Service Date: July 27, 1998

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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| IN THE MATTER of the Application of PACIFICORP for Approval of its Electric Utility Restructuring Transition Plan Filed Pursuant to Senate Bill 390 | ) ) ) ) | UTILITY DIVISION<br><br>DOCKET NO. D97.7.91<br>ORDER NO. 5987f |

## ORDER ON RECONSIDERATION

## BACKGROUND

1. The Montana Public Service Commission (Commission) conducted a public hearing on May 19, 1998, on PacifiCorp's transition plan, PacifiCorp Docket No. D97.7.91, on the issue of large customer choice, the first of two hearings scheduled in this Docket. Senate Bill 390 (now codified at Title 69, Chapter 8, Montana Code Annotated) required customers with usage at 1,000 kilowatts to have choice on July 1, 1998. On June 18, 1998, the Commission issued Order No. 5987e, Order Implementing Large Customer Choice on July 1, 1998. The second hearing on the remaining issues was scheduled to begin August 25, 1998, in Kalispell, Montana.

2. On June 30, 1998 and July 2, 1998, the Department of Environmental Quality and the Northwest Power Planning Council (jointly, DEQ/NPPC) and Plum Creek Timber Company, L.P., (Plum Creek) respectively filed Motions for Reconsideration. In their requests for reconsideration, Plum Creek and DEQ/NPPC maintained that the Commission's Order would prevent competition from developing, contrary to the intent of Senate Bill 390.

3. DEQ/NPPC requested that the Commission reconsider its decision in ¶ 55, in which the Commission established a residual calculation for distribution revenues, and instead order separate cost-based rates for each function. DEQ/NPPC also requested that the Commission remove the last sentence of ¶ 55, maintaining that this sentence established a rate freeze, not a rate cap. DEQ/NPPC asked for elimination of ¶ 39, which it sees as a handicap to remedying mistakes in Order No. 5987e when issuing the Final Order after the August hearing. Finally, DEQ/NPPC asked the Commission to issue an indication of whether DEQ/NPPC's comments

and recommendations, especially on the use of residuals, were considered and why they were or were not accepted.

4. Plum Creek requested that the Commission reconsider and modify its Order No 5987e as it pertains to unbundled production and distribution costs, i.e., to set unbundled costs to reflect the actual costs for the regulated distribution service.

## FINDINGS AND DISCUSSION

5. In Order No. 5987e, the Commission considered recommendations from Plum Creek Timber and PacifiCorp on how to unbundle current tariffed rates into separate functional components. The primary disagreement between Plum Creek and PacifiCorp on unbundling rates involved allocating "residual" revenues produced by current, bundled rates not attributable directly to embedded, allocated production, transmission or distribution costs. The underlying assumption in the Order, as in the methods proposed by Plum Creek and PacifiCorp, is that the sum of the functionally separated rate components must equal the current tariffed rates. PacifiCorp's method assigned responsibility for the residual to the unbundled distribution rate component. Plum Creek's preferred method assigned responsibility for the residual to the unbundled production rates. Alternative methods proposed by Plum Creek apportioned responsibility for the residual among both the unbundled production and distribution rate components.

6. The Commission determined that it is important to set unbundled production rates that will encourage economically efficient initial supply choices (FOF 47). The Commission identified several possible production rate benchmarks from the record, including estimates by PacifiCorp of long-run marginal costs, by Montana Consumer Counsel (MCC) of seller's market clearing prices and by Plum Creek of "realistic" long-run marginal costs (FOF 48). Ultimately, the Commission used PacifiCorp's estimated long-run marginal costs as the appropriate benchmark. The Commission chose not to use MCC's market clearing prices because of on-going disputes over the model that produced those prices. However, the Commission indicated that such prices may approximate relevant opportunity costs and could be an appropriate benchmark for unbundled production rates. Plum Creek suggested that more realistic long-run marginal costs might be $26-35 per mWh, but also agreed to accept PacifiCorp's marginal costs as reasonable for purposes of this proceeding (Tr. 135).

