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December 03, 2013
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RE: RM13-002 Comments

A. Current SDPUC Regulations Concerning PURPA

In December 1982, the South Dakota Public Utilities Commission ("SDPUC") promulgated rules to govern contract negotiations between a public utility and a qualified facility ("QF") as defined under PURPA.[1] A brief summary of these rules is as follows:

- The electric utility and QF shall negotiate standard rates for purchase from QF with a design capacity greater than 100 KW.
- The SDPUC shall resolve any disputes arising between the parties in contract negotiation.
- Capacity credits for long-term contracts should be based on the avoided cost of baseload generation.
- Capacity credits should be constant over the term of the contract.
- Energy credits should be based on the expected hourly incremental avoided costs calculated over the hours in the appropriate on peak and off-peak hours as defined by the utility.
- The data required under Section 133 of PURPA shall be the data utilized to determine avoided costs.
- The QF shall be responsible for interconnection costs.
- Interconnection costs assessments shall be made on a case-by-case basis.
- Recovery of interconnection costs should be levelized over the life of the facility.
- A public utility must purchase energy and capacity from a qualified facility to which the electric utility is directly or indirectly interconnected with certain exceptions.

By and large, these rules were largely deferential, encouraging the parties to reach their own accord on the issues addressed in this rulemaking. The lack of state guidance on the calculation of avoided costs, in particular, significantly increases a QF's costs of negotiation with an electric utility as the methodology for determining avoided costs is contentious. The recent In the Matter of the Complaint by Oak Tree Energy, LLC Against Northwestern Energy For Refusing to Enter into a Purchase Power Agreement, EL11-006 (SDPUC Apr. 28, 2011) (hereinafter

[1] *See* In the Matter of the Investigation of the Implementation of Certain Requirements of Title II of the Public Utilities Regulatory Policy Act of 1978, Regarding Cogeneration and Small Power Production, F-3365 (SDPUC Dec. 14, 2012).

"Oak Tree") demonstrates this undeniable fact. After over 30 years of enforcement, it's a safe conclusion that these rules have been ineffective in achieving the purposes of PURPA in South Dakota.

B. Comments

1. Requirements for the Creation of a Legally Enforceable Obligation

Keeping the purpose of PURPA in mind, as well as the Federal Energy Regulatory Commission's ("FERC") regulations, the SDPUC should adopt the following requirements and guidelines for the creation of a Legally Enforceable Obligation ("LEO"):

a) No Need for Executed Contracts

The SDPUC should continue its stance that QFs do not need to have a contract signed by an electric utility in order to create a LEO.[2] This position aligns with the Congressional purpose behind PURPA and FERC's subsequent regulations: "[O]ne of the principal reasons Congress adopted section 210 of PURPA was because electric utilities had refused to purchase power from non-utility producers."[3] FERC's response to this mandate resulted in 18 C.F.R. § 292.304(d), and the following statement:

> Paragraph (d)(2) permits a qualifying facility to enter into a contract or other legally enforceable obligation to provide energy or capacity over specified term. Use of the term "legally enforceable obligation" is intended to prevent a utility from circumventing the requirement that provides capacity credit for an eligible facility merely by refusing to enter into a contract with a qualifying facility.[4]

b) No Distinction between Firm and Non-Firm Power

South Dakota regulations should allow LEOs for "firm" and "non-firm" QFs.[5] According to the FERC's decision in JD Wind 1, LLC,[6] LEOs cannot be limited to those QFs that provide only "firm power." FERC determined that the Texas Commission ruling that required that LEOs were only available to sellers of "firm power" was wholly inconsistent with PURPA and FERC's regulations implementing PURPA.[7]

c) Signed PPAs Create LEOs

The SDPUC should adopt its holding in Oak Tree and formalize regulations that state that a LEO is created once a QF submits a signed Purchase Power Agreement ("PPA") with the commitment to deliver energy and capacity to a utility at a rate equal to or less than the avoided cost of the utility determined in good faith.[8] However, we encourage the SDPUC to aggressively outline other factors apart from signed PPAs that establish LEOs, as stated in subsection (d) of these comments.

