Department of Commerce
UTILITIES DIVISION

TO: Board

FROM: Staff

DATE: **23 DECEMBER 2011**

SUBJ: Comments on HF 561 as amended by S3380

The Board believes that a diverse fleet of generating resources can be a desirable asset for an electric public utility. Prudent planning for these long-term investments should involve consideration of all reasonable alternatives. It appears that current and future developments may make carbon-emitting generating resources uneconomical and, as a result, make nuclear power plants a more viable alternative for serving customer needs than they have been in the last few decades. However, it may be that additional regulatory certainty is required to create a level playing field for all of the reasonable alternatives.

House File 561 relates to the permitting, licensing, construction and operation of potential new nuclear-fueled electric generation facilities in Iowa. It also affects the way that customers would pay for those facilities by shifting the allocation of risk between the utility and its customers. It is staff's understanding that companies looking to invest in nuclear energy argue that it would be difficult, if not impossible, to finance one or more new nuclear plants without a greater level of assurance of cost recovery than is provided by traditional public utility regulation. However, the precise extent of the required risk-shifting may be difficult to determine.

Potential concerns with HF 561

In this memo, staff outlines some potential barriers to the efficient implementation of HF 561 and describes possible methods to address them. While many of these issues were raised earlier in 2011, the importance was recently heightened by conversation and meetings with staff from the Nuclear Regulatory Commission and the US Department of Energy.

Board staff also identifies sections of the bill that may be subject to multiple interpretations, such that clarification may be helpful. Finally, the memo identifies a few policy considerations that may be worthy of further discussion.

1. Resource concerns and timelines

HF 561 will require the Board to establish advance ratemaking principles within 180 days after the application is filed (which may be extended for an additional 180 days for good cause shown; any further extension will require the agreement of MidAmerican). The bill also allows the Board to hire additional staff, contract with outside consultants, or both, in order to acquire nuclear-plant-related expertise. This may present some issues of timing and resources.

The current bill, if enacted, will take effect on July 1, 2012. If it passes in its current form, the Board would not be able to hire additional staff or issue an RFP for a consultant until July 1, 2012, at the earliest. It is possible that MidAmerican could file its application for ratemaking principles at the same time. If that were to occur, it is unlikely that the Board would have the benefit of the new staff or consultants during much of the time that the application would be pending, as it takes substantial time to hire staff and contract for services. Due to the specialized knowledge required, staff estimates it will take at least six months, and possibly much longer, to hire new staff, select and contract with a consultant, or some combination of the two. At a minimum, this would almost certainly mean there would be no realistic chance of completing the ratemaking principles proceeding in 180 days.

This problem could be alleviated by amending the bill to allow MidAmerican to file an application only after January 1, 2013, or some later date, in order to give the Board six months to hire and contract. Or, MidAmerican could be required to give the Board advance notice of a filing in a time frame sufficient to permit the agency to hire and contract for the additional expertise. In fact, in discussions with MidAmerican regarding this bill, the company has agreed to give the Board at least six months' notice prior to filing, if possible. This would go some way toward addressing the timing and staffing issues. However, it is conceivable that the requirements for possible federal funding to assist with licensing of small nuclear reactors could accelerate the schedule and force MidAmerican to file in a time frame that prevents giving the full six-month notice.

An additional measure to address this problem, at least partially, would be to make the provisions that allow the Board to obtain additional expertise effective upon enactment, rather than on July 1, 2012, effectively giving the agency a bit of a head start. This would give the Board from the date of enactment until January 1, 2013, to begin the process of staffing, either by hiring or by contracting with consultants, before a filing would be possible.

There is a concern on the other side of this equation, as well. If the Board hires nuclear expertise to assist the agency in reviewing proposed ratemaking principles for a nuclear plant, and MidAmerican then decides to delay the filing

of its application for some time, there is the possibility that we will have one or more nuclear experts on staff with no ongoing nuclear projects. They can use the extra time to prepare for the eventual filing, but it could be inefficient if the delay is lengthy.

2. Lack of flexibility

HF 561 includes a number of special provisions for nuclear power plants based upon today's information and timelines. After discussions with agencies such as the Nuclear Regulatory Commission and the U.S. Department of Energy, staff is concerned that some future developments, outside the control of industry or state government, may cause significant changes in the underlying conditions. The inflexible nature of some of the bill's provisions may be a problem if the market develops in an unforeseen manner, particularly if rapid adjustments are needed to respond to the unpredicted changes.

At a minimum, this concern for lack of flexibility could be partially addressed by allowing the Board, Consumer Advocate, and MidAmerican to revise any of the statutory ratemaking principles, but only with the express agreement of the Board, Consumer Advocate, and MidAmerican. This would preserve the certainty of the ratemaking principles that MidAmerican needs while providing a little flexibility to try to address unforeseen circumstances.

