

ASC METHODOLOGY

INVESTOR OWNED UTILITY PRELIMINARY RESPONSE

10/22/2007

The responses below to the BPA requests for feedback are supplemented in their entirety by the “Pacific Northwest Investor-Owned Utility Comments on Long-Term BPA Regional Dialogue Policy Issues” dated October 31, 2006, which comments (including but not limited to Appendices A and B thereto) are incorporated herein by this reference.

1. What construct should BPA use to determine a utility's ASC?

BPA REQUEST FOR FEEDBACK:

The 1981 and 1984 ASC Methodologies determined that BPA would use what was called the "jurisdictional approach method" for determining ASCs. Using this method, BPA relied on the jurisdictional regulator (state utility commission for IOUs or governing body of a publicly-owned utility) of an exchanging utility for information regarding the utility's resources costs. If the resource costs were allowed in retail rates, BPA normally accepted the costs in the utility's ASC. Each time a utility changed its retail rates, BPA required the utility to file for a new ASC determination. These filings were time consuming for BPA, the filing utility, and for intervenors. Many filings were contentious and resulted in subsequent administrative and judicial litigation.

In September 2007, BPA advanced a proposed construct that would result in a simplified determination of ASCs. Representatives of publicly-owned utilities and IOUs responded with similar constructs. One common element in each of these constructs is an ASC determination based on utility filings consistent with information contained in FERC Form 1 filings. This historical information would be escalated to BPA's future rate test period, and in conjunction with load forecasts would result in an ASC for each relevant future year. The IOUs advanced one difference from BPA's and the publics' construct by proposing an after-the-fact true-up of a utility's resource costs and exchangeable load.

BPA's examinations of the interactions between ASCs and the 7(b)(2) rate test have shown that the rate test mitigates most increases in ASCs by increasing the PF Exchange rate used to determine REP benefits. Given the premise that the level of ASCs is not the primary determinant of REP costs, BPA is considering a simplified ASC construct. BPA seeks comment on whether the jurisdictional construct should be replaced with a more administratively efficient construct. Additionally, BPA seeks comment on whether a true-up to resource costs and/or loads should be included in the construct.

RESPONSE:

The basic construct BPA should use to determine a utility's Average System Cost ("ASC") is as follows:¹

- A forecasted ASC for each exchanging utility for every year is used to pay estimated benefits for that year.
- Exchanging utilities will use an electronic filing template to submit their ASC information to BPA on an annual basis by July 1st of every year for the calendar year just concluded.
- The FERC Form 1 provides basic data for determining investor-owned utility ASC, supplemented as necessary. Corresponding data for preference utilities will be taken from similar sources.
- BPA posts on its website a draft ASC determination for each utility and the FERC Form 1 and other data underlying such determinations.
- Interested stakeholders may provide comments to BPA on the draft ASC determinations.
- BPA reviews and responds to the comments and determines the ASCs, posting the comments and BPA responses on BPA's website.
- The investor-owned utilities file with FERC the ASC determined by BPA, and any interested stakeholder may participate in FERC review of the filed ASCs under FERC's procedures for review of filings under section 205 and 18 CFR section 35.31.
- Estimated payments made for every year are trued up to the utility's actual ASC for that year based on submittal of actual FERC Form 1 data.

The use of estimated numbers without a true up is contentious, creates uncertainty, and arguably departs from the NWPA. For example, the notion of using forecasted wholesale market prices as a forward-looking proxy to reflect the timing and cost of new resources in ASCs is flawed. Wholesale market prices typically reflect the marginal cost of generation, but not the capital cost of new capacity. Using market prices would understate the full costs of new resources.

¹ For each exchanging utility that is an investor-owned utility, the ASC is a rate filed by it with FERC under section 205 of the Federal Power Act and section 35.31 of the Code of Federal Regulation ("CFR").

Also for example, the notion of using forecasted loads as a forward-looking proxy for actual exchangeable loads is flawed. Further, utilities have the statutory right to sell to BPA an amount of power equal to 100% of the utility's residential loads within the region. The exchange benefits should be adjusted to match actual loads.

2. Should return on equity be included as a resource cost?

BPA REQUEST FOR FEEDBACK:

The NWPA specifically excludes the cost of terminated generating facilities that have not become operational in the calculation of the ASCs. The 1984 ASC Methodology was driven in part by BPA and other customer concerns that costs associated with terminated plant were inappropriately included in ASCs (in violation of the NWPA) because regulators could adjust the rate of return on rate base to compensate utilities for such otherwise excluded costs. In response to this concern, BPA noted in the 1984 ASC Methodology ROD that "BPA cannot agree that equity returns allowed by regulators do not include, at least tacitly, terminated plant costs and the risks of such terminations." Due to this concern, the 1984 ASC Methodology concluded that the appropriate measure of the rate of return was the embedded cost of long-term debt.