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[2] *See Oak Tree*, EL11-006, Final Decision and Order, at ¶ 8 (SDPUC Feb. 21, 2013).
[3] Cedar Creek Wind, LLC, 137 FERC ¶ 61,006, ¶ 31 (Oct. 4, 2011) (quoting FERC v. Miss., 456 U.S. 742, 750 (1982)).
[4] *Id.* at ¶ 32 (Oct. 4, 2011) (quoting Order No. 69, FERC Stats. & Regs. ¶ 30,128, at 30,880). The SDPUC's position in *Oak Tree* also aligns with the FERC's administrative decision in *Cedar Creek Wind, LLC*, stating that "[W]hen a state limits the methods through which a legally enforceable obligation may be created to only a fully-executed contract, the state's limitation is inconsistent with PURPA, and [FERC's] regulations implementing PURPA." *Id.* at ¶ 35.
[5] For purposes of this comment, "firm" power means readily available power (e.g., coal-fired generation) and "non-firm" powers means intermittent power (e.g., wind-powered and solar-powered generation). *Accord* JD Wind 1 LLC, et al., 129 FERC ¶ 61,148, at ¶¶ 3, 27 (Nov. 19, 2009).
[6] 129 FERC ¶ 61,148 (Nov. 19, 2009).
[7] *See id.* at ¶ 29.
[8] *See Oak Tree*, EL11-006, Final Decision and Order, at ¶ 8 (SDPUC Feb. 21, 2013).

d) Other Factors Leading to LEOs

We encourage the SDPUC to reject the creation of stifling elements such as 1) sufficient guarantees of performance by the QF or a performance bond guaranteeing that the project will be built; 2) a guarantee that the utility and its customers will be held harmless from any QF-related liability if a QF project fails to be constructed or operate appropriately; or 3) concrete evidence of financing. These elements would be antithetical to the purpose of PURPA and would effectively prohibit QFs from entering the marketplace. In contrast, we strongly recommend the SDPUC to establish factors that consider project viability that evidence a LEO. Pennsylvania in particular has taken a similar approach as to project viability and necessary commitments in order to obtain a LEO.[9] Apart from submitting a signed PPA, the SDPUC should consider the following factors to establish LEOs between QFs and Utilities:[10]

a. A reasonable date or range of dates for the commencement of delivery of energy and capacity with the understanding that both parties must act in good faith to deliver power on that date or range;
b. Written evidence that the QF has obtained or taken substantial action to obtain all necessary permits, site acquisition, site development, and FERC certification as a QF;
c. Written evidence that the QF has obtained or taken substantial action to acquire financing for the cogeneration facility or operation;
d. Consideration of other assets, liabilities, and net worth of the QF; and
e. Consideration of the QF's employees and consultants engaged to pursue the particular cogeneration facility or operation.

2. Acceptable Methodology or Methodologies for Determination of Avoided Cost

While within the law, the SDPUC decision in the 1982 Order to defer to the parties to determine the avoided costs of the electric utility fails to adequately protect the bargaining table from favoring one party, in particular, the electric utility. FERC Orders 69 and 70 establish that an electric utility must offer to purchase electric energy and capacity from a QF at a rate equal to the full avoided cost.[11] This requires that the *entire* "savings" be passed from the utility to the QF.[12] However, the lack of guidance from current SDPUC rules ensures that avoided costs and QFs are rarely negotiated.

Avoided costs are defined as the "incremental costs to an electric utility of electric energy or capacity or both which, but for the purchase from the qualifying facility or qualifying facilities, such utility would generate itself or purchase from another source."[13] In determining an appropriate methodology to calculate avoided costs, FERC recommended that state utility commissions consider the following: utility cost projections; availability of capacity or energy from the QF during peak demand periods, the relationship of the availability of energy or capacity provided by the QF to the utility's ability to avoid costs through deferrals of capacity additions, reductions in fossil fuel use, or other means, and the savings related to lower line losses.[14]

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[9] *See e.g.*, S. River Power Partners, L.P. v. Pa. Pub. Util. Comm'n, 696 A.2d 926 (Pa. Commw. Ct. 1997).

