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ATTORNEYS FOR NUCOR STEEL, A DIVISION OF NUCOR CORPORATION

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of its Proposed Electric Service Schedules and Electric Service Regulations, Consisting of a General Rate Increase of Approximately $161.2 Million Per Year, and for Approval of a New Large Load Surcharge	**Docket No. 07-035-93**

TESTIMONY OF MARK DRAZEN
ON BEHALF OF NUCOR
[COST OF SERVICE AND RATE DESIGN]

Before the
Public Service Commission of Utah

In the Matter of the Application of
Rocky Mountain Power For Authority
to Increase its Retail Electric Utility
Service Rates in Utah and for Approval
of Its Proposed Electric Service Schedules
and Electric Service Regulations,
Consisting of a General Rate Increase
of $161.2 Million Per Year, and for
Approval of a New Large Load Surcharge

Docket No. 07-035-93

Direct Testimony of Mark Drazen
Cost of Service and Rate Design

on Behalf of
Nucor Steel-Plymouth, a Division of Nucor Corporation

DRAZEN CONSULTING GROUP
Energy & Regulatory Economics

July 21, 2008

Direct Testimony of Mark Drazen

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Mark Drazen, 8000 Maryland Avenue, Suite 1210, St. Louis, Missouri, USA, and 1405 Fairfield Road, Victoria, B.C., Canada.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A I have worked in this field since 1972 in rate cases, regulatory analysis, project planning and negotiations throughout the United States (40 states and federal jurisdiction) and Canada (eight provinces and federal jurisdiction). Our firm has been in this field since 1937. I have degrees in mathematics and engineering from the Massachusetts Institute of Technology. Details are given in Nucor Exhibit 1.1.

Q ON WHOSE BEHALF ARE YOU TESTIFYING?

A I am testifying on behalf of Nucor Steel-Plymouth, a division of Nucor Corporation and a contract industrial customer of Rocky Mountain Power (RMP).

Q WHAT IS THE SUBJECT OF THIS TESTIMONY?

A This testimony concerns Rocky Mountain Power's proposed Schedule 500, the "alternative pricing proposal for new large loads" presented in the testimony of RMP witness Mr. William Griffith and discussed by RMP witness Dr. Karl McDermott.

Q PLEASE SUMMARIZE THE MAIN POINTS IN YOUR TESTIMONY.

A Rocky Mountain Power has proposed that load additions over 10 MW be charged rates higher than the rates for existing loads over 10 MW and higher than the rates for load additions smaller than 10 MW. Mr. Griffith says that this is because the cost of new supplies exceeds the embedded cost of existing supplies and that large new loads are contributing to rapid growth in total load. Dr. McDermott characterizes the large load surcharge as a form of "marginal cost pricing," which, he says, is supported by economic theory in order to promote efficient consumption decisions.

In fact, RMP's proposal is simply a version of vintage pricing, not marginal cost pricing. As such, it is unreasonably discriminatory in that customers with similar service characteristics would pay different rates simply based on their date of attachment to the system. Moreover, the treatment of growth is inconsistent, in that different rates would apply to the load growth of some customers than to that of other customers.

This is not a new concept. Similar proposals have been made–and repeatedly rejected–for more than 30 years. In fact, a similar idea was proposed for the inter-

jurisdictional allocation of PacifiCorp's costs and was rejected by this Commission. Although the concept may seem appealing, it is not based on sound economics, conflicts with well-established regulatory policy and is impracticable. I recommend that Rate 500–and the underlying rationale–be rejected.

RMP's Proposal

Q PLEASE EXPLAIN THE COMPANY'S PROPOSAL IN MORE DETAIL.

A Rocky Mountain Power's witnesses talk about using "marginal cost principles," but in reality this is a version of vintage pricing. Mr. Griffith has proposed that any *new* load over 10 MW be subject to surcharges, as specified in a new Rate 500. In order to have surcharges apply only to part of the load, Mr. Griffith says that "the incremental load amount would be separately metered" (Page 17, Line 390). The effective surcharge over the regular rate would be 25% starting August, 2008, and increasing to 30% starting August, 2009.