Since implementation of the 1984 ASC Methodology, conditions have changed, including the structure of state regulatory bodies and the regulatory review process. In addition, terminated plants are not as prevalent as they were in 1984 and the recovery of their costs through equity returns is less likely. In light of changing conditions, the issue has been raised whether the use of the embedded cost of long-term debt is still appropriate to reflect return on equity in ASC determinations.

RESPONSE:

Yes, the calculation of ASC for investor-owned utilities should include a return on equity. Investor-owned utilities raise funds to meet capital requirements of new and existing resources by issuing both debt and equity. The costs of capital are a legitimate and necessary cost of new resources (and are included in the rates charged to retail customers).

Since that 1984 ASC Methodology was adopted, circumstances have significantly changed, such that BPA's justification for excluding the return on equity from ASC calculations is no longer valid. Furthermore, assuming *arguendo* that the cost of equity should not be included in the calculation of ASC, the approach BPA adopted in the 1984 ASC Methodology is inequitable and fails to reflect the utility ASC. The 1984 ASC Methodology used a utility's historic cost of debt as the cost of capital based on the erroneous assumption that a utility could raise 100% debt financing at its embedded cost of debt. The rates at which utilities are able to issue debt are directly related to their respective capital structure. A utility that is 100% debt financed would be required by the market to offer significantly higher rates of interest for its debt than a utility that is capitalized by both debt and equity. The utility cost of capital that should be used is the most recent state commission determination of the weighted average cost of capital, including both debt and equity.

3. Should income and revenue related taxes be considered resource costs?

BPA REQUEST FOR FEEDBACK:

In the 1984 ASC Methodology ROD, BPA concluded that income taxes were "not resource costs within the meaning of section 5(c)" and therefore should not be included in the calculation of a utility's ASC. In developing the 1984 ASC Methodology, the issue of taxes centered on two questions: (1) are income taxes resource-related costs, and (2) does a utility exchange the taxes included in rates or the taxes paid by the utility?

BPA's rationale for excluding income taxes from ASC hinged primarily on its concern that IOUs' tax expenses not be spread among BPA's regional customers. IOUs, on the other hand, believed that wholesale rate parity requires payment of all IOU costs, including taxes. They argued that State and Federal income taxes are a necessary cost of producing power.

In deciding whether to include income and revenue related taxes in ASC, there are a number of issues to consider. Such issues include:

- *Whether income and revenue-related taxes are resource costs.*
- *Whether actual taxes paid can be substantially different from taxes included in rates.*
- *Is it appropriate to regionalize differences in state and local income tax rates?*
- *Is it appropriate to shift income taxes to non-taxable entities through the REP?*
- *Determining income taxes can be complex and time-consuming. Is there a way to make it simpler?*
- *Whether taxes are an integral part of a utility's cost of service.*

RESPONSE:

Yes, income taxes and revenue related taxes should be considered resource costs. A utility finances the construction of plant using debt and equity. The return on equity is made available through the utility's net income after taxes. Therefore, income and revenue related taxes are an integral component of resource cost and excluding these costs from ASC would be inconsistent with the NWPA.

FERC Form 1 data reflects actual income and revenue related taxes. Accordingly, reliance on such data is simple, verifiable, and avoids issues regarding any difference between actual taxes and allowances for taxes in retail rates.

The tax exempt status of preference agencies does not excuse them from paying the cost of taxes incorporated in the prices of products they purchase. Similarly, the tax

exempt status of preference agencies does not require the exclusion of income taxes from ASC.

