State of Utah
Department of Commerce
Division of Public Utilities

FRANCINE GIANI
Executive Director

THAD LEVAR
Deputy Director

PHILIP J. POWLICK
Director, Division of Public Utilities

JON HUNTSMAN Jr.
Governor

GARY HERBERT
Lieutenant Governor

MEMORANDUM

To: Utah Public Service Commission

From: Division of Public Utilities

Philip Powlick, Director
Artie Powell, Manager, Energy Section
Thomas Brill, Technical Consultant
Charles Peterson, Technical Consultant
Jamie Dalton, Utility Analyst

Subject: In the Matter of the Application of Rocky Mountain Power for Approval of its Proposed Energy Cost Adjustment Mechanism, Docket No. 09-035-15.

Date: May 26, 2009

BACKGROUND

On March 16, 2009 Rocky Mountain Power (Company) applied to the Commission for an Order approving its proposed Energy Cost Adjustment Mechanism (ECAM). The Company identified an increase in net power cost (NPC) volatility due to various factors outside its control, as the primary reason for its need for an ECAM. Because of this volatility, the Company noted that establishing a fixed level of NPC virtually ensures that customers will either over or underpay the cost of energy they are using.

In the April 22, 2009 Scheduling Order, the Utah Public Service Commission (Commission) requested a scope of issues list and recommendations in response to the Application of Rocky Mountain Power for Approval of its ECAM. The Division of Public Utilities (Division) takes this opportunity to present a Power Cost Adjustment Clause (PCAC) scope of issues, as well as make several recommendations regarding the Company's ECAM application.

SCOPE OF ISSUES

The Division has identified PCAC necessity, mechanism design, included cost elements, implementation and auditing, and unintended consequences as the critical scope of issues. Each of these broad issue areas is addressed, additional issues are identified, and recommendations are made.

Necessity. It is the Company's burden to prove the necessity of a PCAC. This is the threshold question that must be considered before specific mechanisms should be considered. If the Company has not met that burden there is no reason to design a PCAC. Therefore, the Commission might consider determining if the Company has met this burden on a preliminary bases before parties spend the effort on a design of a PCAC. It may be particularly instructive, for example, to review the arguments articulating the detrimental effect of the Energy Balancing Account (EBA), Docket No. 90-035-06, on customers and the Company's ability to effectively and efficiently manage its power costs. What conditions or circumstances have changed in the intervening time between Docket No. 90-035-06 and now to warrant re-introducing a PCAC? A PCAC may be appropriate where some costs and/or revenues are inadequately accounted for in rates established in a normal general rate case. In determining what should or should not be included in a PCAC, the Division recommends that the following criteria should guide the decision:

1. Control – Is the cost/revenue in question within the control of the Company? A "no" answer would point toward the need for a PCAC, however, the following additional variables need also be considered.
2. Predictability – If a cost or revenue item is beyond Company control but is nevertheless predictable, such that a forecast in a rate case can adequately account for change, then including that item in a PCAC may be inappropriate.
3. Magnitude – What is the range of likely change? Small changes may amount to simple "noise" in the ratemaking process and may not be worth implementing a cumbersome adjustment mechanism.
4. Time Horizon – Changes that are beyond Company control and that are also large and unpredictable may appropriately be included in a PCAC if they are likely to

occur quickly. If, however, such change occurs over a long period of time, it may be acceptable to account for it in subsequent rate cases.

Beyond these criteria, the Division has also identified the following policy questions that need to be considered:

5. Absent a PCAC, what are the options available to the Company to control and recover net power costs (e.g. through hedges, forecast test years, frequent rate cases)?

6. Why are these options less effective and beneficial to the Company and customers than a PCAC?

7. What are the relevant public and private interests that will be served by a PCAC? What steps should be taken to ensure that both public and private interests are balanced?

8. What is the division of risks between customers and the Company? Does a PCAC generally, or a specific mechanism, shift an unacceptable amount of risk onto customers? What consideration needs to be given to the relative capacity of the Company compared to customers to hedge or take other steps to control power costs?

Mechanism Design. If a PCAC is necessary, then how should it be designed? Should additional incentive or disincentive measures be included? For example, should the mechanism include a trigger, a deadband, various heat rate targets, or cost-sharing mechanisms? How should recovery or dispersal of accrued funds be achieved? What additional components of a PCAC are needed to ensure that the Company is responsibly and prudently incurring energy costs? Should the mechanism be designed such that the Company is not necessarily guaranteed full cost recovery, particularly for questionable cost items? Does the PCAC contain enough incentives to ensure that the Company efficiently acquires and uses fuel in the generation process?

A PCAC should also ensure that various other types of distortions are prevented. For example, if the Company has higher assurances of cost recovery through an adjustment mechanism, what incentive would it have to expedite needed repairs in the event of an unplanned outage at a low-cost generation facility when it may obtain cost recovery from the purchase of more expensive power or through the operation of a more expensive resource? How will a PCAC affect Company decisions to undertake capital development for generation resources if cost recovery is more assured for market purchases or for the operation of generation resources with relatively higher fuel costs? Would a PCAC incent the Company to favor certain resource or fuel types over others?

If incentive measures are used to ensure efficiency, it is recommended that the Company, in advance, reach agreement with regulators about how much risk both Company and ratepayers should be protected from. A PCAC should not relieve the Company of its obligation to prudently procure fuel, power, or to operate efficiently.