[10] The SDPUC should adopt fair and reasonable guidelines to address project viability and operation. At issue here is whether a QF should be able to create a LEO when there is the risk of the QF not fulfilling its commitment to provide energy/capacity to the utility. The SDPUC should take a fair and reasonable approach, taking into consideration 1) the complaints of utilities that may be required to purchase power and capacity from QFs that do not exist, 2) the purpose of PURPA in providing avenues for QFs not otherwise available, 3) to allow certainty for QFs in their attempts to obtain financing, permits, and other administrative hurdles, and 4) to promote what has otherwise been limited development of QFs in South Dakota since the passage of PURPA.

[11] *See* FERC Order No. 69, *45 Fed. Reg. 12,214* (1980); FERC Order No. 70, *45 Fed. Reg. 17,959* (1980).

[12] This requirement strikes an important balance between fulfilling the dual purposes of PURPA to promote non-fossil fuel generation while ensuring just and reasonable rates. The electric utility's rates should not increase due to purchases from a QF because the QF can only offset electric utility's generation if the electric utility's generation produces a higher marginal cost than the QF would. Ren Orans, et al., *Benchmarking the Price Reasonableness of a Long-Term Electricty Contract*, 25 ENERGY L. J. 357, 358 (2004).

[13] 16 U.S.C. § 824a-3(d) (2013). *See also* Am. Paper Inst. v. Am. Elec. Power Serv. Corp., 461 U.S. 402 (1983) (holding 16 U.S.C. § 824a-3(d) is the equivalent of full avoided costs).

[14] *See* 18 CFR § 292.304(e) (2013).

The Supreme Court, however, distinguished a "just and reasonable rate" under PURPA from a "just and reasonable rate" under traditional ratemaking law. In American Paper Institute, Inc.,[15] the Supreme Court noted PURPA's extensive legislative history supporting the development of non-fossil fuel generation supported the holding that a state utility commission could establish an avoided cost rate that would significantly incentivize the development of alternative energies to the benefit of the utility's ratepayers and the general public.[16] The theory underlying PURPA is that the savings from non-fossil fuel QF generation should be passed to the QF and not the utility or its ratepayers. Therefore, *reducing* consumer's electric rates is not a necessary consideration for establishing an avoided cost methodology although the presence of a QF cannot increase consumer's electric rates.

In Oak Tree, the SDPUC adopted staff member Brain P. Rounds' developed hybrid methodology.[17] Staff's hybrid methodology effectively sets three different avoided costs rates that are to be levelized over the contract term based on an electric utility's projected supply and load.[18]

Projected Load	Avoided Cost Rate
Load < Baseload Generation	Marginal Cost of most expensive baseload generator
Load > Baseload Generation	Market Price of Energy
Load > Baseload Generation But Load > QF Output	MC of most expensive baseload generator for QF Output; MP for remainder to meet load

Staff's recommendation does an excellent job of capturing the direct energy costs avoided and we recommend that the SDPUC formalize this methodology. This methodology has the added benefit that it is relatively simple to calculate. Its major drawback is that it is fairly data intensive. Before formalizing, we think a discussion on how Staff's methodology will achieve the values and goals of PUPRA outside of the Oak Tree proceedings is warranted. Through that discussion, the SDPUC may desire to modify Staff's methodology to better promote renewable energy development in South Dakota.

Further, we recommend that the SDPUC formalize rules to ensure a QF receives payment for the indirect costs avoided, such as the savings incurred from displacing or delaying an electric utility's planned generation units. We believe payment is appropriate in this situation because the QF directly absorbs those costs that the electric utility would have had to incur but for the QF. For example, if an electric utility planned to add a 100 MW coal-fired power plant and a QF had the effect of reducing the utility's planned generation to a 90 MW coal-fired power plant, the QF should be compensated for the fixed costs differential between the size of the two plants as well as the cost of 10 MW of coal generation avoided over the life of the contract.