7. The Commission rejected PacifiCorp's method for unbundling tariffed rates because it produced an unbundled production rate below its estimated long-run marginal costs. The Commission stated that long-run marginal cost appropriately reflects the cost to society of providing the supply service customers are currently receiving, representing an appropriate cost and price against which new entrants should compete and customers considering market alternatives should compare offers (FOF 50). The Commission rejected Plum Creek's preferred method because it produced an unbundled distribution rate component below PacifiCorp's estimated long-run marginal cost. Plum Creek's preferred method also produced an unbundled production rate component that exceeded several of the relevant benchmarks.

8. The Commission chose to unbundle tariffed rates by modifying PacifiCorp's method to produce an unbundled production rate component that is at least as high as the estimated long-run marginal production costs. The Commission indicated its uncertainty over PacifiCorp's marginal costs, absent a comprehensive cost-of-service proceeding, and also noted the subjectivity of using a cost higher than what PacifiCorp's cost study produced, given Plum Creek's acceptance of those costs and the large range of possible alternatives (FOF 53-54).

9. Finally, the Commission determined that there should be no shifting of revenue requirements between the individual cost functions as a result of the hearing on remaining restructuring issues. The Commission stated that large customers would face more uncertainty if, in addition to unknown competitive transition charges, the unbundled distribution and transmission rates would be subject to change.

Summary of Plum Creek and DEQ/NWPPC Motions

10. DEQ/NPPC asserted that the Commission's rate design decision erects a high barrier to competition. According to DEQ/NPPC, the Order results in distribution rates several times higher than embedded and marginal distribution costs and generation rates lower than they should be. DEQ/NPPC maintained that the residual method used in the Order artificially lowers the threshold rate that alternative suppliers must beat to attract PacifiCorp's customers. Without the possibility of profitable marketing alternatives, suppliers will not contest PacifiCorp's market and apply pressure to its supply function, contrary to the intent of Senate Bill 390. DEQ/NPPC asserted that the residual method guarantees PacifiCorp fixed level of revenues in violation of Senate Bill 390.

11. DEQ/NPPC challenged the Commission's goal of setting a correct price signal for the unbundled production rate component stating that the market will set the appropriate price signal. According to DEQ/NPPC, the Commission should set a correct price signal for distribution, use FERC transmission rates and set a cost-based production price for customers who do not choose. DEQ/NPPC maintained that the Commission established an arbitrary production rate and used a method that is inconsistent with the method adopted in its Order on Tier 1 Issues in MPC Docket No. D97.7.90. DEQ/NPPC further maintained that FOF 47 is incorrect in that there is a difference in how much total distribution revenues are collected under Plum Creek's and PacifiCorp's methods.

12. Plum Creek asserted that the Commission's decision ignores long-run distribution costs, resulting in an excessively high, unbundled distribution rate component unsupported by the record. Plum Creek asked the Commission to take notice of the unbundled distribution rates established in the Order on Tier 1 Issues in MPC Docket No. D97.7.90. Plum Creek maintained that while the costs of providing distribution service on MPC's system are not direct evidence of PacifiCorp's distribution costs, the disparity between the distribution rates established in the two cases is unreasonable. Plum Creek stated that because the Commission's decision only focused on production costs the residual distribution rate reflects non-distribution-related costs such as PacifiCorp's "Montana transmission" costs.

13. Plum Creek claimed that the distribution charge was substantially overstated and would prevent competition altogether. A customer or alternative supplier must not only beat the commodity price, but also overcome the additional barrier of the subsidy that flows to the incumbent utility from the overstated distribution charge. According to Plum Creek, PacifiCorp would remain a monopoly, not because it offered a better supply price but because of a subsidy in its regulated distribution charge.