Q WHAT REASONS DOES HE GIVE FOR THIS PROPOSAL?

A He summarizes the rationale for this proposal thus:

> *The combination of the large difference and the anticipated significant load growth in Utah is creating two significant problems:*
>
> *1. Because marginal costs are significantly higher than system average embedded costs, and new loads in Utah are not paying the full marginal cost of service, new large loads will create upward pressure on the rates of all Rocky Mountain Power Utah customers.*

2. *Average embedded cost pricing is sending poor price signals and may be encouraging new customers to make fuel choices that are not economically or societally optimal.* (Page 15, Lines 335-344)

According to his testimony, the "cost of generation to serve new load" is 5.8¢ per kWh or more, as compared to an embedded cost of 4.2¢ per kWh for generation and transmission (Page 15, Lines 325-332). Load additions over 10 MW are predicted to add 246 MW over the next five years (Page 14, Lines 319-323). This is about 7% relative to the 2006 normalized peak of 3,600 MW, or an average of 1.3% annually. To put this in perspective, this is less than half the expected annual growth for Utah as a whole (2.67%), as shown in PacifiCorp's February, 2008 *Integrated Resource Planning Public Input Meeting*[1] (excerpt attached as Nucor Exhibit 1.2).

Mr. Griffith then refers to the testimony of Dr. McDermott to explain "the advantages of marginal cost pricing" (Page 17, Line 378).

Q WHAT DOES DR. MCDERMOTT SAY?

A His testimony is a discussion of the "importance of marginal cost pricing" (Page 5, Line 15). Dr. McDermott's testimony is general in nature. It does not present any analysis of Rocky Mountain Power's costs. He starts off by saying:

This proposal, as I understand it, would set the generation component of rates for specified large, new loads based on marginal cost principles. That is, the rates for these customers would be set to recognize that the marginal cost of providing service is higher than the

[1] www.pacificorp.com/File/File79834.pdf

average embedded cost. I have also been asked to provide my opinion on the merits of this proposal from a theoretical and regulatory policy perspective. (Page 3, Lines 62-67)

He goes on to explain the "importance of marginal cost pricing in economic theory" (Page 5, Lines 95-96). This is the usual argument that:

Marginal cost pricing results in a price signal that produces an efficient allocation of scarce societal resources. Consumers should consume only that amount of energy where the additional resources that society must employ to meet that additional consumption are equal to the value consumer's[sic] *place on that additional consumption.* (Page 5, Lines 97-101)

Further on (Page 7, Line 131), he makes reference to Professor Alfred Kahn and quotes from his book (*The Economics of Regulation*):[2]

Then, if consumers are to decide intelligently whether to take somewhat more or somewhat less of any particular item, the price they have to pay for it (and the prices of all other goods and services with which they compare it) must reflect the cost of supplying somewhat more or somewhat less—in short, marginal opportunity costs.

Dr. McDermott says that "marginal cost pricing" is needed "immediately":

Q. What is the current situation facing Rocky Mountain Power that warrants the immediate application of marginal cost pricing?

A. The Company is rapidly approaching a disequilibrium situation where the demand, i.e., customer load, will significantly exceed the supply, i.e., available generating capacity. Mr. Griffith describes a situation in which industrial customers alone are expecting to increasing load in the next five years by approximately 400 MW, which represents over ten percent of the Company's current Utah peak demand. Much of this new load will be in new facilities with annual demands ultimately exceeding 10 MW. (Griffith, Dir.) (Page 14, Lines 283-291)

[2] Cambridge, MA, 1988, MIT Press, Page 66.

Q DOES DR. MCDERMOTT'S TESTIMONY SUPPORT THE COMPANY'S PROPOSAL?

A Not really. Arguments about the superiority of "marginal cost principles" are not new; the issue has been discussed since the 1970s. Although Dr. McDermott says that "marginal cost has nearly unanimous theoretical support from the economists" (Page 12, Line 254), it has nearly unanimous lack of support as a basis for regulating utility rates. There is no "immediate need" for a change in pricing method; RMP's situation is not much different than that of many other utilities, nor different than circumstances encountered by utilities in the past. Of the 246 MW of new large load projected to come on line in the next five years, one customer accounts for about 40% of the total and part of that customer's load is already up and running in 2008 (per the response to UIEC Data Request 16.2).

