



## **REQUEST FOR FEEDBACK**

### **Average System Cost Methodology**

#### **I. Background**

Section 5(c) of the Pacific Northwest Electric Power Planning and Conservation Act (NWPAA), established the Residential Exchange Program (REP). The REP was intended to provide a form of access to the benefits of the Federal Columbia River Power System to residential and small farm customers of higher cost utilities in the Pacific Northwest, primarily investor-owned utilities (IOUs). Prior to passage of the NWPAA in 1980, BPA issued a Notice of Insufficiency (NOI) to IOU customers due to a projected shortage of firm power. In response to the NOI, IOUs began construction of new thermal resources, which were much more expensive than Federal hydroelectric power. As the costs of these new thermal resources were included in retail rates, large disparities developed between retail rates paid by the IOUs' residential customers and the residential customers of publicly-owned utilities in the region. Because the amount of inexpensive Federal hydroelectric resources could not be increased, Congress provided for an "exchange" of power between the IOUs and BPA.

Under the REP, a utility may sell power to BPA at the Average System Cost (ASC) of the utility's resources. BPA then sells the same amount of power to the utility at BPA's Priority Firm (PF) Exchange rate, which is generally lower. Because the amount of power "exchanged" in section 5(c) is equal, the REP is a paper transaction. BPA makes a payment to the utility for the difference between the utility's ASC and BPA's PF Exchange rate. By statute, the utility must pass this benefit on directly to its residential and small farm customers. Thus, the ASC-based rate, compared to BPA's PF Exchange rate, determines the level at which the residential customers participate in sharing the benefits of low-cost Federal power.

The first ASC Methodology was developed in consultation with the region in 1981. It was later revised in 1984 under contentious conditions. The 1984 ASC Methodology has been used in calculating REP benefits since that time. ASC calculations have been contentious and labor intensive under the 1984 ASC Methodology. Prior to BPA's WP-02 power rate proceeding, BPA sought to resolve REP disputes by offering REP Settlement Agreements (Settlement Agreements) to the IOUs. These Settlement Agreements were challenged in the U.S. Court of Appeals for the Ninth Circuit. On May 3, 2007, the Court held that the Settlement Agreements executed by BPA and the IOUs and other were unlawful.<sup>1</sup>

If the Court's opinions are ultimately upheld, then BPA must be prepared to reinstitute the REP by offering Residential Purchase and Sale Agreements (RPSAs) to IOUs and other eligible utilities. In addition to the RPSAs, BPA is conducting a consultation to revise the ASC Methodology concurrent with BPA's reconsideration of the section 7(b)(2) rate test.

Section 5(c)(7) of the NWPAA requires that the "average system cost" for electric power sold to the Administrator under this subsection shall be determined by the Administrator on the basis of a methodology developed for this purpose in consultation with the [Northwest Power and Conservation] Council, the

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<sup>1</sup> *Portland General Elec. Co. v. Bonneville Power Admin.*, --- F.3d ----, 2007 WL 1288786 (9th Cir. 2007).

Date: October 10, 2007

Purpose/Subject: Request for Feedback on ASC Methodology Issues

Legal Disclaimer: For Discussion Purposes Only



Administrator's customers, and appropriate State regulatory bodies in the region." The ASC Methodology is subject to review and approval by the Federal Energy Regulatory Commission. The NWPA also stipulates three specific costs that are not to be included in the calculation of a utility's ASC.

The three omitted costs are:

1. the cost of additional resources in an amount sufficient to serve any new large single load of the utility;
2. the cost of additional resources in an amount sufficient to meet any additional load outside the region occurring after the effective date of the NWPA; and,
3. any costs of any generating facility which is terminated prior to initial commercial operation.

16 U.S.C. § 839c(c)(7).

As stated previously, the development of the 1984 ASC Methodology was very contentious with strong opinions expressed on many issues. Over time some of these issues have continued to be contentious and new issues have emerged as the electric utility industry has continued to change. Due to previous REP settlements, BPA has not had to implement the REP for some time, and many of these issues have not been revisited or addressed in more than ten years. Now that BPA is preparing to reinstitute the REP, it is timely to look at these issues again in light of the changing conditions of the industry.

## **II. The Consultation Process**

As BPA explores possibly revising the ASC Methodology, it is requesting feedback on some key issues it is reviewing. The Administrator will formally review the ASC Methodology in BPA's upcoming consultation process. In a concurrent process, the Administrator will be formally reconsidering both the Section 7(b)(2) Legal Interpretation and Section 7(b)(2) Implementation Methodology in BPA's upcoming power rate proceeding. Both methodologies are key components in determining the level of benefits that will be paid to utilities participating in the REP.

In consultation with interested parties in the region, including customers, the Council, and appropriate State regulatory bodies, BPA will accept comments on the proposed new ASC Methodology. In addition to written comments, BPA will conduct meetings and offer interested parties an opportunity for oral arguments before the Administrator prior to issuing a new ASC Methodology and a final Record of Decision.



### III. Issues

BPA is seeking feedback on the following issues. This list is not exclusive and feedback on any additional issues is welcome.

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

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.

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

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

Date: October 10, 2007

Purpose/Subject: Request for Feedback on ASC Methodology Issues

Legal Disclaimer: For Discussion Purposes Only



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.

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

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.

### **4. Should transmission costs be considered resource costs?**

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

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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 NWPA 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.

**5. Any other issue you wish to comment on.**