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April 4, 2011

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Clerk's Office
N.C. Utilities Commission

Ms. Renne Vance, Chief Clerk
North Carolina Utilities Commission
430 North Salisbury Street
Raleigh, North Carolina 27603

OFFICIAL COPY

Re: **Docket No. E-100, Sub 127**

Dear Ms. Vance:

Please find enclosed one original and thirty (30) copies of the *Reply Comments of Dominion North Carolina Power* to the Initial Statement of the Public Staff filed in the above-captioned proceeding on March 1, 2011.

Also enclosed is a copy of this filing to be file-stamped and returned with our courier. Please do not hesitate to call me if you have any questions regarding this matter. Thank you for your assistance in this matter.

Sincerely,

Andrea R Kells

Andrea R. Kells

ARK:as

cc: Parties of Record

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STATE OF NORTH CAROLINA
BEFORE THE
UTILITIES COMMISSION

DOCKET NO. E-100, SUB 127

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of	)	
Biennial Determination of Avoided Cost	)	REPLY COMMENTS OF
Rates for Electric Utility Purchases from	)	DOMINION NORTH
Qualifying Facilities – 2010	)	CAROLINA POWER
	)	

Virginia Electric and Power Company d/b/a Dominion North Carolina Power ("DNCP" or the "Company") hereby submits its reply comments to the Initial Statement of the Public Staff ("Initial Statement") filed in the above captioned proceeding on March 1, 2011.

BACKGROUND

On May 5, 2010, the North Carolina Utilities Commission ("Commission") issued an *Order Establishing Biennial Proceeding, Requiring Data and Scheduling Public Hearing* ("Scheduling Order") in the above captioned docket, thereby commencing its biennial determination of avoided cost rates for electric utility purchases from qualifying facilities ("QFs"). The Scheduling Order directed the major North Carolina electric utilities to file a set of proposed rates for purchases from QFs, showing all calculations for determining the proposed rates, including inflation rates, and discount rates used, and proposed standard form(s) of contract between QFs and the utility, and a description of differences between the proposed standard form(s) of contract and the currently approved standard form(s) of contract, including the reasons for such differences. The Company filed with the Commission a comparison of calculations of avoided cost payments under its Schedule 19-LMP and Schedule 19-DRR on July 15, 2010, and filed Comments, Exhibits and Avoided Cost Schedules on November 1, 2010. On

January 12, 2011, the Company filed an updated comparison of calculations of avoided cost payments under its Schedule 19-LMP and Schedule 19-DRR. On February 28, 2011, the Company filed copies of all contracts and amendments between itself and QFs signed in 2010. On March 1, 2011, the Public Staff filed its Initial Statement responding to the electric utilities' statements and exhibits filed in the proceeding.

In its Initial Statement, the Public Staff raised no objection to the Company's proposal to use forward capacity costs from the PJM Reliability Pricing Model ("RPM") for 2011-2013 and from ICF International, Inc. ("ICF") for 2014-2026 to determine its avoided capacity costs. The Public Staff also concluded that the PROMOD inputs into the model used by the Company to estimate avoided fuel costs for on-peak and off-peak periods over the next 15 years, and the model outputs, are reasonable for determining DNCP's avoided energy costs for QFs of 100 kW or less.

Public Staff's comments on other aspects of the Company's proposed Schedule 19-DRR and standard contract are addressed below.

REPLY COMMENTS

I. AVAILABILITY OF SCHEDULE 19–DRR RATES AND CONTRACTS IS APPROPRIATELY LIMITED TO QFS THAT BEGIN DELIVERY OF POWER BEFORE THE END OF THE BIENNIAL STUDY PERIOD.

A. Background.

The Company's proposed Schedule 19-DRR is available to any size-eligible QF with a Certificate of Public Convenience and Necessity ("CPCN"), if a CPCN is required by the Commission, that enters into a contract with the Company and begins deliveries of power prior December 31, 2012 (the "Availability Deadline"). December 31, 2012 is the Availability Deadline because that is the end of the two-year period forming the basis for the estimated avoided cost rates contained in the schedule ("Biennial Period"). Thus, a QF that will not begin delivery of power during the Biennial Period is not eligible for the Schedule 19-DRR rates approved during this proceeding, even though it meets the other requirements for Schedule 19-DRR (a "Non-Period QF").

