

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: December 4, 2003**

REGULAR X **CONSENT** _____ **EFFECTIVE DATE** _____ **N/A** _____

DATE: November 25, 2003

TO: Lee Sparling

FROM: Marc Hellman

SUBJECT: PACIFICORP: (Docket No. UM 926) Approval of Agreement between Bonneville Power Administration and PacifiCorp Regarding Fiscal Year 2004 through 2006 Deferral of Subscription Benefits and Related Matters.

STAFF RECOMMENDATION:

I recommend that the Commission approve PacifiCorp's request to execute agreements with the Bonneville Power Administration to defer a portion of BPA's fiscal year 2004 through 2006 residential exchange payments and amend agreements related to determining the level of benefits and their administration.

DISCUSSION:

On November 24, 2003, PacifiCorp filed a request with the Commission to approve agreements with the Bonneville Power Administration (BPA) relating to residential exchange benefits. (A copy of the application is provided in Attachment A to this memorandum.) The agreement modifies the current financial benefits provided to PacifiCorp's residential and small-farm (Residential) consumers by deferring a portion of BPA's Fiscal Year (FY) 2004, 2005 and 2006 payments to the 2006-2011 time period. Specifically, BPA would defer payments to PacifiCorp of up to \$19.21 million for FY 2004 through 2006. The deferral balance held by BPA will accrue interest at an annual rate of 3.09 percent, compounded monthly. This rate would apply to the deferral balance until such monies are disbursed by BPA. The payment schedule of the disbursement is 60 equal monthly payments beginning, October 1, 2006, and ending September 30, 2011. PacifiCorp's Oregon consumers would still receive financial benefits totaling \$44,646,616 annually through October 1, 2006, absent

any Safety Net Cost Recovery Adjustment Clause (SN CRAC) surcharge. The \$19.21 million per year of PacifiCorp deferrals is based on the four-state commission agreement on the percentage of PacifiCorp residential exchange benefits allocated to each state, for the 2001 through 2006 time period. The \$19.21 per year deferrals is larger than the company's simple pro rata allocation, which is \$10,062,004, because PacifiCorp has elected to be responsible for a greater share of the \$75 million to be deferred among the regions investor-owned utilities. PacifiCorp proposes to defer up to all of Oregon's federal system benefits that are "Monetary" benefits, that is the benefits arising from the 900 aMW of financial benefits of the total initial five-year period of 1900 aMW of benefits for all the investor-owned utilities in aggregate.

PacifiCorp is not requesting any rate change to be implemented with this filing. PacifiCorp anticipates that it will later file for a 4.4 percent increase to its residential rates to be effective March 2004. The range of potential rate increase among all of PacifiCorp's qualifying consumers is 4.2 percent to 5 percent. PacifiCorp proposes to pass through to customers, on a timely basis, the reduction in benefits to levelize rates between the first five-year period of its ten-year contract with BPA, and the second five-year period beginning October 1, 2006. PacifiCorp expects federal system benefits available from BPA will be lower in the second five-year period because BPA rates will be more comparable to market prices. When benefits were established in 2001, the entire western United States was experiencing an energy crisis during which wholesale market prices were extremely high.

Background

For much of 2003, BPA, the Northwest investor-owned utilities, several publicly owned utilities and organizations, and staff from Oregon, Washington and Idaho have participated in settlement negotiations to achieve the following objectives:

- Reduce BPA's near term rates
- Remove the risk that investor-owned utility customers will not receive future BPA benefits
- Promote equitable sharing of federal system benefits among all BPA customers

To achieve near term rate reductions, the parties discussed eliminating the \$200 million litigation risk provision that has these monies being available to Puget and PacifiCorp in the event the utilities are sued over the level and rights to federal system benefits. In addition, parties discussed having the residential and small-farm consumers of investor-owned utilities (Residential) defer current benefits through September 2006 for later distribution from October 1, 2006 through September 30, 2011.

To remove risk that Residential consumers will not receive future benefits, the parties discussed dismissing current litigation threatening Residential benefits and agreeing not to sue on such issues through September 30, 2011.

