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Idaho Public Utilities Commission
Office of the Secretary
RECEIVED
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Boise, Idaho
R. Salter

November 9, 1990

Myrna J. Walters
Commission Secretary
Idaho Public Utilities Commission
472 W. Washington
Boise, ID 83702

Re: Direct Prepared Testimony of Don Reading
Case No. [redacted]
Case No. [redacted]

Dear Ms. Walters:

Enclosed are the originals and nine copies of the above referenced Direct Prepared Testimonies on behalf of the Industrial Customers of Idaho Power. Would you please file the same? The original testimony in each case is for the Reporter.

If you have any questions concerning this filing, please do not hesitate to contact me.

Sincerely,

DAVIS WRIGHT TREMAINE

Peter J. Richardson

PJR/np

Enclosures

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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF IDAHO POWER COMPANY FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY FOR THE RATE BASING OF THE MILNER HYDROELECTRIC PROJECT OR IN THE ALTERNATIVE A DETERMINATION OF EXEMPT STATUS FOR THE MILNER HYDROELECTRIC PROJECT	)	CASE NO. IPC-E-90-8

DIRECT PREPARED TESTIMONY OF DON READING, PH.D.
ON BEHALF OF THE INDUSTRIAL CUSTOMERS OF IDAHO POWER

NOVEMBER 9, 1990

Q. WOULD YOU PLEASE STATE YOUR NAME AND ADDRESS?
A. Don Reading, 1311 North 18th Street, Boise, Idaho 83702.
Q. DO YOU HAVE AN APPENDIX THAT DESCRIBES YOUR EDUCATIONAL AND OCCUPATIONAL HISTORY AND YOUR QUALIFICATIONS IN REGULATORY AND UTILITY ECONOMICS?
A. Yes. Appendix I, attached to my testimony, was prepared for this purpose.
Q. DO YOU HAVE AN EXHIBIT WHICH SUPPORTS YOUR TESTIMONY?
A. Yes. I have an exhibit consisting of one schedule which was prepared under my supervision.
Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?
A. Our firm was retained by the Industrial Customers of Idaho Power (ICIP) to ~examine the request of Idaho Power Company (the Company) for a Certificate of Public Convenience and Necessity (CPCN) concerning the Milner hydroelectric project. My testimony has five sections. First, I briefly describe my understanding of the Company's request. Second, I discuss the problems with

the request and with the rate basing of the Milner project. Third, I address the Company's alternative proposal. Fourth, I suggest some methods of evaluating the project once it is completed and on line. Fifth, I state my recommendations and conclusions.

Q. LET'S TURN TO THE FIRST SECTION OF YOUR TESTIMONY. WOULD YOU PLEASE DESCRIBE THE COMPANY'S REQUEST?

A. Certainly. The Company's CPCN Application sets forth its rather unique request. Specifically, it asks to ... be issued a Certificate of Public Convenience and Necessity for the Rate Basing of the Milner Hydroelectric Generation Facilities ... and for recognition of the Milner royalty and debt service payments made to the Twin Falls Canal Company and the North Side Canal Company, Ltd. ... as revenue requirement expenses. [Application, p. 2.]

Q. IS THAT THE EXTENT OF THE COMPANY'S REQUEST?

A. No. In case the Commission denies the initial request, Idaho Power Company has an alternative proposal: that it be granted exempt status for the Milner project for a period of 20 years from the date of commercial operation to allow the Company to enter into a long-term sale of energy to another utility.

Q. LET'S TURN TO THE SECOND SECTION OF YOUR TESTIMONY. WHAT IS UNUSUAL ABOUT THE COMPANY'S PROPOSAL CONCERNING THE CPCN AND RATE BASING OF MILNER?

A. The Company's proposal departs from usual practice in asking for approval of rate base treatment at the time the CPCN is issued, rather than when the project has been completed or is nearing completion. It wants rate base approval for the Milner project prior to the start of construction. In return, the Company will agree to "cap" the capital cost of the project at $63,350,600, barring several uncertainties.

The key to Idaho Power's approach is its interpretation of the meaning of a CPCN, as described by Company witness Mr. Baggs:

The issuance of a Certificate of Public Convenience and Necessity is a determination by the Commission that the decision to construct the project is reasonable and prudent, and that such construction is in the public interest. If the Company utilizes reasonable and prudent construction practices, the issuance of the Certificate is recognition that the investment, upon completion of construction, is in the public interest and will be rate based for revenue requirement purposes. [Baggs Direct Testimony, p. 5.]

