June 27, 2000

TO: RTO Filing Utilities

FROM: PacifiCorp

RE: Proposal for the RTO to Use Permanent Company Rates to Recover the Costs of Pre-RTO Transmission Costs

---

I. <u>Background -- The RTO Pricing Conundrum</u>

RTO pricing has distinguished between pricing for transmission costs incurred prior to commencement of RTO operations and pricing for the costs of new transmission added after commencement of RTO operations. Most participants seem to be in agreement that the cost of new bulk transmission facilities or other measures needed to relieve congestion should be the responsibility of the entities benefiting from the congestion relief produced by such facilities or measures.

The difficult question is how to treat transmission costs (cost of transmission facilities, and wheeling revenues and expenses) that each participating transmission owner brings into the RTO. The RTO Filing Utilities and most other participants have agreed that such pre-RTO costs should be recoverable over loads, in a manner that does not burden incremental transactions with non-incremental costs. The participants also agree that in allocating pre-RTO costs to loads, we should attempt to minimize cost shifts among the participating transmission owners.

The goal of achieving acceptably small cost shifting without permanent Company Rates has proved elusive. In IndeGO, we:

A. Used allocated Area Rates to avoid the greater cost-shifting that would result from use of postage stamp rates.

B. Phased in cost shifts were over a 10-year period.

C. Provided that during the first two years, there would be no cost shifts and for the next eight years, inter-transmission owner cost shifts would be limited to 2.5 percent per year.

D. Created a complex "Island Rate" to protect certain utilities that otherwise would have faced large negative impacts. The lost revenues from the Island Rates then had to be estimated and had to be reallocated to other utilities.

E. Undertook complex and controversial data collection and modeling efforts to estimate the difference between the Company Rate and the Area Rate for each participating transmission owner.

Despite all of this effort, the IndeGO cost shifts were deemed both by some potential participating transmission owners and by some state retail regulators to be too large to be acceptable. In addition, a number of participants lacked confidence that the data collection and modeling efforts produced reliable cost comparisons.

We currently are engaged in a comparable attempt to avoid excessive cost-shifting. If anything, the modeling and data collection complexities exceed those in IndeGO, and the time for completing the task is much shorter than available in IndeGO. We have no reason to believe either that the modeling results will be deemed more credible than they were to the IndeGO participants or that the resulting cost shifts will be any more acceptable to the participants, including certain of the state retail regulators, than such cost shifts were in IndeGO. <u>In short, we are expending a huge amount of resources better used to address other RTO problems, in an ever more complex modeling effort to make transmission costs to the participating transmission owners come out as close to permanent Company Rates as possible.</u>

II. <u>Proposal -- Use Permanent Company Rates to Recover Transmission Costs Brought into the RTO</u>.

The complex and controversial pricing efforts at heart are designed to undo as much as possible the impacts on the various participating transmission owners of moving away from Company Rates. The simple solution is to retain Company Rates for the recovery of transmission costs incurred prior to the RTO, recovering the preexisting costs of each participating transmission owner over the loads now served by such transmission owner, for the remaining life of the transmission assets now in service. Such permanent Company Rates, collected over loads rather than from incremental wheeling transactions, (1) will not in any manner impair economic efficiency or market competition, (2) will make no transmission owner worse off, and (3) should greatly simplify the pricing process (resulting in a process that actually can be completed by October 15).

III. <u>An Agreement to Adopt Permanent Company Rates for Pre-RTO Transmission Costs Would Greatly Simplify the RTO Work Group Efforts</u>.

A. Almost all of the current and difficult data collection and modeling effort could be eliminated. We would agree that pre-RTO costs of each participating transmission owner would remain with that transmission owner.

B. The only component of the current model that still would have to be negotiated among the participating transmission owners would be the amounts of transfer payments to be included in the Company Rates. Each participating transmission owner currently pays and collects various amounts from other participating transmission owners either under long-term transmission agreements or for short-term transmission services. The appropriate levels of such payments and collections would need to be agreed as a fixed transfer cost component of the permanent Company Rate.

C. With Company Rates, the various participating transmission owners (including any independent transmission owner ("ITC")) would have much greater flexibility to determine on a company-by-company basis whether to provide the RTO with pricing and scheduling authority over that owner's local low-voltage transmission facilities and whether such facilities should be priced to the Company loads on a rolled-in or on a segmented basis. Under Area Rates, participating transmission owners are impacted by the treatment as to pre-RTO low-voltage costs as negotiated with the RTO by other participating transmission owners; with Company Rates each participating transmission owner is largely unaffected by how other participating transmission owners treat such low-voltage transmission costs.