3. Specific provisions with the potential for unintended consequences or which may lack clarity

HF 561 (as amended) would shift nearly all of the construction, licensing, and permitting risk associated with one or more nuclear plants from the company to its customers. This is done, in part, by preapproving the company's spending in annual proceedings throughout the construction, licensing, and permitting period and then guaranteeing recovery of pre-approved prudent costs, including a profit on capital investments. Some of these provisions could create incentives for the company to engage in behavior that could be contrary to the public interest in certain situations.

a. Provisions that may have unintended consequences

Plant abandonment provision (found at p. 8, ll. 8-16). This provision requires that the Board allow full recovery of all prudent expenditures incurred for the proposed plant(s), including profits, if the utility decides, for any reason, not to complete the plant. This provision has the potential to create unintended incentives. For example, imagine that at some point a few years into the project the utility has spent $1 billion on the proposed plant, all of which was determined to be prudent during the annual review proceedings. That year, the company makes a mistake during construction that is entirely the company's responsibility and will cost $50 million to correct. Normally, that cost of

correction would most likely be paid by the company and its shareholders. However, with this provision the company could come to the Board for preapproval of recovery of the cost of the correction. The company would be guaranteed a profit on all spending up to that point. This could create a stronger incentive to walk away from the plant than to complete it. Given that knowledge, the Board would be faced with the choice of (a) making customers pay for the utility's mistake (in order to receive the future benefit of a plant for which customers have already been committed to the tune of $1 billion) or (b) making retail customers pay $1 billion (plus profits) to the utility for a plant that will be abandoned. Under the circumstances, this would likely cause the Board to approve recovery of the $50 million cost of correction, even though it is entirely a result of the company's own error in this hypothetical example.

Thus, this provision could effectively create an incentive for the utility to walk away from the plant, even in the case of errors that are relatively small compared to the overall cost of the plant (once the prudent investment in the plant reaches significant levels). This is perhaps the best example of the way the bill shifts risk from the company to its customers and creates undesirable incentives. It might be addressed by giving the utility some risk associated with abandonment; for example, the Board could be given the authority to deny recovery of profit on the investment in an abandoned plant in appropriate circumstances. In that way, the company would have at least some incentive to continue with the project in circumstances like those described above.

Joint owner payment guarantee (found at p. 6, ll. 1-2). This clause provides that while MidAmerican's customers are responsible for all nuclear generating facility permitting, licensing, and construction costs, that liability is reduced by any amounts paid by the U.S. DOE and by "costs recovered from any joint owners" of the plant. Because the joint owner payments have to be actually recovered by MidAmerican before they are credited against the cost of the facility, this language appears to make MidAmerican's retail customers the guarantors of the joint owners' payments. If the joint owners do not pay, for any reason, MidAmerican would collect the shortfall from its retail customers. This is a good example of the way in which the bill shifts risks from the project owner and manager to the customers, potentially creating some undesirable incentives. For example, a utility that owns and operates a nuclear plant would not have a strong incentive to pursue a joint owner for nonpayment if the joint owner claimed mismanagement of the facility and refused to pay all or part of its share of the cost of the facility, given that the owner-operator utility would be held harmless by its customers. The utility could avoid litigation with its joint owner without losing any money.

Vendor risk negotiation. The guaranteed cost recovery provisions found at various points in the bill may have other unintended consequences. One of the effects of guaranteed cost recovery is that the utility will have a reduced incentive to write contracts that place appropriate amounts of risk with vendors. Since the

company will pass such a significant portion of risk to its customers, the company will have reduced incentive to negotiate vigorously with vendors.

b. *Provisions that may lack clarity/suggested technical corrections*

True-up clarifications. There are two related concerns under this heading. First, at p. 6, ll. 9-12, there is a requirement that in each annual 90-day review proceeding, in addition to determining the level of prudent costs for the next twelve months, the Board must true-up the recovery for the preceding period:

> A determination shall also be made of any adjustment required to balance the preceding period's actual expenditures and financing costs with what had been projected and included in costs recoverable in the previous period.

Arguably, this true-up language would require that the Board allow MidAmerican to recover all of its actual expenditures from the preceding year, even if MidAmerican spent more than the Board had predetermined to be prudent. This language should be revised to clarify that it is a true-up to the preapproved budget, not to actual spending.

The second true-up concern is at P. 6, ll. 17-22. The sentence provides:

> Following issuance of the board's ratemaking principles order, the utility shall file an application with the board on an annual basis providing such information [comparing actual costs to budgeted costs as projected through the expected in-service date], with the understanding that some cost components may be higher than estimated and other cost components may be lower.