Q YOU SAID THAT RMP'S PROPOSAL IS NOT REALLY "MARGINAL COST PRICING," BUT "VINTAGE PRICING." WHAT IS THE DIFFERENCE?

A "Vintage pricing" means that customers pay different rates depending on when they attach to the system. Rocky Mountain Power's proposal, like others I am aware of, really rests on the concept that "new customers should pay the cost of new facilities"–in this case, new generation supply. This means, among other things, that two customers receiving identical service will pay different rates simply because one became a customer earlier than the other. "Non-vintage" pricing is the norm–all (similar)

customers pay the same rate without regard to the date on which they became customers.

True marginal cost pricing, on the other hand, would not discriminate among customers based on vintage. All customers would pay the marginal cost. In this respect, vintage pricing is inconsistent with "marginal cost principles." Finally, the Company's proposed rate is not even based on the actual marginal costs. It is, rather, an arbitrary percentage adder to the otherwise-applicable rate. For example, the response to UIEC Data Request 16.4 says that the 25% and 30% surcharges "were not derived based on any specific quantitative analysis" but, instead, were chosen "so that the resulting prices for new large loads would be somewhat less than those that would be supported based on alternative quantitative approaches."

Q DOES DR. MCDERMOTT SUPPORT A VINTAGE APPROACH OR A NON-VINTAGE APPROACH TO PRICING?

A That is not clear. Toward the beginning of his testimony, he says:

> *For example, marginal cost pricing better matches cost causers with cost payers. Since marginal cost, by definition, is the cost of producing additional output,* ***those customers that consume additional output are matched with the costs that are caused to produce that output****.* (Page 6, Lines 113-116, emphasis added)

Here, Dr. McDermott seems to use the notion that "new load is the cause of new supply."

However, later on he takes a somewhat different tack:

> *Actually, to be economically efficient,* ***all load and all components of rates should be priced at full marginal cost*** *in order to avoid the subsidies, provide the correct signals for load growth and minimize rate pressure on existing customers.* (Page 15, Lines 312-315, emphasis added)
>
> ***My preference as an economist, therefore, is to move to marginal cost pricing for all customers during all times of the year****, at least for generation services. This would provide all customers with the right incentives to conserve energy and would represent a large step in rationalizing energy policy in the face of what could be one of the most challenging decades for energy regulators, customers and suppliers since the 1970s.* (Page 16, Lines 326-332, emphasis added)

In other words, if marginal cost pricing is to be applied at all, it is not just *new* loads that should pay the marginal cost of generation, but *all* loads. This is consistent with the principle that all loads–not just "new" ones–cause and should share in the cost of new supplies.

Q HOW DOES DR. MCDERMOTT RECONCILE THE IDEA THAT ALL CUSTOMERS SHOULD PAY MARGINAL COST WITH THE COMPANY'S PROPOSAL THAT ONLY NEW LARGE LOADS SHOULD PAY A HIGHER COST?

A He says that his experience as a policy-making regulator suggests that customers "need time to adjust to new policies" and "the institution of regulation needs time to adjust as well" (Page 16, Lines 333-334). In the meantime, he feels that this issue can be examined more thoroughly in a separate proceeding.

Q IS THIS LOGICAL?

A It is not. Load growth over the next two years is not so dramatic as to cause a substantial increase in rates. Recall that according to RMP, the average projected growth from large loads is about 1.3% a year over the next five years—less than half of the total projected load growth. There is no need to create a precedent for discriminatory rates at this time. Further, it is not clear what Dr. McDermott means by customers and regulators needing "time to adjust." Adjust to what? Nor has he provided any justification for putting vintage pricing in place for some customers while giving vintage pricing rates for other customers a more thorough examination in another proceeding.

Analysis of the Proposal

Q PLEASE EXPLAIN YOUR COMMENT THAT PROPOSALS LIKE THIS HAVE BEEN MADE–AND REJECTED–FOR OVER 30 YEARS.