Q. DO YOU SEE ANY PROBLEMS WITH THE COMPANY'S PROPOSAL AND ITS UNDERSTANDING OF WHAT IS IMPLIED BY THE ISSUANCE OF A CPCN?

A. Yes. I see several serious problems. First, Mr. Baggs' interpretation of the CPCN's purposes runs counter to established usage. Second, the Company's <u>quid pro quo</u> of a "cap" of the construction expenditures is one-sided and has little value in determining the prudent cost of the plant or the amount that should be included in rate base. Third, the Company's proposal, if adopted, would shift most of the risks of construction onto ratepayers. Risk shifting, without some compensating factors, would be unfair to Idaho

Power's customers and is therefore not in the public interest.

Q. LET'S DISCUSS EACH OF THESE PROBLEMS SEPARATELY. WOULD YOU BEGIN BY ADDRESSING MR. BAGGS' INTERPRETATION OF THE MEANING AND PURPOSE OF A CPCN?

A. Yes. Mr. Baggs claims that issuance of a CPCN for construction of the Milner project will document the Commission's determination that construction is reasonable and prudent and in the public interest. He further claims that if a CPCN is issued and the Company uses reasonable and prudent construction practices, the project itself will be in the public interest and upon completion should be rate based for revenue requirement purposes.

Q. DO YOU AGREE WITH MR. BAGGS' ASSERTIONS?

A. No. Mr. Baggs' view of the implications of a Certificate is overly broad. First, as its decision concerning the Valmy plant makes clear, the Commission does not interpret the issuance of a CPNC as a requirement to proceed with construction and/or a guarantee that the completed project's costs will be included in rate base, regardless of the circumstances.

In the Valmy case the Company argued that because the Commission had granted Idaho Power a Certificate for Valmy I and II, the Company was compelled to build both units. Idaho Power argued that even though the plant's power production was excess capacity, this fact was irrelevant, because a Certificate had been issued. [Idaho Public Utilities Commission, Order No. 20610, p. 94.] Although the Commission did not speak directly to the issue of the Company's understanding of the meaning of a CPNC, it rejected Idaho Power's argument. The Commission found that "Idaho Power's share of the Valmy II generating plant is not used and useful in the service to Idaho ratepayers." [Ibid., p. 103.]

Q. WHAT DID THE COMMISSION CONCLUDE?

A. In determining the amount of Valmy II's costs to be recovered from ratepayers, the Commission concluded that a portion of those costs--specifically the equity return on the investment--should be absorbed by stockholders, not ratepayers, until the plant became used and useful. [Ibid., p. 107.] Clearly, if the Commission had viewed the issuance of a CPNC as a guarantee that a plant's construction costs would be included in rate base, assuming "reasonable and prudent construction practices," it would not have ordered the disallowance concerning Valmy, where the question of prudent construction practices was not at issue.

Q. WHAT IS YOUR NEXT CONCERN ABOUT MR. BAGGS' UNDERSTANDING OF THE MEANING OF ISSUANCE OF A CPNC?

A. Acceptance of Mr. Baggs' notion of a CPNC as a sweeping mandate would effectively free the Company from accountability to the Commission during construction, even though much could happen after the CPNC was issued and before the project was completed--events that would warrant that management alter its course of action. For example, changes in load growth might dictate slow-up, speed-up, or complete abandonment of construction, either to meet increased load or to avoid installing excess capacity. Or technological progress might call for canceling the Milner project and replacing it with a more cost-effective alternative. Or heightened environmental restrictions might impose an intolerable burden of added cost on the Milner project, destroying its economic feasibility.

Any of these events, as well as others, should invite the Company to reevaluate its initial construction decision and possibly reverse or modify it. Yet, under the Company's definition of a CPNC, such events would be irrelevant to the determination of the plant costs to be included in rate base and paid for by ratepayers. Instead, that issue would be judged solely according to whether or not the Company had used "prudent and reasonable construction practices." If Idaho Power was deemed to have done so, by its argument it would be allowed full recovery of the cost of the Milner project, regardless of any economic, financial, technological, environmental, or regulatory events that might otherwise call for alteration of the Company's initial decision.

