrebuttal testimony, Ms. Kelly used a hypothetical situation developed by Mr. Duvall in his Phase II, Part 2 Rebuttal testimony to demonstrate the need for a

strong sharing mechanism to mitigate the potential for operational efficiency to erode. Her discussion also demonstrates that a prudence review does not provide as strong a financial incentive as a strong sharing band.

Q: How do you respond to Mr. Duvall's example?

A: I think Mr. Duvall's example provides an excellent illustration of why the 70/30 sharing mechanism is necessary and how it provides needed financial incentives to maintain operational efficiency when average market costs increase and when average market costs decline.

Let's begin by assuming the situation in which average market costs increase by $200 million. In addition, assume the Company does not have an ECAM in place and is between rate cases. Under these conditions, the Company would bear the full $200 million increase. However, through its "extraordinary" efforts it can save itself $150 million. Clearly the Company has a $150 million incentive to assure that its "power traders and fuel negotiators who must fulfill the obligation to serve customers"[3] are incentivized to make the extraordinary effort to contain costs while fulfilling the obligation to serve.

Now let's again assume the same $200 million average cost increase. But in this case, let's further assume the Company has an ECAM in place that does not provide for a sharing between ratepayers and shareholders. In this situation, the Company would bear none of the $200 million cost increase. The Company's financial position would be unchanged whether it passed through the $200 million increase or undertook extraordinary efforts to limit the increase to $50 million. The Company has no financial incentive to contain costs.

However with a 70/30 sharing mechanism in place, shareholders would be responsible for $60 million of the $200 million increase. By undertaking extra efforts to limit the average cost increase to $50 million, the Company can reduce its exposure to $15 million. The difference between $60 million and $15 million is $45 million. The Company has a $45 million incentive to contain costs.

Now let's suppose the opposite situation in which average costs decline by $200 million, and for purposes of symmetry with the previous example, let's assume that with extraordinary effort, the Company can further reduce costs by an additional $150 million.

[3] Ibid at 123-124

> Without an ECAM, if the Company rides the market down, it makes $200 million. If it undertakes extraordinary efforts, its average power costs could decline by $350 million. In this case the efforts of the Company result in $350 million to be retained by the Company. The Company has a significant financial incentive to manage costs when costs are declining as well as increasing.
>
> Now assume an ECAM with no sharing bands. If the Company does nothing other than ride the market down, customers will receive the $200 million dollar reduction in costs; the Company retains nothing. If the Company makes an extraordinary effort, customers will receive a $350 million reduction in costs; again, the Company retains no reward for its efforts. It has no financial incentive to make the extraordinary effort.
>
> However, with 70/30 sharing bands, the Company's financial position would be improved if it made the extra effort. The Company would retain 30% of the $150 million as well as 30% ($60 million) of the $200 million. So the Company has an additional $45 million incentive to increase efficiency when costs are falling as well as when costs are rising.
>
> Clearly a 70/30 sharing mechanism provides a financial incentive to manage costs that is not present without it.
>
> **Q: How do you respond to Mr. Duvall's claim that a prudence review is the most effective incentive?**
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> A: In light of the illustration above, it is my opinion that a prudence review would not provide an effective incentive to spur the Company to extraordinary efforts. If PacifiCorp's net power costs rise and fall generally commensurate with the market average, I believe the Company is unlikely to have costs disallowed in an ECAM review, because it would be highly resource intensive for intervenors to make the case that any costs should be disallowed if PacifiCorp's costs are rising and falling with average market costs. Indeed, Mr. Duvall does not suggest that the Company would have costs disallowed in the case that it "did nothing more than ride the market down."
>
> A prudence review clearly does not provide as strong of a financial incentive as a significant sharing band. (Phase II, Part 2, ln. 53-109)

A strong sharing mechanism is a necessary design component to protect customers from higher rates resulting from operating inefficiencies. Therefore, in order to be in the public interest any ECAM must include a strong sharing mechanism as part of its design.