A One of the clearest and most forceful rejections of this idea was made by the New York Public Service Commission when Professor Kahn was its chairman–the same Professor Kahn whom Dr. McDermott quotes in support of marginal cost pricing. In 1976, Niagara Mohawk Power Corporation (NMP) proposed that industrial customers should be allocated more cost because it was their load growth that had contributed the most to

the need for new, higher-cost supply. The Commission described this idea as "fallacious":

> *We single out for particular attention the argument advanced by NMP in favor of imposing so disproportionate a part of the burden of the rate increase on industrial customers that it was for those customers it planned the major additions to capacity, which now impose such a grossly increased burden of revenue requirements, and that it is they, therefore, who should properly be made to bear the burden of that excess capacity.* ***This reasoning is fallacious. So far as the costs of providing the generating and transmission facilities that serve all customers are concerned, no customer or group of customers taking power under the same conditions may be said to bear a greater marginal cost responsibility than others. The opposite notion is so widespread namely, that it is the customers whose demand is growing who bear the responsibility for the necessity for expanding capacity and higher current costs, and that it is they therefore who should be made to pay those higher costs that it is important to underline its inherent fallaciousness****. Economic efficiency requires that every purchaser weigh the desirability to himself of consuming a little bit more, or the sacrifice to himself resulting from marginal reductions in purchases against the corresponding marginal cost or savings to the system; only in this way will every customer purchase the proper amount; that is, inefficiently subsidized consumption be avoided. In brief, every customer should, to the extent it is feasible, be charged the marginal cost. Or, to put it another way,* ***the customer who continues to consume at previous levels, while marginal costs are rising, is just as responsible for the system's having to add to its capacity at those rising incremental costs as the customer whose demand is increasing: a diminution in consumption by either would equally avoid the system's having to incur those costs. All consumption, by all customers should, ideally, be subjected to the test of marginal cost prices****.* (re Niagara Mohawk Power Corporation, New York Public Service Commission Opinion No. 76-23, 16 PUR4th 317, 335 (1976), emphasis added)

In other words, the idea that "new loads cause the need for new supply" is simply wrong. It is the *combined* loads of all customers, new and old, that create the need for total supply. In fact, as I shall explain below, the distinction between "old" and "new" loads is inherently arbitrary and is simply not sustainable in any logical fashion.

Mr. Griffith observes that RMP made a similar proposal in its recent Wyoming case, although a stipulation in that rate case referred the matter to a collaborative

process.[3] RMP (at that time, Utah Power & Light) made a similar proposal back in 1981. In that case (Docket No. 9441 Sub 13), the utility proposed a new Schedule No. 17, which the Wyoming Public Service Commission described thus:

> *54. Utah Power seeks to amend the industrial Schedule No. 17 to require all large use industrial customers (those whose demand exceeds one megawatt) to pay rates based upon the 'carrying' costs of the investment in Hunter Unit No. 2 (in service in 1980) and in associated 'backbone' transmission facilities, and in the parallel projected investment in Hunter Unit Nos. 3 and 4.* ***These 'vintaged' rates are supported by Utah Power as being critical to place the extremely high cost of these generating facilities needed to serve the 'unprecedented' Wyoming power growth, mainly on the large industrial customers experiencing such growth****, and to avoid existing residential and other lower use customers' rates from being substantially increased (over 130 per cent) to pay for or to subsidize the industry growth. Under proposed amended Schedule Nos. 6, 8, 9, and 17, Utah Power would grandfather, under lower cost rate schedules, certain customers and usage levels based upon the time the load was served.* (*Re: Utah Power & Light Company,* 46 PUR4th 204, 216, emphasis added)

At that time, Utah Power's system-wide growth had been and was expected to continue at a rate of about 7.5% annually. The Wyoming Commission rejected this proposal:

