

123 FERC ¶ 61,038
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

Chehalis Power Generating, L.P.

Docket No. ER05-1056-002

ORDER ON INITIAL DECISION

(Issued April 17, 2008)

1. This case is before the Commission on exceptions to the January 16, 2007, Initial Decision¹ issued in this proceeding. The central issue is whether Chehalis Power Generating, L.P.'s (Chehalis)² proposed Rate Schedule FERC No. 2 (Rate Schedule or Schedule 2) for providing Reactive Supply and Voltage Control from Generation Sources Service (reactive power service) for its electric power generating facility interconnected to the transmission system of the Bonneville Power Administration (BPA) complies with the terms of the TransAlta settlement agreement (TransAlta Settlement).³ In this order, we affirm the Initial Decision in part and reverse it in part.

¹ *Chehalis Power Generating, L.P.*, 118 FERC ¶ 63,009 (2007) (Initial Decision).

² Chehalis is an exempt wholesale generator under section 32 of the Public Utility Holding Company Act of 1935. *See Chehalis Power Generation L.P.*, 96 FERC ¶ 62,204 (2001). It is authorized to make wholesale sales of power at market-based rates. *See Chehalis Power Generation L.P.*, Docket No. ER03-717-000 (May 9, 2003) (unpublished letter order).

³ *TransAlta Centralia Generation, L.L.C.*, 111 FERC ¶ 61,087 (2005). The TransAlta Settlement is unusual in that a number of parties, such as Chehalis, joined it that were not parties to the original dispute between BPA and TransAlta over payment for reactive power service. Since a number of independent power producers and investor owned utilities also wished to file rates for providing reactive power service to BPA, they joined in the negotiation and eventual settlement of issues initially arising from TransAlta's filing of a rate for reactive power service with the Commission.

I. Background

2. The modern history of reactive power pricing begins with Order No. 888.⁴ In Order No. 888, the Commission decided that reactive power was one of six ancillary services transmission providers must include in their open access transmission tariffs.⁵ The Commission stated that there are two methods of supplying reactive power and controlling voltage: (1) installing facilities as part of the transmission system and (2) using generation facilities. The Commission concluded that the costs of the first method would be recovered as part of the cost of basic transmission service and thus would not be a separate ancillary service.⁶ The second method (using generation facilities) would be considered a separate ancillary service, and must be unbundled from basic transmission service.⁷ The Commission stated that, in the absence of proof that the generation seller lacks market power in providing reactive power, rates for this ancillary service should be cost-based and established as price caps, from which transmission providers may offer a discount.⁸

⁴ *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, FERC Stats. & Regs. ¶ 31,036 at 31,705-06 and 31,716-17 (1996), *order on reh'g*, Order No. 888-A, FERC Stats. & Regs. ¶ 31,048, *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom. Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 535 U.S. 1 (2002).

⁵ Order No. 888, FERC Stats. & Regs. ¶ 31,036 at 31,705. The *pro forma* Open Access Transmission Tariff (OATT) includes six schedules that set forth the details pertaining to each ancillary service. The details concerning reactive power are included in Schedule 2 of the *pro forma* OATT. *Id.* at 31,960.

⁶ Supplying reactive power and voltage control by installing facilities as part of the transmission system is not at issue in this proceeding.

⁷ We note that, in Order No. 890, the Commission modified Schedule 2 of the *pro forma* OATT to indicate that reactive supply and voltage control may be provided by generating units as well as other non-generation resources such as demand resources, where appropriate. *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 72 Fed. Reg. 12,266 (Mar. 15, 2007), FERC Stats. & Regs. ¶ 31,241, at P 888 (2007), *order on reh'g*, Order No. 890-A, 73 Fed. Reg. 2984 (Jan. 16, 2008), FERC Stats. & Regs. ¶ 31,261 (2007).

⁸ Order No. 888, FERC Stats. & Regs. ¶ 31,036 at 31,720-21.

3. The next stage in the development of modern reactive power pricing is *American Electric Power Service Corp.*⁹ In *AEP*, the Commission approved a method for American Electric Power Service Corporation (AEP) to recover costs of reactive power (*AEP* methodology). The *AEP* methodology generally reflects the costs associated with four groups of plant investments including the generator-exciter,¹⁰ generator step-up transformers (GSU), accessory equipment and any remaining production plant investment. Since these groups of production power plant investment involve both reactive and real power, under the *AEP* methodology, an allocation factor is developed to divide the annual revenue requirements of components between real and reactive power production.

4. The allocator used to determine the amount of generator-exciter investment related to reactive power is based on the ratio of $MVAR^2$ to MVA^2 (reactive allocator) where $MVAR$ is megavolt amperes reactive capability and MVA is megavolt amperes capability at a power factor of one. Because GSUs also facilitate the transmission of real and reactive power, GSUs are allocated using the same reactive allocator to determine the portion related to reactive power service. Accessory equipment, including such equipment as auxiliary generators, generator main connections and station buses are allocated to reactive power production using the product of two allocators. The first allocator is the ratio of generator-exciter auxiliary load (MW) divided by total production plant auxiliary load (MW). The second allocator used to determine the portion of accessory equipment that is reactive power-related is the same reactive power allocator used for generator-exciters and GSUs. The remaining production plant investment is calculated by subtracting the generator-exciter, GSU and accessory equipment from total production plant, to avoid double counting. The remaining production plant investment is allocated to reactive power service using the allocator called the remaining power plant investment allocator or balance of plant allocator, which is the product of two ratios. The first ratio is exciter MW/generator MW. The second ratio is the maximum $MVARs$ /nameplate $MVARs$.

5. Once the reactive power related costs of the generator-exciter, GSUs, accessory equipment and remaining production power plant are identified, the sum of these, known as the total reactive power plant investment, is multiplied by a fixed charge rate excluding operation and maintenance (O&M) expenses. For O&M expenses under the *AEP* methodology, a portion of expenses associated with Maintenance of Electric Plant

⁹ *American Electric Power Service Corp.*, 80 FERC ¶ 63,006 (1997), *aff'd*, 88 FERC ¶ 61,141 (1999) (*AEP*).

¹⁰ The cost of the generator-exciter is generally isolated from the turbine-generator-exciter costs based on a manufacturer's suggested percentage.

accounts (Accounts 513, 531 and 544) and Maintenance of Miscellaneous Other Power Generation accounts (Account 554) are assigned to the reactive power revenue requirement. The rest of non-fuel O&M expenses are allocated to the reactive power revenue requirement using the same balance of plant allocator as used for the remaining plant.

II. Chehalis's Proposed Rate Schedule

6. On May 31, 2005, pursuant to section 205 of the Federal Power Act (FPA), Chehalis filed a proposed rate schedule that sets forth its revenue requirement for supplying reactive power service to BPA from Chehalis's electric generating facility (Facility), a 520 MW power plant consisting of two natural gas generators and one steam generator, located in Chehalis, Washington.¹¹ Chehalis's revenue requirement is composed of three components: (1) a Fixed Capability Component, which is designed to recover the portion of plant costs attributable to the reactive power capability of the Facility; (2) a Heating Losses Component, which is designed to recover the value of real power lost as a result of the production of reactive power; and (3) a Service Factor, which is intended to represent the operational status of the Facility.¹²

7. Chehalis explains that it made its filing pursuant to the TransAlta Settlement, which specifies, among other things, procedures for the filing of reactive power service rates by each of the generator settling parties.¹³ Under the terms of the TransAlta Settlement, each generator's reactive power rate must be determined according to the *AEP* methodology, as that methodology existed on the date the TransAlta Settlement was filed, February 16, 2005, (the Current *AEP* Methodology) regardless of subsequent modifications to the methodology or new methodologies adopted by the Commission.

8. BPA filed a timely motion to intervene and a protest of Chehalis's rate schedule filing. Although BPA agreed in the TransAlta Settlement not to challenge rates based upon the Current *AEP* Methodology, it reserved the right to challenge rates on the grounds that they do not comply with the Current *AEP* Methodology.¹⁴

¹¹ *Chehalis Power Generating, L.P.*, 112 FERC ¶ 61,144, at P 2 (2005) (July 2005 Order).

¹² July 2005 Order, 112 FERC ¶ 61,144 at P 8.

¹³ The uncontested TransAlta Settlement was approved by the Commission on April 19, 2005. *Transalta Centralia Generation, L.L.C.*, 111 FERC ¶ 61,087 (2005).

¹⁴ July 2005 Order, 112 FERC ¶ 61,144 at P 14.

9. On July 27, 2005, the Commission accepted Chehalis's proposed rate schedule and suspended it for a nominal period, to become effective August 1, 2005, subject to refund.¹⁵ In that order, the Commission also established hearing and settlement judge procedures.¹⁶ The Commission held the hearing in abeyance to allow for settlement discussions, but the discussions failed.¹⁷

10. A hearing began on September 26, 2006, and the Presiding Judge issued the Initial Decision on January 16, 2007.

III. Discussion

11. As discussed below, we affirm the following determinations by the Presiding Judge: (1) the TransAlta Settlement authorizes annual adjustments only to the Service Factor, not the Fixed Capability Component; (2) the locked-in period in this proceeding is August 1, 2005 through September 30, 2006; (3) the BPA 500 kV switchyard is a transmission facility and is not properly included in Total Production Plant and Accessory Electric Equipment; (4) the Chehalis substation is a transmission facility and is not properly included in Total Production Plant and Accessory Electric Equipment; (5) the transmission reservation fees Chehalis paid to BPA are not properly includible in Total Production Plant; (6) the \$900,000 payment that Chehalis made to BPA is not properly included in Total Production Plant; (7) Chehalis is not entitled to recover a separate Heating Losses Component; and (8) Chehalis's proxy cost of debt is 6.725 percent.

12. As discussed further below, however, we reverse the Presiding Judge and find that Chehalis has supported inclusion of its Facility installation costs in Total Production Plant and Accessory Electric Equipment. To the extent not discussed below, we affirm the Presiding Judge.

13. Based on these determinations, we direct Chehalis to file a revised rate schedule consistent with the determinations made in this order. We also direct Chehalis to make any necessary refunds and file a refund report with the Commission.

¹⁵ *Id.* P 1.

¹⁶ *Id.*

¹⁷ On August 26, 2005, Chehalis filed a request for rehearing of the July 27, 2005 Order. The Commission denied Chehalis's request for rehearing on December 15, 2005. *Chehalis Power Generating, L.P.*, 113 FERC ¶ 61,259 (2005).

A. Annual Updates to Reactive Power Service Rate

1. Presiding Judge's Findings

14. The Presiding Judge finds that the TransAlta Settlement prohibits Chehalis from annually updating the rate components that make up its Fixed Capability Component.¹⁸ The Presiding Judge examines the language and purpose of the TransAlta Settlement and concludes that Chehalis may adjust *only the Service Factor* in its annual update. As a consequence, the Presiding Judge holds that Chehalis may make no filings that would otherwise alter the initial rate (the rate filed on May 31, 2005) until it files for a change that would take effect on or after October 1, 2007.¹⁹

15. The Presiding Judge examines the specific language of the TransAlta Settlement and concludes that section B permits only three types of filings before October 1, 2007: (1) an initial FPA section 205 filing; (2) a subsequent rate filing to change the rate that would be effective on or after October 1, 2007 and (3) filings with the annual Service Factor update.

16. The Presiding Judge finds that section D.14 explains how the Service Factor is to be calculated and applied against the annual rate determined under the Current *AEP* Methodology while the TransAlta Settlement is in effect.

17. The Presiding Judge holds that section D.15 directs Chehalis to provide BPA with its new reactive power service rate based on the updated Service Factor by August 15 of each year for filing with the Commission as a compliance filing. The Presiding Judge cites a sentence in section D.15 that provides that “*the purpose of the submission is to notify the Commission of the adjustment to the Service Factor element in the formula rate established by this TransAlta Settlement,*”²⁰ and concludes that this language is consistent with the TransAlta Settlement’s “scheme of permitting and requiring an annual change only to the Service Factor.”²¹

18. The Presiding Judge rejects Chehalis’s claim that the words “formula rate” in the sentence cited by the Presiding Judge indicate that the TransAlta Settlement established a “formula rate” in the sense generally used in Commission terminology. The Presiding

¹⁸ Initial Decision, 118 FERC ¶ 63,009 at P 8-10.

¹⁹ *Id.* P 25.

²⁰ *Id.* P 22 (citing Ex. CPG-3 at 19 (emphasis added)).

²¹ *Id.* P 22 (emphasis in original).

Judge finds that the TransAlta Settlement has none of the attributes of a traditional formula rate; specifically, the Presiding Judge notes that the TransAlta Settlement has no provisions for particular inputs, terms or conditions, as a formula rate would require. Moreover, the Presiding Judge concludes that Chehalis's interpretation would undermine section B's restrictions on filings before October 1, 2007, as well as directly contradict the sentence in which the term "formula rate" appears, because the rest of that sentence specifies that the purpose of the updated filing is to update the Service Factor.

19. The Presiding Judge concludes that the term "formula rate" as used in the TransAlta Settlement is "merely a logical reference to the simple formula construct of the Settlement Agreement itself, whereby the *AEP* calculation is multiplied by the Service Factor to produce the Schedule 2 amount to be passed on to transmission customers."²² The Presiding Judge states that this "formula" is simply: $A \times B = C$; where "A" is the result of applying the Current *AEP* Methodology (Fixed Capability Component), "B" is the updated Service Factor, and "C" is the Schedule 2 amount.

2. Exceptions

a. Chehalis

20. Chehalis agrees with the Presiding Judge that the TransAlta Settlement establishes a formula of $A \times B = C$, where "A" is the Fixed Capability Component, "B" is the updated Service Factor, and "C" is the Schedule 2 amount. However, Chehalis disagrees with the Presiding Judge's holding about "the source of A."²³ Chehalis agrees that "A" is the result of applying the Current *AEP* Methodology, but rejects the Presiding Judge's holding that "A" remains constant throughout the term of the TransAlta Settlement.²⁴ In Chehalis's view, the plain language of the TransAlta Settlement and principles of contract interpretation provide that Chehalis is permitted to update "A" as well as "B" (the Service Factor), that is, update rate components that factor into calculating its Fixed Capability Component under the Current *AEP* Methodology. Thus, Chehalis's exceptions challenge the Presiding Judge's interpretation of the TransAlta Settlement.

21. Chehalis contests the Presiding Judge's interpretation of section B of the TransAlta Settlement, which states, in relevant part:

²² Initial Decision, 118 FERC ¶ 63,009 at P 25.

²³ Chehalis Brief on Exceptions at 22.

²⁴ *Id.* at 22-23.

Once the initial rate filings described above become effective and once any issues, if any, reserved pursuant to section C.1.c below are resolved, no Settling Party may submit a request to change the rates described in section C.2, C.3, C.4 and C.5 of this TransAlta Settlement pursuant to either sections 205 or 206 of the FPA prior to October 1, 2007, except by unanimous consent of the Settling Parties, or except to the extent necessary to allow new rates to become effective on October 1, 2007.²⁵

22. Chehalis interprets this language to mean that filings “that do not change [s]ection C.5 . . . and that are consistent with [s]ection C.5 are [also] permitted.”²⁶ As a consequence, Chehalis asserts that annual updates are permitted unless prohibited by section C.5, and contends that section C.5 describes rate components that cannot be changed, such as return on equity (ROE) and capital structure, but leaves Chehalis free to update the remaining components of its filed rate.²⁷

23. Chehalis observes that sections C.5.a and C.5.b use the term “Reactive Power Service rate,” while sections C.5.c and D.14.d use the term “annual rate determined by the Current AEP Methodology.” Chehalis argues that the term “Reactive Power Service rate” relates to its initial filing, while the term “annual rate determined by the Current AEP Methodology” relates to subsequent filings with updated Fixed Capability Components. Chehalis claims that its interpretation is supported by BPA’s witness, who acknowledged that section C.5 does not specifically forbid Chehalis from updating components of its rate other than the Service Factor, and Staff’s witness, who acknowledged that section C.5.c does not refine the term “annual rate determined by the Current AEP Methodology” or otherwise tie it back to the term, Reactive Power Service rate.