4. Should transmission costs be considered resource costs?

BPA REQUEST FOR FEEDBACK:

In the 1984 ASC Methodology ROD, BPA concluded that:

- *Existing transmission, as defined by the FERC Uniform System of Accounts, in service as of July 1, 1984, would be included.*
- *For transmission plant commencing service after July 1, 1984, transmission plant costs which can be exchanged are limited to the:*
 - i. *lesser of the costs of transmission facilities required to transmit power from the generating resource to the exchanging utility's system or the sum of the costs of the transmission facilities required to integrate the generating resource to the BPA system and the wheeling costs necessary to wheel the power over the BPA system to the exchanging utility's system.*
- *Total costs of the facility to be exchanged shall be no greater than the facility costs that would have been incurred to interconnect with the BPA system.*
- *All wheeling revenues are credited.*

In 1996, FERC issued Order 888, which led to the separation of generation and transmission functions of all jurisdictional utilities. FERC no longer allows generation and transmission costs to be bundled in rates. BPA has voluntarily complied with this FERC initiative by separating its power and transmission functions and unbundling power rates. In light of the unbundling of BPA transmission and generation rates, the question arises whether to include transmission costs in ASC. BPA noted in the 1984 ASC Methodology ROD that there are no requirements in the NWPAs that BPA must subsidize transmission investments and expenses under the REP. However, some may argue that the purpose of transmission is to integrate resource generation to a network. The question of what constitutes transmission (load center definition, point where transmission line enters into the load area, radial lines, etc.) is another issue.

RESPONSE:

Yes, transmission costs should be included in ASC. However, the 1984 ASC Methodology raises serious issues with respect to transmission, including: i) the arbitrary “vintaging” of transmission, and ii) the complication of “subfunctionalizing” transmission costs into “integration” and “other.” In that regard, the 1984 ASC Methodology (18 CFR Part 301) footnotes include the following:

Transmission plant and the associated cost to be used in the calculation to the average system cost (ASC) are limited to:

- (1) For transmission plant in service as of July 1, 1984, transmission plant will be defined by the Federal Energy Regulatory Commission Uniform System of Accounts and will include radial transmission lines.
- (2) For transmission plant commencing service after July 1, 1984, transmission plant costs which can be exchanged are limited to transmission that is directly required to integrate resources to the transmission system grid. Specifically, transmission costs which can be exchanged are limited to the lesser of the costs of transmission facilities required to transmit power from the generating resource to the exchanging utility's system or the sum of the costs of the transmission facilities required to integrate the generating resource to the BPA system and the wheeling costs necessary to wheel the power to the exchanging utility's system. If the utility chooses to construct facilities which are more costly than the facilities required to interconnect to the BPA system, the total costs to be exchanged shall be no greater than the facility costs that would have been incurred to interconnect with the BPA system.

Section 5(c)(7) of the NWPA directs BPA to develop a methodology for calculating "the average system cost of the [participating] utility's resources" In its 1984 ASC Methodology ROD, BPA noted that, pursuant to Section 5(c)(7) of the Act, the Administrator has considerable discretion when revising the ASC methodology. BPA, therefore, concluded that it would permit inclusion in ASC of transmission costs which reflect integration of generating resources. Nothing has changed since issuance of the 1984 ASC Methodology ROD to indicate that transmission costs should be excluded from ASC. Indeed, as explained below, there exist several reasons why *all transmission costs* should be included in ASC.

Utilities have historically sited generating plants based on overall costs, including transmission. The location of a generating plant is, therefore, determined on an economic basis to evaluate total cost to customers, with transmission being a component of that evaluation. A utility, in deciding on a location for a generating plant, might locate a generating plant closer to load, thereby eliminating transmission plant investment, but, instead, investing in facilities to transport the fuel ("coal by truck"). Alternatively, a utility might determine to locate a generating plant near a coal mine and to invest in transmission plant to transmit the power generated by that plant to load ("coal by wire"), based on total cost. Elimination of transmission costs from ASC amounts to an arbitrary distinction between "coal by truck" vs. "coal by wire" and imposes a penalty on customers of an investor-owned utility that has made an economic decision to locate resources at greater distances from load.

The discriminatory effect of this penalty is particularly evident in the case of location-constrained renewable resources, such as wind, geothermal, and solar generation. These resources hold the potential for development of a significant quantity

of energy, but are not often readily accessible to existing transmission. As such, transmission costs are a significant component of the costs of these resources. For example, in order to access viable sources of wind energy, wind generation plants must often be sited far from existing transmission lines and load. The costs of transmission plant to transmit the power generated by the wind generation plant to load are necessary in order to add wind resources to utility portfolios.

Furthermore, the Federal Energy Regulatory Commission's Order No. 888 requirement to unbundle transmission and generation has no bearing on whether transmission costs should be included in ASC. Under the NWPA, BPA is tasked with developing an ASC methodology that reflects the costs of the utility's resources, a task entirely unrelated to the purpose of Order No. 888.

More fundamentally, transmission should be treated in an equivalent manner in determining ASC and comparing it to the PF Exchange Rate. There is no basis for excluding transmission cost from one and including transmission cost in the other.