

Date Mailed July 17, 2002
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BEFORE THE  
PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation into Rate-Making Mechanisms Relating to Utility Investment in Long-Term Purchase Power Agreements 05-EI-131

Petition of Wisconsin Power and Light Company for Declaratory Ruling Pursuant to Section 227.41 Wis. Stats. Regarding a Purchase Power Incentive Related to Its Tolling Agreement With Rock River Energy LLC 6680-DR-107

**FINAL DECISION**

On September 19, 2001, Madison Gas and Electric Company (MGE) requested that the Commission initiate a generic docket to investigate ratemaking mechanisms related to utility investment in long-term purchase power agreements (PPA). The MGE request followed a March 16, 2001, Petition for Declaratory Ruling (DR) of Wisconsin Power and Light Company (WP&L), that sought approval of a purchase power incentive mechanism that would be related directly to its PPA with Rock River Energy, LLC, a Calpine Energy company. At its open meeting on December 19, 2001, the Commission granted MGE's request for a generic proceeding and placed on hold WP&L's request for a DR in docket 6680-DR-107. On February 5, 2002, the Commission issued its Notice of Investigation (NOI) for generic docket 05-EI-131. On April 16, 2002, a hearing was held with briefs filed on April 30, 2002. At its open meeting, June 6, 2002, the Commission discussed the record in this docket.

### **Findings of Fact**

1. The Commission has a ratemaking policy which takes into account any adverse effect a PPA may have on a public utility's creditworthiness when the PPA in question has capital lease effects on the utility's financial capital structure. Whether a PPA is considered a capital lease is established by the auditing requirements of the Financial Accounting Standards Board.

2. When a PPA in question has capital lease attributes, the Commission compensates the utility for any credit quality degradation by setting the authorized return on equity with respect to the financial capital structure and by the utility recording the PPA on its books as a rate base asset.

3. MGE supports a new approach in which the Commission would compensate the utility during its rate proceeding for any credit quality degradation brought upon by new PPAs. MGE proposes a new compensation mechanism similar to the adjusting ratio calculation presently employed in rate cases for deferred investment tax credits. MGE does not support any additional incentives for entering into PPAs.

4. The Customers First! Coalition supports the MGE proposal as long as the PPA is prudent and any utility requesting compensation for credit degradation proves that it is beneficial to customers in a rate case.

5. Wisconsin Electric Power Company (WEPCO) supports a new approach in which the Commission would compensate the utility during its rate proceeding for any credit quality degradation brought upon by new or existing PPAs. WEPCO proposes a new compensation system based on the methodology that Standard and Poors (S&P) uses when evaluating a public

utility's credit quality. Under the S&P method, the utility's balance sheet and debt coverage ratios are put in the same position, for purposes of credit analysis, as they were prior to the PPA. This requires calculating the proper off-setting equity adjustment and then allowing for a return on that equity adjustment to be recovered in rates. WEPCO does not support any additional incentives for entering into PPAs.

6. Wisconsin Public Service Corporation (WPSC) supports the Commission's present ratemaking policy for PPAs that meets the requirements of a capital lease under Financial Accounting Standards Board (FASB) standards. WPSC supports the S&P approach for those PPAs greater than three years in duration and which do not qualify as capital leases.

7. Xcel Energy (Xcel) indicates that the Commission should reaffirm its policy that compensating utilities for credit degradation when entering PPAs is reasonable. Xcel believes the Commission should adopt a flexible compensation approach to be used during rate proceedings. Xcel indicates that any mechanism to compensate the utilities for entering into PPAs should not be for credit degradation alone. Any adopted process should allow utilities to request additional compensation dependent upon unique aspects of PPAs such as in-service dates, the use of an existing site, the promotion of renewable generation, etc.

8. WP&L believes that the PPA incentive put forth in its original declaratory ruling petition is the appropriate mechanism for compensating an electric public utility for the adverse effects to its credit quality resulting from the use of PPAs as well as for advancing important public policy goals. WP&L's PPA incentive would be applied during a rate proceeding and would be equal to a return on the fixed component of the PPA that reflects the average equity component and rate of return approved for Class A electric utilities in their most recent rate

Dockets 05-EI-131, 6680-DR-107

cases. WP&L would allow for incentive compensation under certain Commission-determined circumstances such as new PPAs for longer than five to ten years and generation projects greater than 100 MW located in Wisconsin.

9. The Citizens' Utility Board (CUB) indicates the Commission's present policy is the appropriate one to use because it is PPAs with capital lease attributes that are most likely to create adverse credit quality impacts for the utility. CUB proposes that utilities can request compensation on a case-by-case basis during their respective rate proceedings for those PPAs that do not qualify as capital leases. CUB believes there is no need to provide additional incentives for utilities to acquire purchased power.

10. The Wisconsin Industrial Energy Group (WIEG) believes the appropriate compensation approach is to treat purchased power only where factually warranted, as a capital lease or in a manner consistent with S&P's method of converting purchased power contracts into debt equivalents. Any adjustments for credit degradation should be made in the context of a rate case. WIEG does not support any additional incentives for entering into PPAs.