24. Chehalis also argues that section D.15 indicates that the Service Factor is merely a single element in a larger formula because it uses the term “formula rate” in describing the purpose of the annual compliance filing Chehalis is required to file with the Commission. “The purpose of the submission is to notify the Commission of the Service Factor element in the *formula rate* established by this Settlement Agreement.”²⁸ Chehalis

²⁵ Ex. CPG-3 at 3-4.

²⁶ Chehalis Brief on Exceptions at 18. Sections C.2, C.3 and C.4 are inapplicable to Chehalis.

²⁷ Chehalis claims that section C.5.a does not contradict the use of updated rate components and that section C.5.b, which also applies to the initial filing, is silent on the formula rate issue.

²⁸ Ex. CPG-3 at 19 (emphasis added).

maintains that the TransAlta Settlement's use of "formula rate," read in light of its interpretation of sections B, C.5.c, and D.14, indicates that it may annually update the rate components that compose its Fixed Capability Requirement.

25. Additionally, Chehalis points to language in section D.15 that requires Chehalis to provide BPA with "the new reactive power rate, the new Service Factor, and all data needed to verify the Service Factor."²⁹ Chehalis argues that this language supports its position because the term "new reactive power rate" must refer to a rate with updated inputs to which the Service Factor is applied. Chehalis asserts that there is no need to supply BPA with the "new reactive power rate" ("C" in the formula) if BPA is supplied with the updated Service Factor ("B" in the formula) and BPA already has the Fixed Capability Component ("A" in the formula) because it is constant throughout the term of the TransAlta Settlement.³⁰ Chehalis asserts that section D.15 requires Chehalis to submit the "new reactive power rate" because the values for *both* "A" and "B" are subject to change.

26. Similarly, Chehalis claims that the Presiding Judge erred by holding that the TransAlta Settlement fails to set forth any attributes of a traditional formula rate. Chehalis states that the TransAlta Settlement requires periodic updates, that it identifies the inputs required for the formula rate and that the formula is the Current *AEP* Methodology, together with the "schedules" referenced by its witness.

b. Staff

27. Staff argues that the Presiding Judge erred in stating that the locked-in period in this proceeding is August 1, 2005, through September 30, 2006.³¹ Staff contends that the correct period is from August 1, 2005, through September 30, 2007. Staff asserts that this is the time period prescribed in the TransAlta Settlement during which the rate will remain in effect. Staff further argues that the underlying annual revenue requirement determined under the Current *AEP* Methodology will not change until Chehalis files to change it under section 205 of the FPA effective on or after October 1, 2007, or until BPA seeks to change it under section 206 effective on or after October 1, 2007.

²⁹ *Id.* at 19.

³⁰ Chehalis Brief on Exceptions at 24.

³¹ Staff Brief on Exceptions at 10-12.

3. Opposing Exceptions

a. BPA

28. BPA argues that the Presiding Judge correctly held that section B permits only three types of filings before October 1, 2007, and that annual updates to components of Chehalis's rate other than the Service Factor are not permitted.³² BPA contends that it is unlikely that the parties to the TransAlta Settlement intended to resolve issues pertaining to current and future reactive power service rate filings, but remained silent on other revisions they had contemplated. BPA observes that sections B and C.5 direct Chehalis to annually adjust its Service Factor, but do not authorize any adjustments to other rate components. Similarly, BPA asserts that sections D.14 and D.15 detail specific procedures for revising the Service Factor, but do not authorize or discuss other compliance filings.

29. BPA rejects Chehalis's interpretation of the term "formula rate." BPA agrees that the reactive power service rate adjusts annually pursuant to a defined formula, but observes that the TransAlta Settlement does not refer to anything other than the Service Factor's being adjusted. BPA maintains that, prior to October 1, 2006, Chehalis is to update the Service Factor and calculate a new rate by multiplying its same annual revenue requirement by the new Service Factor.

30. BPA also asserts that reliance on the phrase "annual rate" is misplaced. BPA maintains that nothing in the word "annual" requires or suggests that the rate be subject to other types of cost updates. It adds that in section C.2.c, the dollar amount used as the cost of service remains unchanged for the entire period of October 1, 2005 through September 30, 2007.

31. BPA also asserts that while its witness agreed that sections C.5 and D.15 do not specifically forbid updates to cost components, the witness explained that section B prohibits such updates.

b. Staff

32. Staff argues that the Presiding Judge correctly held that the TransAlta Settlement allows updates only to the Service Factor before October 1, 2007.³³ Staff disagrees with Chehalis's interpretation of the term "formula rate." Staff cites section D.15 and argues that the term "formula rate" must be understood to refer to the application of the Service

³² BPA Brief Opposing Exceptions at 14-19.

³³ Staff Brief Opposing Exceptions at 16-29.

Factor to the Fixed Capability Component. Staff asserts that Chehalis's arguments must fail for three reasons: (1) the TransAlta Settlement does not provide for annual updates other than of the Service Factor; (2) the TransAlta Settlement expressly prohibits rate filings prior to October 1, 2007; and (3) the Fixed Capability Component of Chehalis's rate is not a formula and cannot be updated before October 1, 2007.

33. Staff observes that the term "formula rate" appears only once in the TransAlta Settlement, and then, only in reference to updating the Service Factor to be applied to the rate.³⁴ Staff argues that Chehalis's interpretation would create meaning where there is none, and that the use of the term "formula rate" suggests sloppy draftsmanship rather than an intent to contradict the main thrust and balance of the TransAlta Settlement. Staff claims that Chehalis's interpretation ignores the moratorium against rate filings until October 2007, as well as the TransAlta Settlement's specificity with respect to calculating the Service Factor. Staff contends that Chehalis's interpretation is unlikely because it makes no sense for the settling parties to have devoted so much time to specifying procedures with respect to the Service Factor, while making no similar provisions with respect to updating the Fixed Capability Component itself.

34. Staff asserts that there is nothing in the TransAlta Settlement or in *AEP* that supports the notion that the Current *AEP* Methodology is intended to be a rate formula. Staff maintains that it is a formula, but not a "formula rate" as that term is generally used in Commission proceedings. Instead, Staff asserts that Chehalis's rate schedule reflects a stated rate, a single dollar amount. Staff notes that the TransAlta Settlement is completely devoid of a formula for calculating the Fixed Capability Component. Staff concludes that it is inconceivable that the TransAlta Settlement would be completely silent about a formula for something as significant as the Fixed Capability Component.

35. Staff argues that Chehalis's actual practice indicates that it regards section B's prohibition on filings that "change the rates described in . . . section C.5" as prohibiting updates to rate components other than the Service Factor.³⁵ Staff states that Chehalis filed an update on September 29, 2006, but did not indicate it was a compliance filing. Indeed, Staff points out, Chehalis did not file it with the instant docket number, but presupposed an ER docket, which generally indicates that the applicant considers the submittal a section 205 filing. Because this is a section 205 filing, Staff asserts, it would be a clear violation of section B because it would change the rate before October 1, 2007. Thus, Staff notes, the only change Chehalis proposed was a new Service Factor, and thus

³⁴ *Id.* at 19.

³⁵ Staff Brief Opposing Exceptions at 22.

was in conformance with the TransAlta Settlement.³⁶ Staff also notes that the other settling parties made filings only updating their Service Factors.

36. Staff also rejects Chehalis's argument that nothing in section C.5 specifically forbids Chehalis from making other changes to its rates. Staff argues that this claim ignores section B's prohibition on filings that "change the rates described in . . . section C.5" before October 1, 2007.

37. Staff also argues that Chehalis has not filed a formula rate.³⁷ Staff asserts that a formula rate at the Commission includes components identifiable by FERC account number and does not result in a dollar amount until the formula inputs for a particular time period are applied. Staff adds that the Commission requires formula rates to be specific. Staff further states that the formula itself is the rate and notes that Chehalis's Schedule 2 includes only a stated dollar amount, not a formula. Staff notes that Chehalis did not address this fact. Staff also notes that prior to this case Chehalis had been providing reactive power service to BPA at no charge. Thus, according to Staff, Chehalis made its "initial rate filing" on May 31, 2005, and Chehalis cannot submit a request to change that rate before October 1, 2007.³⁸

38. Finally, Staff disagrees with Chehalis's assertion that any silence in section C.5 supports its argument that, unless specifically prohibited, Chehalis is entitled to update its rate components. Staff argues that this completely ignores the moratorium in section B and that contract construction principles do not provide for giving effect to unstated terms.³⁹

³⁶ Staff explains that Chehalis appended information to that update filing that it intends "to support a rate up to the Revised Annual Rate in the event the Commission ultimately agrees with Chehalis's interpretation of the TransAlta Settlement."

³⁷ Staff Brief Opposing Exceptions at 25.

³⁸ Staff further explains that the Commission previously found that Chehalis's filed rate schedule was a "changed" rate subject to suspension and refund rather than an "initial rate." Staff Brief Opposing Exceptions at 26 (citing *Chehalis Power Generating, L.P.*, 112 FERC ¶ 61,144, *reh'g denied*, 113 FERC ¶ 51,259 (2005)).

³⁹ Staff Brief Opposing Exceptions at 28-29 (quoting *Arkansas Power and Light Co.*, 21 FERC ¶ 63,101 (1982), *summarily aff'd*, 24 FERC ¶ 61,306 (1983) ("As Staff correctly notes, silence creates no inferences unless the circumstances are such that a response would be called for. (citation omitted). If Cities' view were accepted, the drafter of a contract would be required to state intent under every provision of a contract or risk an adverse inference from silence. The law creates no such duty."))

c. Chehalis

39. Chehalis opposes Staff's exception pertaining to the locked-in period. Chehalis argues that the Presiding Judge correctly held that the locked-in period is from August 1, 2005 through September 30, 2006.⁴⁰ Chehalis explains that the Commission has accepted for filing in Docket No. ER06-1548-000 Chehalis's revised rate for Reactive Service for service commencing October 1, 2006.⁴¹ Chehalis adds that Staff ignores the fact that the filing of an annual Service Factor update results in the filing of a new rate.

4. Commission Determination

a. Chehalis's Exceptions

40. We deny Chehalis's exceptions and affirm the Presiding Judge's holding that the TransAlta Settlement authorizes annual adjustments only to the Service Factor. Although ambiguous, we conclude that when the TransAlta Settlement is read in its entirety, it evinces a "scheme of permitting and requiring an annual change only to the Service Factor."⁴² For example, section B prohibits filings that "change the rates described in section . . . C.5," but permits and requires an annual filing updating the Service Factor. No other annual updates are mentioned. Section B further directs that Chehalis update the Service Factor according to the procedures set forth in sections D.14 and D.15, both of which are silent with respect to updating the Fixed Capability Component. Thus, we read section B as generally prohibiting filings that change Chehalis's rate, but specifically excepting filings updating its Service Factor, and we regard the absence of an exception for updates to the Fixed Capability Component as evidence that the TransAlta Settlement intends the Fixed Capability Component to remain constant throughout the TransAlta Settlement. Therefore, we conclude that section B contemplates updates to the Service Factor only.

41. Similarly, sections C.5, D.14 and D.15 address Chehalis's requirement to make annual updates, but reference only updates to the Service Factor. For example, although section C.5.b provides for an initial Service Factor, and section C.5.d provides for an initial ROE and cost structure, the only language in section C.5 pertaining to annual updates is in section C.5.c—and it requires Chehalis to annually recalculate the Service Factor. Moreover, sections D.14 and D.15 contain detailed instructions explaining how

⁴⁰ Chehalis Brief Opposing Exceptions at 10-12.

⁴¹ *Id.* at 12 (citing *Chehalis Power Generating, L.P.*, 117 FERC ¶ 61,235 (2006))

⁴² Initial Decision, 118 FERC ¶ 63,009 at P 22.

Chehalis should calculate and communicate its annual Service Factor update, but contain no similar information with respect to its Fixed Capability Component. In fact, the TransAlta Settlement is silent with respect to updates to components other than the Service Factor, a point underscored by language in section D.15 directing Chehalis to make a compliance filing for the “[t]he purpose of . . . notify[ing] the Commission of the adjustment to the Service Factor”⁴³ and the lack of similar language with respect to the Fixed Capability Component. It is also worth noting, despite the TransAlta Settlement’s ambiguity, that no other settling party has adopted Chehalis’s interpretation.

42. In order to hold that the TransAlta Settlement permits annual updates to the Fixed Capability Component, we would have to find that the settling parties intended to silently authorize updates that are never mentioned or discussed in the TransAlta Settlement. Rather than support Chehalis’s argument, this silence by the settling parties indicates that they did not intend to authorize updates to the Fixed Capability Component.⁴⁴ We would also have to discount the fact that the settling parties crafted a detailed procedure for the single update that they did mention—the annual Service Factor update. Chehalis has failed to explain why the settling parties would specify the Service Factor update as an exception to the general rule against filings in section B, repeat the command to file the Service Factor update in section C.5 and set forth the procedures applicable to the Service Factor update in sections D.14 and D.15, but never once mention updates to the Fixed Capability Component. Moreover, Chehalis has failed to offer a persuasive reason why the settling parties would be so detailed and specific with respect to the Service Factor update and yet intend to authorize updates to the Fixed Capability Component silently or by implication. Accordingly, we hold that sections B, C.5, D.14, and D.15 evince a “scheme of permitting and requiring an annual change only to the Service Factor.”

43. We also reject Chehalis’s interpretation of sections B and C.5. Chehalis argues that because section B forbids filings that “change the rates described in section . . . C.5,” it does not forbid filings that are consistent with section C.5. Chehalis maintains that section C.5 describes the rate components that cannot be changed, such as the ROE and capital structure, “but leaves [it] free to update the remaining components of its filed

⁴³ Ex. CPG-3 at 19 (emphasis added).

⁴⁴ See *Consolidated Gas Supply Corp. v. FERC*, 745 F.2d 281, 291 (4th Cir. 1984), cert. denied, 472 U.S. 1008 (1985) (“It is a reasonable interpretation device to conclude that what someone has not said, someone has not meant.”); *Mobil Oil Corp. v. FPC*, 570 F.2d 1021, 1025 (D.C. Cir. 1978) (citing *Texas Gas Transmission Corp. v. FPC*, 441 F.2d 1392, 1396 (6th Cir. 1971), approvingly for proposition that in contract law, silence should not be interpreted as indicating agreement between the parties).

rate.”⁴⁵ Chehalis claims that “[a]n update filing pursuant to [s]ection B is consistent with [s]ection C.5.”⁴⁶

44. We disagree. Chehalis’s basic claim is that updates to the Fixed Capability Component are permitted “unless prohibited by section C.5.”⁴⁷ However, this interpretation is inconsistent with section C.5 and without support in section B. Contrary to Chehalis’s interpretation, section C.5 does not prohibit any annual updates.⁴⁸ The only filing prohibited in section C.5 is a rate schedule with an effective date before August 1, 2005,⁴⁹ and the only mention of annual updates is the language in section C.5.c requiring annual updates to the Service Factor. Similarly, although Chehalis acknowledges that it may not update its ROE and capital structure, section C.5 makes no mention of prohibiting such updates.⁵⁰ Thus, the source of the prohibition on updates that Chehalis acknowledges, albeit incompletely, is actually section B’s ban on filings that “change the rates described in section . . . C.5.” This prohibition is unqualified, save for the requirement that Chehalis file an annual Service Factor update.⁵¹

45. Similarly, Chehalis’s interpretations of the terms “Reactive Power Service Rate,” “annual rate determined by the Current AEP Methodology,” “new reactive power rate,”

⁴⁵ Chehalis Brief on Exceptions at 18.