Therefore, I reject Mr. Baggs' interpretation of the meaning of a CPNC. Instead, I agree with Staff's interpretation in case U-1006-265 that the issuance of a CPNC is an authorization by the Commission for the Company to begin construction, not a requirement that construction commence, nor a certification that the decision to start construction was prudent. [Ibid., p. 101.]

Q. WHO DECIDES THE MEANING OF A CERTIFICATE OF CONVENIENCE AND NECESSITY, AND WHAT FACTORS ARE SALIENT FOR DETERMINING THE RATE BASING OF A GENERATING FACILITY?

A. Ultimately it is the Commission that must determine the precise meaning of the issuance of a CPNC. If it follows Staff's interpretation in Case U-1006-265, then no decision on rate basing is called for at this time. If it construes the issuance of a Certificate as an endorsement of the prudence of the decision to begin construction, then I believe that the Commission should reject the Company's application.

The Company has not provided evidence in its filing that would allow the Commission to determine the reasonableness or prudence of the Company decision to build Milner. For that the Commission would need a substantial amount of additional information concerning this plant and alternative forms of generation. For example, the Company should have provided information showing the Milner project to be the least costly alternative available to ratepayers. While I do not dispute the many advantages of hydro projects over other forms of generation, those benefits should not be the sole basis upon which the determination is made. The Company has presented no evidence that the construction of Milner is less costly than installation of demand-side management measures, nor has it presented any evidence concerning the need for this project.

Numerous other questions concerning the construction of this project remain unanswered that demand a thorough analysis on the part of Staff and intervenors as well as the Commission and should precede any determination of prudence. For example, the Company has not explained the rationale behind its 5% contingency factor, nor has it explained in any detail the other components of its "commitment estimate." The Company is equally uncommunicative as to how it determined that the estimated cost of this project is between 37.80 and 52.93 mills per kwh.

Q. ARE THERE OTHER UNCERTAINTIES ASSOCIATED WITH THE MILNER PROJECT THAT WOULD PRECLUDE THE COMMISSION FROM PREAPPROVING A RATE BASE CAP FOR MILNER?

A. Yes. In its decision concerning Valmy II the Commission stated that its statutory charge was to "establish 'just and reasonable' rates." [Ibid., p. 105.] For at least two reasons, the Commission will be unable to determine that adding this project to the Company's cost of service will produce just and reasonable rates. First, the "cap" set by the Company is contingent upon several favorable predictions. If inflation heats up or the scope of the project changes, then, under the Company's proposal, its "commitment estimate" would no longer hold as the cap for the capital cost of the project. (I discuss this in greater detail below.)

Second, the Company has estimated the project cost at between 37.80 and 52.93 mills per kwh. While it is unclear what costs and assumptions this estimate includes, presumably one of them is the Company's best estimate of the operating costs of the plant. Nevertheless, several of the latter are uncertain and could change, making the plant uneconomical.

For example, the Company has agreed to pay for one-half of the cost of reconstructing the Milner dam over the life of the FERC license. While it appears that $11,700,000 is the best estimate for the total cost to rehabilitate the dam, the estimate is uncertain. Indeed, the estimate has already apparently increased from an earlier estimate of $9,000,000. [Packwood Direct Testimony, p. 10; and Agreement Regarding the Ownership, Construction, Operation and Maintenance of the Milner Hydroelectric Project, p. 60.] The Company is also responsible for a portion of the annual mitigation expenses, which are likewise uncertain.

For these and other reasons, the Company cannot accurately estimate the cost per kwh of the Milner project. Thus, neither can the Commission. Nor can the Commission determine today that just and reasonable rates will result from inclusion of the future capital costs of the plant in a future rate base and preapproval of the royalty and debt service payments to be made to the canal companies for revenue requirement purposes.