This is commonly referred to as the "expansion planning approach" and is similar to the more commonly employed "differential revenue approach," but is far less complex as it only looks at costs and does not therefore need to employ a financial model to determine a utility's revenue requirements to meet planned generation.[19] Under this approach, a planning model is developed to determine the electric utility's expansion plans with and without the QF present.[20] The difference between the two expansion plans is passed on to the QF as an avoided cost.[21]

If the SDPUC believes this modeling makes the avoided cost calculation overly complicated but agrees with this recommendation that a QF should receive payment for costs avoided by displacing or delaying generation expansion, we encourage the SDPUC and staff to review the proxy unit model as an alternative. Similar to the methods described above, the proxy unit method compensates a QF for anticipated savings through the displacement or delay of the electric utility's next planned baseload generation unit projected in the electric utility's ten-year resource plan.

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[15] Am. Paper Inst., Inc. v. Am. Elec. Power Serv. Corp., 461 U.S. 402 (1983).

[16] *See* Stanley Martin, *Problems with PURPA: The Need for State Legislation to Encourage Cogeneration and Small Power Production*, 11 B.C. ENVTL. AFF. L. REV. 149, 180 (1983) (citing Am. Paper Inst. v. Am. Elec. Power Serv. Corp., 461 U.S. 402 (1983)).

[17] *See Oak Tree*, EL11-006, Final Decision and Order, at ¶ 24 (SDPUC Feb. 21, 2013).

[18] *See* Testimony and Exhibits of Brian P. Rounds on Behalf of Commission Staff Public Version (Nov. 21, 2012).

[19] For more discussion on the different types of avoided costs methodologies, see Edison Electric Institute, *PURPA: Making the Sequel Better than the Original* (Dec. 2006).

[20] *Id.*

[21] *Id.*

We believe this is incredibly important to incentivize renewable energy development in South Dakota. As was mentioned in the Oak Tree proceedings, it is estimated that over 50,000 MW of coal-generated capacity will be retired in the next 20 years in the Eastern Interconnect.[22] At the same time, load is projected to increase. Electric utilities are going to need new electric generating facilities. To the extent a QF helps an electric utility avoid expansion costs by assuming the financial risk of building an electric generation facility, the QF should be compensated for that avoided cost.

4. Appropriate Contract Term

In the 1982 Order, the SDPUC did not establish a minimum or maximum contract term, leaving it to the parties to negotiate. At a minimum, we recommend that an electric utility shall be obligated to purchase electricity from a QF for ten years to avoid potential income tax liability.[23] However, a longer contract term should be required if the QF can demonstrate a longer contract term is necessary to secure the best available financing.[24] It is well accepted within the wind industry that a 20- to 25- year contract term is necessary to secure the best available financing to develop a wind energy facility. We encourage the SDPUC to establish a presumption that a 20- year contract term provides for the best available financing for a negotiation between a qualified wind energy facility and an electric utility unless the parties negotiate to waive such presumption. All other qualified facilities should have a minimal burden of proof to show a longer contract is necessary to obtain the best available financing.

The SDPUC took a similar position in Oak Tree when it required Northwestern Energy to enter into a 20-year contract with Oak Tree Energy, LLC in order for Oak Tree Energy, LLC to secure financing. We believe this policy most effectively affirms the purposes of PURPA to optimize use of non-fossil fuel facilities and energy and provide just and reasonable rates to consumers. We also believe it would have the added benefit of encouraging more wind energy development in South Dakota.

Very Truly,

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[22] *Oak Tree*, Testimony of J. Richard Lauckhart, EL11-006, Transcript 26:1-5 (SDPUC Mar. 21, 2012).
[23] *See* IRS Notice 88-129 (providing a safe harbor from income taxation of an interconnection payment if the interconnection is not included in the utility's rate base, the purchase agreement is at least ten years and the electric utility does not sell power to the qualifying facility of more than five percent of total power flowing over the interconnection).
[24] *See e.g.* Ren Orans, et al., *Benchmarking the Price Reasonableness of a Long-Term Electricity Contract*, 25 ENERGY L. J. 357, 360 (2004) (stating long-term financing is critical to develop new generation).