MEMORANDUM

TO: Utah Public Service Commission

FROM: Praxair, Inc.

Cory D. Sinclair, Ph.D., J.D.

COPIES TO: Rocky Mountain Power

Paul Clements
Daniel Solander

The Division of Public Utilities

Philip Powlick, Director
Artie Powell, Energy Section Manager

The Office of Consumer Services

Michele Beck, Director
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DATE: November 17, 2010

SUBJECT: In the Matter of Rocky Mountain Power for Approval of an Electric Service Agreement Between Rocky Mountain Power and Praxair, Inc.
Docket No. 10-035-115

I. INTRODUCTION

I have been asked by Praxair, Inc. ("Praxair") to prepare a response to the Office of Consumer Services' Comments on the Application of Rocky Mountain Power for Approval of an Electric Service Agreement Between Rocky Mountain Power and Praxair, Inc. (hereinafter the "Office Comments"). A copy of my credentials and qualifications are attached as Exhibit 1. If called to testify, I would testify as follows:

II. SUMMARY

Praxair's proposed Electric Service Agreement ("ESA") with Rocky Mountain Power should be approved. The only objection to the special term contract has been filed by the Office of Consumer Services (the "Office"). In those comments, the Office presents no evidence that

the historical treatment of Praxair as a special term customer should be abandoned. Moreover, fundamental economic precepts illustrate that the special term contract is economically efficient and is in the best interest of all other Rocky Mountain Power ratepayers.

III. SPECIAL TERM CONTRACTS FOR PRAXAIR ARE STANDARD PRACTICE AND HAVE BEEN USED FOR MANY YEARS

Rocky Mountain Power and Praxair have regularly negotiated special term contracts for some time. These special term contracts have been negotiated and approved because of Praxair's particular and unique position in the marketplace. Praxair is unique in the marketplace because it is a bypass risk, it would be placed at a significant competitive disadvantage if its competitors obtained its input prices, and it has a unique load profile. These qualities have existed for many years, always resulting in the negotiation of a special term contract with Rocky Mountain Power. Accordingly, the special term contract with Praxair has become standard practice.

The Office Comments acknowledge that Praxair has historically been a special contract customer, but asserts that this fact is insufficient to approve the special term contract at issue. (Office Comments 2.) This assertion contradicts Utah law that prior determinations of administrative agencies are entitled to great weight, and departures from those previous determinations can only be made for cogent reasons. *Husky Oil Co. of Delaware v. State Tax Comm'n of Utah*, 556 P.2d 1268, 1271 (Utah 1976).[1] Replacing continuity with unpredictability (as the Office advocates) imposes an economic cost on both Praxair and all other Rocky Mountain Power customers.

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[1] In *Husky Oil*, the Utah Supreme Court was asked to review an adverse decision of the Utah State Tax Commission. The Court held that prior decisions of the administrative agency are given great weight under the Public Administrative Law and Procedures and that a long history of certain treatment should not be deviated from absent cogent reasons. *Husky Oil*, 556 P.2d at 1270-71. Similarly, Rocky Mountain Power and the Public Service Commission have a long history of offering and approving special terms to Praxair. The Office has provided no evidence to support a conclusion that the historical treatment of Praxair should be disregarded.

IV. PRAXAIR'S SPECIAL TERM CONTRACT MEETS THE CRITERIA AND GUIDELINES SET FORTH BY ROCKY MOUNTAIN POWER

There are at least three economic reasons why Rocky Mountain Power's special term contract with Praxair should be approved: (1) Praxair is a significant bypass risk; (2) Praxair faces potential competitive disadvantages without the contract; and (3) Praxair has a unique load profile. In preparation for responding to the Office Comments, I requested through counsel that the Division of Public Utilities send its internal criteria and guidelines for approving special term contracts (hereinafter referred to as the "Criteria and Guidelines"). Pursuant to those Criteria and Guidelines, each of these economic reasons are grounds for approving Praxair's special term contract.

First, as set forth in the Criteria and Guidelines, a company that presents a bypass risk should be given special terms to ensure that remaining ratepayers are not made worse off:

> If an additional sale can be made through competitive pricing of service, which produces revenues in excess of the marginal cost of providing the service, that excess will make a contribution to fixed costs which would otherwise have been born by the other customers.[2]

This criteria is consistent with fundamental economic precepts. Bypass refers to replacement of the services of incumbent utilities by competing alternatives as a consequence of regulatory restrictions on incumbents. More specifically, if a current customer of Rocky Mountain Power may choose to purchase and obtain its power from an alternative source with minimal expense, an economically rational actor will compare the energy costs of the two possible alternatives plus the switching costs associated with purchasing energy from an alternative provider.[3] However, this decision by the customer imposes negative externalities on remaining Rocky Mountain

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[2] Criteria and Guidelines 3-4.