Q. WOULD YOU PLEASE DISCUSS THE "CAP" ON THE CAPITAL COST OF MILNER THAT THE COMPANY HAS PROPOSED?

A. Certainly. The Company has offered to treat its "commitment estimate" of the capital cost of Milner as a cap on the amount to be preapproved for rate base. While the

Company's proposal has surface appeal, there are several arguments, in addition to those discussed above, against the Commission's adopting the Company's quid pro quo. First, the commitment estimate does not offer a guarantee that the proposed cap will in fact be the amount that the Company proposes for inclusion in rate base. Mr. Packwood notes that Idaho Power will commit to building the project for $63,350,600, "as it may be adjusted to account for documented changes in escalation rates or scope." [Packwood Direct Testimony, p. 13.] He goes on to explain what is meant by "documented changes":

> If major inflation occurs, resulting in higher cost indices, the Commitment Estimate would be adjusted to reflect these inflated cost indices. Examples of possible scope changes which could affect the project ceiling are Force Majeure or acts of God impacting the construction, design optimization for which increased energy more than offsets the increase in initial investment, and foundation or site conditions significantly more expensive than indicated by exploratory drilling. [Ibid.]

The Company's reservations with respect to the cap do not guarantee the commitment estimate will be the rate based amount. That is, little is left to affect the price of the plant that the Company has not already covered in its escalation and scope disclaimer.

Q. WHAT PROBLEMS DO YOU SEE WITH THE COMPANY'S CAP PROPOSAL?

A. There are several. First, the Company does not define "major" inflation. Conceivably, any inflation above what is included in the commitment estimate would be grounds for the Company adjusting its estimate and including these increased costs in rate base. Yet, the Company doesn't explain the projected escalation rate included in its commitment estimate. Hence, the Commission cannot know whether the Company is working from a tight budget or an ample one.

Second, the Company's expansive scope qualification can cover a multitude of factors. Suppose, for example, that the Company decides to increase the size of the project. Would it be fair to charge ratepayers for the additional costs without examining the Company's decision? But under the Company's proposal, such a change would presumably come within its definition of scope and hence not be subject to further review. (It is noteworthy that many utilities involved in the construction of large nuclear power plants cited changes in scope as the source of a significant percentage of their cost overruns.)

Third, the Company's cap proposal is one-sided. The Company wants to increase the cap if major inflation occurs, but it does not offer to reduce the cap if inflation subsides and falls significantly below the escalation allowance included in the Company's commitment estimate. I see no reason for the Commission to agree to such an unbalanced arrangement.

Finally, Idaho Power does not explain how its proposed 5% contingency fits in with its escalation and scope adjustors. Generally, a contingency of this nature is included in a cost estimate to cover precisely such factors as changes in scope and escalation. Hence the Company has not only covered its uncertainties with its disclaimers but added a substantial buffer by inclusion of a contingency in the commitment estimate. While I am not opposed to the use of a contingency, (it is common practice), I believe it is important for the Commission to realize how little risk the Company is proposing to take on. (I am surprised that the Company has not included a provision for increases in borrowing costs; but then again, this might be covered under the Company's escalation limitation.)

Q. YOUR NEXT CONCERN DEALT WITH THE RISKS INHERENT IN THE COMPANY'S PROPOSAL AND THE PROPOSAL'S IMPACT ON THE COMPANY'S RATEPAYERS. WOULD YOU PLEASE EXPLAIN?

A. Yes. The Company's proposal assigns most of the risks of constructing Milner to its ratepayers while eliminating most of the potential risks to its stockholders. Ratepayers would shoulder all the following: the risk of escalation of construction costs, the risk of increased scope, the risk of load growth changes, the risk of technological changes, the risk of poor management decision-making (other than strict construction prudence), the risk of environmental changes, the risk of regulatory changes, the risk that the project will not be used and useful, and the risk that the project will not be economical.

Idaho Power's stockholders, on the other hand, would face only the risk that the Company would not use reasonable and prudent construction practices and the risk that some costs of the plant might not be allowed in rate base if the Company exceeded its cap. The latter risk is practically eliminated by the broadly defined escalation and scope reservations that accompany the Company's proposal.

Clearly, while ratepayers would bear a great deal of risk, the stockholders would incur very little.

Even though the Company's request shifts most of the risks associated with construction of the Milner project to ratepayers, the Company has not offered to simultaneous reduce its cost of equity. In my opinion if the Commission adopts the Company's proposal, which I strongly recommend against, it should also at a minimum reduce the Company's cost of equity below the Commission's last authorized return of 12.25%. [Idaho Public Utilities Commission, Order No. 20924, p. 62.]