IV. To Address The Resource Acquisition Bias Resulting from an ECAM, Energy Efficiency and Renewable Resource Targets Must Be Established Part of a Risk Mitigation Strategy and In Place Prior to Implementing an ECAM

Throughout this proceeding, WRA's fundamental concern with PacifiCorp's proposed ECAM is its implications for resource selection. As WRA witness, Ms. Kelly, explains:

> Both theory and after-the-fact studies in the academic literature verify that an ECAM distorts long-run planning incentives in favor of the acquisition of resources whose costs are captured by an ECAM. Unless short-term wholesale purchases and natural gas are excluded from PacifiCorp's ECAM, which would nullify the Company's purpose in requesting an ECAM, the bias created will strengthen PacifiCorp's incentive to meet customer's growing resources needs with natural gas fired resources and through short-term wholesale electricity purchases to meet capacity requirements.
>
> Because of the risky nature of these resources, I consider an incentive toward these resources not to be in the public interest. If the incentive were towards resources that best protect customers, the change in the resource acquisition incentive could be in the public interest. Unfortunately this is not the case.
>
> The wholesale electricity market and natural gas market are volatile with asymmetric risks. From any reasonable level, prices can soar higher than they can fall. Therefore the full cost of a strategy that relies heavily on these resources is unknown at the time it is entered into. Market purchases can be partially hedged 3 months to 3 years out through what the Company terms "Front Office Transactions," but if the wholesale markets are disrupted, the Company will not be able to replace those purchases as they expire at the same price as before. Therefore meeting capacity needs with this type of resources incurs risk. And, while the capital costs of natural gas resources are generally known at the time the decision is made to acquire such a resource, fuel over the life of the resource is an unknown and depends on what occurs in the natural gas markets over the life of the plant. Because natural gas as a fuel has become highly volatile, natural gas resources are also "risky." Without an ECAM, shareholders share in the risk that the cost of a market heavy and natural gas heavy resource mix will be higher than expected. However, if an ECAM is in place, the full cost of these resources will be passed through to customers. Shielding shareholders from all but prudence risk removes a natural disciplining force.
>
> Conversely, other resources, including renewable resources and demand side management resources, have little to no variable cost for inclusion in an ECAM. Fuel for these resource types is virtually free. The majority of the costs

> are capital costs that are incurred upfront. In the case of renewable resources the capital costs are ratebased and then recovered over the life of the facility.[4]
>
> However, when capital is constrained, management prefers resource acquisitions with smaller capital outlays. By creating a bias in favor of market and natural gas resources with their smaller capital requirements, an ECAM furthers a disincentive to acquire resources that require upfront capital outlays. These incentives in favor of market and natural gas resources and disincentives for renewable resources and DSM are significant to customers at this time, because PacifiCorp's planning studies have demonstrated that renewable resources and DSM best manage risk and uncertainty. (Phase II, Part 2, Kelly Direct, ln. 43-80)

The resource acquisition bias caused by an ECAM as described by Ms. Kelly cannot be addressed through ECAM design, yet this bias must be addressed and mitigated or an ECAM cannot be in the public interest. An ECAM simply cannot be in the public interest if it could result in a resource acquisition strategy that bypasses cost effective opportunities to reduce green house gas emissions while mitigating the risk of increasingly volatile fossil fuel prices.

Therefore, a new docket should be opened to address resource acquisition and risk mitigation prior to implementing an ECAM. Energy efficiency and renewable resource targets would be considered as risk mitigation measures. The Commission could set a four to six month time limit on activities in this docket.

V. Conclusions

WHEREFORE, for the foregoing reasons, WRA requests a Commission order denying PacifiCorp's application for an ECAM. In the alternative, WRA requests the Commission open a new docket to investigate methods to mitigate the effect of an ECAM on resource planning and acquisition prior to implementing an ECAM and include a 70/30 sharing mechanism in the design of the ECAM.

[4] The cost of DSM programs are recovered through a tariff rider.

Respectfully Submitted,

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