To promote an equitable sharing of federal system benefits, the parties discussed methods to more frequently, rather than once every five years or BPA rate period, determine the "value" of federal power (how much BPA power is cheaper than market), and use an independent source for the market price of power rather than having BPA decide it in its own rate cases.

The result of these discussions is an agreement between BPA, the Northwest investor-owned utilities (of which PGE, PacifiCorp and Idaho Power serve 75% of Oregonians), and most publicly owned utilities. The provisions of the agreement are as follows:

- 1) BPA will use a new method to calculate how much money goes to the IOUs (such as PGE and Pacific) for the 2007-2011 period. BPA will:
 - a. Use a new independent source for the market price forecast, rather than BPA selecting a number. This new method will apply for the time period October 1, 2006 through September 30, 2011. This approach removes BPA's ability to arbitrarily set the level of benefits for the Residential consumers of the investor-owned utilities; and provides reasonably comparable benefits to those made available to Residential consumers of the publicly owned utilities.
 - b. Establish a floor and cap on the annual level of benefits provided to the Residential consumers of the investor-owned utilities of \$100 and \$300 million, respectively. Using the 4-state PUC agreement¹ on allocation of benefits for the 2007 – 2011 period, this translates into roughly a floor and cap of \$40 and \$125 million per year, respectively, for Oregon's Residential consumers served by PGE, PacifiCorp and Idaho Power.² The current level of benefits received by those customers is roughly \$125 million per year. The current \$125 million was set during the 2001 energy crisis and hence represents a time when BPA was envisioned to be well below market; i.e., the value of the federal system was very great.

¹ The September 17, 1999, 4-state agreement regarding allocation of BPA benefits was adopted by BPA in its Record of Decision.

² PacifiCorp estimates that beginning October 1, 2006, PacifiCorp's Oregon benefits will be at a minimum the sum of \$14,515,920 and \$15,435,208, reflecting the return of the deferral and PacifiCorp's Oregon share of the investor owned utility aggregate \$100 million annual minimum of benefits, respectively. The Oregon PacifiCorp cap in benefits post October 1, 2006, is estimated by PacifiCorp to equal \$46,275,942 not including the return of the deferral.

- 2) BPA will:
 - a. Implement a 7.5% rate decrease on or about March 1, 2004, with no SN CRAC for FY 2004. The rate decrease will be retroactive to October 1, 2003, so there are refunds due but no interest will accrue on the refund amounts. BPA will also revise the way it calculates the SN CRAC with the likely outcome that a zero SN CRAC will be in place for fiscal year 2005.
 - b. Begin a collaborative process to identify cost savings and revenue enhancements that produce, over a two-year period, \$100 million in additional net revenues to BPA. (I doubt the PUC will be active in this process.)
- 3) The investor-owned utilities in aggregate commit to defer receipt of federal system benefits from BPA totaling \$75 million per year for three years, and to have those monies returned during the 2007 through 2011 time period. Puget and PacifiCorp also agree to waive contractual rights to \$200 million in additional benefits that arise from public agency challenges to the level and determination of benefits to the utilities' Residential consumers. The total reduction in benefits for the 2004 to 2006 time period is \$425 million, of which \$225 million is essentially a loan. Oregon's share of this amount, using the 2001 through 2006, allocation of benefits among the investor-owned utilities, will be no more than \$30 million per year or \$90 million over the three years, 2004 through 2006.
- 4) All current litigation claims filed by the publicly owned utilities challenging the level and determination of benefits to Residential consumers will be voluntarily dismissed and utilities will sign covenants not to file, support, or in any way aid any lawsuits regarding the same through 2011.

Some publicly owned utilities might oppose the settlement because they wish to preserve the option to sue, or pursue current litigation challenging BPA's policies with respect to the Residential consumers of the investor-owned utilities. For example, on November 18, 2003, the Snohomish Board unanimously voted not to sign the agreement, in large part because it wanted to maintain its court challenges to the benefits received by Residential customers. The settlement is not voided ab initio because Snohomish could decide to support the settlement before the 90-day period expires as discussed in the utility filings.