### **Conclusions of Law**

The Commission is authorized to issue this order under Wis. Stat. ss. 196.02(1); 196.28; and 196.37.

### **Opinion**

In this docket, there was agreement in two broad areas. The first area was that any compensation related to PPAs be examined during a utility's rate proceeding. The second area was that no party questioned the Commission's current ratemaking treatment of PPAs that have

capital lease effects on the utility's financial capital structure. The Commission concurs in these two observations.

There were two areas of major disagreement. The first is whether new PPA incentive compensation approaches should be applied when a PPA does not necessarily have capital lease like attributes but may still cause credit quality degradation for a utility. A variety of new PPA incentive methods were proposed to implement such compensation approaches. The Commission believes that it is important to maintain financially strong public utilities and that it is reasonable to consider the risk to shareholders associated with entering into contracts with independent power producers. However, the Commission finds that it is premature and would likely require a rulemaking to adopt any particular compensation method at this time. For that reason, the Commission prefers to adopt the flexible approach suggested by Xcel Energy. Under that flexible approach, a utility can request compensation on a case-by-case basis during its respective rate proceeding for those PPAs that do not qualify as capital leases. At that time, the public utility would be free to author and support at hearing any compensation approach and level it feels is proper for those PPAs that degrade its credit quality. The Commission believes that such a utility would need to present strong evidence that the PPA in question would in fact cause material credit quality degradation. The Commission believes its present ratemaking policy covering only those PPAs that have capital lease like attributes may be too strict, but that does not mean that any PPA or series of PPAs would necessarily degrade credit quality either.

The last area of disagreement concerns whether it is reasonable for the Commission to authorize an electric public utility to collect, in rates, an award or incentive for entering into a PPA which is in addition to the amount designed to compensate the utility for credit quality

degradation. Such an incentive would ostensibly be to foster important public policy goals. Only two parties, WP&L and Xcel Energy, suggested that the Commission adopt such a new approach. The Commission does not agree at this time. There is no need to incent conduct that a public utility should ordinarily undertake as part of its obligation to serve. As CUB and WIEG highlight, the state's utilities have also not been reticent in signing PPAs.

Lastly, with the above guidance, WP&L's request for a declaratory ruling in docket 6680-DR-107 may once again proceed.

### **Order**

1. During a full review of the rates of an electric public utility, as defined under Wis. Stat s. 196.20(4) (a) (2), the Commission will continue to establish just and reasonable rates that are designed, in part, to compensate that utility for entering into any reasonable and prudent PPA that the Commission finds qualifies under FASB standards as a capital lease.

2. During a full review of the rates of an electric public utility, as defined under Wis. Stat s. 196.20(4) (a) (2), an electric public utility, as defined under Wis. Stat s. 196.20(4) (a) (2), may:

a. Present, and has the burden to prove, any approach and amount it claims is just and reasonable to compensate it for credit quality degradation caused by a reasonable and prudent PPA that qualifies under FASB standards as a capital lease.

b. Present, and has the burden to prove, any rationale, approach and amount it claims is just and reasonable to compensate it for credit quality degradation caused by a reasonable and prudent PPA that does not qualify under FASB standards as a capital lease.

Dockets 05-EI-131, 6680-DR-107

3. An electric public utility, as defined under Wis. Stat. § 196.20(4) (a) (2), shall not request authorization to raise rates designed to compensate it from entering into any reasonable and prudent PPA that does not degrade the credit quality of the utility.

4. This order pertains only to long-term PPAs involving electric public utilities, as defined by Wis. Stat. § 196.20(4)(1)(2), and wholesale merchant plants, as defined by Wis. Stat. § 196.491(1)(w).

5. The stay of the proceeding in docket 6680-DR-107 is lifted. WP&L may proceed to seek a declaratory ruling in that case, limited to the effects of the PPA with Rock River Energy, LLC on WP&L's credit quality.

Dated at Madison, Wisconsin, \_\_\_\_\_

By the Commission:

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Lynda L. Dorr  
Secretary to the Commission

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See attached Notice of Appeal Rights

Notice of Appeal Rights

Notice is hereby given that a person aggrieved by the foregoing decision has the right to file a petition for judicial review as provided in Wis. Stat. § 227.53. The petition must be filed within 30 days after the date of mailing of this decision. That date is shown on the first page. If there is no date on the first page, the date of mailing is shown immediately above the signature line. The Public Service Commission of Wisconsin must be named as respondent in the petition for judicial review.

Notice is further given that, if the foregoing decision is an order following a proceeding which is a contested case as defined in Wis. Stat. § 227.01(3), a person aggrieved by the order has the further right to file one petition for rehearing as provided in Wis. Stat. § 227.49. The petition must be filed within 20 days of the date of mailing of this decision.

If this decision is an order after rehearing, a person aggrieved who wishes to appeal must seek judicial review rather than rehearing. A second petition for rehearing is not an option.

This general notice is for the purpose of ensuring compliance with Wis. Stat. § 227.48(2), and does not constitute a conclusion or admission that any particular party or person is necessarily aggrieved or that any particular decision or order is final or judicially reviewable.

Revised 9/28/98