⁴⁶ *Id.*

⁴⁷ *See id.*

⁴⁸ Chehalis itself implicitly recognizes this fact when it argues that BPA’s witness “acknowledged that no portion of section C.5 specifically forbids Chehalis from making other changes to its rates.” *Id.* at 19-20.

⁴⁹ *See* Ex. CPG-3 at 12.

⁵⁰ Section C.5.d states: “For the initial proposal Chehalis will use a return on equity of 11 percent and a capital structure of 50 percent equity and 50 percent debt in performing the Current AEP Methodology calculation.” *Id.* at 13.

⁵¹ In other words, section B is a general prohibition on *all* filings that “change the rates described in section . . . C.5,” such that an update to the Fixed Capability Component or to the ROE is prohibited. The only exception to this general prohibition is the Service Factor update because it is specifically permitted and required by section B itself.

and “formula rate” are inconsistent with, and have no support in, the TransAlta Settlement.

46. Chehalis argues that the term “Reactive Power Service Rate,” which first appears in section C.5.b, refers to its initial rate filing, while the term “annual rate determined by the Current *AEP* Methodology,” which first appears in section C.5.c, refers to subsequent filings that may update the Fixed Capability Component. However, section B repeatedly uses the term “initial rate filing” without ever employing the term “Reactive Power Service Rate,” much less introducing it as a substitute for “initial rate filing.” Similarly, section C.5.b, which introduces the term “Reactive Power Service Rate,” uses the term “initial filing” without specifically or unambiguously linking it back to “Reactive Power Service Rate.”⁵² Moreover, neither “Reactive Power Service Rate” nor “annual rate determined by the Current *AEP* Methodology” are formally defined or distinguished in the TransAlta Settlement.⁵³ To accept Chehalis’s interpretation, we would have to read sections C.5.b and C.5.c in isolation from, and without reference to, section B, ignore the internal inconsistency in section C.5.b and impose an interpretation that has no support in the language of the TransAlta Settlement. Accordingly, we reject Chehalis’s interpretation of these terms.

47. We also observe that section C.5.c, which requires that the “[t]he recalculated (new) Service Factor . . . be applied to the annual rate determined by the Current *AEP* Methodology to determine the rate for next year,”⁵⁴ specifically uses the word “recalculated” in reference to the Service Factor, but not with respect to the term “annual rate determined by the Current *AEP* Methodology.” Thus, we conclude that the term “annual rate determined by the Current *AEP* Methodology” is not intended to refer to a “recalculated” rate.

48. We also reject Chehalis’s interpretation of the term “the new reactive power rate” in section D.15. Chehalis argues that the term “the new reactive power rate” in the phrase “[t]he plant owner will provide the *new reactive power rate*, new Service Factor, and all data needed to verify the Service Factor” refers to a rate with an updated Fixed

⁵² Section C.5.b states, “When it files for Commission approval of a *Reactive Power Service rate* for the Chehalis plant, Chehalis will use the *Current AEP Methodology* to determine compensation and will apply a Service Factor of 63.1 percent for the *initial filing*.” Ex. CPG-3 at 12 (emphasis added).

⁵³ Chehalis itself implicitly admits this point by arguing that “Staff’s witness acknowledged that section C.5.c does not refine the term ‘annual rate determined by the Current *AEP* Methodology.’” Chehalis Brief on Exceptions at 20.

⁵⁴ Ex. CPG-3 at 19.

Capability Component. Chehalis claims that “[n]othing in [s]ection D.15 precludes such an interpretation,”⁵⁵ and that the only reason to supply BPA with the “new reactive power rate” is if the Fixed Capability Component is subject to change during the duration of the TransAlta Settlement.

49. We disagree. There is nothing about the term “the new reactive power rate” that indicates that it must be the product of an updated Service Factor as well as an updated Fixed Capability Component. Chehalis assumes, without warrant, that the Fixed Capability Component must be updated to result in a “new reactive power rate.” The fact that the Service Factor alone is annually updated is itself sufficient to create a “new reactive power rate.” Moreover, as we have explained, the TransAlta Settlement contains no language describing a filing to update Chehalis’s Fixed Capability Component. However, it does contain detailed and specific instructions with respect to updating the Service Factor.

50. Similarly, Chehalis’s argument that there is no need to supply BPA with the “new reactive power rate” if the Fixed Capability Component is to remain constant is not persuasive. While this requirement may be open to multiple interpretations, they cannot be unreasonable or inconsistent with the Presiding Judge’s overall interpretation of the TransAlta Settlement. For example, it is entirely plausible and consistent with the Presiding Judge’s view that BPA would want to receive the “new reactive power rate” along with the updated Service Factor in order to allow BPA, already in possession of the value of the Fixed Capability Component, to easily determine whether Chehalis had correctly calculated the “new reactive power rate.” Moreover, we find it relevant that Chehalis is required to only supply an updated Service Factor, but is not required to include an updated Fixed Capability Component. Based on our reading of the TransAlta Settlement as a whole, this fact indicates that it is unnecessary to submit an updated Fixed Capability Component because, unlike the Service Factor, the Fixed Capability Component is to remain constant through the term of the TransAlta Settlement.

51. Finally, we affirm the Presiding Judge’s holding that the TransAlta Settlement does not establish a formula rate as that term is generally used in Commission proceedings. We note that the term “formula rate” is used only once in the entire TransAlta Settlement—at the end, in section D.15.⁵⁶ Moreover, the term “formula rate” is not defined in the TransAlta Settlement. Accordingly, based on our reading of the TransAlta Settlement as a whole, we agree with the Presiding Judge’s holding that the term “formula rate” is “merely a logical reference to the simple formula construct of the

⁵⁵ Chehalis Brief on Exceptions at 21.

⁵⁶ The settlement only has two sections after this, section D.16 and D.17.

TransAlta Settlement agreement itself, whereby the *AEP* calculation is multiplied by the Service Factor to produce the Schedule 2 amount to be passed on to transmission customers.”⁵⁷

52. We hold, however, that whether the TransAlta Settlement establishes a “formula rate” as Chehalis argues is immaterial to whether or not Chehalis may update its Fixed Capability Component. As we have explained, when read as a whole, the TransAlta Settlement establishes a “scheme of permitting and requiring an annual change only to the Service Factor.” For example, while section B prohibits filings that “change the rates described in section . . . C.5,” it specifically directs Chehalis to file annual Service Factor updates. Thus, whether the TransAlta Settlement is interpreted to establish a formula rate or to provide that a new rate is filed each time Chehalis updates its Service Factor, the fact remains that an annual update to the Service Factor is the only update contemplated in section B. In other words, if we decide that the Presiding Judge correctly held that the TransAlta Settlement does not establish a formula rate, then section B establishes a general rule against filings that change Chehalis’s reactive power rate, and creates a specific exception for filings updating the Service Factor. However, even if we were to hold that the Presiding Judge erred and that the TransAlta Settlement does establish a formula rate, nothing in section B indicates that the Fixed Capability Component is a rate component that may be annually updated. On the contrary, section B’s directive to annually update the Service Factor underscores the conspicuous absence of any similar requirement with respect to the Fixed Capability Component, and indicates that updates to the Fixed Capability Component are prohibited because the TransAlta Settlement intends the Fixed Capability Component to remain constant throughout its duration. Thus, even if we were to agree with Chehalis’s interpretation of “formula rate,” we would still find, based on what we have said above, that the Service Factor is the only component of the formula that may be updated.

b. Staff’s Exception

53. We deny Staff’s exception and affirm the Presiding Judge’s holding that the locked-in period in this proceeding is August 1, 2005 through September 30, 2006. In Docket No. ER06-1548-000, Chehalis filed a new reactive power rate schedule. The Commission accepted the rate schedule, effective October 1, 2006, as requested, subject to refund, subject to the outcome of the instant proceeding and subject to a compliance filing.⁵⁸ As a consequence, the rate schedule at issue here is only in effect—and thus “locked-in”—for the period of August 1, 2005 through September 30, 2006. We note,

⁵⁷ Initial Decision, 118 FERC ¶ 63,009 at P 25.

⁵⁸ *Chehalis Power Generating, L.P.*, 117 FERC ¶ 61,235 at P 1, 11.

however, that the rate schedule in Docket No. ER06-1548-000 is still subject to the TransAlta Settlement, and specifically to our finding that the TransAlta Settlement permits annual updates only to the Service Factor.

B. Specific Items in Total Production Plant and Accessory Electric Equipment

1. BPA 500 kV Switchyard

a. Presiding Judge's Findings

54. The Presiding Judge explains that, as all the participants agree, the Facility is transmission equipment, the costs of which would be included in FERC Transmission Account 353 and not under any of the plant production and accessory equipment accounts that were addressed in *AEP*. The Presiding Judge further explains that Chehalis is an independent power producer and not also a transmission provider as are traditional utilities like AEP, and Chehalis does not have an OATT under which it can recover transmission costs. He explains that thus Chehalis would use Schedule 2 to pass those costs through to transmission customers.

55. The Presiding Judge observes that, as equitable as it may appear, Schedule 2 is not a catch-all account through which generating companies can pass to transmission customers all transmission costs for which there is no other mechanism. To be includible, he asserts, costs must be related specifically to reactive power service, at least by some logical allocation, as with the reactive power capability component of production plant. According to the Presiding Judge, Chehalis has failed to demonstrate any such connection. He also notes that Chehalis can include only what was part of the Current *AEP* Methodology, as defined in the TransAlta Settlement. Because this item was admittedly not included and is not related to the production of reactive power, he concludes that Chehalis cannot include it here.⁵⁹

b. Exceptions

Chehalis

56. Chehalis argues that the Presiding Judge erred in excluding the BPA 500 kV switchyard from both Total Production Plant and Accessory Electric Equipment. Chehalis argues that the switchyard is the point at which reactive power can enter BPA's transmission system from the Facility.⁶⁰ Without the switchyard, Chehalis argues, no

⁵⁹ Initial Decision, 118 FERC ¶ 63,009 at P 78-79.

⁶⁰ Chehalis Brief on Exceptions at 38.

reactive power would enter the transmission system.⁶¹ Chehalis states that because it is an independent power producer, it cannot recover costs of the Facility under an OATT, thus making such costs appropriate for recovery in the filed rate. Chehalis argues that its witness testified that the Commission has allowed other independent power producers to recover costs of this nature in reactive power service rates.⁶² Chehalis adds that these types of costs were not addressed in the context of the reactive power supply service charge in *AEP* because the costs of such facilities were already being recovered in *AEP*'s transmission rates.

c. **Opposing Exceptions**

i. **BPA**

57. BPA states that the Presiding Judge noted and Chehalis agreed that the BPA 500 kV switchyard and the Chehalis substation are transmission equipment.⁶³ As such, BPA states, the costs would be included in FERC Transmission Account 353 and not in any of the plant production and accessory equipment accounts that were addressed in *AEP*.⁶⁴ BPA argues that it is irrelevant whether Chehalis has transmission customers or rates for transmission service, and it is not reasonable for Chehalis to shift costs that it may not be able to recover elsewhere to the reactive power supply service rates charged by BPA. BPA also distinguishes the proceeding in Docket No. ER03-624-000, which Chehalis relied on, by pointing out that the filing was not protested, was accepted by a delegated letter order and does not, therefore, establish Commission precedent.

58. BPA notes that the FERC Statement of Account describes FERC Transmission Account 353 as pertaining to “the cost of installed transforming, conversion and switching equipment used for the purpose of changing the characteristics of electricity in connection with its transmission or for controlling transmission circuits.” BPA maintains that Chehalis has thus improperly included the switchyard costs in the total costs assigned to Accessory Electric Equipment and Total Production Plant.⁶⁵

⁶¹ *Id.*

⁶² *Id.* at 39 (citing Schedule 1 Attachment B in Docket No. ER03-624-000).

⁶³ BPA Brief Opposing Exceptions at 27.

⁶⁴ *Id.*

⁶⁵ *Id.* at 28.

ii. Staff

59. Staff asserts that the Presiding Judge did not err in excluding the BPA 500 kV switchyard from Total Production Plant or Accessory Electric Equipment. Staff states that its witness explained that a switchyard is a location where “numerous transmission lines of the same voltage are interconnected and controlled,” which is a transmission function.⁶⁶ According to Staff, the BPA 500 kV switchyard interconnects the Facility substation to a 500 kV transmission line that ran between the 500 kV buses of two substations: Paul and Allston. Staff states that the configuration of the Facility interconnection substation mitigates potential negative reliability strains that the interconnection may have caused on the Paul-to-Allston 500 kV circuit.⁶⁷ Staff argues that Chehalis never directly argued that the Facility performed a production function; rather, Staff states, Chehalis argues that but for the Facility, no reactive power would flow. Staff states that, under this logic, all transmission facilities would be allocated to reactive power production because, without them, no real or reactive power would flow.⁶⁸

60. Staff explains that this has never been Commission policy. Staff also observes that the switchyard should not be included in Total Production Plant because the Facility connects to it on the 500 kV high voltage sides of Chehalis’s generator step-up transformers, which are located in the Facility substation. Staff explains that all the power generated at the Chehalis plant, therefore, has already been transformed to 500 kV, which can be transmitted across the high-voltage BPA system.

61. Staff maintains that thus, even if the function of the BPA 500 kV switchyard were determined by what it was connected to, here the input and output voltage of the switchyard is all 500 kV, clearly indicating that it is no more than a transmission facility. Staff further notes that under the Current *AEP* Methodology, the electric plant accounts included in Total Production Plant are FERC Account Nos. 310-346. Staff explains that none of the equipment contained in the BPA 500 kV switchyard would be properly booked to these accounts.⁶⁹ Staff also objects to Chehalis’s argument that the switchyard should be included in Total Production Plant and Accessory Electric Equipment because Chehalis is responsible for costs directly assigned to it, including interconnection costs. Staff states that this argument is raised for the first time on brief. Staff also argues that this has nothing to do with whether the BPA 500 kV switchyard provides reactive power.

⁶⁶ Staff Brief Opposing Exceptions at 36.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 37.