This could mean that line items or accounts in the budget that exceed the pre-approved levels have to be netted against line items where the actual cost is below pre-approved levels, meaning the company is first in line for the benefit of any items that come in below budget, with customers second in line. In an extreme case, this provision also may give the company the ability to avoid the consequences of cost overruns by managing the timing of claims for other costs in areas where the project is under budget.

However, this sentence could also be nothing more than a requirement that the company update its projected costs on an annual basis (although if that is all it means, then the language about understanding that some may be higher and others may be lower seems to have no purpose). Again, this is language that should be clarified.

Expression of intent (p. 4, l. 27 – p. 5, l. 1). The bill provides that MidAmerican can begin to recover licensing, permitting, and certificate costs as soon as it

"expresses its intent" to file an application or seek NRC approval. It is not clear how the company would "express its intent" so as to initiate the ability to collect these costs. It is also unclear how the timing of this would work, given the need to review and approve the company's proposed advance ratemaking principles and the resulting tariff pages specifying the terms and conditions for the rider. The intended operation of this provision could be clarified.

Recovery commencement upon issuance of order (p. 5, ll. 30-31). Similarly, the bill provides that cost recovery for a nuclear plant shall commence upon issuance of the order approving advance ratemaking principles. It is not clear how this fits with the preceding provision allowing recovery of costs from the date the utility expresses its intent to pursue licensing or permitting. It may mean that all costs incurred after the expression of intent must be recovered, but that recovery does not start until the Board's order is issued, but that leaves a potential gap if the company chooses not to pursue the project, as permitted by HF 561, p. 9, ll. 20-28.

c. Other comments

Staff understands the intent of HF 561 is to make nuclear power plants a viable alternative source for future baseload power, particularly in an environment in which carbon emissions are constrained. In doing so, HF 561 causes significant shifts in both current energy policy and traditional ratemaking principles. While the current bill restricts those changes to nuclear power plants, staff believes some provisions of HF 561 may go beyond leveling the playing field and could give a nuclear power plant unintended advantages over alternative sources of electric power. That may cause utilities to seek similar benefits for other investments, either in legislation or before the Board, in search of regulatory equality. It may be appropriate for the Legislature to have some policy discussions regarding the appropriate incentives required to create a level playing field without creating a bias in favor of one reasonable alternative over the others.

Financial provisions. Other provisions of the bill would prohibit the Board's traditional use of double leveraging (unless the utility equity ratio exceeds 55 percent). This would arguably allow a utility to fund some of its investment with lower-cost debt at the parent company level while receiving a higher equity return for those investment dollars at the operating utility level. The bill would also require the use of the utility's actual capital structure, preventing the possible use of a hypothetical capital structure for ratemaking purposes. An alternative treatment would be for the company to bring its financial principles before the Board instead of embedding them in the bill._ The Board recognizes that a nuclear power plant may require a different capital structure than has been traditional; determining how that structure should be different in order to advance the public interest is the type of regulatory decision the Board makes on a regular basis.

*Recovery period for permitting and licensing costs (*p. 6, ll. 28-32). This provision requires that all costs associated with US NRC permitting or licensing must be recovered over a period not to exceed the estimated construction period. Under normal ratemaking principles, these costs would typically be capitalized and recovered over the useful life of the facility, so that the customers who benefit from the plant pay the costs associated with obtaining that benefit. At this point, we do not have information regarding the expected costs, but it is likely they will be significant. Moreover, to the extent they are backloaded or they increase beyond projected levels, resulting in higher payments in later years, this requirement could cause significant rate increases in the later years of construction.

Retired coal plants (found at p. 8, ll. 17-26). This provision requires that the utility be allowed to recover the net book value of any coal-fired generating facility that entered service prior to 1974 and is committed to retirement in anticipation of the operation of a new nuclear plant, if retirement is determined by the Board to be prudent. This includes recovery of the investment and a profit on that investment. Proper rate treatment of early retirements is usually a rate case issue and in the past the Board has typically allowed recovery of the remaining investment in a prudently-retired plant but has not always allowed the company to earn a return on that investment, effectively balancing the interests of customers and shareholders. This provision would prohibit consideration of that balancing of interests.

Comparison to other alternatives (p. 8, ll. 32-33). This provision would exempt proposed nuclear plants from the existing requirement that a public utility that proposes a new plant must show that it has considered other feasible sources of long-term supply and the proposed plant is reasonable when compared to those alternatives. A few lines below (lines 8-12), a new requirement for nuclear plants is added. It requires that the company demonstrate, through a detailed business case, that it is prudent to build the proposed nuclear plant.

The precise purpose of these provisions is not specified or made clear and the term “detailed business case” is not defined. Further, it has no generally-accepted definition in the area of public utility regulation. The only thing that can be said at this time is that it may not involve consideration of, and comparison to, other feasible sources of long-term supply. This section could be clarified if the intent can be determined.