

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NARRAGANSETT ELECTRIC COMPANY :
LAST RESORT SERVICE ACQUISITION PLAN : Docket No. 3605

REPORT AND ORDER

I. BACKGROUND

The 2002 Amendments to the Utility Restructuring Act (“URA”) require electric distribution companies, such as Narragansett Electric Company (“Narragansett”) to provide Last Resort Service (“LRS”) to any customers who have left standard offer for any reason and are not otherwise receiving electric service from nonregulated power producers.¹ R.I.G.L. § 39-1-27.3(c) states:

In recognition that electricity is an essential service, each electric distribution company shall arrange for a last resort power supply for customers who have left the standard offer for any reason and are not otherwise receiving electric service from nonregulated power producers. The electric distribution company shall procure last resort service supply from wholesale power suppliers. Prior to acquiring last resort supply, the electric distribution company will file with the commission a supply acquisition plan or plans that include the acquisition procedure, the pricing options being sought, and a proposed term of service for which last resort service will be acquired....All such components of the acquisition plans, however, shall be subject to commission review and approval. Once an acquisition plan is approved by the commission, the electric distribution company shall be authorized to acquire last resort service supply consistent with the approved acquisition plan and recover its costs incurred from providing last resort service pursuant to the approved acquisition plan.²

Rather than having the authority to approve the actual LRS rates, the Commission has been granted the authority to approve a LRS acquisition plan, specifically, the acquisition procedure, the pricing options sought and the term of service. As long as Narragansett complies with an approved LRS acquisition plan, it is entitled to recover its costs associated with providing LRS.

¹ R.I.G.L. § 39-1-27.3(c) (2002).

II. ACQUISITION PLAN

On May 3, 2004, Narragansett filed its proposed LRS acquisition plan, through the pre-filed direct testimony of Michael J. Hager, the Director of Energy Supply – NE for National Grid USA Service Company. Mr. Hager testified that Narragansett’s proposed procedure for acquiring LRS is similar to the procurements in 2003 and would include eleven steps: (1) issuance of an RFP to all interested wholesale power suppliers; (2) receipt of initial responses to the RFP, including background information, indicative pricing and proposed changes to the proposed power supply agreement; (3) review of the initial responses and resolution of any disputed contract language; (4) review of the initial responses with the Division of Public Utilities and Carriers (“Division”); (5) receipt of final, binding prices; (6) evaluation of the final, binding prices; (7) consultation with the Division regarding final, binding prices; (8) selection of a supplier; (9) execution of a power supply contract; (10) filing of the resulting LRS rates with the Commission; and (11) filing of a summary of the bids received on a confidential basis with the Commission for its review.³

Next, Mr. Hager indicated that with regard to the pricing options sought and the proposed term of service, the pricing options being sought by the Company are different from past procurements. In the past, a responsive price would have to include all commodity-related charges associated with the supply of LRS. However, in this case, there is some uncertainty surrounding certain wholesale market rules, particularly with regard to a proposed Locational Installed Capacity (“LICAP”) Market.⁴

² R.I.G.L. § 39-1-27.3(c) (2002).

³ Narragansett Exhibit 1 (Pre-filed testimony of Michael J. Hager), pp. 4-5.

⁴ Id. at 12.

According to Mr. Hager, if the Federal Energy Regulatory Commission (“FERC”) issues a final order regarding the structure of the proposed LICAP market prior to the date when the indicative pricing is due, Narragansett will seek pricing on an “as delivered” energy basis meaning that Narragansett would only be required to pay for LRS that is actually consumed by its LRS customers.⁵ Consequently, there would be no demand charges and no minimum purchase requirements and the price would have to include all commodity related costs associated with the supply of LRS.⁶

Mr. Hager indicated that even if FERC has not issued a final order, or if there is a pending appeal affecting the certainty of the market, Narragansett will still seek pricing on an “as delivered” energy basis for all commodity related costs, but *excluding capacity costs*, and *only* for the period September 2004 through February 2005. If Narragansett were to select a price option that passes through actual capacity costs rather than bundling them, the monthly retail LRS rate will be set on the contract price plus an adder for the estimated capacity cost for each month.⁷

Mr. Hager indicated that Narragansett would procure LRS separately for two customer classes – residential and C&I for the period September 1, 2004 through February 28, 2005, with an option to enter into contracts for residential customers for the period March 1, 2005 through August 31, 2005.⁸ Narragansett would procure the second

⁵ Id., Exhibit MJH-4 (Request for Power Supply Proposals), § 5.2 states, “Prices which contain demand components, minimum purchase requirements or which vary by time-of-use within a calendar month will be rejected. Prices which exclude one or more market costs (e.g. uplift costs, Installed Capacity, etc.) may, at Narragansett’s discretion, be rejected.”

