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STATE OF WASHINGTON

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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April 22, 1998

NOTICE OF TERMINATION OF NOTICE OF INQUIRY

Re: Notice of Inquiry: Examining Regulation of Electric Utilities in the
Face of Change in the Electric Industry
Docket No. UE-940932

TO ALL INTERESTED PERSONS:

This report will serve to document the results of the Commission's Notice of Inquiry, *Examining Regulation of Electric Utilities in the Face of Change in the Electric Industry*; close this inquiry; and identify areas where the investigation of issues will continue as the Commission moves forward in a formal review of its rules specifically addressed in the inquiry. The purpose of this inquiry was to gather information about structural change in the electricity industry; to identify the implications of industry changes for utility regulation; and to produce recommendations concerning specific rules and regulations currently used by the Commission. In particular, the inquiry focused on the Commission's regulatory rules and procedures concerning least-cost resource planning, competitive bidding for resources, and review of the prudence of utility expenditures.

The pace and scope of change in the electric industry has been faster and broader than the Commission could have imagined. While interested persons were responding to questions posed in the inquiry, regulated electricity companies began bringing a variety of filings to the Commission for approval in response to "competitive events," including special contracts, open access tariff filings, and mergers. To put interested persons on notice how it would adapt regulatory authority to the more competitive circumstances facing the state's electric industry, the Commission adopted eight principles. The inquiry thereafter focused on ways in which the policy principles could be achieved as the electric industry evolves into a more competitive marketplace.



In the intervening two and one-half years, it has become apparent that changes in the electric industry will be driven by legislative and economic forces beyond the control of the Commission. In addition, Governor Gary Locke has issued Executive Order 97-02 requiring all agencies to review their administrative rules, a process that offers the Commission, the electric companies, and interested persons an opportunity for a review of the rules governing least cost planning and competitive bidding.

In light of these changes, the Commission is closing the electric notice of inquiry. This memorandum summarizes the status of the inquiry and makes recommendations for subsequent steps.

The Commission extends its appreciation to all persons who participated in the notice of inquiry, and by that participation informed both the substance and quality of this inquiry. We acknowledge the substantial time, effort, and resources dedicated to preparing and filing comments throughout the process, and we look forward to continuing an open dialogue with all interested persons as the electric industry continues to evolve, and the Commission continues to evaluate the tools it uses to fulfill its statutory mission in the face of that evolution.

Section I of this report outlines the procedural history of the Commission's inquiry from its inception to the present. Section II highlights key developments related to competition in electricity service that have occurred subsequent to the inquiry. Section III summarizes the Commission's review of the areas of specific focus of the inquiry.

I. Procedural Background

The Commission issued its notice of inquiry (NOI) on December 16, 1994, and invited comments and observations of general trends concerning competition in the electric industry, and the implications of those trends for regulation. In addition, the NOI solicited comments regarding the Commission's regulatory rules and procedures pertaining to least-cost resource planning, competitive bidding for resource acquisition, and review of the prudence of utility expenditures.

The Commission received comments from thirty-eight persons. Seventeen persons submitted comments in a subsequent round of reply comments, including three who did not respond in the initial comment period. Commentors represented a broad spectrum of electricity interests, including the three jurisdictional investor-owned electric utilities (IOUs), the Public Counsel Section of the Office of the Attorney General, the financial community, industrial and residential customers,

environmental and low-income public interest groups, publicly-owned utilities, independent power producers (IPPs), labor, and utility stockholders. Copies of submittals from both the initial comment round and the reply comment phase of the NOI are available from the Commission upon request.

On August 14, 1995, the Commission issued a letter summarizing the general substance of comments received in the inquiry. The letter noted that the Commission did not have sufficient information, at that time, about the emerging context of the industry to either refine existing or develop new regulatory tools to address resource planning, resource bidding, and prudence determination. The letter proposed and requested comment on a set of interim policy principles to guide the Commission's decisions during the transition to a more competitive electric industry. Seventeen persons submitted 70 pages of comments on those proposed principles. After considering the comments received, the Commission on December 13, 1995, amended and adopted the principles as an Interpretive Policy Statement. The Commission indicated it would use these principles to inform judgments about filings and issues brought before it as customers and jurisdictional companies adapt to emerging competition in the electric industry. In addition, the Commission informed the participants that it would defer decisions concerning regulatory tools affecting resource planning, resource bidding, and prudence review until a clearer picture of industry structure and regulatory context emerged. Near term focus was placed on factors and processes external to the Commission, including rule making at the Federal Energy Regulatory Commission (FERC) and developments affecting the role of the Bonneville Power Administration (BPA).