> *Utah Power has not borne its burden of proof with evidence showing: that 'vintage' pricing is just and reasonable and meets the W.S. 37-2-119 requirement that the proposed rates are based upon existing facilities which are 'used and useful' for Wyoming service; and that the proposal will not result in unfairly or unduly discriminatory and preferential rates between classes and users within the industrial class, and between Wyoming users and similar users in other states. This conclusion is reinforced by the substantial evidence of the Intervenors showing* ***unfair and unjust discrimination and preferences arising out of the 'vintage' pricing concept****; and the evidence demonstrating that Utah Power's current and projected systemwide growth reasonably compares with that of prior years when Wyoming users supported the far greater growth in the other states served by Utah Power. Utah Power's vintaging proposal is unsupported and should be denied.* (46 PUR4th 204, 217, emphasis added)

[3] See *In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Wyoming, Consisting of a General Rate Increase of Approximately $36.1 Million Per Year, and For Approval of a New Renewable Resource Mechanism and Marginal Cost Pricing Tariff* in Docket No. 20000-277-ER-07.

Another case where the issue was argued at length and the regulator came to the same conclusion was that of TransCanada PipeLines, before Canada's National Energy Board. In that case, the pipeline increased its rate base by about 86% (from $3.0 billion to $5.6 billion), in response to requests from gas transportation shippers. The self-described "existing shippers" argued that the higher cost of the new facilities should be borne only by the "new shippers." The concept and the reasoning were essentially the same as in the New York and Wyoming proceeding, with the same result:

> ***With regard to the debate as to who caused the need for the new facilities, the Board is persuaded by the argument that it is the aggregate demand of all shippers that gives rise to the need for additional pipeline capacity***. (*TransCanada PipeLines GH-5-89 Reasons for Decision, Volume I—Tolling and Economic Feasibility*, National Energy Board, Page 13 (November, 1990), emphasis added)

In other words, it is incorrect to claim that "new loads" are the ones that cause "new costs" and try to price service on that basis.

Q DR. MCDERMOTT SAYS THAT THE NEED FOR SOME FORM OF MARGINAL COST PRICING IS GREATER NOW THAN EVER BEFORE. IS THAT TRUE?

A No. Utilities in the 1970s were facing large differentials between the cost of existing and new supplies and were expecting high growth rates. In the 1970s, it was not uncommon for utilities to project growth rates of 5%-7% per year.

Q YOU ALSO MENTIONED THAT THE UTAH COMMISSION HAS REJECTED THIS IDEA. IN WHAT CASE?

A This was a case concerning the inter-jurisdictional allocation methodology for allocating PacifiCorp's costs among the various states (Docket No. 97-035-04). In that proceeding, the Commission said:

> ***We conclude that the basis of cost apportionment is cost causation reflecting the characteristics of current rather than historical usage****. This is the traditional meaning given the cost-causation principle. In the 1990 Order, the Commission affirmed that principle by rejecting a proposal to partition plant on a historical basis. Nothing in this record causes us to change this decision. In addition, we agree with the reasons the Division enumerated in this Docket to support that position: (1) Current use of existing plant is cost causative since current loads require facilities to continue to operate; (2) PacifiCorp serves an aggregate load and resources are not devoted to the exclusive use of a particular customer group; (3) cost causation is dynamic not static in that it reflects current relative use of shared plant; (4) divisional assignment of shared plant violates the principle of direct assignment which requires exclusive not shared use; and (5) the FERC requires it for wholesale and transmission transactions.* ***An historical-use-based cost apportionment method results in a form of vintage pricing. Vintage pricing has not been accepted in this jurisdiction, and the Division asserts it can result in absurd outcomes****.* (*In the Matter of a Proceeding to Establish An Allocation Methodology to Separate PacifiCorp's Assets, Expenses and Revenues Between Various States*, Public Service Commission of Utah Docket No. 97-035-04, April 19, 1998, emphasis added)

The Utah Public Service Commission's prior rejection of vintage pricing concepts stands in contrast to RMP's proposal here. If the cost of new supply were to be allocated (or assigned) primarily to growing loads within Utah, customers (or regulators) in other states could argue that such costs should be treated the same way in the inter-jurisdictional allocation, thus subverting the Commission's prior decision.

Q PLEASE SUMMARIZE THE PROBLEMS WITH VINTAGE PRICING PROPOSALS, SUCH AS THAT PROPOSED BY ROCKY MOUNTAIN POWER.