[3] *See* James C. Bonbright, *Principles of Public Utility Rates*, 20-21 (1969) (describing benefits of price discrimination by pricing to large customers who have a feasible option to generate their own electric power).

Power customers who must pay the departing customer's share of the residual fixed costs. Thus, the remaining customers now have higher costs of electricity because fixed costs do not depend on the number of customers that receive service from Rocky Mountain Power.

To combat this bypass risk, Rocky Mountain Power and other utility providers have negotiated special term contracts in an effort to change the economics of the departing customer's decision. Specifically, as the price offered by Rocky Mountain Power (or other factors such as the period of delay for price increases) is changed, the bypass risk changes. It is economically efficient for Rocky Mountain Power to offer a reduced price or more favorable terms to those parties that present a bypass risk as long as Rocky Mountain Power is able to capture its incremental costs of providing energy to that customer.[4] Any amount received above incremental costs is used to pay some percentage of fixed costs that would not otherwise be paid if the customer had opted to purchase its electricity from another source. The Criteria and Guidelines echo these economic principles, "[b]y recovering the marginal cost of supplying the special contract customer, the cost of remaining customers is unchanged, i.e., they are no worse off." (Criteria and Guidelines 4.)

Praxair is a bypass risk. With minimal expense and in a very short period of time, Praxair could bypass Rocky Mountain Power and become part of Kennecott Utah Copper's ("Kennecott") load. Praxair is a tenant of Kennecott with its smelter located on Kennecott land. With very little expense, Praxair could sell its substations to Kennecott and no longer have any demand for Rocky Mountain Power. From an economic point of view, Praxair will choose this option if the price of power from Kennecott plus the minimal switching costs are less than the price of power available from Rocky Mountain Power. If Praxair is no longer a customer

[4] *Id.* at 317-18, 383 (acknowledging that marginal cost plays an important role in rate setting for utilities and that price discrimination strategies used to attract customers that would otherwise not be part of the utility's service is beneficial to remaining ratepayers as long as the negotiated price is above the incremental cost level).

because Kennecott has an alternative energy source and decides to bypass Rocky Mountain power due to price, Rocky Mountain still must pay the residual fixed costs, which will ultimately be paid by the remaining ratepayers. Accordingly, Praxair's special term contract should be approved because the price that Praxair has agreed to pay Rocky Mountain Power is above the marginal cost of supplying Praxair, leaving all remaining customers better off.

Second, competitive concerns require that Praxair be offered special terms. This justification is also recognized by the Criteria and Guidelines as one to consider when approving special terms:

> A related problem exists where Customer A is in the Company's service territory and Customer B, the direct competitor is located in a different utility's service territories. If Customer B has been given a discounted electric price, Customer A is disadvantaged in the widget market. A special contract rate, which meets the primary criteria, would be appropriate to eliminate Customer A's disadvantage.

(Criteria and Guidelines 9.) This scenario describes Praxair's circumstances. Praxair is a global company that supplies atmospheric, process, and specialty gases, high-performance coatings, and related services and technologies to a wide variety of customers and in highly competitive markets. In the markets that Praxair competes, energy prices represent a significant percentage of total input costs. One of Praxair's competitors has an air separation plant in Bountiful, Utah, that receives energy from Bountiful City, which has no requirement that prices be published and is free to deviate from the list price for any customer. Praxair is placed at a significant competitive disadvantage when Bountiful City charges below-tariff prices for the competitor's essential input while Rocky Mountain Power makes no such concession.[5] This competitive disadvantage is precisely the example presented above in the Criteria and Guidelines as grounds

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[5] *See* Bonbright, 384 (describing that "fair competition" is a maxim that must be considered in every price discrimination practice considered by utility companies).

for approving a special term contract. Moreover, if Praxair's competitors learn the input prices that Praxair pays, this informational asymmetry also places Praxair at a considerable competitive disadvantage. It is equivalent to Praxair's competitors using an insider to provide them information about Praxair's costs and operations. To maintain competitive equities, Praxair's special terms should be approved and kept confidential.