II. Subsequent Developments

Subsequent to adoption of the policy principles, the Commission addressed a number of specific filings, proposals, and issues related to competition in electricity service. Power contracts related to special customer circumstances were approved for several industrial customers of Puget Sound Power & Light Company (Puget). PacifiCorp filed such a contract for its largest industrial customer in Washington. Puget filed, and the Commission approved, a tariff permitting it to offer partially market-based prices to its general industrial customer class. Puget Sound Power & Light Company and Washington Energy Company completed a corporate merger into Puget Sound Energy, Inc. (PSE), to include their retail natural gas and electric operations. The Washington Water Power Company (WWP) received approval to serve a large industrial customer located in Northwest Washington, formerly served by a public utility district, as a full requirements customer of BPA; the provision of service has been delayed, pending resolution of complex transmission arrangements.

WWP requested and received approval to continue its non-bypassable distribution level charge to support conservation and low income weatherization programs. PSE received approval for, and implemented, a similar distribution level charge.

Retail open access pilot projects affecting all customer classes are currently offered by both PSE and WWP. PacifiCorp requested and received approval for a banded rate tariff to participate in WWP's retail access pilot for large industrial customers. WWP recently received approval to implement a portfolio access pilot for residential and commercial customers, allowing those customers a choice of energy options without having to change energy service providers.

In 1996, the FERC issued its Orders 888 and 889 regarding open access transmission tariffs and standards of conduct associated with wholesale transmission and generation transactions. These rules have established the framework for a competitive generation market, at least at the wholesale level. Several issues arising from FERC's asserted jurisdiction over rates and services pursuant to these Orders are currently pending in federal court.

Also during 1996, the four Northwest governors convened a study group to perform the Comprehensive Review of the Regional Energy System. This study was completed in December 1996, with recommendations delivered to the governors on the role of BPA and the structure of the region's wholesale and retail power systems. These recommendations asserted that the region's state and local jurisdictions should move actively toward electric service competition at the retail level, with appropriate safeguards to protect consumer and public purposes interests. Concerning consumer driven retail competition, the recommendations included a strong regulatory role in customer protection involving licensing of generation providers, continuing price regulation of distribution functions, and consumer information and education. In addition, the report recommended open access pilots to identify problems and solutions for delivering the benefits of competition to all customer classes.

In 1997, Governor Locke issued Executive Order 97-02, requiring state agencies to conduct a four year review of their "significant" rules. The Commission has developed and submitted a plan and schedule for reviewing its rules. The review of the competitive bid rules (WAC 480-107-060,070) and the least-cost plan rule (WAC 480-100-251) is scheduled to be completed by the end of 1999. During this review, the Commission will conduct an open process in which interested persons will have the opportunity to participate.

Several bills impacting the electric industry were enacted by the Washington Legislature during its 1998 session. One bill requires IOUs to submit unbundled cost studies to the Commission, and requires large public utilities to file similar studies with the State Auditor by September 30, 1998. The bill also requires these filings to include a report on service quality and reliability data. The Commission and the State Auditor are required to report to the Legislature by December 1, 1998, on the cost studies, the reliability studies, and an examination of the ways to disclose and label generation fuel mix issues. Another bill requires utilities to adopt certain basic consumer information and protection policies. The bill also calls for a comprehensive study performed together with the Department of Community, Trade, and Economic Development (DCTED). A third bill requires utilities to make available bi-directional metering equipment for customers who install site specific renewable generation equipment of less than 25 kW.

III. Commission Review of the NOI Comments

Since the initiation of the NOI, the trend toward greater consumer choice in electricity service, at both the wholesale and retail level, has accelerated and broadened. As the Commission noted in its August 14, 1995 letter on the status of the NOI, this trend derives from federal and regional policy initiatives and developments in the wholesale power market. In view of this firmly established trend, the Commission believes that it is necessary to consider modifications to existing rules governing resource planning and resource acquisition. These modifications will be addressed in greater detail during the review of rules and the rule making process scheduled to take place through 1999 as part of our compliance with EO 97-02.

A. Least-Cost Planning Rule

1. Background

This rule, WAC 480-100-251, requires utilities regulated by the Commission to file a plan every two years describing the mix of both supply-side and demand-side resources that will meet the future needs of customers at the lowest cost to the utility and its ratepayers. Preparation of these plans involves forecasting utility loads over a long period (typically 20 or more years); evaluating available supply-side and demand-side options for meeting that load; and preparing both an integrated resource plan (IRP) to develop the lowest cost mix of these supply-side and demand-side resources and a near term action plan consistent with the long term plan.