Reducing benefits to Residential customers reduces BPA's costs thereby allowing lower rates to the public agencies. (No Oregon publicly owned utility opposition to the settlement is known at this time.) Some environmental groups may oppose the settlement because they perceive greater pressure on BPA to reduce monies for fish restoration and other environmental objectives. BPA is committing to seek \$100 million in cost reductions and revenue enhancements over a two-year period, and BPA's

revenue requirements will increase in 2007 to 2011 to repay the \$225 million in deferrals to the IOUs. The Columbia River-Inter Tribal Fish Commission may oppose the settlement based on concerns expressed in correspondence to BPA rate case parties dated October 10, 2003. I believe CUB is supportive of the settlement.

Key Issues

The key issues are:

Is this settlement beneficial for PacifiCorp Residential consumers?

How does PacifiCorp propose to manage the rate impacts of the settlement?

What interest rate should apply to any deferrals related to Residential benefits?

Each of these key issues will be discussed in turn.

Is this settlement beneficial for PacifiCorp Residential consumers?

This settlement benefits PacifiCorp Residential consumers and Oregonians, in general. The settlement benefits all Oregonians because it will allow BPA to reduce its rates. Any reduction in rates is positive for Oregon given the state of its economy.

With respect to benefits to PacifiCorp customers, the agreement provides certainty regarding the minimum and maximum level of benefits available to the Residential consumers for the five-year period beginning October 1, 2006. The agreement will also reduce BPA's activities in the wholesale market by eliminating BPA's obligation to provide any power to the investor-owned utilities. Currently BPA's intent is to provide all 2200 aMW of benefits for the five-year period beginning October 1, 2006, in the form of power.

Further, with respect to PacifiCorp Residential consumers, the settlement greatly reduces the potential for court-ordered reductions in BPA benefits allocated to the Residential consumers of the investor-owned utilities. This is achieved because current litigation challenging the level and method of providing federal system benefits for Residential consumers would be dismissed. Further, all of the public litigants must sign covenants not to challenge the method or level of benefits provided to Residential consumers through September 30, 2011. PacifiCorp currently receives approximately \$63.9 million in annual benefits. If these benefits were eliminated through a successful legal challenge, the result would be a 16 percent rate increase for Residential consumers.

The settlement also removes BPA's discretion to arbitrarily establish the level of benefits available to Residential consumers. The benefit of BPA power is measured by the difference in cost between buying BPA power and an equivalent amount of power in the open market. For example, if the price of BPA power equaled the wholesale market price of power, there is no current benefit of having BPA power. On the other hand, if BPA power were priced much lower than wholesale market alternatives, as was the case in 2001, then there are substantial benefits to having access to BPA power.

The Residential consumers, for the five-year period beginning October 1, 2001, had rights to 1900 aMW of BPA power. During 2001, the wholesale price of power for a flat block power product, provided for a five-year term, was well in excess of \$50 per mWh. BPA reported market prices in excess of \$100 per mWh. Assuming a market price of \$50 per mWh, and 1900 aMW, and a BPA price of a flat-block product of \$20 per mWh, the economic value of the power is $1900 \text{ aMW} * (50 - 20 \text{ \$/mWh}) * 8760 \text{ hours per year} = \500 million . Residential benefits however are not \$500 million annually. Benefits are much lower because BPA determined the wholesale market price forecast in its own rate case. The BPA-established market price is \$38 per mWh. BPA had initially set the wholesale market price at \$28.1 per mWh and only agreed to revise the price after active intervention by the PNW public utility commissions.

BPA has not yet adopted a wholesale market price forecast for the five-year period beginning October 1, 2006. As noted earlier in this memorandum, under this agreement BPA must use independent sources to determine wholesale market prices for the purpose of establishing the level of benefits for Residential consumers. Absent the settlement, the wholesale price forecast would be established by BPA in its rate case. At a recent four-state commission meeting with BPA, Steve Wright, Administrator of BPA, relayed to the four state commissions that BPA would likely adopt a conservative (low) wholesale price forecast. If BPA used a five-year rate period, as it did in the first five years of PacifiCorp's ten-year contract, it would be difficult for the four-state commissions to challenge BPA's order on this issue. The reason is that there is not a liquid market for five-year term power. During the settlement discussions over the course of several months, there were many discussions with power market experts and it was evident that a liquid wholesale market existed out two to perhaps three years at most.