The third reason that Praxair's special term contract should be approved is because Praxair, like Kennecott, has a unique load profile.[6] Once again, this justification was recognized in the Criteria and Guidelines, "[t]o warrant special contract consideration, the customer's load profile must impose significantly unique load characteristics on the system." (Criteria and Guidelines 10-11.) Praxair's operations and power needs are directly related to the needs of Kennecott, which has a widely recognized unique load pattern. Kennecott utilizes its large generating capabilities to reduce its reliance on Rocky Mountain Power, particularly in the summer months when prices are at their highest level. Praxair's load profile depends largely on Kennecott's load. This is because of the symbiotic relationship between Kennecott's smelter and Praxair's air separation plant, both of which are located on Kennecott's land. This unique load profile, combined with the competitive concerns and significant bypass risk, all support the approval of the special terms contract.

V. THE OFFICE COMMENTS PRESENT NO EVIDENCE TO WARRANT A DEPARTURE FROM THE WELL-ESTABLISHED PRACTICE

The Office of Consumer Services appears to offer three reasons why Rocky Mountain Power's special term contract with Praxair should not be approved. First, the Office Comments assert that the long-standing practice of special term contracts with Praxair does not support the

[6] *Id.* at 292 (describing how the objectives and criteria of a sound rate structure include the principle that the burden of meeting total revenue requirements must be distributed *fairly* among the beneficiaries of the service).

contract at issue; second, the Office argues that the physical and business relationship between Praxair and Kennecott does not justify non-tariff rate treatment; and third, the Office contends that there may be situation where a customer bypassing Rocky Mountain Power may actually be better for existing ratepayers. Importantly, none of the Office's arguments are supported by independent evidence or economic theory. Each argument is presented merely as a response to Praxair's submission. Given these general deficiencies, each argument is addressed in turn.

First, the Office asserts that the long-standing practice of negotiating and approving special term contracts with Praxair has no bearing on the instant contract. This assertion is contrary to Utah law and fundamental economics. As described above, under clear Utah law, prior determinations by administrative agencies are given substantial weight and should only be deviated from for cogent reasons. *See Husky Oil*, 556 P.2d at 1271. The Office offers no cogent reasons for deviating from the prior determinations.

Utah law on this point is not only clear, it is economically sound. A competitive business like Praxair must have some ability to forecast or predict its future input prices to perform any future projections on price, quantity, and/or capacity. By assuring that past determinations are given significant weight, the Utah Supreme Court has recognized that this information can be incorporated into a special contract customer's future projections with some degree of certainty. Without this assurance, Praxair and other special contract customers have little to no ability to project beyond the life of the current contract, which is economically inefficient.

The second point raised by the Office is that the physical proximity to Kennecott and the existing business relationship with Kennecott do not justify the special term contract. This argument misinterprets the justification put forth by Praxair in support of the contract. The physical proximity to and the existing business relationship with Kennecott, on their own, are

innocuous facts. However, they demonstrate the ease and minimal expenses associated with bypassing Rocky Mountain Power and joining Kennecott's load. The physical proximity illustrates that a bypass transmission line could be installed on Kennecott's property with relative ease. The bypass risk would be lower if Praxair were not a tenant on Kennecott's land simply due to the costs associated with transporting energy from Kennecott to Praxair. However, because Praxair is a tenant of Kennecott, the transportation costs are negligible.

Similarly, the ongoing business relationship between Kennecott and Praxair illustrates that the two have and continue to work together on providing energy and oxygen to one another. This is shown by the symbiotic relationship that has developed between the two entities, where Praxair's load is largely dependent upon Kennecott's load. This relationship is strong evidence that the two would be able to reach an agreement on terms for purchasing additional energy. Without this type of connection, the probability of a successful bypass declines. As shown, these two facts validate the veracity of Praxair's claim that it is a bypass risk.

Lastly, the Office contends that, while a bypass risk is ordinarily a proven justification for providing special terms, that there may be a situation where a customer leaving Rocky Mountain Power may actually be good for the remaining ratepayers. This possibility, although wholly absent from the Criteria and Guidelines to consider when evaluating a special term contract, is incomplete at best. First and foremost, the Office has presented no evidence that the price of an alternative source of energy for Rocky Mountain Power is sufficiently high to make remaining Rocky Mountain Power customers better off if Praxair is no longer a customer. Indeed, the Office has put forth no evidence that the price of energy that could be purchased to meet the excess demand is currently so high that it renders that option unavailable or inefficient. Moreover, the Office's assertion that excess demand can only be satisfied by a reduction in

demand ignores fundamental principles of supply and demand that show that an increase in supply can accomplish the same objective. The Office has put forth no evidence that an increase in the supply of electricity cannot be achieved more efficiently than reducing demand (achieved by letting Praxair join Kennecott's load). Lastly, the elasticity of both demand and supply influence how successful the Office's possibility would be—a characteristic that is not addressed by the Office. Given the presence of fixed costs that must be paid by all ratepayers and extremely low energy prices today, the Office's scenario seems improbable.