Cost Elements in Mechanism. If a PCAC is determined to be necessary, and an adjustment mechanism has been designed, what power costs and revenue should be included? The Division recommends using decision criteria outlined above to evaluate specific cost/revenue items (control, predictability, magnitude, and time horizon). Which costs and performance dimensions are within or beyond the Company's control? Which costs are partially within the Company's control? How much volatility is too much? What costs can be reasonably be predicted? The Division does not disagree with the concept that those power costs that are difficult to predict, are volatile, and are clearly outside Company control would be candidates for inclusion in a PCAC. Costs that can be reasonably predicted should be reviewed within a rate case and not included in a PCAC.

The Division has questions on the degree to which market purchases should be included in a PCAC. As noted above, does a PCAC create an incentive to purchase power rather than build additional generation resources? If the Company, through its own choices, relies on market purchases to meet its native load requirements, should it have the protection of a PCAC or should the risk of this managerial decision be borne by the Company and its shareholders?

Since fuel costs are typically included in a PCAC, there may be a need to make a more precise determination about how these fuel costs should be controlled. It currently appears that most of the Company's fuel purchases are made through long-term contracts, which minimizes the threat of price volatility. The criteria the Division has provided would suggest such costs not be included in a PCAC. But would such an exclusion of long-term purchases incent the Company to rely inappropriately on short-term contracts?

Hedging practices (both for fuel and power) are a significant area of concern. How would current power cost hedging practices change with implementation of a PCAC? Hedging practices typically involve decisions about balancing price stability and against price minimization. Would a PCAC make the Company indifferent between the two? If a PCAC were in place, how would the appropriate hedging strategy be determined? What would be the tradeoff in the incremental costs associated with the premium prices that ratepayers currently pay for Company strategies to hedge against price instability? Should the Commission require that the Company follow specified and approved hedging practices in order to receive cost recovery?

Implementation and Auditing. Implementation includes auditing, monitoring, and rate recovery. Because the role of auditing an adjustment mechanism will inevitably fall to the Division, the Division has spent time and effort in assessing what PCAC auditing will entail. Will PCAC auditing occur on a monthly or an annual basis?

If the Commission determines that a PCAC is warranted, the Division strongly recommends that PCAC auditing occur on a monthly basis. The auditing of an adjustment clause will demand considerable Division resources, and the Division believes that an annual audit is neither advisable nor practical. It is imperative that the Division be able to complete such audits in a timely fashion, without excessively burdening available staff or resources. Therefore, the Division recommends that the Company prepare a complete trial monthly package at the FERC subaccount level. The Division will review the Company's trial package and will work with the Company to ensure the package is complete and will allow auditing in a timely fashion.

Unintended Consequences. As noted earlier, distortions or perverse incentives are possible with a PCAC. These could result in various unintended consequences. For example, a hidden, unintended consequence of a deadband may be a perverse incentive to manage power costs so as

to end up outside the deadband. Another unintended consequence may affect Demand-Side Management (DSM). How will Company incentives for DSM be maintained if PCAC recovery is possible for short-term purchases? Could the Company make uneconomic choices if certain costs or revenues are included in a PCAC but others are not?

Additional Questions.

1. In addition to covering fuel cost volatility, does the PCAC also allow for recovery of changes in quantities?

2. Is there evidence that Company earnings and financial strength have been negatively affected because it cannot reasonably recover volatile fuel and purchased power costs?

3. Does a PCAC reduce Company risk such that an adjustment to allowed rate of return should be made?

4. What is the effect on Company earnings and financial strength if a PCAC is in place during periods of prolonged fuel/purchase price deflation?

5. Should limits or caps be implemented to ensure that the Company cannot recover excessive volumes of costs that are generally undesirable (such as spot electricity purchases on-peak)?

RECOMMENDATIONS

While the Division is not philosophically opposed to the idea of a PCAC, it recommends careful attention be paid to the structure of the mechanism, what costs are included in the adjustment mechanism, and the implementation of the adjustment mechanism. The Division recommends that the outcome should ensure that the PCAC achieves a balance between the Company (e.g. price stability, financial stability, and creditworthiness) and ratepayers (e.g. price stability, affordable energy, and accurate price signals for consumers), as well as least cost/least risk.

If a PCAC is adopted, the Division requests guidance from the Commission regarding the implications for a PCAC on risk and cost hedging. The Division remains concerned about the role hedging may play in a PCAC and in identifying what the tradeoffs are between moving from

a significantly "hedged" fuel cost environment to a more market-driven environment that would ostensibly accompany a PCAC. We suggest that the Commission consider explicit hedging guidance to guide Company practices and to define hedging costs and consequences for which the Company can receive recovery.

Section 54-7-13.5 requires that any balancing account mechanism be implemented at the conclusion of a general rate case. Further, Utah Commitment 23 in the Mid American acquisition Docket 05-035-54 required that Rocky Mountain Power file its request for a PCAM at 90 days in advance of a general rate case filing and that intervener testimony on the PCAM would be due at the same time as testimony in the general rate case. The company will meet the 90 day in advance filing of its ECAM. The rate case in Docket 09-035-15 is not scheduled to be filed before June 15, 2009. The Division believes that there are a number of options available to the Commission on how to proceed with this Docket and the rate case. Those could include consolidation for purposes of hearing, keeping the Dockets completely separate except for implementation or asking the Commission to address the necessity issue more rapidly than other issues. These issues can be discussed at the scheduling conference to be held on June 2, 2009. At this point, the DPU recommends that this Docket and the rate case be separate. When the rate case is filed, a subsequent scheduling (or technical) conference can be held to consider consolidation of this docket into the rate case.

Cc: Service List, RMP General Rate Case, Docket No. 09-035-23
Service List, RMP ECAM Application, Docket No. 09-035-15