The rule was adopted on May 19, 1987, with the expressed purpose of ensuring that each electric utility regulated by the Commission meets its load with a least-cost mix of supply-side and demand-side resources. PacifiCorp and WWP complied with the rule by submitting plans every two years. Puget filed plans through 1992; following its merger, PSE's most recent plan is being prepared and is expected to be filed in Spring 1998.

Although a review process is not a formal part of the rule, the Commission and Staff review plans for consistency with the requirements of the rule, and notify the utilities of any deficiencies or concerns regarding the substance of the plan. While information and analysis included within the plans are considered as part of rate making and other proceedings, the Commission does not prospectively approve expenditures included in the action plan.

The existing rule was developed in the context of monopoly utility service of a bundled product consisting of electricity generation and delivery (transmission and distribution). In this context, the least-cost planning process provides an opportunity for the utility's monopoly customers, along with the public and Commission Staff, to influence utility decisions. As the monopoly service provider, the utility acts as an exclusive agent for its customers. The least-cost planning process provides a means for the customers and the public to provide input on decisions made by the utility on their behalf. The rule also creates a "level playing field" for evaluating investments in energy efficiency and investments in supply-side resources, and a context for the utility to evaluate the relative environmental characteristics of competing resource choices.

2. Positions of Commentors

The majority of comments in the NOI favored preserving the least-cost planning rule and the planning process. Nearly all commenting persons also offered advice about how the rule and practice could be modified to better function in a more competitive and less monopoly industry. The only commentor recommending the rule be eliminated was PSE, which argued that long term planning is unnecessary in a competitive industry. Both WWP and Pacific supported least-cost planning, but argued it should be made less prescriptive and should accommodate each utility's strategy for responding to competitive opportunities. Both WWP and Pacific said planning should function largely as an educational process.

The Washington State Energy Office (WSEO), Northwest Power Planning Council (NPPC), low income advocates, Public Counsel, environmental advocates, and the International Brotherhood of Electrical Workers (IBEW) argued that the planning rule should be retained and even strengthened. They argued that least-cost planning is not command-and-control regulation; rather, it provides an important framework for balancing issues, making decisions, and explaining those decisions. These groups recommended that the plans developed by utilities should be treated more formally by the Commission than the current acknowledgment. Several recommended that the plans be approved -- at least as to planning methodology.

Independent power producers (IPP) recommended that planning be retained, and that a long-term view of resource development be expected of the utilities and be documented in publicly-available resource plans.

Industrial customers and associations made no specific recommendations regarding least-cost planning, except that it should not involve the assignment of "environmental costs" that would ultimately be reflected in prices. As part of their general argument in support of open access to non-utility suppliers for large customers, the Washington Industrial Customers for Fair Utility Rates (WICFUR) suggested that least-cost planning should apply only to the "full requirements" customer loads.

3. Discussion

The Commission will consider various revisions to its least-cost planning rule during its formal review of rules and rule making process, scheduled to take place through 1999. Where service continues to be provided by a monopoly, or by a utility with significant ability to affect the choices of service available to customers, the rationale and importance of least-cost planning remains. While the initial steps toward competition in retail service are being taken in the electricity service industry in Washington, the industry is not effectively competitive in any existing retail markets. The number of customers with alternatives to utility electricity supply may expand beyond the pilot programs currently offered; however, under any scenario, a large proportion of consumers will likely continue to receive bundled, traditional utility service for some time into the future. Even those customers who may be able to choose alternative electricity suppliers likely will continue to take distribution and other network service from a monopoly utility.

Consequently, while we believe that the least-cost planning process continues to be desirable and important, we also acknowledge that modifications to the current rule may be appropriate to better reflect the potential influence of future competition.

The Commission believes revisions to the rule may be appropriate for the purpose of focusing its application to monopoly utility-supplied services, bundled or unbundled. Consequently, a major emphasis should be on planning for generation and energy efficient resources and distribution services for loads that continue to be served on a monopoly bundled basis, and only on distribution services for those loads to be served on an unbundled basis. Additionally, such planning also should focus on maintaining reliability of the distribution network. This framework follows the recommendation made by WICFUR, but explicitly extends the scope of planning to include the monopoly services of the distribution network.

A number of commenting persons also recommended that the planning process could be improved if the Commission were to take more definitive action on plans placed before it. For example, the Opportunity Council argued that the Commission should approve actions identified in action plans. This could constitute a form of preapproval of utility actions. Other persons, including Public Counsel and WSEO, recommended that the planning process be strengthened by approving the planning methodology and/or the objectives identified in the plans rather than specific expenditure levels.