Citing the Commission's recent interpretation of a "legally enforceable obligation" ("LEO") under 18 C.F.R. § 292.304(d) in Docket Nos. E-2, Sub 966[1] and SP-467, Sub 1[2] (collectively, the "Arbitration Orders"), the Public Staff believes it is inconsistent with the Public Utility Regulatory Policies Act of 1978 ("PURPA") for a Non-Period QF to be denied "currently approved avoided cost rates." *Initial Statement* at 19-20. At a minimum, according to the Public Staff, a Non-Period QF "should be entitled to the proposed avoided cost rates, subject to those rates being trued up if the Commission-approved rates are higher than the proposed rates." *Id.* at 20.

B. <u>DNCP Reply</u>.

As discussed in more detail below, the Company disagrees that the Availability Deadline is inconsistent with PURPA. The Company agrees that Non-Period QFs should be entitled to the then-proposed avoided cost rates, subject to being trued-up based on the Commission's final order in a biennial proceeding, which in fact reflects current Company policy for Non-Period QFs. The Company disagrees that 18 C.F.R. § 292.304(d) applies in standard rate context, or that if applicable, 18 C.F.R. § 292.304(d) would entitle a Non-Period QF to receive current Commission approved avoided cost rates. Instead, application of 18 C.F.R. § 292.304(d) would lead to multiple determinations of avoided costs for each Non-Period QF "calculated at the time"

[1] *In the Matter of EPCOR USA North Carolina LLC v. Carolina Power & Light Company d/b/a Progress Energy Carolinas, Inc,* Order on Arbitration, January 26, 2011 (the "EPCOR Order").
[2] *In the Matter of Economic Power & Steam Generation, LLC v. Virginia Electric and Power Company, d/b/a Dominion North Carolina Power,* Order on Arbitration, June 18, 2010 (the "EP&S Order").

the QF was deemed to have created a LEO "based upon forecasts using data as of the time the [LEO] is incurred." EP&S Order at 7. Such a process, the Company submits, is the antithesis of the rationale for standard rate options, which is to allow small QFs, and the Company, to avoid the transactional cost of individual rate estimates and contract negotiations.

1. <u>The Availability Deadline is Appropriate in a Standard Rate Context</u>.

Avoided costs determined in the Commission's biennial proceedings are necessarily based on the assumption that QFs will begin power deliveries during the Biennial Period. For example, in this proceeding, DNCP's Schedule 19-DRR rates are all based on the assumption that a QF will start delivering power to the utility in either 2011 or 2012. Accordingly, the avoided capacity rates start in 2011 or 2012, as applicable, and run for 5, 10 or 15 years from 2011 or 2012, as applicable. Similarly, with respect to 100 kW or smaller QFs, for which fixed avoided cost energy rates are required, avoided cost energy rates start in 2011 or 2012, and run for, 5, 10 or 15 years from 2011 or 2012, as applicable.

There will be no avoided cost rate estimates developed or approved in this proceeding for QFs that begin operating in 2013, 2014 and beyond. Thus, even assuming that a Non-Period QF was otherwise entitled to currently approved Schedule 19-DRR, new avoided cost estimates would need to be calculated for years not covered by the currently approved Schedule 19-DRR (2013 and onward), using different data and assumptions from those used in the current approved Schedule 19-DRR.

2. <u>The Company Offers a Standard Rate Option to Non-Period QFs</u>. The Company's existing policy with respect to Non-Period QFs is to enter into contracts with such QFs at the rates and terms and conditions contained in the then-proposed Schedule 19-DRR that covers the applicable biennial period, subject to true-up based on the Commission's final order in

such biennial proceeding. Applying this policy to the currently proposed Schedule 19-DRR, during the interval between January 1, 2011, and the Commission's order in this proceeding, the Company will enter into contracts with QFs that can meet the Availability Deadline at the rates and terms and conditions contained in its proposed Schedule 19-DRR. The rates and contract terms would be trued-up to reflect any increase in the rates approved in the Commission's final order in this proceeding. The Company will enter into contracts with Non-Period QFs that cannot meet the Availability Deadline in this proceeding at the rates and terms and conditions contained in the Schedule 19-DRR as proposed in the next biennial proceeding. The Company is willing to memorialize its existing policy in Schedule 19-DRR if desired by the Commission.