14. According to Plum Creek, the distribution rate in excess of actual costs is unreasonable, unjustly discriminatory and inconsistent with the requirement in Senate Bill 390 that all suppliers, transmission service providers and customers have nondiscriminatory and comparable access to distribution facilities. The overstated distribution charge denies customers practical access to the market. Plum Creek maintained that the unbundled distribution rate is also inconsistent with the core purpose of Senate Bill 390 to promote competition. Competition and cus-

tomer choice is not only about traditional price signals and allocative efficiency, but also about dynamic efficiencies which competition promotes.

15. Plum Creek asserted that the Commission's concern for an appropriate unbundled production rate is misplaced because the market will send the relevant production price signal. If the unbundled production rate component is overstated, the market will correct the price signal since PacifiCorp can bid against competitors down to its actual cost. Plum Creek maintained that the market cannot correct an understated production rate component.

16. There would be no unfair disadvantage to PacifiCorp in limiting distribution charges to cost of service and requiring the Company to compete against market prices on the production component, as intended by Senate Bill 390, according to Plum Creek. Thus, rather than being inappropriate for PacifiCorp to recover fewer revenues from the production rate component under competition, it would be far more inappropriate for PacifiCorp to collect substantially more revenues from distribution rates than it costs to provide that service. If PacifiCorp believes that the unbundled distribution rate components are not adequate, Plum Creek suggested that PacifiCorp might file a comprehensive cost of service case, which is a remedy not available to customers and competitors.

17. Plum Creek disagreed with FOF 47. Plum Creek stated that its methods do differ from PacifiCorp's in how much total distribution revenue is collected. Dr. Rosenberg's Method B would collect $16.3 million, while PacifiCorp's method would collect $17.5 million. Plum Creek also requested that the Commission change its decision that there be no shifting of functional revenue requirements following a hearing on remaining restructuring issues.

18. Plum Creek stated that it conditioned its acceptance of PacifiCorp's estimated marginal costs on the use of those marginal costs as a starting point for determining unbundled rate components. Plum Creek's methods take into account both production and distribution costs to allocate residual revenues. Plum Creek asserted that both its Methods B and D are viable alternatives for allocating the residual revenues which reasonable reflect evidence of distribution costs, while conforming to the Commission's principle that the production component should be at least as high as long-run marginal costs.

Allocation of Residual Revenues in Rate Unbundling

19. As explained in the Order, the currently tariffed rates for the large industrial customer class generate revenues that exceed what PacifiCorp estimated to be the embedded, allocated and marginal costs of serving these customers. The residual revenues generated by current rates are primarily responsible for the debate over how to set unbundled tariffed rates in preparation for customer choice. This debate, the Commission's attempt to establish reasonable unbundled tariffs and the subsequent Motions for Reconsideration painfully illustrate the importance of verifying, through a comprehensive rate case, a utility's revenue requirement, class cost of service and rate design before attempting to unbundle tariffs. The restructuring timetable in Senate Bill 390 did not allow for a comprehensive rate case for PacifiCorp.

20. DEQ/NPPC asserted that the Order does not indicate that the Commission considered DEQ/NPPC's recommendation against the use of residuals. DEQ/NPPC's testimony and its Motion suggest that the unbundled distribution and production rate components should be based on cost and transmission should reflect FERC approved rates. However, DEQ/NPPC did not introduce into evidence any specific unbundled rates for consideration, or specify which costs to use in setting unbundled rate components, embedded costs or marginal costs. Without a comprehensive rate case, there is no record to support unilaterally reducing tariffed rates. Therefore, the sum of the unbundled rate components must equal current tariffed rates. This does not guarantee PacifiCorp any level of revenues, as DEQ/NPPC stated. The unbundled rate components established by the Order comply with Senate Bill 390's requirement that rates not exceed those in effect on of July 1, 1998.

Efficient Price Signals and Barriers to Competition

21. DEQ/NPPC and Plum Creek both maintained that the Order unnecessarily focused on setting an economically appropriate unbundled production rate component, because unregulated supply markets would convey appropriate price signals. DEQ/NPPC stated that the production rate components produced by the Order are lower than they should be and artificially reduce the threshold rate that suppliers must beat.