The Commission understands that some persons would like to use the planning process to reduce the uncertainty of utility management decisions and subsequent regulatory review. However, the Commission believes that the major value of the planning process lies in 1) providing an open process to discuss utility decisions; 2) a consistent means for understanding and evaluating alternatives; and 3) a document accessible for reviewing and evaluating the rationale and bases for utility management decisions. Development of the plan and subsequent review by the Commission cannot and should not substitute for actual management of the company's capital and other assets. Nor should the process substitute for the Commission's subsequent review in rate cases and other proceedings of how those decisions have or have not served the public interest. The planning process should be an information generating tool that is flexible, not a rigid and prescriptive tool that constrains either the companies from fulfilling their responsibility to shareholders or the Commission from fulfilling its responsibility to customers and the public.

Consequently, the Commission believes that it should not modify its review of plans to constitute any form of preapproval of utility expenditures. The information generated in plans should continue to be used as an important part of the information relied upon by the Commission in rate making or other proceedings related to utility service. In addition, the Commission intended the plans' information to be used by the utilities for their business decisions to ensure they provide sufficient capacity,

quality, and services necessary for the customers who rely upon them in their role as monopoly distribution companies. To ensure that this information is as meaningful and useful as possible, the Commission will review the methods employed to develop the long-term and short-term plans in greater detail as part of its rule making, to ensure that the plans are comprehensive and balanced in terms of aligning business decisions with public goals. The Commission continues to believe that accountability for the actions and decisions identified in the plans rests with the companies.

Finally, a number of persons including WWP and PacifiCorp suggest that the two year filing requirement for IRPs may be too prescriptive. Plans may be more useful and constructive if they fit the actual time frame of major management decisions. PacifiCorp has proposed that information can be made more current through plan updates produced and filed in between major resource modeling and planning cycles. The Commission believes this notion has merit, and therefore will consider changing the filing requirements for various components of the plans as it undertakes revisions of the planning rule.

The Commission expects that the role played by Staff in the planning process at a minimum will include 1) participating in technical advisory groups; 2) reviewing and commenting upon the methods and analytical tools used in the plans; and 3) monitoring utility circumstances to determine when, or if, plan updates should be required. Staff should be able to make judgements about whether the plan and the action plan are logically and consistently derived based upon the planning methodology and analytical tools. The Commission does not expect Staff to make judgements about the advisability or appropriateness of any specific utility management decision or project expenditure level. Once a plan is filed, the Commission expects Staff to make an expedited review, based upon their ongoing participation in the plan's development.

The Commission, in its review of plans, will continue to identify the specific issues and particular details on which we will request the company to develop information and to conduct analysis through the planning process.

B. Competitive Bidding Rule

1. Background

The Commission adopted competitive bidding procedures to implement the provisions of the Public Utilities Regulatory Policies Act of 1978 (PURPA) and FERC regulations pertaining to sales and purchases of power by electric utilities from qualifying small power producers or qualifying cogenerators. Through bidding, payment by electric utilities to these qualifying facilities (QFs) of "avoided costs" is established through a "market" process, rather than an administrative one. WAC 480-107-060 requires each electric utility to file a request for proposals (RFP) every two years, within 90 days of filing its IRP.

In 1989, the Commission adopted rules which require jurisdictional electric utilities to solicit bids from generation and conservation suppliers (WAC 480-107-060,070). These rules had two objectives: ensuring that regulated companies do not pay too much for purchased power resources, and ensuring that utilities compare opportunities in competitive wholesale markets with the cost of utility owned projects. These rules were modified in 1994 to synchronize the timing of solicitations with the completion of least-cost plans, and to permit negotiation of bid prices.

In 1995, WWP submitted a "compliance" filing in lieu of an RFP which identified a request for a zero-megawatt resource block. In its filing, which the Commission ultimately approved, WWP identified no impending need for new firm electric resources, consistent at that time with its most recently filed IRP, and therefore proposed that the Company forego formal solicitation for new resources. WWP contended it did not wish to send false signals to the marketplace causing potential resource suppliers to expend time and financial resources preparing bid proposals at a time when WWP was experiencing a surplus of both energy and capacity. In 1996, following the submittal of its IRP, PacifiCorp submitted a similar compliance filing in lieu of its RFP for precisely the same reasons.

Recently, WWP requested that the Commission grant a waiver of the portion of the competitive bidding rule requiring the issuance of an RFP, reiterating its claim that the Company has no immediate resource need. The Commission approved that application, but required WWP to file its avoided costs for public comment, to preserve compliance with PURPA.