Staff adds that where to book costs is determined based on the function of the Facility, not on the party that is responsible for such costs. Here, Staff states, the Facility performs a transmission function and does not belong in Total Production Plant or Accessory Electric Equipment.⁷⁰

62. Finally, in response to Chehalis's reliance on a proceeding in Docket No. ER03-624-000, Staff asserts that nothing in that proceeding supports including transmission costs in Total Production Plant.⁷¹

d. Commission Determination

63. We affirm the Presiding Judge's finding that the BPA 500 kV switchyard is not properly included in Total Production Plant and Accessory Electric Equipment. As the Presiding Judge explains, and we agree, the switchyard is a transmission facility whose costs are not included in any of the plant production of accessory equipment accounts that were addressed in *AEP*.⁷² Significantly, Chehalis does not take exception to this finding. Rather, as Staff points out, Chehalis argues that the costs should be included because, without the switchyard, no reactive power would enter the transmission system. This argument, however, cannot sustain Chehalis's position. Chehalis provides no precedent to support its position, and, moreover, following Chehalis's logic would result in all transmission facilities being allocated to reactive power production because, without them, no reactive power would enter the transmission system. In addition, the fact that Chehalis cannot recover the transmission costs of the switchyard because it is an IPP without an OATT, is no reason to shift these costs to Total Production Plant and Accessory Electric Equipment. Chehalis has simply provided no rationale for such a shift and we fail to see one.

64. Further, in making its argument that the switchyard should be included in Total Production Plant and Accessory Electric Equipment, Chehalis ignores that in this proceeding it is bound to follow the Current AEP Methodology. Chehalis has made no showing, and there is no evidence in this record, that the costs of the BPA 500 kV switchyard would be properly booked to the electric plant accounts that are reflected in the Current AEP Methodology.

⁷⁰ *Id.*

⁷¹ Staff Brief Opposing Exceptions at 39 (citing *Calpine Corporation Finance Co.*, 105 FERC ¶ 61,097 (2003)).

⁷² *See also* BPA Brief Opposing Exceptions at 27 and Staff Brief Opposing Exceptions at 36.

65. Finally, we reject Chehalis's argument that the Commission has allowed other independent power producers to recover costs of this nature in reactive service power supply rates. The only case it cites in support – *Calpine Construction Finance Co., L.P.*, Delegated Letter Order, Docket No. ER03-624-000, issued May 12, 2003 – was a delegated letter order. Such a letter order does not constitute binding precedent and, thus, does not support Chehalis's position.⁷³

2. The Chehalis Substation

a. Presiding Judge's Findings

66. The Presiding Judge explains that this item is “on all fours” with the BPA 500 kV switchyard, as the parties appear to agree.⁷⁴ He states that the Chehalis substation is a transmission facility whose costs would be included in FERC Transmission Account 353 if Chehalis had maintained accounts according to the Commission's Uniform System of Accounts. He concludes that its cost is a transmission expense, but not includible in Schedule 2 for the same reasons applicable to the BPA 500 kV switchyard.

b. Exceptions

Chehalis

67. Chehalis argues that the Current *AEP* Methodology permits the treatment it proposes. Chehalis argues that Commission reactive power supply service policy through February 16, 2005, includes substation costs in both Accessory Electric Equipment and Total Production Plant. In support of its argument, Chehalis argues that the Commission allowed the inclusion of such accounts in another case, Docket No. ER03-624-000, which Chehalis claims is consistent with its approach in this proceeding. Chehalis argues that it properly included the Chehalis substation costs in Total Production Plant and Accessory Electric Equipment.⁷⁵

⁷³ See *Midwest Generation, LLC*, 95 FERC ¶ 61,231, at 61,799 (2001) (“actions taken by its staff pursuant to delegated authority ‘do not constitute precedent binding the Commission in future cases’” (quoting *Phoenix Hydro Corp.*, 26 FERC ¶ 61,389, at 61,870 (1984), *aff'd*, *Phoenix Hydro Corp. v. FERC*, 775 F.2d 1187, 1191 (D.C. Cir. 1985))).

⁷⁴ Initial Decision, 118 FERC ¶ 63,009 at P 80.

⁷⁵ *Id.*

c. **Opposing Exceptions**

BPA

68. BPA makes the same arguments against including the costs of Chehalis's substation as it did for the 500 kV switchyard, discussed above. BPA agreed with the Presiding Judge's findings that such costs are transmission costs and not under any of the total Production Plant and Accessory Electric Equipment accounts that were addressed in *AEP*.⁷⁶

d. **Commission Determination**

69. We affirm the Presiding Judge's finding that the substation costs are not properly included in Total Production Plant and Accessory Electric Equipment for the reasons set forth by the Presiding Judge and those set forth herein in section C.1. (BPA 500 kV Switchyard).

3. **Transmission Line Capacity Reservation Fee**

a. **Presiding Judge's Findings**

70. The Presiding Judge explains that, during the construction of the plant, Chehalis made three payments to BPA to reserve long-term firm point-to-point service.

71. The Presiding Judge asserts that Chehalis's claim that without the reservation there would be no certainty that it could deliver reactive power to the transmission system, and therefore the payments should be included in Total Production Plant, has no merit.⁷⁷

72. The Presiding Judge explains that generators are permitted to pass reactive power costs on to transmission customers only because reactive power is assumed to benefit the transmission system.⁷⁸ He states that when Chehalis's generators are operating to produce real power, whether for firm or interruptible service and in whatever amount, their operations can be tailored to produce reactive power up to system capability. The transmission provider, according to the Presiding Judge, can then call on Chehalis to provide whatever reactive power the transmission provider needs, within Chehalis's

⁷⁶ BPA Brief Opposing Exceptions at 27.

⁷⁷ Initial Decision, 118 FERC ¶ 63,009 at P 81.

⁷⁸ *Id.* P 82.

capability, to safeguard the transmission system by requiring Chehalis to maintain the transmission provider's desired voltage schedule.⁷⁹

73. The Presiding Judge observes that Chehalis offers no reason why the transmission provider would forego the opportunity to safeguard its own transmission system by not availing itself of Chehalis's capability of providing the reactive power in whatever amount it needs because Chehalis has not paid it a reservation fee. According to the Presiding Judge, the reservation fee was paid solely for Chehalis to transmit its real power, not to transmit reactive power to serve transmission. He asserts that it is the transmission provider, not Chehalis, that may need reactive power for transmission purposes, and, if Chehalis's generators are in operation, the transmission provider will schedule it regardless of whether or not Chehalis has reserved any capacity on its transmission system. He asserts further that if Chehalis were not transmitting real power, there would be no need for its reactive power. And, he notes, there is no indication that there was even another producer of real power nearby on the transmission provider's system for whom Chehalis's reactive power would be useful or needed. Clearly, the Presiding Judge states, the reservation fee served only Chehalis's purpose of selling its real power, and was unrelated to reactive power service. He thus concludes that it cannot be included in Schedule 2.

b. Exceptions

Chehalis

74. Chehalis argues that the Presiding Judge erred in determining that the transmission line capacity reservation fee should be excluded from Total Production Plant. Chehalis states that the Presiding Judge fails to understand the "intertwined" nature of transmission for real and reactive power.⁸⁰ Chehalis argues that the production of reactive power does not occur without the production of real power. If there is no transmission capability for the real power, Chehalis argues, reactive power would likewise not be available. According to Chehalis, the transmission reservation fee guarantees that transmission service is available for reactive power, and the cost is appropriately included in the development of Chehalis's rate.⁸¹

⁷⁹ *Id.*

⁸⁰ Chehalis Brief on Exceptions at 40.

⁸¹ *Id.* at 41.

c. Opposing Exceptions

i. Staff

75. Staff asserts that Chehalis ignores the fact that its own witness agreed that real power can be delivered pursuant to non-firm transmission service, which does not require a transmission line capacity reservation fee. It adds that although it may inhibit Chehalis's ability to transmit real power for sales, the lack of firm point-to-point transmission capacity does not inhibit the ability of Chehalis's plant to produce reactive power. Staff points out that the reservation fee is a transmission cost, not a production or construction cost; it relates to costs to reserve long-term firm point-to-point transmission service, which ensured that, when the Facility was ready to enter commercial operation, Chehalis would have access to transmission capacity to deliver its power.⁸² The reservation fee, therefore, allowed Chehalis to transmit its power for real power sales, not to produce reactive power. Accordingly, Staff asserts, the reservation fee was not properly included in Total Production Plant.

ii. BPA

76. BPA asserts that the costs associated with the fees are not construction costs, but are costs pertaining to the purchase of tariff transmission services. BPA also argues that, even if the tariff transmission service charges could be reasonably allocated to production plant, Chehalis has failed to demonstrate that the costs were necessary in order to provide reactive power supply service. BPA also emphasizes that, on cross-examination, Chehalis's witness acknowledged that non-firm transmission service is adequate to deliver reactive power, and non-firm transmission service does not require a reservation fee.⁸³

d. Commission Determination

77. We affirm the Presiding Judge's decision not to allow the inclusion of Chehalis's transmission reservation fees in Total Production Plant. As the Presiding Judge explains, the reservation fees served only Chehalis's purpose of selling its real power, and was unrelated to reactive power service. Indeed, as Staff and BPA point out, the reservation fee ensured that transmission capacity would be available to Chehalis when its plant became operational. The reservation fee that Chehalis paid to BPA, moreover, was paid under BPA's OATT, which provides for payment of a reservation fee equal to one-

⁸² Staff Brief Opposing Exceptions at 40.

⁸³ BPA Brief Opposing Exceptions at 28-29.

month's charge to reserve transmission capacity for one year.⁸⁴ The costs associated with this fee are not construction costs, but costs related to the purchase of transmission service under BPA's OATT.

78. Finally we agree with BPA that, even if the transmission reservation fee could be reasonably allocated to Total Production Plant, which we find it could not, Chehalis failed to demonstrate that the fees were necessary to provide reactive power. In this regard, Chehalis's own witness acknowledged that non-firm transmission, which does not require a reservation fee, would have been adequate to deliver reactive power.⁸⁵

4. \$900,000 Payment to BPA

a. Presiding Judge's Findings

79. The Presiding Judge explains that Chehalis included a \$900,000 payment to BPA in Total Production Plant, which it described as being for the purpose of terminating an option development agreement so that it could proceed with the Chehalis project. The Presiding Judge also notes that BPA further explained that the purpose of the payment was as a partial refund of monies advanced to Chehalis by BPA in consideration of a ten-year option to purchase power from the plant that Chehalis granted to BPA.

80. He explains that it would be improper to include the payment in cost of production plant—the payment was associated with a commercial power purchase, not the construction of the Facility. The Presiding Judge further explains that Chehalis's witness later changed his story, claiming that the costs were in the nature of a repayment to BPA for payments BPA had made for project costs. Under the circumstances, the Presiding Judge explains that Chehalis's latest version lacks credibility. In conclusion, the Presiding Judge held that the payment was a return of monies paid for a power purchase and not a construction cost that may be included in Total Production Plant.⁸⁶

⁸⁴ BPA OATT § 17.3.

⁸⁵ BPA Brief Opposing Exceptions at 29, citing Tr. at 81: 14-23 (Honeycutt).

⁸⁶ Initial Decision, 118 FERC ¶ 63,009 at P 88-92.

b. Exceptions**Chehalis**

81. Chehalis argues that the Presiding Judge misunderstood or did not review its testimony, and that its position was established well before the hearing.⁸⁷ Chehalis states that its witness demonstrated that the \$900,000 corresponds with certain development costs previously paid by BPA under the parties' option development agreement that were shifted to Chehalis when Chehalis paid \$900,000 to BPA.

c. Opposing Exceptions**i. Staff**

82. Staff asserts that the Presiding Judge did not err in excluding the \$900,000 payment to BPA from Total Production Plant.⁸⁸ Staff argues that the payment was associated with a commercial power purchase arrangement, not the construction of the Facility and therefore is not includable in Total Production Plant. Staff asserts further that the burden is on Chehalis to support its proposed rate as just and reasonable; it is not on Staff to support elimination of the costs. Further, Staff states that even if Chehalis's new explanation were accepted, Chehalis has not recognized any additional payments made by BPA to Chehalis as the equivalent contributions in aid of construction. Staff notes that BPA has indicated that such payments would more than offset the effect of the \$900,000 payment and would require Chehalis to reduce the cost of the production plant accordingly. Moreover, Staff asserts, the fact remains that there is no evidence in the record to support Chehalis's witness's claim or verify his new explanation.

ii. BPA

83. BPA asserts that the \$900,000 payment is a payment associated with a commercial power purchase arrangement and is not a proper cost to assign to production plant in service.⁸⁹ Moreover, it asserts, if such a payment is an allowable cost of construction, Chehalis must recognize additional payments made by BPA to Chehalis as the equivalent of contributions in aid of construction, which would more than offset the \$900,000 payment and would require Chehalis to reduce the cost of production plant accordingly.

⁸⁷ Chehalis Brief on Exceptions at 42-46.

⁸⁸ Staff Brief Opposing Exceptions at 42-46.

⁸⁹ BPA Brief Opposing Exceptions at 30-31.

d. Commission Determination

84. We affirm the Presiding Judge's finding that the \$900,000 payment is not properly included in Total Production Plant, and thus not permitted under the Current *AEP* Methodology. As Staff observes, the burden is on Chehalis to support inclusion of the \$900,000 payment in Total Production Plant, and we find that Chehalis has not met that burden. Indeed, as BPA (the other party to the dollar exchange) explains, the \$900,000 payment was a payment associated with a commercial power purchase arrangement and is not a proper cost to assign to production plant in service. Chehalis does not dispute that statement, but attempts, without any evidence, to convert that payment into something else, i.e., that the \$900,000 corresponds with certain development costs previously paid by BPA and that those costs were shifted to Chehalis when it paid \$900,000 to BPA.

85. The Presiding Judge had the opportunity to weigh the evidence and observe the demeanor and credibility of the witnesses, and concluded that Chehalis's version of what occurred lacked credibility. We affirm the Presiding Judge's finding that the payment was a return of monies paid for a power purchase and not a construction cost that may be included in Total Production Plant. Moreover, even if we were to accept Chehalis's position, which we do not, Chehalis has failed to explain why it has not recognized any additional payments made by BPA to Chehalis as the equivalent of contributions in aid of construction. As BPA has explained, and Chehalis has not rebutted, these additional payments would more than offset the \$900,000 payment and would require Chehalis to reduce the cost of Total Production Plant accordingly.

5. Installation Costs

a. Presiding Judge's Findings

86. The Presiding Judge explains that the issue here is the recovery of costs of installing the Facility's generating plant and accessory electric equipment and Chehalis's use of multipliers that slightly exceed 100 percent to arrive at the direct and indirect costs of installation included in Total Production Plant and Accessory Electric Equipment. The Presiding Judge expresses concern that the multipliers exceed 100 percent and notes that the multiplier for these costs was 17.93 percent in *AEP*.⁹⁰ The Presiding Judge finds that if Chehalis can break the costs of labor for installing the generating equipment out of add-on costs to Staff's satisfaction in a compliance filing, with supporting documentation, it should be entitled to include those amounts in Total Production Plant

⁹⁰ Initial Decision, 118 FERC ¶ 63,009 at P 93.

and Accessory Electric Equipment, with the remainder going to Balance of Plant.⁹¹ If Chehalis cannot perform such cost break out, the Presiding Judge explains that as an alternative, Chehalis could substitute the *AEP* 17.93 percent as a proxy, and assign only the remaining 82.07 percent to Balance of Plant, of which a small portion would then be allocated to reactive power producing facilities.⁹² And, if Chehalis cannot satisfy Staff in a compliance filing that it can apply either alternative, the Presiding Judge finds that all of the amounts claimed as cost of installation should go to Balance of Plant.⁹³

b. Exceptions

i. Chehalis

87. Chehalis argues that the Presiding Judge erred in determining that it needed to either break out costs in a compliance filing to Staff's satisfaction or use 17.93 percent as a multiplier for labor costs.⁹⁴ Chehalis asserts that it incurred costs in connection with the development, construction and operation of the Facility. Chehalis states that, as a merchant generator, it is not required to file a FERC Form No. 1 with the Commission, which includes the type of cost breakdown that Staff is accustomed to seeing.⁹⁵ Chehalis argues that because it did not construct the facility itself, but rather hired contractors, it does not have a detailed cost breakdown, as it would have had had it constructed the facility on its own.⁹⁶ Chehalis states that it tried to obtain detailed records from its contractor but the records were no longer available. Even if they were available, Chehalis states that the information contained in them could be considered proprietary. Chehalis asserts that it allocated costs on the basis of an equitable proportion of costs attributed to each unit or job, and argues that the Commission has recognized this approach in another case where detailed records were not available. Finally, Chehalis takes issue with the Presiding Judge's reliance on the *AEP* 17.93 percent as a proxy, claiming that it is unsupported and results in underrecovery.