22. The Commission determines that it properly attempted in the Order to convey economically correct price signals in unbundled production rates. The purpose of unbundling tar-

iffed rates is to promote the development of retail electricity supply markets which do not exist now. Unbundled production rates reflect regulated supply service available to customers that have not chosen an alternative supplier during the transition period. Market prices will reflect unregulated supply service that does not necessarily have the same service characteristics as regulated supply service (e.g., price stability, reliability, firmness, and term). Unbundled production rate components should facilitate efficient decisions by customers considering market-based supply service. Customer decisions based on improper signals could lead to short-term inefficiency and a market structure that is not sustainable. Initial market distortions could interfere with the Commission's ability to accurately evaluate the status of workable competition.

23. DEQ/NPPC did not cite any evidence to support its assertion that the unbundled rate component adopted in the Order artificially reduces the price alternative suppliers must beat below what it should be. DEQ/NPPC's Motion and prefiled testimony seem to support a cost-based production rate component (DEQ/NPPC Motion, p. 3, June, 1998, Testimony of Alan Davis, p. 3), but DEQ/NPPC did not specify which costs should be used or propose specific unbundled rates.

24. Montana typically ranks among those states with the lowest electricity rates. PacifiCorp's Montana retail rates are lower than those of other Montana investor-owned utilities. PacifiCorp's annual reports and press releases routinely characterize the Company as one of the lowest cost electricity providers in the United States, which Plum Creek used to support its argument that PacifiCorp has negative stranded costs (January, 1998, Testimony of Dr. Alan Rosenberg, p 8). DEQ/NPPC agreed that PacifiCorp might have negative stranded costs (June, 1998, Testimony of John Goroski, p. 4). Although the Commission has not decided stranded cost issues, by definition a low cost utility with negative stranded costs should have an unbundled production rate lower than estimates of the average market prices used to determine stranded costs. It is contradictory to assert that PacifiCorp's production costs are low enough to result in negative stranded costs and then suggest that unbundled production rates based on those costs should be increased in order to improve the attractiveness of alternative suppliers to PacifiCorp's customers.

25. Plum's Creek position, not supported by the record, was that the high distribution rate that would result from the Order would create a barrier to entry by allowing PacifiCorp to maintain its monopoly, not because it can offer a better price, but because of a subsidy from the dis-

tribution charge. Although the Order would result in most of the residual revenues being recovered in unbundled distribution rates, Plum Creek acknowledged that the functional identity of the residual revenues is unknown (May, 1998, Testimony of Dr. Alan Rosenberg, p. 19). Furthermore, the unbundled production rate component would cover PacifiCorp's allocated embedded costs and estimated long-run marginal costs. Plum Creek accepted these costs as reasonable for purposes of this case.

26. A distribution charge that exceeds distribution costs is not necessarily a barrier to competition in electricity supply. Even if the Commission eliminated the residual altogether, alternative suppliers would still have to compete against PacifiCorp's low unbundled production rates. In fact, if the entire residual were eliminated, the unbundled production component could be even lower, since the long-run marginal production cost-based rate adopted in the Order exceeds allocated embedded production costs for the large industrial class.

27. If PacifiCorp's cost studies are correct, DEQ/NPPC's and Plum Creek's proposals would encourage market entry by artificially inflating the unbundled production component with residual revenues. However, if PacifiCorp's estimated marginal production costs are understated, the Order could result in a barrier to entry. The Order acknowledged a degree of uncertainty concerning the accuracy of PacifiCorp's cost estimates, given the absence of a comprehensive cost of service study. Plum Creek correctly stated that it would be much more difficult for markets to overcome an incumbent's understated production rates than correct for overstated rates. PacifiCorp could file to increase regulated rates if residual revenues allocated to production rates and lost through customer choice adversely affected regulated distribution revenues. An upward adjustment to the unbundled production rates could better guarantee that an unintended barrier to competition is not created if PacifiCorp's cost estimates are wrong.