Q. WHY WOULD ADOPTION OF THE COMPANY'S PROPOSAL CALL FOR A REDUCTION IN IDAHO POWER'S COST OF EQUITY?

A. It is a basic financial principle that the greater a security's risk, the higher the investor's required return, and vise versa. If the Commission significantly reduces stockholder risk by adopting the Company's proposal, then it should reduce the Company's cost of equity. In Idaho Power's last rate proceeding, the Company's witness Mr. Bowers acknowledged this principle, testifying that "the greater a security's risk the higher the required return for that risk." [Bowers Di, Case No. U-1006-265, p. 31.] Mr. Bowers also testified that a risk-free rate of return can be approximated by using the interest rate on long-term government bonds. [Ibid., p. 30.] Recently, long-term (30-year) U.S. Treasury Bonds have been carrying an interest rate of about 9.0%, which is significantly below the Company's authorized return on equity. Under the Company's proposal, the equity risk supporting the Company's investment in the Milner project would more closely approximate that of a government bond than of a security yielding 12.25%, the Commission's last authorized return.

Q. WOULD YOU ILLUSTRATE THE IMPACT OF EQUITABLE RATEPAYER TREATMENT, ASSUMING ACCEPTANCE OF THE COMPANY'S PROPOSAL?

A. Certainly. Let us assume that the Company's investment in Milner (and in the Swan Falls project) is financed in the same proportion as the Company's capital structure, and that the investor's return requirement on the equity portion of this investment is approximately 10% (one percentage point above the measure of a risk-free rate), this would indicate that the Company's cost of equity should be reduced by about a quarter of one percent (0.25%) to 12.0%, using the Commission's last authorized return. I have depicted these calculations on my Schedule 1. The Company earned 13.86% on average equity during 1989. I would therefore recommend that if the Commission accepts Idaho Power's recommendations in this case, it investigate the Company's earnings situation and authorize a rate decrease, if one is seen to be warranted. Indeed, it appears that, absent such a decrease, an earnings investigation is currently warranted.

Q. LET'S TURN TO THE THIRD SECTION OF YOUR TESTIMONY. WOULD YOU ADDRESS THE COMPANY'S ALTERNATIVE PROPOSAL AND ANY PROBLEMS WITH IT?

A. Yes. In the case that the Commission does not grant the Company's request for a Certificate of Public Convenience and Necessity and the rate basing of the Milner project, Idaho Power wants the Commission to deregulate the Milner facility for a period of 20 years. I find the Company's alternative proposal troublesome.

Q. PLEASE EXPLAIN.

A. I question the integrity of the Company's proposal, especially when one examines the cost of this project relative to Swan Falls, which the Company is not proposing be deregulated.

The estimated cost per kw of the Milner project is $1,086. Adding in the Company's share of the cost of repairing the dam increases this figure to $1,187. Compared to Swan Falls at $3,244 per kw, Milner may be a bargain, and much more profitable. It is easy to see why the Company has framed its proposal in this way. Idaho Power and its stockholders would benefit from the economies associated with the deregulated Milner, while ratepayers would defray the relatively high costs of the regulated Swan Falls. That may be good private business, but it's not good public policy.

Q. HAVE YOU IDENTIFIED ANY OTHER PROBLEMS WITH THE COMPANY'S ALTERNATIVE PROPOSAL?

A. Yes. The proposed deregulation could place an additional future burden on ratepayers. According to the Company's plan, after 20 years either the plant would continue to operate under its exempt status, or the Commission would issue the Company a CPNC and allow it to rate base the plant at that time. In the latter case, the Company proposes, the value of the plant for revenue requirement purposes would be based upon the then current cost of replication (reproduction cost less depreciation). Once again the benefits of the Company's proposal would be retained by stockholders. Adoption by the Commission of the Company's proposal would be tantamount to guaranteeing the Company's shareholders a substantial gain on the project at the expense of ratepayers, due to the replication provision. The Commission should reject the Company's alternative request as proposed. However, if the Commission is inclined to adopt the Company's proposal, it should set the buy-back rate at the lesser of the original cost less depreciation and the fair market value.

Q. LET'S TURN TO THE FOURTH SECTION OF YOUR TESTIMONY. WOULD YOU BRIEFLY DISCUSS WHAT THE