A Some of the problems are:

- Discrimination;
- Arbitrariness;
- Inconsistency;
- Inefficiency;
- Uncertainty; and
- Impact on economic development.

Discrimination results when similar customers (or loads) are charged different rates. RMP's proposal is discriminatory in two respects. First, an "old" 10 MW customer would pay a lower rate than a "new" 10 MW customer, even though the conditions of service might be identical. Second, not all "new" load is treated the same. Two "new" loads of 6 MW each would pay less than a single "new" load of 10 MW. Growth by Residential and General Service customers is ignored. RMP thus does not even consistently apply its avowed principle that "new load causes new supply costs."

Arbitrariness is inherent in RMP's proposal because there is no logical or consistent way to distinguish between "old" and "new" usage (which is why I put those terms in quotation marks). Decisions must be made regularly, in real-time, regarding how much electricity to use. A customer who continues to use incandescent lights when compact fluorescents would be more efficient is clearly contributing to the need

for growth. A customer who chooses an electric oven over a gas oven when remodeling (or when replacing an industrial drying oven) contributes to growth. All these small decisions add up to a significant amount of electricity usage that is created by choices made every day by "old" customers.

Even the distinction between "old" and "new" customers is unclear. For example, if Martha Butcher moves from a smaller house to a new, larger house in RMP territory, is she an "old" or "new" customer at the new location? Meanwhile, if Henry Baker moves into Martha's old house from another state, he is a "new" customer, but at an "old" location. RMP's proposal doesn't solve these issues, it ignores them. These illustrate the principle, mentioned above, that is the combined loads of *all* customers that create the need for new supply.

Inconsistency means that the attempted association of new supply with the users that "caused" the need is likely to be ignored when an existing source of supply must be replaced. If a "new" customer is charged with the cost of a "new" source of supply, then it logically follows that when an existing generating plant is decommissioned (or a supply contract must be renewed at a higher rate), only "old" customers should pay the higher costs. Further, what might happen in the future if new supply costs are lower than embedded cost? Would customers with growing loads then receive rates lower than the average embedded cost? (Lest this seem unrealistic, that is exactly what happened 10-15 years ago in some states.)

Inefficiency results from the fact that trying to set some rates closer to marginal cost necessarily results in setting other rates further from marginal cost. This is the result of having an embedded cost revenue requirement. This is sometimes called "piecemeal efficiency," or more accurately, simply inefficiency.

Uncertainty results from the lack of clear logic underlying such a proposal. The 25% and 30% surcharges are not based on any specific analysis. What would prevent RMP from raising the percentage surcharges in the future? Similarly, the 10 MW threshold could be changed (in Wyoming, RMP proposed 5 MW). The most fundamental uncertainty is that RMP has proposed a basic policy change from uniform (non-discriminatory) pricing to vintage pricing.

The impact on economic development is unclear. More to the point, Rocky Mountain Power's goal is unclear. Is the goal to reduce the amount of large load additions in Utah? Or does RMP expect the same load growth to materialize, but simply extract more money from those customers? What will happen if some of that economic development simply moves to an adjoining state?

Summary

Q PLEASE SUMMARIZE YOUR TESTIMONY.

A Rocky Mountain Power has characterized its proposed Rate 500 as an implementation of "marginal cost pricing." In fact, it is simply a version of vintage pricing. As such, it is

unreasonably discriminatory in that customers with similar service characteristics would pay different rates simply based on their date of attachment to the system. Moreover, the treatment of growth is inconsistent, in that different rates would apply to the load growth of some customers than to that of other customers. Neither of these discriminatory aspects is consistent with the economic theory that Dr. McDermott has presented. In principle, "marginal cost pricing" means that all customers, new and old, should face the same marginal costs, as determined by their service characteristics (voltage level, time of day, and so on). This Commission, like others, has previously unequivocally rejected vintage pricing concepts similar to those proposed here.

I recommend that Rate 500–and the underlying rationale–be rejected.

Q DOES THAT CONCLUDE YOUR TESTIMONY AT THIS TIME?

A Yes, it does.