2. Positions of the Commenting Persons

The competitive bidding rule evoked the most criticism of all the regulatory tools addressed in the NOI. The independent generators (IPPs) were the only strong supporters of the bidding rule. The Natural Resources Defense Council (NRDC) also supported the rule, and Pacific and the American Wind Energy Association (AWEA) recommended establishing "green RFPs" to meet renewable targets, which they also recommended. IPPs argued that if bids do not result in a winning proposal, a utility should be held to its bid or its avoided cost standard for any subsequent resource acquisition. A number of persons supported elimination of the bidding rule, including WSEO, NPPC, Puget, Mr. Rogers, Mr. Warwick, Puget Shareholders, and WICFUR (as to non-core service). Generally, the bidding rule process was characterized as "too prescriptive" given the number of opportunities now available in the wholesale power market. A common theme among commentators was that utilities should not be forced to consider non-utility generation and told how to choose between competitive options.

3. Discussion

As a means of implementing PURPA, the Commission established the bidding rule as a preferred forum for avoided cost determination, replacing what was previously known as administratively-determined avoided costs. The Commission's intent in establishing a market test for determining these avoided costs was to generate bids between PURPA developers that were lower than the administratively-determined costs, and to allow the utilities to purchase only the supply of resources needed. The Commission agrees with many of the commentators that recent developments in the wholesale market have reduced the need for such a test, and that competitive bidding for resources may not fit well with the current industry structure. However, as long as PURPA requirements remain in place, the Commission believes this approach is preferable to the administrative method when new resources are being acquired. The Commission believes the process of bidding should become less administratively burdensome, and will re-examine the role of competitive bidding in its upcoming rule review, given the status of PURPA at that time. In the meantime, the Commission will continue to be flexible in considering exceptions to the bidding rule when the utilities face no impending need for new firm resources.

C. Prudence Review

1. Background

Each of the IOUs bears the burden of demonstrating the prudence of new resource acquisitions to the Commission. A demonstration of prudence includes a showing that 1) the selection of each resource was necessary and reasonable, 2) the costs of acquisition were appropriate based upon what a reasonable board of directors and company management decided given what they knew or reasonably should have known to be true at the time the decision was made, and 3) the costs were regularly evaluated. The prudence review is currently conducted by the Commission exclusively in general rate increase cases.

2. Positions of Commentors

Given the introduction of competitive risk into the industry, most persons who provided comments suggested that prudence reviews be made less complicated and litigious. Many (WSEO, NPPC, IPPs, Puget, and industrial customers) proposed that resource acquisitions be either pre-approved or convened in a separate proceeding closer in time to decisions than a general rate increase case. WWP suggested that specific prudence reviews be replaced with performance-based rate making. Pacific appears to agree, but did not make this specific recommendation. The financial houses generally argued for better management of regulatory risk by reducing or streamlining the prudence review process. Puget shareholders argued that the Commission should only review power contracts as to "due diligence," and that this should be accomplished in thirty days.

The only persons to support the current prudence review process were WICFUR and Public Counsel. Both indicated a willingness to consider alternatives.

3. Discussion

The Commission continues to believe that prudence evaluation remains an important tool to ensure that utilities are not indifferent to cost or to the consequences of poor decision-making. General rate increase proceedings were established as the forum in which to evaluate prudence, because issues pertaining to the need and price of a resource acquisition can only be determined in a forum where each decision can be viewed in conjunction with all other of the company's resource decisions.

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The Commission believes there is no other currently available forum, sufficient in both rigor and scope, within which to make this determination. For that reason, the Commission does not believe preapproval of particular resource acquisitions is appropriate, as this would inappropriately shift the risk of those decisions from utility management to rate payers.


Consistent with the discussion of the least-cost planning process, the Commission does not support any recommendation that would constitute any form of preapproval of utility expenditures. However, the Commission will continue to consider suggestions that do not rise to the level of preapproval of resource decisions.

With this report, the Commission closes the Notice of Inquiry, *Examining Regulation of Electric Utilities in the Face of Change in the Electric Industry*, Docket No. UE-940932. The Commission defers consideration of formal changes to its least-cost planning and competitive bidding rules until its upcoming rule review and rule making process, scheduled to take place through 1999. We invite and welcome the participation in those rule makings of the industry and observers who have informed this NOI.

Sincerely,


ANNE LEVINSON
Chair


RICHARD HEMSTAD
Commissioner


WILLIAM R. GILLIS
Commissioner