D. Current controversy over the potential expansion of the RTO area by the addition of participating transmission owners located in Canada, in Colorado or in the Desert Southwest is driven primarily by cost-shifting concerns. With permanent Company Rates, any such cost shifting would be greatly reduced.

IV. But What Will FERC Say?

The FERC has a strong historic preference for rolled-in rates. Therefore, the FERC would prefer that the RTO have neither permanent Area Rates nor permanent Company rates. The FERC, however, seems to recognize that the various load-based pricing approaches for pre-RTO costs do not impact achievement of the FERC's major RTO goals. Therefore, the FERC has signaled that it will be flexible on this issue if necessary. In Order 2000, the FERC stated that it was particularly concerned if Company Rates were applied to new transmission facilities, or if Company Rates negatively impacted incentives for efficient expansion. The FERC also stated that after some fixed term, the RTO must file with the FERC recommendations as to whether the Company Rate should be modified.

> "We therefore believe that it is appropriate to allow RTOs to propose the use of license plate rates [i.e., Company Rates] for a fixed term of the RTO's choosing. However, RTOs that propose the use of license plate rates must make clear how transmission expansion will be priced, that is, whether license plate rates or some other mechanism will be applied to the cost of new transmission facilities, and how such pricing affects incentives for efficient expansion. In addition, we will require that before the end of the fixed term, the RTO must complete an evaluation of fixed cost recovery policies based on the factual situation of the particular RTO, and file with the Commission its recommendations on any changes that should be instituted. We emphasize that we are not requiring that the RTO continue or abandon the use of license plate rates at that time, but we will require the RTO to justify its choice to continue or discontinue using license plate rates, or otherwise change the method for fixed cost recovery. We believe that this approach provides participants in RTOs significant flexibility, and is consistent with the principles articulated in the open architecture requirement for RTOs."

Very recently, in an "Order Denying Petition, Without Prejudice and Providing Guidance," dated May 17, 2000 in Docket EL00-39-000, the FERC reviewed an independent system operator proposal submitted by the Southwest Power Pool, Inc., that was deficient in a number of respects. One of the features of the proposal was Company Rates to remain in effect for an indefinite time period. The order did not forbid such a pricing feature, but required an explanation of the reasons for and the economic impacts of this pricing proposal.

> "In Order No. 2000, we stated that it would be appropriate to allow RTOs to use license plate rates for a fixed term of the RTO's choosing. This does not imply that an RTO can use license plate rates indefinitely with no further explanation. Moreover, we indicated that an RTO proposal for license plate rates must make clear how transmission expansion will be priced, and how such pricing affects incentives for efficient expansion. SPP failed to comply with these requirements. Accordingly, we direct SPP to address these points when it files its subsequent RTO proposal."

Finally in an "Order Accepting for Filing and Suspending Proposed Tariff Revisions and Establishing Hearing and Settlement Judge Procedures," dated May 31, 2000 in Docket ER00-2019-000, the FERC reviewed the revised tariffs of the California ISO. The California ISO proposed load-based recovery of transmission costs that transitioned from Company Rates to postage stamp rates over a 10-year period, with a cap on annual cost increases. In response to the protests of high-cost publicly-owned transmission systems that were considering whether to participate in the RTO, the FERC sent the pricing proposal to a Settlement Judge for further consideration:

> "In conclusion, we reiterate that, at this juncture, we are not able to ascertain whether the ten-year transition period and the proposed $72 million annual cap provides the proper compromise of costs and benefits. Additionally, we recognize that our rulings on other issues may impact this compromise. Therefore, we instruct the parties, with the assistance of the appointed settlement judge, to further evaluate and consider all relevant costs and benefits and the proper context of such amounts in the selection of an appropriate transition period."

Thus, RTO West must explain the special factors that led it to the permanent Company Rate solution. These factors are compelling and relate to an RTO proposal that overall should be a superior proposal. The factors include:

A. The fact that both many participants and some state retail regulators consider the benefits from an RTO in the Northwest to be smaller than the benefits from an RTO in other parts of the country. Therefore, such parties are less willing to agree to cost shifts among participating transmission owners and among states.

B. The fact that the RTO must be approved not only by the FERC, but also by the retail regulators of seven states. Proposals other than permanent Company Rates will make receipt of all necessary approvals much more difficult. This point will carry much more force if some of the state regulators echo the point.

C. The fact that permanent Company Rates remove major opposition to the later addition to the RTO area of higher-cost transmission systems located in Canada, as well as to the east of the current RTO area and possibly in some areas of the desert Southwest.

D. The fact that permanent Company Rates will be applied so as not to impact the efficient allocation of the costs of new transmission facilities and will be part of an economically efficient transmission pricing approach, including market-based congestion clearing and minimization of rate pancaking between the RTO and interconnecting transmission systems.