3. <u>18 C.F.R. § 292.304(d) is not applicable to Schedule 19-DRR.</u>

Schedule 19-DRR is a standard rate approved by the Commission pursuant to its obligation under 18 C.F.R. § 292.204(c)(1) to put standard rates into effect for QFs with a design capacity of 100 kW or less. As permitted by 18 C.F.R. § 292.304(c)(2), the Commission has expanded standard rates to apply to QFs of five MW or less. Standard rates adopted by the Commission are required to be "consistent with paragraphs **(a) and (c)** of [18 C.F.R. § 292.304]." 18 C.F.R. § 292.304(c)(3)(i) (emphasis added). In short, 18 C.F.R. § 292.304(d) is not applicable to Commission approved standard rates. Moreover, as discussed below, artificially grafting 18 C.F.R. § 292.304(d) onto the standard rate context would not entitle a QF to the currently approved standard rates and would embroil the Commission and the Company into myriad individual rate setting proceedings.

4. <u>Invocation of 18 C.F.R. § 292.304(d) would not entitle a QF to Schedule 19-DRR Rates.</u>

The LEO Option would not, as the Public Staff suggests, entitle a QF to the avoided cost rates contained in Schedule 19-DRR. 18 C.F.R. § 292.304(d) provides a QF with the right to:

(1) To provide energy as the qualifying facility determines such energy to be available for such purchases, in which case the rates for such purchases shall be based on the purchasing utility's avoided costs calculated at the time of delivery; or

(2) To provide energy or capacity pursuant to a legally enforceable obligation for the delivery of energy or capacity over a specified term, in which case the rates for such purchases shall, at the option of the qualifying facility exercised prior to the beginning of the specified term, be based on either:

(i) The avoided costs calculated at the time of delivery; or

(ii) The avoided costs **calculated at the time the obligation is incurred.**

(emphasis added).

The meaning of subsection (d)(2), as Public Staff notes, was at issue in the EPCOR[3] and EP&S proceedings. In the EP&S Order, the Commission held that, under the specific facts of that case, a QF established an LEO in November 2009 because at that time the QF had (1) obtained a CPCN, and (2) made clear to the purchasing utility that it wanted to sell its output. EP&S Order at 8-9. Having established an LEO, the Commission held that the QF was entitled to avoided cost payments "based upon forecasts using data as of the time the [LEO] is incurred" (i.e., November 2009). *Id.* at 7-9.

Thus, under the plain language of 18 C.F.R. § 292.304(d)(2)(ii), and consistent with the Commission's rulings in the EP&S proceeding, a Non-Period QF invoking 18 C.F.R. § 292.304(d)(2) would not be entitled to the currently effective Schedule 19-DRR. Instead, that QF would be entitled to avoided costs **"calculated at the time the obligation is incurred"** and "based upon forecasts using data as of the time the [LEO] is incurred." For example, a Non-Period QF that established an LEO in October 2012 for a

[3] DNCP's analysis focuses on the EP&S proceeding because it involved an unconstructed QF. The EPCOR proceeding involved two already-constructed and operating QFs. It is entirely within the control of already-operating QFs that meet the other eligibility requirements for Schedule 19-DRR to meet the Availability Deadline.

facility that would begin delivering power in December 2014 would not be entitled to avoided cost rates approved in this proceeding, but rather avoided cost calculated at the time of the LEO. Further, such avoided cost estimates would be based upon forecasts using data available in October 2012, not forecasts based on the data used in this proceeding. In short, there would be potentially endless rounds of calculations of avoided costs as of each QF's LEO, which would defeat the whole purpose of establishing standard rates.