⁶ Id. at 12.

⁷ Id. at 13. The estimated capacity cost for each month would be the arithmetic average of the capacity cost price adders for each month for all bids received. Id.

⁸ Separating the customer classes is consistent with the 2003-2004 procurements because the residential LRS class does not presently have any realistic competitive supply choices and therefore, is relatively stable, whereas, over time, there has been a significant fluctuation in the number of customers and total loads on LRS which occurs when the timing of the LRS procurement does not track the market closely

six-month supply in the event that (1) the bids for the second six month period produce prices with an arithmetic average of less than or equal to ninety percent of the arithmetic average of the lowest price bidder for the first six-month period or (2) the arithmetic average of the monthly prices from the lowest bidder is less than or equal to ninety percent of the arithmetic average of the then current expected procurement cost (contract price plus fuel trigger adjustment component) of Standard Offer Service (“SOS”) for the same period or (3) the arithmetic average of the monthly prices from the lowest bidder is less than or equal to the arithmetic average of the lowest bid price for the first period, but only after consultation with and agreement from the Division. He noted that suppliers could bid for either one or both six-month periods and for one or both of the customer classes and that the winning bidder for both periods could be the same or different, depending on their proposals.⁹

Additionally, Narragansett proposes seeking supply proposals for the residential class for the periods September 2005 through August 2006 and September 2006 through August 2007 periods. For each of these periods, Narragansett would procure supply if (1) the arithmetic average of the monthly prices from the lowest bidder in the period is less than or equal to the SOS fixed price component during the same period and Narragansett is assured that there will be no changes in the eligibility rules for LRS through the end of that period and (2) the supplier provides strong assurances that any changes in the LRS eligibility rules prior to the end of that period would not result in increased procurement

enough. In order to avoid market arbitrage where customers for whom a market is available use LRS as an alternative market supplier rather than as a true last resort option, Narragansett proposes only procuring LRS supply for the non-residential customers for a single six-month period. This will allow the LRS to more accurately reflect the market. Because of the significant fluctuations in LRS caused by non-residential customers, suppliers will calculate a higher “risk premium” into the bid price. Suppliers have indicated that requesting bids according to the two customer classes should mitigate the impact of this risk on residential customers. See Order No. 17532 (issued August 6, 2003).

costs to or litigation costs with Narragansett. Furthermore, in the event suppliers propose different price options, the Company requests the ability to select such price options if, after consultation with the Division, it is determined that such options are in the best interests of ratepayers.¹⁰

Mr. Hager did note that there are added risks to procuring power for a longer term, primarily related to potential market rule changes. He indicated that “past experience with market rule changes has shown that each time a market rule has been changed, one or more parties to various agreements have used that opportunity to seek to shift contractual obligations to the Company.” As indicated above, Mr. Hager noted that the lack of certainty regarding LICAP may result in Narragansett revising its traditional procurement process by reimbursing the counterparty based on a calculation of actual capacity costs rather than accepting only a bundled price. However, the shorter a procurement term, the less likely it will be that a supplier will interpret a rule change in a manner inconsistent with Narragansett’s expectations at the time a contract is executed.¹¹ It is for this reason that Narragansett has proposed objective standards and will seek assurances from suppliers when procuring power for periods beyond six to twelve months.¹²

Mr. Hager explained that the winning supplier would be chosen from those bidders that have the following characteristics: a demonstrated ability to provide service during the relevant period; either acceptable financial strength or the ability to provide required financial security; and the willingness to execute a power supply contract that is

⁹ Narragansett Ex. 1, pp. 7, 9-10.

¹⁰ Id. at 10-11.