Alleged Unreasonable, Unjustly Discriminatory and Illegal Unbundled Tariffed Rates

28. Plum Creek maintained that the Order's unbundled distribution rates are unreasonable, unjustly discriminatory and inconsistent with Senate Bill 390 because they substantially exceed estimated distribution costs. The Commission determines that the Order's unbundled distribution rates are not unreasonable or unjustly discriminatory. The distribution rates would not recover more revenues from customers who continue service from PacifiCorp than the existing bundled tariffed rates previously determined to be just and reasonable, in which the resid-

ual is embedded. Before making adjustments to existing rates, the Commission must conduct a comprehensive rate case to verify the amount of any residual and individual class costs of service to determine whether rates are unreasonable or unjustly discriminatory.

29. The Order focused on establishing a cost-based production rate component rather than a cost-based distribution rate component, which would lead to an unbundled distribution rate for the large general service class that exceeds estimated distribution costs. As discussed in paragraphs 21 through 26, the Commission's focus is justified in order to promote an efficient and orderly transition to market-based electricity supply service. Ideally, comprehensive revenue requirements and class cost of service / rate design case should have preceded PacifiCorp's restructuring, which was not allowed under the timetable in Senate Bill 390. The fact that unbundled distribution rates for the large general service class exceed the allocated embedded costs in this proceeding is not unjustly discriminatory in violation of §69-3-330, MCA, since there has been neither a hearing nor due investigation of unbundled distribution revenue requirements and class cost of service. Under Senate Bill 390, the Commission retains its statutory authority to set cost-based distribution rates on an on-going basis, after properly conducted, public proceedings pursuant to Title 69, Chapter 3, MCA. In addition to a rate hearing conducted on the petition of a public utility, the Commission also could consider whether rates are unjustly discriminatory on the complaint of a customer such as Plum Creek.

Senate Bill 390's Purpose of Promoting Competition

30. Plum Creek asserted that the unbundled distribution charge is contrary to Senate Bill 390's core purpose of promoting competition because it handicaps customers in exercising choice and suppliers wishing to compete. Plum Creek's assertion could be true if the unbundled distribution rate recovered production-related costs. However, the residual revenues allocated to the distribution rate were not functionally defined, and the costs that formed the basis for the production rate were not disputed. A cost-based, unbundled production rate should signal opportunities to only those new entrants who can truly apply competitive pressures leading to dynamic efficiency gains through innovation and increased productivity, which is consistent with the core purpose of SB 390 and is the purpose of the Commission's Order.

Differences in Total Distribution Revenue Collected

31. Plum Creek and DEQ both asserted that finding of fact 47 is incorrect. DEQ stated there is a difference between the distribution revenues collected by PacifiCorp's and Plum Creek's methods. Plum Creek stated that Dr. Rosenberg's Method B collects $16.3 million of distribution revenue compared to PacifiCorp's $17.5 million proposal. The Order's finding is correct. Plum Creek's Method A would produce distribution revenues of $17.503 million, while PacifiCorp's method would produce $17.642 million, a difference of less than one percent. There is about an eight-percent difference between Plum Creek's Method B and PacifiCorp's method. In contrast, distribution revenues collected from the residential class under Plum Creek's Method A would be 34 percent higher than those collected under PacifiCorp's method, and distribution revenues collected from the Large General Service class about 30 percent of those collected with PacifiCorp's method. The disparity in who pays under these alternative methods is more significant than the disparity in the total distribution revenues collected, especially without a comprehensive investigation of PacifiCorp's revenues and class cost of service.

Functional Revenue Shifts Following Hearing on Remaining Issues

32. Both DEQ and Plum Creek asked the Commission to reconsider its decision that there should be no shifting of revenue requirements among functions as a result of the hearing on the remaining restructuring issues in this case (FOF 39). This decision was intended to reduce the uncertainty facing large customers in the interim period before stranded cost issues were finally decided. Given the level of disagreement over appropriate rate unbundling, the Commission grants this request.