II. BIENNIAL RESET OF ENERGY PAYMENTS

A. Biennially Reset Energy Payments Have Served the Interests of Both QFs and Ratepayers and Should be Continued.

Under the Company's proposed Schedule 19-DRR, energy rates for QFs above 100 kW are fixed in two year increments over the life of DNCP's standard Agreement for the Sale of Electrical Output ("PPA") through one of two methods. A QF may elect to (1) receive the energy payment approved by the Commission in each biennial proceeding or (2) receive energy payments based on long-term levelized generation mixes with adjustable fuel prices. *See* Schedule 19-DRR Sections VI.A & VI.B.

This biennial reset method for energy payments is not a recent development. The method was first approved by the Commission on an experimental basis in 1989 in Docket No. E-100, Sub 57.[4] The Commission granted permanent approval to the existing Schedule 19-DRR energy rate method in 1990 in Docket No. E-100, Sub 59.[5]

[4] *In the Matter of Biennial Determination of Avoided Cost Rates For Sale and Purchase of Electricity Between Electric Utilities and Qualifying Facilities – 1988/1989*, Order Establishing Standard Rates and Contract Terms for Qualifying Facilities, Docket No. E-100, Sub 57 (March 10, 1989).
[5] *In the Matter of Biennial Determination of Avoided Cost Rates for Sale and Purchase of Electricity Between Electric Utilities and Qualifying Facilities*, Order Establishing Standard Rates and Contract Terms for Qualifying Facilities, Docket No. E-100, Sub 59 (Sept. 10, 1991).

As stated in *JD Wind,*[6] in adopting its QF regulations, the FERC recognized that "in order to be able to evaluate the financial feasibility of a [QF], an investor needs to be able to estimate, with reasonable certainty, the expected return on a potential investment before construction of a facility." *JD Wind Rehearing* at P 23. The Schedule 19-DRR pricing mechanism achieves this objective.

The Company's energy mix approach reflects the different purposes of the capacity and energy rates in a typical project financed QF PPA. The capacity rate, which was and continues to be fixed over the term of the contract, is intended to cover the financing cost associated with a facility, while the energy rate is intended to recover the cost of fuel and O&M, which can vary over time. The Company's energy mix approach to energy rates under Schedule 19-DRR allows energy rates to reset according to fluctuations in commodity and O&M costs, which as discussed below, benefits both QFs and ratepayers. DNCP submits that the existing energy payment mechanism, coupled with the fixed capacity payment, has and most likely will continue to provide investors with the reasonable certainty required for financing small QFs.

In addition, the Company's method protects both the QF and ratepayers from the ill effects resulting from the inherent likelihood of error in fixed energy prices based on long-term forecasts of generation mixes and fuel prices. Predicting long-term fixed energy rates with accuracy is extremely difficult because of such factors as (1) the potential for new and more restrictive environmental regulations such as carbon legislation, (2) the increased emphasis on renewable energy at premium prices, (3) renewed interest in energy conservation and demand response programs, (4) volatile commodity market prices, and (5) the correlations between fuels. Moreover, because estimates of avoided energy costs are dependent on a number of long-term

[6] *JD Wind 1, LLC, et al.*, 129 FERC ¶ 61,148 (2009), *order denying requests for rehearing, reconsideration or clarification*, 130 FERC ¶ 61,127 (2010) ("*JD Wind Rehearing*") (together, "*JD Wind*").

assumptions that may not play out as anticipated, the risk of forecast error escalates as the forecast period lengthens.

Under the Company's method, the ratepayer or QF, as applicable, will bear the financial burden of inaccurate forecasts for only a relatively brief two-year period. Under the long-term fixed energy rate approach suggested by the Public Staff, if actual fuel and/or O&M costs decline compared to the long-term estimate of these costs, the fixed energy payments will be too high, the QF disproportionately benefits from over-recovery, and the ratepayer bears the cost of paying too much in avoided energy costs. Conversely, if actual fuel and/or O&M costs rise, then the fixed energy rates will be too low, the QF does not receive an accurate payment according to the market, and under-recovery of its variable energy costs could result in forcing the QF out of business, which would subject the ratepayers to the costs of higher market rates.