⁹¹ *Id.* P 98 (noting that labor costs were included in Total Production Plant and Accessory Electric Equipment in *AEP*).

⁹² *Id.* P 99.

⁹³ *Id.* P 100.

⁹⁴ Chehalis Brief on Exceptions at 46-54.

⁹⁵ *Id.* at 47.

⁹⁶ *Id.* at 48.

ii. Staff

88. Staff asserts that although the Presiding Judge correctly found that Chehalis failed to demonstrate that it incurred the costs of installation it claims, he erred in suggesting that Chehalis make a compliance filing subject to Staff review or that Chehalis use the percentage developed in *AEP* as a proxy.⁹⁷ Staff explains that while it did not challenge the claimed equipment costs, it did argue that Chehalis had not provided sufficient documentation to support its allocation of these costs. As to making the compliance filing subject to Staff review, Staff asserts that FERC litigation staff has no responsibility to do so and, in any case, it is inappropriate to give Chehalis another opportunity. Also, Staff asserts that this approach inappropriately leaves BPA out of the process.

89. As to the Presiding Judge's suggestion to use a proxy of 17.93 percent, Staff asserts that it is unsupported, no participant suggested a proxy and there is no basis in the record for finding that the suggested allocation percentage, developed for a fully-integrated utility, would be appropriate for a merchant generator such as Chehalis.

90. Staff further asserts that because Chehalis did not present sufficient accounting detail to support the allocation of installed costs, Staff recommended that those costs be excluded from Total Production Plant and Accessory Electric Equipment. Staff states that the costs should be included in Chehalis's Balance of Plant.

91. Staff adds that it did not challenge the fact that Chehalis may have incurred installation costs, but did challenge the allocation/accounting breakdown of those costs into multipliers. Staff also asserts that Chehalis's proposed allocation method flies in the face of the Current *AEP* Methodology, by which AEP broke down the costs within the installed cost categories into the appropriate FERC accounts, thus justifying the breakdown.

92. Finally, Staff states that the Current *AEP* Methodology is a cost-based methodology and thus Chehalis must support its costs and the allocation of those costs. Staff argues that Chehalis cannot be exempt from supporting its claimed costs and allocations, and demonstrating that its reactive power rate is just and reasonable.

c. Opposing Exceptions

i. Chehalis

93. Chehalis states that it does not disagree with Staff that the Presiding Judge erred in suggesting that Chehalis break out costs to Staff's satisfaction in a compliance filing or

⁹⁷ Staff Brief on Exceptions at 26-34.

that Chehalis use the multiplier from *AEP*.⁹⁸ However, Chehalis states, it disagrees with Staff's conclusion that the cost of installation should be limited to inclusion in just Balance of Plant.

94. Chehalis argues that, contrary to Staff's arguments, the costs are actual costs that were verified during the construction process and subsequently re-verified. Chehalis argues that it explained its derivation of the costs in detail.

95. With respect to the level of detail of the costs, Chehalis states that Staff cannot come to grips with the fact that the Commission granted Chehalis and most independent power producers waivers with respect to portions of the Commission's regulations, including the Commission's Uniform System of Accounts (USofA). Chehalis adds that its records reflect actual costs incurred and this evidence is enough to satisfy Chehalis's section 205 burden. It explains that the USofA regulations recognize that a rate applicant can incur costs under contract and that Chehalis is holding itself to the same standard as any entity that has contract work. It adds that limiting Chehalis to labor costs, as Staff proposes, would result in the underrecovery of the actual costs to install equipment and discriminatory treatment when compared with *AEP*.

96. Chehalis further states that it has allocated actual costs in equitable proportion, consistent with the Electric Plant Instructions in Part 101 of the Commission's regulations. Chehalis also complains that Staff first introduced the *AEP* allocation percentage at hearing and that Chehalis had no opportunity to subject it to discovery or rebuttal. It argues that Staff's reliance on a single percentage for comparison is flawed, especially in the absence of any substantive analysis.

ii. Staff

97. Staff asserts that, to the extent the Presiding Judge excluded costs of installation from Total Production Plant and Accessory Electric Equipment, he did not err.⁹⁹ Staff explains that its witness excluded the installed costs because Chehalis had not presented sufficient accounting detail to support the allocation of those costs. While Staff agrees that the Presiding Judge erred in fashioning alternative remedies, Staff asserts that Chehalis's argument confuses the cost issue with the issue of the allocation of those costs. Staff emphasizes that it excluded the cost of installation from Total Reactive Production Plant and Accessory Electric Equipment because Chehalis inappropriately allocated those installed costs—Staff did not exclude the installed costs from balance of

⁹⁸ Chehalis Brief Opposing Exceptions at 12-19.

⁹⁹ Staff Brief Opposing Exceptions at 46-52.

plant. In this regard, Staff explains that it supports the costs and indicates that it already stated it accepted them at face value.

98. Staff further points out that it never suggested using AEP's 17.93 percent multiplier, but instead referred to *AEP* for the Current *AEP* Methodology and the appropriate way to determine the allocator for these costs. It adds that it was the Presiding Judge, not Staff, who proposed using 17.93 percent as a proxy for Chehalis's unsupported allocator. It also notes that there is nothing in the record that supports making a finding that 17.93 percent would be appropriate for a merchant generator such as Chehalis.

99. Staff asserts that Chehalis should have specifically broken down its costs into labor, materials and supplies for turbo-generator installation. Instead, it notes, Chehalis included all on-site construction costs and then assumed that the amount of total construction costs associated with the turbo-generator units was equal to the ratio of turbo-generator purchase cost to all equipment purchase costs. In reality, Staff maintains, this is not an equal ratio, but one that is closer to one-fifth of the turbo-generator to total material cost. Staff concludes that the unreasonableness of Chehalis's 110.24 percent allocator is abundantly clear when compared to the 17.93 percent allocator derived in *AEP*. It asserts that Chehalis cannot be exempt from demonstrating that its proposed reactive power rate is just and reasonable by supporting its claimed costs and allocations.

d. Commission Determination

100. We grant Chehalis' exception, deny Staff's exception, and reverse the Presiding Judge.

101. We find that Chehalis provided sufficient cost justification for its proposed installation costs. Here, Chehalis hired contractors to construct its facility, unlike in *AEP*, where AEP constructed its facility itself. AEP recorded its labor and materials in accounts maintained pursuant to the USofA, but Chehalis is not required to maintain its accounts pursuant to the USofA or file a Form No. 1.¹⁰⁰ Thus, Chehalis did not have available to it the detailed accounting records in the format that would be maintained by a public utility, nor was it required to keep such records. Therefore, it is not reasonable to expect Chehalis to be able to provide the kind of detailed cost support that was used by AEP to justify its cost levels.

¹⁰⁰ Chehalis, an independent power producer, was granted waiver of those requirements. *Chehalis Power Generating, L.P.*, Docket No. ER03-717-000 (May 9, 2003) (unpublished letter order).

102. Given these circumstances, we find that the approach taken by Chehalis was reasonable and we will allow it to reflect the Owner Cost, as shown on Exhibit No. CPG-63, page 4, column E (which includes the amounts shown on CPG-63, page 1, lines 1, 2 and 3) in its calculations. As Chehalis explains on brief, once it acquired the land, it contracted with Parsons Energy & Chemicals Group Inc. (Parsons) for engineering and procurement services under an Engineering and Procurement Contract and The Industrial Company (TIC) for construction services.¹⁰¹ As Chehalis further points out, it sought an additional breakdown of the costs incurred, but was informed by TIC that such a breakdown was no longer available. However, as Chehalis explains, during the construction process the actual costs from the contractors were verified and, subsequently, TIC provided a “roll up” of total project costs that were reported to Chehalis confirming that the construction costs came directly from TIC’s internal accounting system and that the engineering and plant equipment costs came from Parson’s accounting system.¹⁰²

103. The dollar amount differences between Chehalis’s Equipment Costs (Exhibit No. CPG-63, page 4, column B) and Owner Cost (Exhibit No. CPG-63, page 4, column E) are attributable to Chehalis’s Direct and Indirect Costs under its Engineering and Procurement Contract (EPC) with its contractor, as well as its own indirect costs. These costs include, among other things, labor, structures, temporary construction equipment, performance testing, and land. Staff states that the claimed amounts are not properly supported, but it does not specifically take issue with the types of costs used by Chehalis in deriving the multipliers applied to the Equipment Costs (Exhibit No. CPG-63, page 4, column B, lines 25, 26, and 31) which are then used by Chehalis to determine Direct Cost, Indirect Cost and Owner Cost. Instead, Staff argues that the multipliers are too high resulting in installation costs that are too high relative to those costs in *AEP*, but Staff does not attempt to show that the costs Chehalis seeks to include differ from those that were included in *AEP*. Chehalis is a generator not subject to this Commission’s USofA and because it has provided all of the accounting information readily available to it, along with its contractor’s explanation of audit procedures during the construction period, we find that Chehalis has reasonably supported its costs in this proceeding.¹⁰³

¹⁰¹ Chehalis Brief on Exceptions at 47-48.

¹⁰² *Id.* at 48-49 (further noting that, according to TIC, these costs were audited against actual records on a quarterly basis and, during construction, were subject to a quarterly audit between Chehalis, TIC and Parsons).

¹⁰³ See *Dynegy Midwest Generation, Inc.*, 121 FERC ¶ 61,025, at P 23 (2007) (Commission accepted Dynegy’s proposed O&M costs for use in the *AEP* methodology even though it did not follow the USofA) (*Dynegy*).

104. Because we find that Chehalis has properly supported its costs and Staff has made no showing that any of these costs are improperly included, we grant Chehalis's exception, deny Staff's exception, and reverse the Presiding Judge's determination, i.e., that all of the amounts claimed as costs of installation should be allocated to the category called Remaining Cost of Production Plant or sometimes referred to as Balance of Plant. We also reject the Presiding Judge's two alternative approaches. First, there is simply no basis in the record of this proceeding to use 17.93 percent as a proxy to allocate installation costs in this case. That percentage was adopted by the Presiding Judge from the *AEP* case, and was not proposed by any party in this proceeding. Second, we reject the Presiding Judge's proposal to give Chehalis another opportunity to break out its costs in a compliance filing in a manner satisfactory to Staff. Such an approach is unnecessary since we find that Chehalis has met its burden to support its proposed installation costs.

C. Heating Losses Component

105. The issue presented to the Presiding Judge was whether Chehalis's proposal to include a Heating Losses Component of \$500,622.71 is permitted under the TransAlta Settlement and, if so, what the appropriate level of the Heating Losses Component should be.

1. Presiding Judge's Findings

106. The Presiding Judge explains that Chehalis determined the Facility's heating losses by first calculating the difference in current that would be produced between running the generators and GSUs at unity while producing the maximum real power claimed by Chehalis, and running them at the power factors of 0.80 and 0.78, the maximum reactive power capability at full real power claimed by Chehalis. According to the Presiding Judge, Chehalis then used industry and manufacturers' standards to calculate the additional MWs that would be consumed. He adds that Chehalis then applied the average hourly price per MW of \$45.08, based on the Dow Jones Mid-Columbia Index for 2004, to calculate the market price of the additional MWs consumed in the production of the reactive power, and then multiplied the result by the Service Factor of 63.1 percent, representing the percentage of time that the generators are assumed to be in operation. In sum, the Presiding Judge explained, Chehalis assumed that the generators would produce their maximum reactive power capability, rated at full real power production, every hour of their operation, and calculated the opportunity costs that would be lost by not being able to sell the MWs that were consumed as heating and stray losses in producing this reactive power.¹⁰⁴

¹⁰⁴ Initial Decision, 118 FERC ¶ 63,009 at P 112-15.

107. The Presiding Judge asserts that Chehalis's position has no merit. He explains that the TransAlta Settlement sets forth the rate methodology to be used by Chehalis as the "Current *AEP* Methodology." He adds that this phrase was defined in the TransAlta Settlement as the rate methodology established by the Commission in Opinion No. 440 and in *WPS Westwood*. He says that the TransAlta Settlement required Chehalis to use the Current *AEP* Methodology in combination with a Service Factor to determine its compensation when it files for a reactive power service rate. The Presiding Judge points out that these decisions do not even mention heating losses and that to accept Chehalis's perverse logic that the heating loss claim should be entertained because it was not specifically barred by the TransAlta Settlement would open the door to a universe of claims on items similarly unmentioned in the TransAlta Settlement.

108. Further, the Presiding Judge explained, even if the TransAlta Settlement had permitted merchant generators to include heating losses in Schedule 2, Chehalis would not be permitted to pass on any heating losses to transmission customers because none had been incurred for transmission purposes. He points out that during the test year the transmission provider never required Chehalis to supply reactive power to the system other than what was needed for Chehalis's own generation. He further explains that, as determined in Order No. 2003, operating within the deadband is merely meeting the generator's obligation, and it is not really performing a transmission function that should entitle it to compensation.

109. Moreover, the Presiding Judge asserts, even if it were entitled to recover reactive power costs from transmission customers, Chehalis would be entitled to claim only a miniscule amount of heating losses through Schedule 2. He states that the most critical fault with Chehalis's calculation is its reliance on reactive power capability, an item totally unrelated to heating loss costs. He asserts that it is improper to peg the amount of an expense to a mere capability of incurring it and charging captive ratepayers for that capability when it is clear that the expense will never be incurred in any amount remotely approaching that magnitude.¹⁰⁵

110. As to Chehalis's calculation of heating losses, the Presiding Judge explains that traditional accounting, regulatory rules and simple logic require heating losses to be calculated on the basis of reactive power actually produced in the test year, which was reflected in its average power factor exceeding 0.998, rather than at its assumed power factors of 0.80 and 0.78. Making this substitution in Chehalis's calculation, the Presiding

¹⁰⁵ *Id.* P 120. The Presiding Judge states that even with the certainty that Chehalis's generators will not produce maximum reactive power every minute of its operations during the entire year, Chehalis calculated its heating losses as though they would.

Judge asserts, significantly reduces the amount of heating losses by a factor of hundreds. Using Staff's calculation, which he states is undisputed on the mechanics, and using Chehalis's market price of \$45.08 per MWh, its correct heating losses would be \$2,253.