¹¹ Id. at 7-9.

acceptable to Narragansett. Once Narragansett has narrowed the field solely to those bidders with the above characteristics, Narragansett will then choose the bidder offering the lowest price.¹³ It is possible that a supplier may provide bids for more than one block of power. It is also possible that a supplier may be the lowest bidder for one block, but not another, but require that it be awarded both blocks in order to agree to provide service. In such a case, the Company may elect to award the combined service to the supplier if analysis determines that doing so will provide the lowest overall cost to ratepayers.¹⁴ Mr. Hager stated that “Narragansett is proposing to retain some discretion to modify the terms of the final power contract and may also decide to award a contract based on a non-conforming bid. Narragansett would only consider a non-conforming bid if it would benefit customers to do so.”¹⁵

With regard to an acceptable power supply contract, Mr. Hager noted that individual wholesale power suppliers typically request contract changes that are not intended to shift the risks or costs between the supplier and Narragansett, but rather to add clarity to the contract. However, he also indicated that “to the extent a contractual change would shift risks or costs between the supplier and the Company, the Company will evaluate the economic cost of the proposed shift and factor the cost into the bid price.” He stated that any such analysis would be included in Narragansett’s information filing to the Commission.¹⁶ In addition to that kind of analysis, Narragansett’s

¹² See 9-12 (explaining the criteria for procuring power for residential customers for periods following the September 1, 2004 through February 28, 2005 period).

¹³ Id. at 14.

¹⁴ Id. at 14-15.

¹⁵ Id. at 15.

¹⁶ Id. at 16.

confidential informational filing with the Commission would contain a summary of the initial and final bids as well as the final executed power supply contract.¹⁷

In accordance with the notice requirements of R.I.G.L. §§ 39-3-10 and 39-3-11, Narragansett will file the LRS rates for the six-month period commencing September 1, 2004 with the Commission no later than August 1, 2004. Residential customers taking LRS will continue to pay the SOS rate while non-residential customer will pay the actual LRS rate for each month.¹⁸

Finally, Mr. Hager indicated that Narragansett is not proposing to change any eligibility requirements for taking LRS. Narragansett maintains that it is in compliance with the Rhode Island Restructuring Amendments of 2002. Regardless, Narragansett believes that any changes to eligibility requirements should be addressed in a separate proceeding outside of the rate setting docket.¹⁹

IV. DIVISION'S POSITION

On May 13, 2004, the Division submitted a Memorandum prepared by its expert witness, Dr. John Stutz of the Tellus Institute. Dr. Stutz summarized Narragansett's proposed LRS acquisition plan and expressed his opinion that it is reasonable and appropriate. He also noted that the LRS acquisition plan is responsive to Division concerns which have been raised in past LRS dockets.²⁰

Addressing Narragansett's approach with regard to LICAP uncertainty, Dr. Stutz indicated that "The Company's proposal to deal with that uncertainty minimizes the risk premium due to such uncertainty, while still providing a reference price against which to

¹⁷ Id. at 16-17. In addition to filing a complete copy of the power supply contract under a request for proprietary treatment, Narragansett will also file a redacted public version.

¹⁸ Id. at 17-18.

¹⁹ Id. at 18-19.

judge bids for supply in the subsequent 30 months.” Furthermore, with regard to the proposed procedures for evaluating bids for supply for the periods February 2005 through August 2005, September 2005 through August 2006, and September 2006 through August 2007, Dr. Stutz opined that “[a]cceptance of the Company’s proposals provides an opportunity to secure residential supply at a known cost for up to 3 years, while minimizing the likelihood of locking in overly high costs or creating future disputes with supplies.²¹

V. HEARING

Following notice, a public hearing was conducted on May 17, 2004, at the Commission’s offices, 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR NARRAGANSETT ELECTRIC:	Thomas G. Robinson, Esq.
FOR THE DIVISION:	Paul J. Roberti, Esq. Assistant Attorney General
FOR THE COMMISSION:	Cynthia G. Wilson, Esq. Senior Legal Counsel

Michael Hager testified on behalf of Narragansett. Dr. Stutz testified on behalf of the Division. Mr. Hager summarized the proposed LRS Acquisition Plan, explaining that it is similar to the plan that was approved in 2003.²² However, he explained that there are two slight differences from previous years. The first is in response to Division concerns regarding procurement periods and the second is in response to uncertainty in locational capacity market rules.²³

²⁰ Div. Ex. 1 (Memorandum of John Stutz, 5/6/04).

²¹ Id.

²² Tr. 5/17/04, pp. 7-8.

²³ Id.