VI. CONCLUSION

In short, none of the summary explanations provided by the Office are supported by economic evidence or theory. In contrast, Praxair and Rocky Mountain Power have jointly negotiated special terms that temporarily prevent Praxair from joining Kennecott's load while guaranteeing that Praxair continue to contribute to Rocky Mountain Power's fixed costs. These circumstances have been regularly recognized as grounds for approving the special term contracts with Praxair and there is no evidence or theory put forth by the Office to support deviating from this practice.

DATED this 17th day of November, 2010.

/s/ Cory D. Sinclair
Cory D. Sinclair, J.D., Ph.D.

EXHIBIT 1

Cory D. Sinclair, J.D., Ph.D.

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Dr. Sinclair has significant experience in law and economics, damage analysis, risk analysis, valuation, antitrust, intellectual property, and commercial litigation. He is licensed attorney and has worked on large commercial matters as both an economist and as an attorney. He has been retained as an expert in Utah and has written and spoken about expert-related issues. Dr. Sinclair has taught economics to undergraduate and graduate students, including applied microeconomics, industrial organization, law & economics, and theories of damages.

EMPLOYMENT HISTORY

May 2006 to May 2007, January 2009 - Present
Attorney
Parsons Behle & Latimer
Salt Lake City, UT
Litigation / Damages analysis

May 2007 to December 2008
Consultant
North Harvard Group
Salt Lake City, UT
Litigation / Economic consulting

April 2005 to July 2005
Intern
Department of Justice
Antitrust Division
Washington D.C.

August 1998 to May 2003; January 2009 - Present
Adjunct Faculty
Economics Department
University of Utah
Salt Lake City, UT

EDUCATION

J.D. 2006
University of Utah
Member of the Order of the Coif

CALI Award for Academic Excellence for Antitrust, Law & Economics, and Federal Income Tax

Ph.D. 2003 (Economics)
University of Utah
Fields of Specialization: Industrial Organization and Antitrust Economics, Econometrics, Labor Economics
Dissertation: Econometric analysis of high profile labor market

B.S. 1998 (Economics)
University of Utah
President's Award Recipient for Academic Excellence

TEACHING EXPERIENCE

Law & Economics

Industrial Organization (with Mark Glick)

Introduction to Microeconomics / Macroeconomics

Microeconomic Theory

Macroeconomic Theory

Economics of Professional Sports

Graduate Industrial Organization (with Mark A. Glick)

PUBLICATIONS AND PRESENTATIONS

"Experts in Antitrust Cases,"(with Lara Swensen) *in* Litigators on Experts (Wendy Courture and Allyson Haynes ed. 2010).

"Damages Resulting From a Lost Opportunity: The Proper Damage Date in Utah Contract and Tort Cases" (with Mark A. Glick) *in* UTAH BAR JOURNAL, Vol. 23, No. 4 (July/August 2010).

American Needle v. NFL – The Supreme Court's Latest Decision on Joint Ventures (presented at Utah State Bar Summer Convention, July 2010).

"Gibbons v. Gibbons: A How-To Guide for Achieving an Efficient Valuation and an Equitable Distribution of Stock Assets in Divorce Proceedings," Journal of Law & Family Studies, Vol. 7 (2005).

"Building for the Rich, Broadcasting to the Poor: How the N.B.A. Responded to a Changing U.S. Economy," (with Peter Philips) Proceedings of the Third International Conference on Sports Economics, Panhellenic Association of Sports Economics and Managers, (2003). Paper presented at Conference in Athens, Greece, in February 2003.

"Sam Gompers," (with Peter Philips) in Joel Moykr ed., Oxford Encyclopedia of Economic History. Oxford University Press (2003).

PROFESSIONAL AFFILIATIONS

Licensed member of Utah State Bar

Admitted to practice in U.S. District Court for District of Utah

President and Member of Antitrust and Unfair Competition Section of Utah State Bar

Law & Economics Society

Member of Intellectual Property Section of Utah State Bar

Invited Reviewer for "The Economics of Sports" 2d. ed. Michael Leeds and Peter Von Allmen, Addison Wesley (2004)