111. The Presiding Judge further asserts that Chehalis erred in using a market price on the premise that it had lost the opportunity to sell the MWs on the market. He explains that it could only have lost the opportunity to sell them if it were otherwise operating at full capacity, which it did not do very much during the year. He adds that there is no evidence that Chehalis experienced any lost opportunity costs.¹⁰⁶

2. Exceptions

a. Chehalis

112. Chehalis asserts that the Presiding Judge erred in determining that the Heating Losses Component is not permitted under the TransAlta Settlement. Chehalis claims that the Presiding Judge's position is based on an incorrect understanding of the term, Current AEP Methodology. Chehalis points out that while the term is defined as the rate methodology set forth in the cases cited by the Presiding Judge, the relevant section of the TransAlta Settlement adds the phrase "as [the rate methodology established by the Commission] currently exists as of the date of this TransAlta Settlement. . . ."¹⁰⁷ It maintains that the Commission has accepted many reactive service filings with a heating losses component through the period covered by the TransAlta Settlement. With respect to *WPS Westwood*, Chehalis asserts that while the filing in that proceeding included a heating losses component, that issue was not even identified or otherwise discussed. Chehalis further cites to other cases in which the Commission accepted the filings even though they included heating losses components. According to Chehalis, the Commission had the opportunity to reject the heating losses components, but chose not to

¹⁰⁶ *Id.* P 124-25. If it more appropriately used the variable costs of producing the additional MWs (\$41.02), the Presiding Judge stated, its heating losses would be reduced to \$2,050. The Presiding Judge further rejected Staff's proposal that the losses should be based on lost profits, not lost revenues as used by Chehalis. He explains that Staff's approach fails to take into account the fact that Chehalis has already incurred the heating costs in producing the reactive power and should be able to recover them in lost revenues, if it were entitled to recover lost opportunity costs.

¹⁰⁷ Chehalis Brief on Exceptions at 55.

reject them.¹⁰⁸ It adds that the fact that other entities did not include a heating losses component is irrelevant and is not indicative of intent with respect to the TransAlta Settlement.

113. Chehalis next argues that the Presiding Judge erred in determining that the Heating Losses Component, even if permitted, is overstated.¹⁰⁹ It maintains that its calculation of the Heating Losses Component is fully consistent with Commission policy during the period addressed by the Current *AEP* Methodology.

114. Chehalis further explains that the Current *AEP* Methodology precludes reliance on any subsequent modifications to the methodology or new methodologies adopted by the Commission.¹¹⁰ Chehalis argues that the Presiding Judge ignored this restriction in developing his own approach to the Heating Losses Component. It adds that the standard of review under the TransAlta Settlement is the public interest standard and in order to adopt a Heating Losses Component developed on any methodology other than that proposed by Chehalis, the public interest standard must be met for Chehalis's rate as a whole¹¹¹.

115. In addition, Chehalis asserts that its approach is consistent with other reactive filings. It argues that if participants in the TransAlta Settlement disagreed with the approach permitted in the numerous reactive service rate filings within the period covered by the Current *AEP* Methodology, they were free to raise the issue in the TransAlta

¹⁰⁸ *Id.* at 59-60. Chehalis cites to other Commission orders and numerous delegated letter orders, which it asserts accepted filings containing a heating losses component. *Id.* at 60-61.

¹⁰⁹ *Id.* at 63.

¹¹⁰ *Id.* at 64.

¹¹¹ *Id.* at 64. Chehalis asserts that its Fixed Capability Component is \$2,954,013.56 without the Service Factor applied and that the rate with the Heating Losses Component included and the Service Factor applied is \$2,179,900.73. It maintains that because the rate under the TransAlta Settlement is subject to a significant discount as a result of the Service Factor, even if a record had been developed to address the public interest standard, the almost insurmountable burden would not exist.

Settlement, but they did not.¹¹² Chehalis further asserts that Commission precedent supports its position that variable costs and lost profits are appropriately included in the Heating Losses Component.¹¹³ According to Chehalis, in those cases the Commission acknowledged that the use of opportunity cost-based costs is clearly reasonable.

116. Finally, Chehalis asserts that the reduction in Chehalis's cost recovery sought by the Presiding Judge with respect to the Heating Losses Component was already taken into account by the application of the Service Factor. It concludes that because the Presiding Judge's treatment of the Heating Losses Component amounts to an amendment to the TransAlta Settlement, such amendment is only permitted if the public interest standard is met.¹¹⁴

b. Staff

117. Staff asserts that the Presiding Judge appropriately rejected Chehalis's Heating Losses Component and correctly found that there was no evidence that Chehalis experienced any lost opportunity costs.¹¹⁵ It argues that Chehalis did not claim lost opportunities in its direct case and it should not be allowed to use its rebuttal testimony and briefs to shoehorn the issue into this case. Indeed, Staff asserts, Chehalis unequivocally stated in its transmittal sheet that "Chehalis is not at this time requesting a 'lost opportunity' component to its rate." Second, Staff contends that when Chehalis did raise the issue it did not provide the verification required by the Commission.¹¹⁶ Finally, Staff maintains that Chehalis is not entitled to lost opportunities under its interconnection agreement with BPA.

118. Staff explains that it is addressing the issue of lost opportunity costs because it is concerned that the Presiding Judge misapprehended Staff's discussion of lost opportunity costs. Staff states that its position was that if the Presiding Judge accepted Chehalis's

¹¹² *Id.* at 66. Chehalis also asserts that the initial decision in *Dynegy Midwest Generation, Inc.*, 116 FERC ¶ 63,052, at P 156 (2006) (*Dynegy ID*) supports its position that compensation for heating losses should be based on rated capability.

¹¹³ *Id.* at 68 (citing *Duke Energy Fayette, Connective and Virginia Elec. and Power Co.*, 114 FERC ¶ 61,318 (2006)).

¹¹⁴ Chehalis Brief on Exceptions at 69.

¹¹⁵ Staff Brief on Exceptions at 35-41.

¹¹⁶ *Id.* at 35 (citing *Northeast Utilities Service Co.*, 62 FERC ¶ 61,294, at 62,296 (1993)).

method (full reactive power capability), he should use lost profits as the basis to calculate heating losses. Staff further states that even accepting Chehalis's claim that its total loss was 11,106 MWh based on the full capability of the unit, the total annual value would be \$45,090 or \$28,462 after application of the Service Factor. Staff states that the Presiding Judge took Staff's discussion further than Staff intended by applying Staff's calculations to Chehalis's heating losses based on Staff's recommended approach (actual operations times cost, without regard to lost opportunities).¹¹⁷ Staff concludes that, as a policy matter, the Commission should recognize that, if costs associated with heating losses are to be allowed, they should be based not on pure speculation, but on a reasonable basis for such an allowance, such as actual historical costs for providing such service.

3. Opposing Exceptions

a. Staff

119. Staff asserts that the Presiding Judge did not err in determining that the Heating Losses Component is not permitted under the TransAlta Settlement.¹¹⁸ Staff argues that the words "heating losses" do not appear in either *AEP* or the TransAlta Settlement. It maintains that it is nonsensical to argue that the absence of language specifically prohibiting heating losses means that the inclusion of heating losses is permitted, particularly in light of the plain language of the TransAlta Settlement stating that Chehalis's reactive power rate must be determined using the Current *AEP* Methodology.

120. Moreover, Staff argues that the Commission orders and delegated letter orders that Chehalis relied on are not precedential or merits determinations, and since *AEP*, at no time has the Commission issued an order stating that it has changed the *AEP* methodology. With respect to *WPS Westwood*, Staff argues that Chehalis's argument demonstrates a complete lack of understanding of the Commission's decisions "accepting" filings.¹¹⁹ Acceptance of a filing, subject to refund, Staff explains, means only that the filing meets the basic filing requirements set forth in the Commission's regulations and that it is not patently deficient; it does not mean that the Commission approves a rate schedule. The Commission's order in *WPS Westwood*, Staff asserts,

¹¹⁷ *Id.* at 40-41. Staff agrees with the Presiding Judge's description of Staff's position that resulted in a heating losses amount of \$2,050.

¹¹⁸ Staff Brief Opposing Exceptions at 52-55.

¹¹⁹ *Id.* at 56.

merely allowed Westwood's filed rate to become effective during the pendency of the settlement or hearing proceedings.¹²⁰

121. Further, Staff explains that Chehalis's reliance on *WPS Westwood* is misplaced for three reasons: (1) the *WPS Westwood* case was resolved by a black box settlement that was silent on heating losses; (2) the *WPS Westwood* settlement specifically does not establish any principles or precedent with regard to methodology and specifically provides that acceptance of the settlement does not constitute a determination on the merits; and (3) the importance of *WPS Westwood* is that it sets forth the Commission's policy of applying the *AEP* methodology to reactive power rates. Staff concludes that the Current *AEP* Methodology does not include allowance for a Heating Losses Component.¹²¹

122. Staff adds that, contrary to Chehalis's argument, the public interest standard does not apply and the Service Factor is irrelevant. Staff argues that there is nothing in the record to support Chehalis's statement that it signed the TransAlta Settlement with the expectation of including a Heating Losses Component. Staff also argues, with respect to Chehalis's argument about the effect of the Service Factor, that Chehalis is simply complaining about the bargain it struck in the TransAlta Settlement, noting that prior to the TransAlta Settlement its reactive power rate was zero. It asserts that the TransAlta Settlement did not negate Chehalis's obligation to support its proposed rate as just and reasonable, with or without the Service Factor. Finally, with regard to Chehalis's argument that the Presiding Judge's treatment of the Heating Losses Component amounts to an amendment to the TransAlta Settlement, Staff asserts that the TransAlta Settlement simply does not provide for a Heating Losses Component.¹²²

123. Staff next argues that the Presiding Judge did not err in determining that Chehalis's proposed Heating Losses Component, if permitted, is overstated.¹²³ Staff asserts that Chehalis's reliance on the *Dynegy* initial decision is misplaced; aside from the fact that the decision has not been reviewed by the Commission, the *Dynegy* initial decision undermines Chehalis's own arguments. Staff explains that the judge in *Dynegy*

¹²⁰ Staff notes that the reactive power rate in *WPS Westwood* was ultimately resolved by settlement. It adds that the Commission acted similarly with respect to Chehalis's filing, which is now before the Commission following a hearing and initial decision.

¹²¹ Staff Brief Opposing Exceptions at 59.

¹²² *Id.* at 61.

¹²³ *Id.* at 61-63.

specifically found “even more compelling is the fact that the AEP Methodology does not include a Heating Losses Component at all”¹²⁴

124. Staff further argues that heating losses, if allowed, should be based on actual operations.¹²⁵ Staff argues that Chehalis’s use of maximum output is inappropriate because a plant may not be operated at full reactive capability at all times, and only if the system, in fact, demanded such full performance. Staff explains that its witness used actual output to determine heating losses, and asserts that the Commission should affirm the Presiding Judge’s finding that Chehalis is not entitled to heating losses.¹²⁶

125. Finally, Staff asserts that heating losses, if allowed, should not be based on lost opportunities, but that Chehalis should only be compensated for its lost profits, exclusive of costs.¹²⁷ Staff states that the interconnection agreement between Chehalis and BPA does not provide for lost opportunities. Staff further argues that Chehalis miscalculated its heating losses based on lost total revenues, not lost profits, thus placing itself in a better position than it would have been in if it had made the sales it claims it lost. Staff contends that it is important to remember that these were sales that were never made for power that was never produced. Staff adds that Chehalis does not maintain records of sales that it does not make, thus it cannot identify or otherwise provide documentation regarding the costs associated with these claimed lost sales. Staff also asserts that it is incorrect for Chehalis to assume that it could have sold the real power it lost in generating heat in the market for the Average Dow Jones Mid-Columbia Price for 2004. If Chehalis is seeking a cost-based rate (which it must under the Current *AEP* Methodology), Staff maintains, it cannot price its heating losses at the market rate. According to Staff, it is more accurate to use the plant’s heat rate multiplied by its fuel cost. If lost revenues are to be recovered, Staff asserts, then they should be calculated by subtracting costs Chehalis did not incur (\$41.02) from the market price (\$45.08).

b. BPA

126. BPA agrees with the Presiding Judge’s conclusion that the TransAlta Settlement strictly limits the reactive power service rate to one calculated using the Current *AEP*

¹²⁴ *Id.* at 62-63 (quoting Presiding Judge in *Dynegy ID*, 116 FERC ¶ 63,052).

¹²⁵ *Id.* at 63-66.

¹²⁶ Staff adds that, even if heating losses are allowed, the Commission should affirm the Presiding Judge’s finding that the heating losses amount to \$2,050.

¹²⁷ *Id.* at 66-70.

Methodology.¹²⁸ BPA also agrees with the Presiding Judge’s opinion that the TransAlta Settlement’s silence on the subject of heating losses should not be construed as a green light to their inclusion in Chehalis’s reactive power service rate. BPA further states that Chehalis misstates the meaning of *WPS Westwood*, which was cited in the TransAlta Settlement for a single reason: because in it, the Commission directed generators to use the *AEP* methodology.¹²⁹ BPA also states that Chehalis’s assertion that a long number of Commission orders have allowed heating losses as part of the *AEP* methodology is wrong. None of the cases resulting in these orders allowed the inclusion of heating losses in rates established using the *AEP* methodology.¹³⁰

127. BPA also argues that Chehalis’s claim that heating losses are a “standard component of the majority of Reactive Service filings of [independent power producers]” is misleading because Chehalis itself admitted in discovery that the inclusion of heating losses components is common in PJM, but the majority of reactive power service rate filings outside PJM do not include them.¹³¹ BPA next argues that Chehalis does not adequately respond to its pointing out that none of the other parties to the TransAlta Settlement included heating losses in the reactive power service rate.¹³² BPA points out that TransAlta itself never included heating losses in its original reactive power service rate filing that led to the TransAlta Settlement.¹³³ BPA states that the Presiding Judge found that even if heating losses were permitted, they were not properly calculated because Chehalis’s calculation is based on a hypothetical operating profile of a .78/.80 power factor, when Chehalis actually operates the Facility at close to unity on an average basis.¹³⁴ BPA finally notes the disparity between its witness’s testimony and Chehalis’s witness’s testimony about plant efficiency, heating losses and reactive power production. Chehalis’s witness described a decrease in generating plant efficiency resulting from increased heating losses associated with a constant high level of reactive power production. BPA’s witness countered that the efficiency loss was equivalent to a heat rate penalty because as reactive output is increased, the plant must burn more fuel to

¹²⁸ BPA Brief Opposing Exceptions at 32.

¹²⁹ *Id.* at 33.

¹³⁰ *Id.* at 35.

¹³¹ *Id.*

¹³² *Id.* at 36.