Mr. Hager provided a chart to explain the procurement periods and purchase criteria.²⁴ He explained that Narragansett will definitely procure power supply for the six-month period September 2004 through February 2005 for residential and non-residential customers. He then explained that if certain conditions are met, as set forth in his pre-filed testimony, Narragansett will procure power supply for residential customer for the period March 1, 2005 through August 31, 2005. Then if certain conditions are met, Narragansett will procure power supply for the periods September 1, 2005 through August 31, 2006 and possibly September 1, 2006 through August 31, 2007. However, Narragansett will not skip a procurement period. If the conditions are not met for a certain period, Narragansett will only procure up to that point and not beyond.²⁵ Mr. Hager noted that longer procurement plans have certain risks attached given the frequency with which market rules change. He maintained that regardless of the type of contract, each market rule change invites challenge from a supplier over cost shifting responsibility.²⁶

Addressing the uncertainty in locational capacity pricing rules, Mr. Hager explained that in the event FERC does not approve a final set of rules that alleviates all market uncertainty, Narragansett proposes procuring the capacity requirements on an actual pass through of market costs as opposed to locking in a price that has a premium attached which may be higher than actual costs.²⁷ In other words, whereas Narragansett has previously procured power supply on an all requirements, load following, all inclusive price basis, if the capacity market rules are still uncertain, Narragansett will

²⁴ Narragansett Exhibit 2.

²⁵ Tr. 5/17/04, pp. 18-26.

²⁶ Id. at 11-17, 25-28.

²⁷ Id. at 8-11.

procure on an all requirements, load following, all inclusive price excluding the capacity charges basis. To the extent there is certainty in the capacity market, Narragansett will procure power supply on the same basis as in the past.²⁸ If the LICAP charge is excluded and charged to retail customers as a pass-through cost, the charges will be reconciled during the annual standard offer service reconciliations.²⁹

Discussing the basics, Mr. Hager explained that LICAP is a generation market in which the installed capacity payment is designed to send a market signal for generation capacity in specific geographic locations in order to ensure sufficient capacity in those regions to meet the reliability criteria that is established for those regions. Under LICAP, the New England region will be split into four zones, each with its own capacity requirement. Generators will bid into each of the four zones. The bids in each zone can be different. More generation constrained areas should have higher costs than unconstrained areas. Bids into the Rest of Pool zone (Rhode Island) are expected to be lower than NEMA Boston or Southwest CT. However, while ISO-NE has provided an estimate of costs, the actual costs are uncertain. Mr. Hager indicated that the ISO-NE proposal suggests that the Rest of Pool should clear close to \$0.00. However, given the uncertainty, suppliers may still attach a premium to their prices.³⁰

In response to questions from the Bench, Narragansett agreed that if market conditions have not changed significantly at the time Narragansett is to procure power for the second six-month period, under R.I.G.L. § 39-1-27.3(c), the Commission is not required to conduct a full review of a proposed Acquisition Plan and that Narragansett

²⁸ Id. at 39-40

²⁹ Id. at 41-42.

³⁰ Id. at 28-39.

may continue to procure power under the Acquisition Plan approved in this docket. The Division also agreed with the conclusion.³¹

However, in order to determine whether the market conditions have changed, Narragansett agreed to provide the Commission with an assessment of the market as it exists at the time the procurement process would need to commence. This date was set at November 1, 2004.³² The Division indicated that it would need approximately two weeks to review Narragansett's assessment and provide the Commission with a position.

Narragansett was also seeking flexibility or discretion under the LRS acquisition plan to enter into power supply contracts with non-substantive changes, to analyze any non-conforming bids that might shift risks between Narragansett and the supplier to enter into such contracts if Narragansett's analysis showed a benefit to the ratepayer. The parties stipulated on the record to continue under the 2002 agreement and Commission findings regarding the Commission's authority if Narragansett exercised flexibility under its proposed Acquisition Plan.³³

³¹ Id. at 73-75.

³² Id. at 46-47, 52-53.

³³ Id. at 43-45, 52. In Docket No. 3444, Narragansett filed a letter with the Commission, setting out the agreement between the Division, the Attorney General and itself regarding the flexibility to be afforded Narragansett under the proposed acquisition plan and the suggested scope of the Commission's review of Narragansett's actions thereunder. First, the letter stated that the approved LRS acquisition plan should provide Narragansett with some flexibility or discretion, when faced with a non-conforming bid, to make a decision that it believes would be to the benefit of ratepayers.

