

September 1, 2004

To: All Parties Of Record

RE: Docket No.04-035-04 *In the Matter of the Petition of Desert Power, L.P. for Approval of a Contract for the Sale of Capacity and Energy from its Proposed QF Facilities*

To All Interested Parties:

The Commission has reviewed the proposed Power Purchase Agreement between Desert Power, L.P., and PacifiCorp filed August 5, 2004 and finds that one component of the Agreement does not appear to be consistent with the method and prices we approved for large Qualifying Facilities (QF) in Docket No. 03-035-14. Further, we do not have evidence regarding the basis for this deviation.

Specifically, in Docket No. 03-035-14 we did not approve inflation adjustments to components of the capacity price. However, the contract before us bifurcates the fixed capacity price into a capital capacity price and an operations and maintenance (O&M) capacity price with an inflation adjustment to the O&M capacity price using the Consumer Price Index (CPI). There are two issues here. One is the amount and propriety of the O&M capacity price that is subject to inflation adjustment and the second relates to the choice of inflation index.

First, the proposed bifurcation represents O&M cost as approximately 30 percent of the fixed capacity price. This is significantly higher than the 10 percent of *fixed* O&M used to estimate fixed annual payments for capital cost in PacifiCorp's IRP 2003. We recognize that the approved avoided cost method additionally capitalizes *variable* O&M cost assuming an 85 percent capacity factor and that when this is added to fixed O&M cost, the total O&M cost included in the capacity price settlement in Docket No. 03-035-14 is about 30 percent. However, we have insufficient discussion in the record for us to determine that including capitalized variable O&M in a payment that reflects avoided *capacity* cost is consistent with a decision to subject this part of the capacity payment to inflation adjustment. One value of indexing QF payments is to track actual avoided utility cost and ensure ratepayer neutrality. While the use of an index to resolve differences in opinion regarding future natural gas prices and therefore avoided *energy* costs over time was discussed in depth in Docket No. 03-035-14, a

comprehensive discussion of the propriety of indexing components of the fixed capacity price, i.e., avoided capital cost, is missing from the 03-035-14 docket and approved stipulation.

Second, it is not clear to us that the 2.5 percent inflation factor used to estimate fixed and variable O&M cost over time both in Docket No. 03-035-14 and IRP 2003, represents a long run estimate of the CPI rather than some other long-run inflation factor, nor that either one is related to actual changes in PacifiCorp's O&M cost.

Because the subject Agreement has a 20-year life and may serve to inform pricing components included in other long-term agreements, we find that additional evidence is required to determine that this component of the Agreement appropriately identifies avoided utility cost, is just, reasonable and meets the ratepayer indifference requirement. It is presently our intent to issue an order approving the Agreement without the bifurcation and indexing of the capacity price. Prior to issuing an order, we invite additional comments, evidence, or suggestions from the parties to be filed on this issue no later than September 10, 2004.

Sincerely,

/s/ Julie Orchard
Commission Secretary
G#40246

JPO/af