¹³³ *Id.*

¹³⁴ *Id.* at 37.

maintain a constant level of net real power output. BPA states that Chehalis's witness's description contradicts the concept of lost opportunity power sales. Using a market power price instead of the incremental fuel consumption overstates the real opportunity costs of heating losses. BPA argues that if the market price at any time is not higher than the equivalent cost of fuel, the Facility should not dispatch and would not incur any heating losses. Since Chehalis's rate must be cost-based, BPA argues, the cost of additional fuel used for actual reactive output should form the basis of any opportunity cost associated with heating losses and such cost of fuel should be based on actual reactive power production. BPA conclude that the Presiding Judge properly found that, even if Chehalis were permitted to include a heating losses component in its filed rate, the proposed rate component cannot be accepted because it was not correctly calculated.¹³⁵

c. Commission Determination

128. While we affirm the Presiding Judge's overall finding that Chehalis is not entitled to recover a separate Heating Losses Component, we do not agree with some of the Presiding Judge's reasoning. The Presiding Judge states that the *AEP* methodology does not permit the recovery of heating losses. This is not entirely correct. In *Dynegy*, the Commission found that heating losses related to the fixed costs of producing reactive power were included in the *AEP* methodology.¹³⁶ Thus, the Commission explained, "allowing recovery of a separate heating losses component that includes fixed costs associated with heating losses would amount to double counting of fixed costs for heating losses as such costs are already included in the fixed capability component under the *AEP* [m]ethodology."¹³⁷

129. The Commission further explained in *Dynegy* that while the *AEP* methodology is limited to fixed cost recovery, if an applicant could demonstrate that it incurs variable costs associated with heating losses, the Commission would consider such recovery.¹³⁸ Here, however, the parties agreed to use the rate methodology established in *AEP* and in *WPS Westwood* (preceding *Dynegy*), which, as the Commission explained in *Dynegy*, provides for the recovery of fixed costs associated with heating losses. Thus, Chehalis is not entitled to recover any variable costs associated with heating losses.

¹³⁵ *Id.* at 38.

¹³⁶ *Dynegy*, 121 FERC ¶ 61,025 at P 68-70.

¹³⁷ *Id.* P 70.

¹³⁸ *Id.* P 71.

130. Even if Chehalis were permitted to recover variable costs associated with heating losses, we would reject its proposal for recovery. We agree with the Presiding Judge that the critical fault with Chehalis's calculation of its Heating Losses Component is that it is based on reactive power capability for both fixed and variable costs. While capability is a reasonable measure for "fixed" costs, which are associated with plant and do not vary with the level of service provided, it is not an appropriate measure for "variable" costs, which vary with the level of service provided.¹³⁹ Thus, Chehalis improperly calculated a Heating Losses Component for variable costs based on reactive power capability.

131. Further, we affirm the Presiding Judge's finding that there is no evidence that Chehalis incurred opportunity costs due to lost sales as a result of heating losses. As the Presiding Judge found, during the test year in this proceeding Chehalis was never required to supply reactive power outside of the deadband. Moreover, as BPA explains, increased heating losses due to an increase in reactive power production do not require a generator to ramp down real power production and thus lose sales, as Chehalis has assumed in its calculations. Instead, it requires the use of more fuel to maintain the same level of real power production. Thus, as BPA asserts, using a market power price instead of the incremental fuel consumption overstates the real opportunity costs of heating losses.¹⁴⁰ Chehalis therefore incorrectly assumed that heating losses result in an equivalent amount of lost sales.

132. Finally, we find that none of the cases Chehalis cites support inclusion of a separate heating losses component in addition to the recovery of heating losses allowed under the Current *AEP* Methodology. First, we note that many of the cases Chehalis cites are delegated letter orders that do not constitute binding precedent.¹⁴¹ In addition, as to the other cases cited by Chehalis, section 35.4 of the Commission's Rules and Regulations, 18 C.F.R. § 35.4 (2007), specifies that "[t]he fact that the Commission

¹³⁹ The use of rated capability inflates heating losses costs because capability is always larger than actual output. Chehalis has provided no justification for taking this approach with respect to the variable costs associated with heating losses.

¹⁴⁰ BPA Brief Opposing Exceptions at 38.

¹⁴¹ See *supra* note 74.

permits a rate schedule or any part thereof . . . to become effective shall not constitute approval by the Commission of such a rate schedule”¹⁴²

D. Cost of Debt

1. Presiding Judge’s Findings

133. The Presiding Judge explains that the TransAlta Settlement specifies most of the elements of the capital structure to be used in performing the Current *AEP* Methodology calculation: Chehalis is required to use a ratio of 50 percent equity and 50 percent debt, and to assume a return on equity of 11 percent. The Presiding Judge also explains that the cost of debt was left for determination in the current proceeding.¹⁴³ The Presiding Judge observed that the actual capitalization for Chehalis is 100 percent equity, and therefore the Commission’s usual practice of determining the cost of debt in an applicant’s capital structure by using the company’s embedded cost of debt cannot be used.¹⁴⁴ In such cases, he explains, the Commission must use a proxy, often the parent company. The Presiding Judge notes that all of the participants proffered proxies, but states that each has its problems.¹⁴⁵

134. The Presiding Judge states that neither of BPA’s proffered proxies—Chehalis’s parent company, Suez, or BPA itself—was appropriate. He explains that Suez is headquartered in France and has worldwide, diversified operations that do not resemble Chehalis’s. BPA, he explains, is a governmental entity with almost no market risk. The Presiding Judge dismisses Suez and BPA as proxies “out-of-hand.”¹⁴⁶

135. The Presiding Judge also finds that Commission Staff’s proffered proxy, the use of Moody’s Baa-rated Public Utility Index yield, was not appropriate because the

¹⁴² See also *Midwest Generation, LLC*, 95 FERC ¶ 61,231 at 61,799 n.17 (“In *Northeast Utilities Service Co.*, 74 FERC ¶ 61,065 (1996), the Commission discounted a claim that it had resolved an issue in earlier cases, where that issue ‘was not affirmatively decided by the Commission.’” (citing *United States v. Shabani*, 513 U.S. 10, 16 (1994); *Illinois Board of Elections v. Socialist Workers Party*, 440 U.S. 173, 183 (1979); and *Webster v. Fall*, 266 U.S. 507, 511 (1925))).

¹⁴³ Initial Decision, 118 FERC ¶ 63,009 at P 159.

¹⁴⁴ *Id.* P 160.

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* P 161.

Commission has never used Moody's as a proxy, it covers only regulated companies and Chehalis is not regulated, except for its reactive power allocation.¹⁴⁷ He asserts, moreover, that if Chehalis were to attempt to raise debt in the marketplace, it could only do so on the basis of its overall operations; it could not sell debt instruments solely based on the reactive power allocation.

136. The Presiding Judge found that while Chehalis's method for choosing proxies was not objectionable, its execution was faulty.¹⁴⁸ He explains that Chehalis claims to have constructed a proxy group, information that would accurately gauge the cost of debt for other independent power producers doing business in the Pacific Northwest. Thus, he explains, Chehalis deemed the other generators subject to the TransAlta Settlement are appropriate proxies. He further explains that because the data for them was not publicly available, Chehalis proposes to use the cost of debt for their parent companies. He further explains that Chehalis used the average of the cost of debt for Calpine and TransAlta, 7.855 percent.¹⁴⁹ The Presiding Judge notes that the data later became available and resulted in an average of 8.76 percent, although Chehalis did not claim that higher amount.

137. The Presiding Judge finds that the parents' costs of debt were a poor substitute for the subsidiaries and they did not fit the criteria laid out by Chehalis. He explains, given that the figures for the subsidiary independent power producers became available before all the testimony was filed and are part of the record, there is no good reason for using the costs of debt of their parents. Further, he explains, the Calpine entities are not comparable to Chehalis and cannot properly be used as proxies, because they are financially troubled and on the verge of bankruptcy, and they have risky and unrepresentative financial standing. He observes that this leaves only the two TransAlta subsidiary-independent power producers as suitable proxies. He then asserts that while choosing a proxy group with only two entities may not be preferred, there is no precedent for disqualifying the group solely on that basis. Moreover, he states, the participants' failure to offer reasonable comparables leaves him with no choice. Thus, he adopts 6.725 percent, the average cost of debt of those two qualifying independent power producers.

138. The Presiding Judge adds that the reasonableness of the 6.725 percent figure is confirmed by its closeness to the average yield of Moody's Baa-rated Public Utility Index (6.36 percent). He explains that one might expect that there would be much less of a difference between regulated and unregulated companies when it comes to debt,

¹⁴⁷ *Id.* P 162.

¹⁴⁸ *Id.* P 163.

¹⁴⁹ *Id.*

compared to equity, where the risks are small in any event. He further explains that this is especially the case now where many of the investment costs of unregulated generation are passed on to transmission customers in the form of reactive power charges.

2. Exceptions

a. BPA

139. BPA argues that the Presiding Judge erred in finding that the TransAlta subsidiaries' average cost of debt of 6.725 percent is a reasonable proxy for Chehalis's cost of long-term debt.¹⁵⁰ It asserts that the cost of debt should be set at either the cost of debt of Chehalis's parent company or the cost of debt of the interconnected transmission owner, BPA.

140. BPA argues that the TransAlta subsidiaries' initial, non-litigated cost of debt proposals in proceedings settled without establishing the cost of debt cannot serve as appropriate proxies for cost of debt calculations in this proceeding. It takes issue with the Presiding Judge's finding that he had no other choice. BPA asserts that a reasonable alternative is to use BPA's cost of debt as a proxy. BPA explains that it is the transmission provider to which the Facility is interconnected. It further argues that the Commission looks only for risk equivalency in assessing credit risk. BPA maintains that it has the equivalent credit of an A rated utility, and thus presents a minimal risk associated with payment of reactive power service charges. It adds that the Presiding Judge cannot disregard, without explanation, BPA's argument that it is irrelevant whether a proxy's credit risk pertains to its status as an entity owned by the federal government.

b. Staff

141. Staff argues that the Presiding Judge erred in finding that Staff's use of the Moody's Baa Public Utility Index as a proxy for Chehalis's cost of debt was inappropriate.¹⁵¹ Staff initially states that, on its own, the cost of debt determined by the Presiding Judge is a reasonable number. However, it states, his proxy is not based on principle that can be applied in future cases, in which the dollar amount could be quite large. Staff indicates that it is addressing the issue so that the Commission can give guidance in future cases, where rates for regulated operations should be determined based on the risk of other regulated operations.

¹⁵⁰ BPA Brief on Exceptions at 5-10.

¹⁵¹ Staff Brief on Exceptions at 12-26.

142. Staff agrees with the Presiding Judge that the proxies most frequently relied upon by the Commission, the entity's parent company and the interconnected transmission provider, are unsuitable.¹⁵²

143. Staff asserts that because Chehalis receives guaranteed payments for reactive service from BPA regardless of whether it actually provides reactive power and this service comprises less than one percent of Chehalis's sales, it would be improper and contrary to Commission ratemaking to allow Chehalis's riskier unregulated operations to affect the price for its regulated jurisdictional operations. It argues that the Commission should find that it is appropriate to allocate the cost of reactive operations only to reactive rates and the costs of real power operations only to real power rates.

144. Staff argues that the Presiding Judge failed to address the relationship between the risk profiles of TransAlta and Chehalis. Staff states that at the end of 2004 TransAlta's debt was rated BBB- by Standard & Poor's (S&P), the lowest investment grade rating assigned by S&P. Staff asserts that there is no evidence in the record to suggest that Chehalis or its parent is close to non-investment grade status.

145. Staff states that it looked to establish a cost of debt appropriate for the regulated reactive power operations of Chehalis and notes that the Commission has used the Moody's Public Utility Index as a proxy for the cost of debt in earlier cases. Staff explains that Moody's Baa Public Utility Index represents the average rating of United States regulated investor owned utilities in 2005.

146. Staff states that the Presiding Judge correctly found that no case has addressed the appropriate proxy for a company for which there is no suitable debt cost among the subject entity, the entity's parent, or the entity's interconnected transmission provider. Thus, Staff asserts, any proposal for choosing a proxy will be considered novel. Thus, Staff argues, one must look to Commission precedent in similar areas and exercise judgment as to which scenario most closely resembles the case at hand.¹⁵³

147. Staff maintains that the Commission has relied on Moody's Public Utility Index in situations in which a company's cost of debt was unavailable¹⁵⁴ or when the Commission needed to assure itself that the cost of capital was being set at a reasonable level. Based on Commission precedent, Staff asserts that Moody's Baa Public Utility Index appears to be the most appropriate source for a proxy cost of debt. Staff asserts that the rates being

¹⁵² *Id.* at 14 n.5.

¹⁵³ Staff Brief on Exceptions at 17.

¹⁵⁴ *Id.* at 17.

set here are for reactive power service, a regulated utility operation not subject to market forces and, thus, the rates should likewise be based on data reflective of lower risk, regulated operations. Staff adds that Chehalis's reactive power operations face even less risk than most regulated services.¹⁵⁵ Staff concludes that the rates to be established in this proceeding have nothing to do with Chehalis's riskier unregulated enterprises, either in fact, or as a matter of policy and law. The Commission, it argues, should look only to factors related to the regulated reactive power operations.

c. Chehalis

148. While Chehalis agrees with the Presiding Judge's decision not to use BPA or Moody's Baa Public Utility Index as a proxy for Chehalis's cost of debt, Chehalis argues that the Presiding Judge erred in excluding Hermiston and Goldendale's cost of debt from the proxy group.¹⁵⁶ Chehalis states that it used publicly available information that would accurately gauge the cost of debt for independent power producers doing business in the Pacific Northwest, and which would reflect the cost at which Chehalis would be able to secure debt in the market. It explains that its proxy used the other generators subject to the TransAlta Settlement: TransAlta's Centralia and Big Hanaford plants and Calpine's Goldendale and Hermiston plants. Chehalis states that these projects are owned by entities engaged in the same line of business, subject to similar market risks, displacement risks on the spot market (because of hydroelectric resources) and the elements of the TransAlta Settlement.¹⁵⁷ Chehalis argues that the Presiding Judge's decision to exclude Goldendale and Hermiston's cost of debt proxy data runs counter to *MISO I* as affirmed in *MISO II* and is not supported by the record.¹⁵⁸ In *MISO I*, Chehalis argues, the presiding judge had a similar challenge—the need to find a proxy because there was an absence of publicly-traded, independent, pure electric transmission companies that could be used to estimate the return. Chehalis explains that there the judge used a proxy group of companies that were similar businesses with similar profiles and sizes (exclusion from the proxy group was not tied to credit ratings). Chehalis further asserts that the mere fact that the cost of debt among the four proxy companies

¹⁵⁵ Staff Brief on Exceptions at 17-23.

¹⁵⁶ Chehalis's Brief on Exceptions at 78.

¹⁵⁷ *Id.* at 78-79.

¹⁵⁸ *Id.* at 79 (citing *Midwest Indep. Transmission Sys. Operator, Inc.*, 99 FERC ¶ 63,011 (2002) (*MISO I*) and *Midwest Indep. Transmission Sys. Operator, Inc.*, 100 FERC ¶ 61,292 (2002) (*MISO II*), *order on reh'g*, 102 FERC ¶ 61,143 (2003), *order on remand*, 106 FERC ¶ 61,302 (2004), *aff'd in pertinent part and rev'd in other parts sub nom. Pub. Serv. Comm'n. of Ky. v. FERC*, 397 F.3d 1004 (D.C. Cir. 2005)).

varies is expected among independent power producers and does not require exclusion where there was no showing that the cost of debt for Goldendale and Hermiston before the parent's bankruptcy filing was affected by such bankruptcy filing.

149. Chehalis further argues that while the Presiding Judge correctly rejected the use of Moody's Baa-rated Public Utility Index as a proxy, he errs in relying on it to confirm his adoption of 6.725 percent as the average cost of debt. It argues that the basis for such reliance is his unsupported conclusion that there would be much less of a difference between regulated companies and unregulated ones when it comes to debt, compared to equity, where the risks are small in any event, except for entities on the verge of bankruptcy. Chehalis concludes that, just as the Presiding Judge rejected Staff's proposed risk analysis based on treating reactive power service as a stand-alone service, the Commission should also reject the Presiding Judge's reliance on Moody's as confirmation of the cost of debt.