Second, the July 17th letter stated that "[i]f Narragansett retains discretion within the plan to modify the procurement process, it should also have the responsibility to exercise that discretion reasonably. Thus the exercise of discretion under the plan should be subject to review." More particularly, the letter indicated that this review should occur during the process when Narragansett is deciding which supplier and which contract option to accept. As part of its plan, Narragansett has agreed to consult with the Division regarding each of the initial bids, including those, if any, that do not conform to the requirements in the acquisition plan. Narragansett has also agreed to advise the Commission immediately if Narragansett decides to choose an option that does not conform to the requirements of the approved acquisition plan. Because the Division will be privy to all available options, it will have the opportunity to raise concerns regarding Narragansett's choice and whether it conforms to the approved LRS acquisition plan. Finally, Narragansett would include the basis for its decision to accept a non-conforming bid in its informational filing with the Commission "after the commitment is made, but just prior to the effective date

With regard to Mr. Hager's concerns about risks associated with longer term procurements, Dr. Stutz indicated that he also has some discomfort with longer term procurements, but on the other hand, he has insecurity about not developing a portfolio approach and being permanently stuck in the short term. He noted that Narragansett has worked with the Division in a helpful way to bridge the gap and provide an opportunity to look to the long term, but with no obligation to lock in at too high a price.³⁴

IV. COMMISSION FINDINGS

After considering the evidence, the Commission rendered a bench decision, approving Narragansett's LRS Acquisition Plan as filed with the understanding that the Commission shall have the right to review Narragansett's final LRS power supply contract for compliance with the approved Plan and to review the prudence and reasonableness of any discretionary actions taken by Narragansett under the Plan. The Commission finds that Narragansett's proposal is in the best interest of ratepayers at this time. Narragansett finds that Narragansett's decision to guard as much as possible against the adverse effects of market uncertainty in pricing to be wise at this time.

Narragansett shall file a market assessment by November 1, 2004 in order to determine whether the Company should continue to procure LRS in accordance with the Plan approved in this docket. The Division should make a responsive filing by December

of the purchase." Accordingly, this will provide the Division and Commission with a number of opportunities to review Narragansett's actions during the selection process.

The July 17th letter also indicated that Narragansett's discretionary actions under an approved LRS acquisition plan should also be subject to an after-the-fact prudence review. Such a review would most likely be prompted if Narragansett's discretionary action, such as a decision to accept a non-conforming bid, had an adverse impact on the ratepayers. The review would be based on a review of the facts before Narragansett at the time it exercised its discretion. The letter concluded with the statement that, "with these limitations, Narragansett agrees that, notwithstanding the notification to the Division and Commission...the Commission retains the authority to conduct a retrospective review of the exercise of Narragansett's discretion undertaken under an approved plan. Narragansett's actions would also be subject to review for compliance with the Plan approved by the Commission."

1, 2004. In accordance with the statute, if the market has not changed significantly in six months, the Commission may allow Narragansett to continue to procure LRS under the same acquisition plan until such time as the competitive market conditions change.

The Commission also finds that the continuation of the agreement between the parties in Docket 3444, as approved in Commission Order 17203, is a reasonable approach to the issue of the Commission's right to review the prudence of Narragansett's discretionary actions under the approved Acquisition Plan as well as to review Narragansett's actions for compliance with the Plan.

The Commission is pleased that Narragansett has responded to the Division's concerns as discussed in Docket 3515 regarding the procurement terms for last resort service supply. It will be interesting to review the results of the new procurement.

Accordingly, it is hereby

(17903) ORDERED:

1. Narragansett Electric Company's proposed Last Resort Service Acquisition Plan covering the six-month period, September 1, 2004 through February 28, 2005, is hereby approved.
2. Narragansett Electric Company's proposed Last Resort Service Acquisition Plan covering the optional periods for residential customers, is hereby approved.
3. Narragansett shall file a market assessment by November 1, 2004.
4. The Division will make a responsive filing to Narragansett's market assessment which includes a recommendation regarding whether Narragansett

³⁴ Tr. 5/17/04, pp. 54-55.

should procure the six-month period March 1, 2005 through August 31, 2005 under the Last Resort Service Acquisition Plan approved herein.

5. The Commission shall have the right to review Narragansett's Last Resort power supply contracts for compliance with the approved Acquisition Plan, and to review the prudence and reasonableness of any discretionary actions taken by Narragansett under the approved Acquisition Plan.
6. Narragansett Electric Company shall comply with all other findings and instructions contained in this Report and Order.

EFFECTIVE AT WARWICK, RHODE ISLAND PURSUANT TO A BENCH DECISION ON MAY 17, 2004. WRITTEN ORDER ISSUED JULY 12, 2004.

PUBLIC UTILITIES COMMISSION

Elia Germani, Chairman

Kate F. Racine, Commissioner

Robert B. Holbrook, Commissioner