B. *JD Wind*.

The Public Staff questions whether, in light of *JD Wind*, the Company's decades-old method for determining energy payment is consistent with PURPA. In *JD Wind*, FERC stated that one of the purposes of its regulations was to "to establish a fixed contract price for its energy and capacity at the outset of its obligation," and that a QF's right to long-term avoided cost contracts or LEOs with rates determined at the time the obligation is incurred, is not affected by the fact that avoided costs at the time of delivery ultimately differ from those calculated at the time the obligation is originally incurred. *Initial Statement at* 20 (citations omitted).

In *JD Wind*, FERC did not make any holdings requiring the use of any particular method for calculating avoided cost, Order on Rehearing at P 22, or indicate what could satisfy the fixed contract price requirement. In another context in 1998, the FERC did provide some insight on what may be permissible, when it described a "fixed price contract" as

> any legally enforceable obligation wherein the rates for purchase by a utility of the power produced by a QF are established in advance of the purchase. The fixed price may be a single, uniform rate for kilowatt or kilowatt hour for all power, including a *fixed formula rate*, or a complex schedule of time-differentiated rates and other payments. The contracts term may range from decades to months.

Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Interconnection Facilities, FERC 1988-1998 Proposed Regulation Binder ¶ 32,457 at 32,171 ("*Administrative Determination*") (emphasis added).[7]

This discussion indicates that a formula rate is appropriate as a fixed price rate for QF avoided cost obligations. The Company submits that the energy price determination mechanism exemplified by Section VI of DNCP's Schedule 19-DRR is such a fixed formula rate, especially considering the fixed mix option under which the price is determined by applying updated commodity prices to the fuel mix established at the onset of the contract and corresponding with the year the QF intends to deliver energy to the Company.

C. <u>Fixed Energy Rates, if Ordered, Should Be Implemented in the Next Biennial Proceeding</u>.

When the Company prepared its filings in this proceeding, it did so with the expectation that the Commission would continue its long-standing practice of allowing biennial reset of avoided energy rates. Consequently, the Company has not prepared any long-term energy rate estimates other than rates for projects rated at 100 kW or less. Further, the Company has not made any determination whether the DRR method would be the appropriate method to calculate fixed avoided cost energy rates for QFs larger than 100 kW. Because of the risk to ratepayers and QFs discussed above, this is not a decision or a calculation that should be made in haste. Moreover, there is no evidence that the Company's current method of calculating avoided energy

[7] The Administrative Determination was a notice of proposed rulemaking. Ultimately, the FERC terminated the proceeding in 1998 without adopting any rule changes on the grounds, essentially, that the rulemaking had been overtaken by events; primarily the passage of EPACT 1992, which created EWG status as an alternative to QFs and the development of competition. *Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Interconnection Facilities*, 84 FERC ¶ 61,265 (1998).

costs has discouraged QF development in North Carolina. Accordingly, if the Commission should decide that fixed energy rates are required by PURPA, it should implement that decision starting with the next biennial proceeding. Such a ruling would give the Company and all other stakeholders time to make a thoroughly thought out and deliberate decision on the appropriate method for calculating long-term fixed energy rates and related issues, including the appropriate contract term given the increased risk to ratepayers.

III. SUBSEQUENT RATEMAKING ACTION

A. The Schedule 19-DRR Regulatory Disallowance Clause.

The fifth paragraph of the PPA deals with a situation in which a regulatory body with jurisdiction, such as this Commission, the Virginia State Corporation Commission ("VSCC") or FERC issues an order (a "Regulatory Order") that (1) prohibits rate recovery of payments made to a QF, and/or (2) requires the Company to refund to its ratepayers payments already made to a QF (the "Regulatory Disallowance Clause"). In the event of such a Regulatory Order, the Regulatory Disallowance Clause provides that rates under the PPA will be reset on a prospective basis at the levels that the Company is allowed to recover in rates. Further, if a Regulatory Order requires the Company to refund to ratepayers previous payments to a QF, then the QF is similarly required to refund the Company those amounts. The Commission has approved standard Schedule 19 PPAs containing a clause similar to the Regulatory Disallowance Clause since at least 1997,[8] well after the Commission's order in Docket No. E-11, Sub 41 referenced in the Initial Statement.