For the five-year period beginning October 1, 2006, the Residential consumers of the investor-owned utilities are to receive 2200 aMW of federal system benefits. Assuming the independent wholesale market price forecast exceeds what BPA would have adopted otherwise through its rate case, by one \$/mWh, Residential benefits increase by roughly \$19 million.

The table below illustrates the economics of the deferral and the use of an independent wholesale market price forecast. Column (B) represents the present value of the total \$75 million deferral. The first three years represent the three years for which the benefits are reduced by \$75 million. The last five years, 2007 through 2011, represent the repayment of the deferral by BPA to the investor-owned utilities.

Economics of Value of Settlement With Respect to
Deferrals and Independent Market Price Forecast
(\$000,000)

(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
	Present	Present		Present	Present		Present	
	Value of	Value of		Value of	Value of		Value of	
	Deferral	One Mill		Deferral	One Mill		Two Mills	
		Delta			Delta		Delta	
<u>Year</u>	<u>@ 3.09%</u>	<u>@ 3.09%</u>	<u>net</u>	<u>@ 8.0%</u>	<u>@ 8.0%</u>	<u>net</u>	<u>@ 8.0%</u>	<u>net</u>
2004	(\$75.000)		(\$75.000)	(\$71.590)		(\$71.590)		(\$71.590)
2005	(\$75.000)		(\$75.000)	(\$68.336)		(\$68.336)		(\$68.336)
2006	(\$75.000)		(\$75.000)	(\$65.229)		(\$65.229)		(\$65.229)
2007	\$32.625	\$17.063	\$49.688	\$27.085	\$14.165	\$41.250	\$28.331	\$55.416
2008	\$32.625	\$16.552	\$49.177	\$25.853	\$13.116	\$38.969	\$26.232	\$52.086
2009	\$32.625	\$16.056	\$48.681	\$24.678	\$12.145	\$36.822	\$24.289	\$48.967
2010	\$32.625	\$15.574	\$48.199	\$23.556	\$11.245	\$34.801	\$22.490	\$46.046
2011	\$32.625	\$15.108	\$47.733	\$22.485	\$10.412	\$32.897	\$20.824	\$43.309
Total	(\$61.875)	\$80.353	\$18.478	(\$81.498)	\$61.083	(\$20.415)	\$122.167	\$40.669

The reason the total for column (B) is not zero, but in fact is a large negative number equaling almost \$62 million, is due to the BPA proposed ratemaking treatment of the deferral. The monies owed to the investor-owned utilities would be included in BPA's revenue requirement. As such, the obligation increases BPA's costs thereby increasing BPA's rates. Assuming BPA has total loads of 8000 aMW, and Residential benefits are 2200 aMW, then Residential consumers end up paying for 27.5 percent of their own

deferral. (The \$32.625 value in Column "B" is the net payment to the investor-owned utilities reflecting the fact that they, and thus their Residential consumers end up paying for 27.5 percent of BPA's costs including the return of the deferral.)

Column (C) represents the value of increasing Residential benefits by \$1 per mWh. The increase in value, at a 3.09 percent discount rate, exceeds the "cost" of the deferral. Columns (E) through (I) illustrate the analysis using an 8 percent discount rate. The cost of the deferral increases in this example because BPA is accruing interest on the deferral balance at 3.09 percent while Residential consumers could arguably discount the money by 8 percent on an annual basis. The analysis shows that if the independent forecast increases the applicable market price forecast by \$2 per mWh, then this agreement provides \$40 million of benefits to Residential consumers.