## DECISION ON RECONSIDERATION

33. On reconsideration, the Commission modifies its determination on the appropriate unbundled rate design. In Order No. 5987e, the approach the Commission adopted for unbundling tariffed rates appropriately focused on production rates. The resulting unbundled rates were supported by record evidence and not unlawful. Whether the rates would actually support the intended purpose of Senate Bill 390 and promote competition in supply markets, however, would depend on whether the cost information in the record was accurate and whether alternative suppliers could compete against PacifiCorp's production costs.

34. The Commission agrees with Plum Creek that if the unbundled production rate is set incorrectly, developing markets might be hampered less if the rate is set too high than if it is set too low. Plum Creek accepted PacifiCorp's cost studies in this proceeding. However, there has not been a comprehensive rate case to verify those studies. Therefore, the unbundled production rate could be based on incorrect estimates of long-run marginal costs. Increasing the production rate component may reduce the potential for an unintentional market barrier. In weighing and balancing these concerns, the Commission determines that it will select a number within the range proposed on the record that will be less likely to create a market barrier than the production rates established in Order No. 5987e.

35. On reconsideration, the Commission sets the production rates equal to an effective per unit rate of 24 mills/kWh. This effective rate is within the range of PacifiCorp's forecast of embedded production costs used in its stranded cost calculations and within the range of market clearing prices estimated by MCC. As indicated in Order 5987e, retail market clearing prices may reflect PacifiCorp's relevant opportunity costs, which may be an appropriate price signal. With an effective per unit production rate of 24 mills/kWh, there is a greater sharing of the residual revenues between production and distribution rates. This result is more in accord with the Commission's Order on Tier 1 Issues in MPC Docket No. D97.7.90.

## CONCLUSIONS OF LAW

1. All Findings of Fact are incorporated in this Order as Conclusions of Law.

2. PacifiCorp furnishes electric service for consumers in the State of Montana and is a public utility under the regulatory jurisdiction of the Montana Public Service Commission. The Commission properly exercises jurisdiction over PacifiCorp's rates and operations. §§ 69-3-101 and 102, MCA.

3. The Commission exercises authority over public utilities and the electric utility industry restructuring pursuant to its authority under Title 69, Chapter 8, MCA (Senate Bill 390 or "Electric Utility Industry Restructuring and Customer Choice Act").

4. The Commission provided adequate public notice of all proceedings and an opportunity to be heard to all interested parties in this Docket. §§ 69-3-303, 69-3-104, and 69-8-202, MCA; and Title 2, Chapter 4, MCA (Montana Administrative Procedures Act).

5. Customers with individual loads greater than 1,000 kilowatts and for loads of the same customer with individual loads at a meter greater than 300 kilowatts that aggregate to 1,000 kilowatts are entitled to choice of electricity supply on or before July 1, 1998. The Commission properly exercised its jurisdiction in bifurcating the public hearings to implement Senate Bill 390 to enable choice for those customers entitled to choice on July 1, 1998. § 69-8-201, MCA.

6. The Commission properly exercises jurisdiction in setting unbundled rates for production (supply) as part of the process of approving a utility's transition plan and implementing choice. The Commission has on-going jurisdiction and regulatory oversight over public utility distribution and transmission services, for which it must establish just and reasonable rates through established ratemaking principles. §§ 69-8-403, MCA.

## ORDER

THE MONTANA PUBLIC SERVICE COMMISSION HEREBY ORDERS: The Motions for Reconsideration of DEQ/NPPC and Plum Creek Timber Company are granted in part as described herein. PacifiCorp shall file productions rates equal to an effective per unit rate of 24 mills/kWh.

DONE AND DATED this 23rd day of July, 1998 by a vote of 5-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

_____
DAVE FISHER, Chairman

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NANCY MCCAFFREE, Vice Chair

_____
BOB ANDERSON, Commissioner

_____
DANNY OBERG, Commissioner

_____
BOB ROWE, Commissioner

ATTEST:

Kathlene M. Anderson
Commission Secretary

NOTE: You may be entitled to judicial review in this matter. Judicial review may be obtained by filing a petition for review within thirty (30) days of the service of this order. Section 2-4-702, MCA.