The Public Staff asserts that because the PPA "is a standard agreement for renewable QFs contracting to sell five MW or less," the Regulatory Disallowance Clause "seems unwarranted

[8] *In the Matter of Biennial Determination of Avoided Cost Rates for Electric Utility Purchases from Qualifying Facilities – 1996*, Order Establishing Standard Rates and Contract Terms for Qualifying Facilities, Docket No. E-100, Sub 79 (June 19, 1997).

and likely to discourage QF development." Initial Statement at 21. Further, the Public Staff argues that the Regulatory Disallowance Clause "has the effect of changing the rate paid to the QF because of subsequent regulatory action," which the Public Staff states was rejected in an April 1, 1983 order in Docket No. E-100, Sub 41. *Id.*

B. The Regulatory Disallowance Clause is Warranted and There is No Evidence That It Discourages QF Development.

The Company's purchase of energy and capacity from QFs is not optional. Currently, pursuant to PURPA, and the rules, regulations and orders of this Commission, the VSCC and FERC, the Company has a mandatory obligation to purchase energy and capacity from QFs of 20 MW or less at the Company's avoided cost, on the theory that the development of QFs provides a societal benefit. Because the Company is legally required to purchase energy and capacity from QFs, there should never be an order disallowing rate recovery of those QF payments. If, however, a Regulatory Order does in fact disallow recovery of QF payments, there is no principled reason to force the Company and its shareholders to continue to make uncompensated payments to the QF. The relatively small size of Schedule 19-DRR QFs does not affect this principle.

The Public Staff asserts that the Regulatory Disallowance Clause is "likely to discourage QF development." There is nothing in the record of this proceeding to support this proposition. Presumably, QFs and their lenders should know, as does the Company, that a regulatory disallowance is a remote possibility under existing law and precedent. *E.g., Freehold Cogeneration Associates v. Bd. Of Regulatory Commissioners of New Jersey*, 44 F.3d 1178 (3d. Cir. 1995). However, the Public Staff does not explain why DNCP, or any other utility, should bear even the remote possibility that its shareholders should bear the burden of a disallowance.

Moreover, the risk of disallowance, while remote, is real. In 1993, this Commission disallowed North Carolina rate recovery of a portion of the Company's avoided cost payments to two Virginia QFs because it concluded that the avoided cost payments ordered by the VSCC exceeded DNCP's avoided costs. *Ex rel. Utilities Commission v. North Carolina Power*, 338 N.C. 412; 450 S.E.2d 896 (NC 1994). *See also Hopewell Cogeneration Limited Partnership v. State Corporation Commission*, 249 Va. 107, 453 S.E.2d 277 (Va. 1995); *cert. denied*, 516 U.S. 817 (1995) (disallowing recovery of a portion of DNCP's QF payment to non-Schedule 19 QFs whose payments were based on VSCC approved Schedule 19 rates).

In sum, there is no evidence that the Regulatory Disallowance Clause has or is likely to discourage QF development. Further, while the risk of a regulatory body requiring a utility to purchase power from a QF and then it or another regulatory body disallowing recovery of the purchase payments is remote, it is real. There is no principled reason for this risk to be borne solely by the Company and its ratepayers. The Commission should reject the Public Staff's recommendation and approve the Company's Regulatory Disallowance Clause.

IV. LINE LOSS PROVISIONS

The Company has determined to withdraw its proposed amendment to the line loss provision in Schedule 19-DRR, without prejudice to offering the same or a similar proposal in a future proceeding. Because it is withdrawing the proposed amendment, the Company will not address the merits of the Public Staff's comments on the proposed amendment.

CONCLUSION

Wherefore, Dominion North Carolina Power respectfully requests that the Commission accept these reply comments to the Initial Statement of the Public Staff.

Respectfully submitted,

DOMINION NORTH CAROLINA POWER

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Attorneys for Virginia Electric and Power Company

Dated: April 4, 2011

CERTIFICATE OF SERVICE

I hereby certify that the foregoing *Reply Comments of Dominion North Carolina Power* to the Initial Statement of the Public Staff submitted in Docket No. E-100, Sub 127 has been served this day by mail, first class, postage prepaid, or electronically upon all parties of record in the above-captioned docket.

This the 4th day of April, 2011.

By: Andrea R. Kells

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