There are some countervailing points that can be made regarding the overall analysis. First, is the disturbing feature that PacifiCorp's Residential consumers must "pay" for fair performance by BPA under the terms of the existing contract. (Residential consumers are "paying" \$60 to \$80 million dollars as columns (B) and (E) illustrate.) That is, the independent price forecast could be considered the best unbiased estimate. The reason this whole approach was developed was to nullify BPA's discretion and threats to arbitrarily reduce the market price forecast from its "true" value. It should be recognized that BPA is a political agency. It may be worthwhile to immunize the Residential benefits from near term adverse political considerations.

Second, with Oregon's economy still weak, now is not the time to voluntarily increase rates by reducing Residential benefits. This point can be addressed, however, by recognizing that the Commission could decline to authorize the utility's request to pass through to customers the decrease in Residential benefits but instead build up a large negative balance to be repaid from 2006 through 2011. However, it may be unwise to allow Residential consumers to build up such a large debt to the utility because it is unknown what level of Residential benefits may be established for the time beginning October 1, 2006. If benefits are much less than current benefit levels, significant rate shock could occur as rates are reset to both reflect the reduced Residential benefits and a payback to the utility for excess benefits paid during 2004 through September 2006.

How does PacifiCorp propose to manage the rate impacts of the settlement?

PacifiCorp envisions raising rates roughly 4 percent around March 2004, to reflect the effects of the deferral. PacifiCorp did not identify any rate change unrelated to this agreement that is envisioned to occur over the next few years.

What interest rate should apply to any deferrals related to Residential benefits?

Over the last twenty years of managing Residential benefits, the interest rate applied to any monies owed to customers by the utility, or monies owed by customers to the utility has not been consistent between PGE and PacifiCorp. The Commission policy regarding balancing accounts has been to use the utility's authorized rate of return. PGE has been using its authorized rate of return on the Residential benefits balancing account. This rate is roughly 9 percent. PacifiCorp, by contrast to PGE, has been using its short-term borrowing rate. This approach is consistent with a 1981 letter to PacifiCorp from Bill Kramer, the then Utility Program Director. At the time the letter was issued, short-term interest rates were above long-term interest rates and Commission authorized rates of return. The current short-term borrowing rate is around 1 percent. PacifiCorp also has not charged Residential consumers any interest when monies are owed to the company. The Residential balancing account for PacifiCorp currently has a relatively small balance of about \$1 million owing to Residential consumers.

I recommend that the current disparate treatment between PGE and PacifiCorp continue in the near term. Staff understands that the Commission may open a docket early next year to address the appropriate interest rate for balancing/deferral accounts. Assuming that such a docket is opened, this is the appropriate vehicle to make a policy decision regarding the interest rate for balancing/deferral accounts.

Finally, I believe it is unreasonable to apply interest to the balancing account when the company owes Residential consumers money, but not apply interest when Residential consumers owe the company money. PacifiCorp has adopted this policy, as strange as it may seem for two reasons. First, PacifiCorp interprets BPA contract language as requiring this treatment. Second, PacifiCorp believes that since it can elect whether or not to pass through changes in benefit levels, if a balance is owing to the company it is by company action to manage rates that such a result occurs. I would note that to the contrary, the Commission also, because of rate concerns, might require the company to not raise rates to pass through reductions in Residential benefits. While the Commission is required by federal law to pass through, in full, Residential benefits, there is flexibility afforded in contract language between the utility and BPA such that rate management is available within some bounds. For example, the current contracts require the balancing account to be no larger than total benefits available over a 180-day period. With the deferrals, as requested by the commission staffs and investor-owned utilities, this time period is increased to 36 months. Therefore significant flexibility is available to the Commission to manage rate impacts. If PacifiCorp seeks to continue to not accrue interest on monies owing to the company, that policy should

continue as it benefits Residential consumers. I do not support the Commission ordering PGE to do the same.

Other Discussion

The BPA payments to PacifiCorp does not enrich PacifiCorp shareholders

PGE, PacifiCorp and Idaho Power all pass through to customers, in full, these benefits. Shareholders earn no profits on the pass through. Before the October 1, 2003, SN CRAC increase, the Oregon portion of the benefits was \$63 million for PacifiCorp-Oregon, and \$58 million for PGE.