3. Opposing Exceptions

a. BPA

150. BPA argues that Staff and Chehalis failed to demonstrate that their proposed cost of debt proxies are appropriate.¹⁵⁹ BPA argues that the wide disparity between the costs of debt of Calpine's subsidiary independent power producers and the TransAlta subsidiary independent power producers confirms not just Calpine and its subsidiaries' risky credit ratings, but also demonstrates their unrepresentative financial standing that makes them unsuitable for inclusion in a proxy group.

151. BPA further argues that Chehalis disingenuously argues that because the Calpine subsidiary costs of debt predate the Calpine bankruptcy, Calpine's credit rating at that time was not inconsistent with other independent power producers. BPA points out that Calpine's 2004 Form 10-K states: "Our credit ratings have been downgraded and could be downgraded further Such downgrades can have a negative impact on our liquidity by reducing attractive financing opportunities and increasing the amount of collateral required by trading counterparties."

152. BPA also argues that Staff fails to support its position. BPA asserts that the Commission has never authorized the use of Moody's as a proxy for debt and has only confirmed the reasonableness of a discounted cash flow analysis or the company's own debt.

¹⁵⁹ BPA Brief Opposing Exceptions at 43-46.

b. Staff

153. Staff asserts that the Presiding Judge did not err in rejecting the use of a proxy cost of debt of two Calpine plants, Chehalis's parent company and BPA.¹⁶⁰ Staff asserts that the Presiding Judge correctly found that Calpine's Goldendale and Hermiston plants are not appropriate proxies for Chehalis. With respect to Chehalis's argument that *MISO I* and *MISO II* support its contention that exclusion from the proxy group was not tied to credit ratings, Staff responds that there is no indication in *MISO I* that any of the companies in the proxy group suffered low credit ratings. Thus, it argues, *MISO I* does not stand for the proposition that credit ratings are irrelevant in selecting a proxy group. Moreover, Staff asserts, the presiding judge in *MISO I* favored the proxy group he chose in part because it included comparable risk companies. Staff concludes that, contrary to Chehalis's suggestions, the issue here is the proper rate for Chehalis's reactive power operations, not its merchant power business.

154. Staff further asserts that the Commission has recognized the importance of matching the level of financial risk intrinsic to the capital structure with the level of financial risk included in the cost of capital.¹⁶¹ It argues that use of Calpine's debt cost would create a disparity between the required, moderate risk capital structure and the much riskier cost of debt proposed by Chehalis.

155. Staff argues that Chehalis ignores the fact that the rates being set here are for regulated reactive power service, not merchant operations. Staff also argues that *Kern River* demonstrates that the Commission does not allow companies with risk profiles that diverge from that of the company at issue in the proceeding to be included in a proxy group.¹⁶²

156. In response to Chehalis's argument that Calpine's bankruptcy filing in December 2005, is irrelevant, Staff asserts that Chehalis ignores the facts in the record and fails to affirmatively justify its cost of debt proposal. Staff explains that S&P's gave Calpine a credit rating of B at the end of 2004, which is considered a junk bond rating. According to Staff, the debt costs of Calpine's subsidiaries are even higher, suggesting that investors consider these generators to be even greater credit risks. Staff concludes that there can be no question that Calpine's, and its subsidiaries', financial distress was reflected in credit ratings that warn investors to steer clear.

¹⁶⁰ Staff Brief Opposing Exceptions at 83-95.

¹⁶¹ *Id.* at 89.

¹⁶² *Id.* at 90-91 (citing *Kern River Transmission Co.*, 117 FERC ¶ 61,077 (2006)).

157. Staff agrees in general that it is appropriate to use the Moody's Public Utility Baa Index to assess whether the debt cost in a proposed capital structure is acceptable. However, in this case, Staff argues that Moody's Baa yield is the best approximation of the cost of debt for Chehalis's reactive power operation.

158. Staff further asserts, contrary to the arguments of BPA, that the Presiding Judge correctly found that SUEZ and BPA are inappropriate proxies for Chehalis's costs of debt.¹⁶³ It argues that BPA has provided no rationale for the Commission to accept SUEZ as a suitable proxy. Staff also asserts that BPA is not an appropriate proxy because BPA does not explain how BPA and Chehalis are equivalent in risk. Chehalis's practically risk-free reactive power service may, Staff maintains, be close in risk to BPA's transmission operations, but there is no supporting evidence in the record.

c. Chehalis

159. Chehalis opposes Staff's approach to the cost of debt, arguing that to accept it the Commission would be required to depart from its precedent in three ways.¹⁶⁴ First, Staff asserts, it would require the Commission to base the cost of debt on a single electric service from an entity that is subject to the Commission's jurisdiction for all electric service from the entity. The second, Staff asserts, would require the Commission to accept Moody's Index for proxy purposes. The third, Staff asserts, would require the Commission to assume that the risk profile faced by the entities included in the Moody's Index is consistent with that of Chehalis. Chehalis argues that neither Staff's nor BPA's approach are reconcilable with Commission precedent on cost of debt.

160. Chehalis takes issue with Staff's assertion that the cost of debt must be based on the regulated service at issue, arguing that no case cited by Staff supports this proposition. Citing *Bluefield*¹⁶⁵ and *Hope*,¹⁶⁶ Chehalis argues that those cases focused on the enterprise and corresponding risk, including the geographic market, and asserts that Commission policy has followed those cases and should continue to follow them.¹⁶⁷ It argues that Staff has ignored these bedrock principles. According to Chehalis, if it were

¹⁶³ Staff Brief Opposing Exceptions at 93-95.

¹⁶⁴ Chehalis Brief Opposing Exceptions at 19-35.

¹⁶⁵ *Bluefield Waterworks & Improvement Co. v. PSC of W. Va.*, 262 U.S. 679 (1923).

¹⁶⁶ *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

¹⁶⁷ Chehalis Brief Opposing Exceptions at 21.

to secure debt in the market, the only rate at which Chehalis could do so would be a single rate reflective of Chehalis's overall risk profile. Thus, it argues, its cost of debt would be based on the composite risk profile of all electric power operations. Chehalis also argues that if Chehalis's cost of debt were set at the rate proposed by Staff, such a rate would be less than the rate at which Chehalis could secure debt in the market and would be contrary to the finding in *Hope*.

161. Chehalis further argues that Staff is unable to provide any support for the proposition that the Commission establishes rates of return based on a single service without considering the risk profile of the entity providing the service, and distinguishes the cases cited by Staff.¹⁶⁸

162. Chehalis further argues that the rationale for Staff's selection of the Moody's Index is flawed. Chehalis argues that it is an independent power producer, not a vertically integrated utility or average regulated enterprise. Chehalis also asserts that Staff's statement that the Commission has accepted the Moody's Index as a proxy is misleading. Chehalis argues that Staff subsequently acknowledges that the Commission has never used the Moody's Index as the cost of debt and goes on to distinguish the cases cited by Staff as support for prior Commission acceptance of the Moody's Index.¹⁶⁹ For instance, Chehalis argues that in *SunShine* the Commission actually required the use of actual cost of debt.

163. Chehalis next argues that Staff inappropriately ignores Chehalis's risk profile. It asserts that Staff does not reconcile Chehalis's risk profile with that of the utilities in Moody's Index.¹⁷⁰ It emphasizes that the Moody's Index is most representative of regulated operations for U.S. utilities in general, while, as Staff recognizes, Chehalis is a merchant generation facility.

164. Finally, Chehalis argues that BPA's cost of debt is not an appropriate proxy.¹⁷¹ Chehalis asserts that while the Commission has approved the use of the interconnected transmission provider as a proxy in certain reactive power proceedings, the same is not true when the applicant has contested its use. It maintains that where the Commission has accepted the use of the interconnected transmission provider without further analysis, it has done so because it recognizes that the use of the interconnected transmission

¹⁶⁸ *Id.* at 23-26.

¹⁶⁹ *Id.* at 27-29.

¹⁷⁰ *Id.* at 30.

¹⁷¹ *Id.* at 32-35.

provider will result in a conservative estimate of the independent power producer's cost of capital and the independent power producer has not objected.

165. Chehalis further argues that there are several reasons why BPA is inappropriate to use as a proxy. Chehalis points out several benefits flowing from BPA's status as a federal power marketing agency that significantly affect its financial risk profile. It adds that the significant quantity of federal hydroelectric resources owned and operated by BPA represents a risk to merchant, fossil fuel fired generators like Chehalis. Thus, Chehalis asserts, BPA's risk profile is not comparable to Chehalis's risk profile.

d. Commission Determination

166. We affirm the Presiding Judge's findings with respect to the cost of debt for Chehalis. Based upon the record in this proceeding, we conclude that 6.725 percent, which reflects the average costs of debt of the TransAlta subsidiaries' Centralia and Big Hanaford, is a reasonable cost of debt for use by Chehalis as a proxy in this proceeding.

167. We find that BPA fails to support its claim that its cost of debt is a suitable proxy for Chehalis. While the Commission has previously accepted generators' proposals to use the interconnected utility's rate of return as a proxy in reactive power cases, it has done so because it was proposed by the generator and the interconnected utility's return was a conservative estimate of the generator's return, as the generator essentially faces more risk than the interconnected utility.¹⁷² However, the Commission has never required that a generator use its interconnected utility's return as a proxy, and Chehalis did not propose to use the return of the interconnected utility (in this case, BPA). Further, in this case, the interconnected utility – BPA – is a governmental agency that is unlike Chehalis and that faces different risks. Thus, it would be improper to adopt BPA's cost of debt as a proxy for Chehalis given their quite dissimilar risk profiles.

168. Further, we find that Staff's approach to the cost of debt is also unacceptable and affirm the Presiding Judge on this matter. While Staff agrees that, on its own, the cost of debt determined by the Presiding Judge is reasonable, it argues that, as a matter of policy, the Commission should find that reactive power service is an operation separate from the generators' real power business and that particularly the debt cost allocated to reactive power rates should reflect only the debt costs of reactive power operations. It claims that the Moody's Baa Public Utility Index appropriately reflects the risks of these operations. We disagree with Staff's approach.

¹⁷² See, e.g., *Bluegrass Generation Co., L.L.C.*, 118 FERC ¶ 61,214, at P 86 (2007); *Calpine Fox, LLC*, 113 FERC ¶ 61,047, at P 17 (2005).

169. While Staff agrees that the cost of debt determined by the Presiding Judge is reasonable, it claims that his method for determining a proxy is not based on a principle that can be applied in future cases. Staff explains that, as more independent generators without traditional capital structures apply for regulated reactive power rates, the Commission will need to determine the appropriate proxy capital structure to apply to this regulated service. Accordingly, Staff states that it is raising this issue so that the Commission can give guidance for future cases like this. We find that Staff's request for more general policy guidance is not appropriate because the limited record in this proceeding does not provide a sufficient basis to construct such a policy and the cost of debt determination herein is only applicable to a historical period that has expired.

170. In addition, as explained by the Presiding Judge, the Chehalis reactive power operations are not a stand-alone part of its operations. Rather, they are part of Chehalis's overall operations whose primary purpose is to sell real power. Debt costs typically are determined for a whole company based on its overall risk profile, and Chehalis itself has no debt, but its parent issues debt and raises money for its operations as a whole.¹⁷³ In addition, contrary to the implications of the approach Staff espouses here, a company typically would not identify the risks associated with each individual component of its operations and obtain debt capital for each of these components. Staff certainly has not shown that Chehalis's behaviors or actions were different from companies engaged in the same line of business. Moreover, Staff does not explain why this case should be treated any differently from the hundreds of return cases that have preceded this one. Indeed, the logical end result of Staff's approach would be to have a separate risk analysis and debt cost for every component of a company's operations (an approach that the Commission has never taken). Accordingly, we reject Staff's recommendation.

171. Finally, we affirm the Presiding Judge's rejection of the cost of debt proposed by Chehalis. While the Presiding Judge found that the use of TransAlta's subsidiaries cost of debt was appropriate in determining a proxy because they have investment grade credit ratings, he rejected the use of Calpine's subsidiaries' Hermiston and Goldendale costs of debt in Chehalis's computation of a proxy. We agree with the Presiding Judge's approach. We disagree with Chehalis's argument that the decision to exclude these generators is contrary to the findings in *MISO I* and *MISO II*, where, according to Chehalis, the companies that formed the proxy group faced analogous risks, with no exclusions based on credit ratings. In *MISO I* and *MISO II*, the companies comprising the proxy group accepted by the Commission all had investment grade ratings. Here, the Presiding Judge properly disqualified the two Calpine subsidiaries from the proxy group

¹⁷³ See *Boston Edison Co.*, 79 FERC ¶ 61,328, at 62,430 (1997) (return is properly calculated on a company-wide basis; not on a customer-specific or contract-specific basis).

because Calpine had a below-investment grade credit rating. Therefore, we find that *MISO I* and *MISO II* are not contrary to the Presiding Judge's determination.

172. Staff takes issue with the Presiding Judge's adoption of the TransAlta subsidiaries as a suitable proxy, arguing that the Presiding Judge failed to compare the risk profiles of TransAlta and Chehalis. It argues that, at the end of 2004, TransAlta's debt was the lowest investment grade rating by S&P and there was no indication that Chehalis was close to non-investment grade status. We disagree. While TransAlta's debt may have been the lowest assigned investment grade rating, it was still investment grade and appropriate to include in a proxy group in this proceeding. We thus find that, while the Presiding Judge appropriately dismissed the Calpine subsidiaries because of their below investment grade rating, he properly found that the inclusion of TransAlta's subsidiaries was appropriate because TransAlta's debt is investment grade.

173. We also disagree with BPA's assertion that the costs of debt for the TransAlta subsidiaries cannot serve as a proxy because they were part of settlements that did not establish the cost of debt. The costs of debt figures for the TransAlta subsidiaries, submitted into the record by Chehalis and used by the Presiding Judge, are the actual costs of debt for these subsidiaries.¹⁷⁴ Thus, there is no reason they cannot serve as a proxy for Chehalis in this proceeding.

E. Issues Raised in Initial Decision but Not Included in Joint Statement of Issues

174. Chehalis quotes the Presiding Judge's recommendation that BPA consider revising its tariff to eliminate payments to companies for the capability to provide reactive power that is not needed or useful to the transmission system, but is useful only for the generating companies' own needs.¹⁷⁵ Chehalis is correct that this "issue" does not appear on the parties' joint list of issues. The problem with Chehalis's objection to the Judge's recommendation is that it is not part of the findings and conclusions of the Initial Decision. The Presiding Judge did not order BPA to do as he recommended and therefore Chehalis's argument is without merit.

The Commission orders:

(A) The Initial Decision is hereby affirmed in part and reversed in part, as discussed in the body of this order.

¹⁷⁴ See Ex. No. CPG-32.

¹⁷⁵ Chehalis Brief on Exceptions at 12.

(B) Chehalis is hereby directed to file, within 30 days of the date of this order, revisions to its rate schedule reflecting the Commission's findings herein.

(C) Within 45 days of the date of this order, Chehalis is hereby directed to make refunds from the refund effective date, August 1, 2005, through September 30, 2006, with interest calculated in accordance with 18 C.F.R. § 35.19(a) (2007), and to file a refund report with the Commission within 15 days of the date refunds are made. If no refunds are due, Chehalis is hereby directed to file a report so stating with the Commission within 45 days of the date of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.