Consequences of no settlement

If there is no settlement, for the five-year period beginning Oct. 1, 2006, BPA must provide 2,200 average megawatts yearly to the IOUs as a whole. However, BPA has the option to provide the benefits in power or cash, or a mix of the two. Utilities thus do not know how much power they must have available to meet loads. Also, the current contracts provide BPA considerable latitude to establish the level of benefits available to the Residential consumers of the investor-owned utilities. This is because BPA sets the market price forecast used to determine the per kWh benefit available to IOU consumers. Finally, if there is no settlement, benefits to the IOU residential and small-farm consumers remain at risk due to outstanding lawsuits challenging the level of benefits provided to these customers.

\$50 million risk litigation monies

To further reduce near term cash outlays, BPA has also obtained the deferral of an additional \$50 million in annual payments due in total to Puget and PacifiCorp relating to exposure to legal contract challenges. The Commission issued Order No. 02-414 on June 20, 2002, approving an agreement between PacifiCorp and BPA that:

....allows BPA to defer the payments that were to begin October 1, 2002. The monies deferred would accrue interest at an annual rate of 4.46 percent, compounded monthly. PacifiCorp may terminate the agreement if it believes that the lawsuit settlement agreement between the publics and the investor-owned utilities will not conclude to PacifiCorp's satisfaction. In addition, the Washington, Idaho or Oregon regulatory commissions may terminate the

agreement if any of the commissions objects to or disapproves continuation of the deferral period. Once the agreement is terminated, beginning on the date of a new six-month period, BPA shall pay PacifiCorp the deferred cash payments and begin the monthly payments associated with the litigation risk.³

If the settlement is voided ab initio, because some public agencies seek to pursue their litigation attacking the level and method of benefits to Residential consumers, the Commission might choose to consider directing PacifiCorp to request, or approving PacifiCorp's own request that, the risk litigation payments begin.

Additional Background

Commission authorization with regards to this proposed contract is required pursuant to ORS 757.663, which reads as follows:

In order to preserve the benefits of federal low-cost power for residential and small-farm consumers of electric utilities, the Public Utility Commission may require an electric company to enter into contracts with the Bonneville Power Administration for the purpose of securing such benefits. The contracts shall be subject to approval by the commission....

In docket UM 926, the Commission investigated the residential and small-farm consumers' access to federal system benefits and method of delivery (power or cash). As a result of the UM 926 investigation, the Commission issued Order Nos. 00-678 and 01-427, directing both PGE and PacifiCorp to enter into 10-year power purchase contracts with BPA relating to residential exchange benefits. These contracts provided PGE and PacifiCorp both cash and cost-based federal power. On October 31, 2000, PacifiCorp and PGE executed ten-year subscription settlement agreements with BPA. PacifiCorp and BPA later agreed to convert the power sale portion of the federal system benefits into cash.

ALTERNATIVES FOR COMMISSION CONSIDERATION:

In addition to the staff recommendation, there are alternative actions the Commission could take regarding the PacifiCorp request. One alternative is to not approve amending the current contracts. The effect of this action would likely be a default on the

³ June 11, 2002, Public Meeting memo by Marc Hellman to John Savage

terms of the settlement in that it is unlikely the investor-owned utilities could achieve the \$75 million in deferrals. Staff does not support this alternative.

Another alternative is to direct PacifiCorp to request payment of the litigation risk monies upon April 1, 2004, in the event the settlement is voided.

PROPOSED COMMISSION MOTION:

The Commission approve PacifiCorp's request to execute agreements with the Bonneville Power Administration to defer a portion of BPA's fiscal year 2004 through 2006 residential exchange payments and amend agreements related to determining the level of benefits and their administration.

The Commission approve PacifiCorp's request to defer Oregon monetary benefits and such amounts shall be no more than \$19,207,962 for BPA's Fiscal Year 2004, and no less than \$10,062,004 and no more than \$19,207,962 per year for the period October 1, 2004 through September 30, 2006.

Electronic Copy of Attachments is not Available