BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, vs. PACIFICORP d.b.a. PACIFIC POWER, Respondent.	**DOCKET UE-100749** **PACIFICORP'S ANSWER IN OPPOSITION TO STAFF'S PETITION FOR RECONSIDERATION**

I. INTRODUCTION

1. Pursuant to WAC 480-07-370(1)(c)(iii) and the Notice of Opportunity to File Answer issued by the Washington Utilities and Transportation Commission (Commission) on April 5, 2011, PacifiCorp (or the Company) submits this Answer in Opposition to Commission Staff's Petition for Reconsideration filed on April 4, 2011.

2. Staff seeks reconsideration of the Commission's capital structure decision in Order 6 entered on March 25, 2011 (Order). Based on the following arguments, the Company requests that the Commission deny Staff's petition.

II. ARGUMENT

A. Staff's Reliance on Average Equity Ratios is Unpersuasive.

3. Staff asks the Commission to adopt its proposed 46.5 percent equity ratio based on the claim that this ratio is consistent with the average equity ratio for electric utilities nationally.[1] Staff's argument is unpersuasive for several reasons.

[1] Commission Staff Petition for Reconsideration ¶ 5.

4. First, Staff's position is inconsistent with its return on equity (ROE) analysis because Kenneth L. Elgin, Staff's cost of capital witness, used two different proxy groups. For equity ratio, Mr. Elgin used the "average level of equity ratios for electric utilities in this country."[2] For his ROE analysis, Mr. Elgin used a more selective proxy group that he believed was "much more comparable to PacifiCorp."[3] Notably, if Mr. Elgin used his more selective proxy group of comparable utilities to analyze an appropriate equity ratio, it would show that the average projected common equity ratio of his proxy group is 50.4 percent—much closer to the Company's actual equity ratio than his proposed 46.5 percent.[4] Although the Commission correctly rejected Mr. Elgin's proxy group because of its "questionable statistical reliability,"[5] the fact that Mr. Elgin supports his equity ratio and ROE analysis using two different and conflicting methods undercuts his argument.

5. Second, Staff's argument fails to account for the fact that the national average allowed ROE is substantially higher than Staff's proposed 9.5 percent and the Commission's adopted 9.8 percent. Fundamental financial theory recognizes that as more debt is added to a firm's capital structure, the cost of debt and equity will rise.[6] Yet Staff's basic argument is that its proposed equity ratio is "safe" merely because that is what other utilities across the country use. However, on average, those other utilities have allowed ROEs approximately 85 basis points greater than

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[2] Commission Staff Petition for Reconsideration ¶ 5.
[3] Elgin, Exh. No. KLE-1T 23:1-2. Although Mr. Elgin was comparing his proxy group to the Company's 22 utility proxy group, logically if his selective group is more comparable than a select group of 22 utilities it is also more comparable than an average of all the utilities in the country.
[4] Williams, Exh. No. BNW-7T 9:8-10.
[5] Order ¶ 78.
[6] However, assuming a 100% equity capital structure to start, all else equal, the weighted average cost of capital of a firm will fall as debt is added to the capital structure. At some point the weighted average cost of capital reaches a minimum. This record suggests that occurs at approximately a single "A" credit rating. *See* Gorman, Exh. No. MPG-26 5:21-24. As more debt is added to the capital structure past that point, not only does the cost of debt and equity continue to rise, but the weighted average cost of capital stops declining and actually begins to rise costing customers more in the long-run.

what Staff recommended for PacifiCorp.[7] The higher leverage employed by other electric utilities in the country comes at a cost. Therefore, the safety of these other utilities' capital structures (which Staff assumes without evidence or analysis) is purchased in part with ROEs that are far higher than what Staff recommended or what the Commission adopted for the Company. Because of this discrepancy, the equity ratios Staff relies upon do not provide a meaningful comparison.[8]

6. Staff's position—seeking an unreasonably low ROE and an unreasonably low equity ratio—jeopardizes the Company's single "A" credit rating, the loss of which would increase costs to customers. The Commission has acknowledged that solid credit ratings benefit customers by minimizing costs and the evidence in the record provides quantitative support for this position.[9] PacifiCorp's requested equity ratio and ROE work together to support its current credit rating, which allows the Company to attract capital on reasonable terms and maintain access to critical financial markets.

7. Third, Staff's comparison to other utilities fails to consider whether the utilities in its national proxy group have power cost recovery mechanisms. Mr. Elgin's own analysis suggests that if PacifiCorp had a power cost recovery mechanism, its equity ratio should decrease by 4 percent to account for the decreased operational risk.[10] Therefore, if the national average of 46 percent includes a substantial number of utilities with cost recovery mechanisms, comparing this average to PacifiCorp requires the imputation of an additional 4 percent of equity to account for PacifiCorp's higher operational risk. This imputation results in an average equity ratio of at least 50 percent.

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[7] Elgin, Exh. No. KLE-7 2 (average ROE for 2010 was 10.34 percent).
[8] Elgin, Exh. No. KLE-7 2.
[9] *Wash. Utils. & Transp. Comm'n v. Avista Corp.* Docket UE-100467, Order 07 at n. 37 (Nov. 19, 2010); Williams, Exh. No. BNW-7T 12:3-9.
[10] Elgin, Exh. No. KLE-4 3:6-9.

B. The Commission's Order Does Not Set New or Problematic Precedent.

8. Staff argues that the Commission's decision may set a precedent in Washington that would encourage other utilities, *i.e.* Avista and Puget Sound Energy, to seek a higher credit rating along with the required greater equity ratio.[11] Staff ignores the fact that, prior to the Order, the Commission had already acknowledged that: "Stronger credit ratings will result in lower long-term costs to Avista's customers and should allow longer intervals between general rate cases."[12] Thus, Commission policy and precedent are clear that customers benefit from stronger credit ratings—which cannot be maintained without the appropriate equity ratio.[13]

C. Staff's Argument that the Company Could Make the Same Capital Expenditures at a 46.5 Percent Equity Ratio is Misplaced.

9. Staff argues that there is no support in the record for the claim that, "PacifiCorp could not successfully make the same capital expenditures were it more economically capitalized at 46.5 percent equity."[14] This argument misses the point. The Company may be able to finance its capital expenditures at a lower equity ratio (assuming stable economic conditions), but the Company's financing costs would increase significantly. As noted above, the Commission recognizes that strong credit ratings result in lower overall costs to customers because they allow the Company better access to the financial markets, in good times and bad, at better rates and lower costs.[15] The evidence in the record demonstrates that if the Company had been rated

[11] Commission Staff Petition for Reconsideration ¶ 10.
[12] *Wash. Utils. & Transp. Comm'n v. Avista Corp.* Docket UE-100467, Order 07 at n. 37 (Nov. 19, 2010).
[13] Staff's argument also fails to account for the fact that both Avista and Puget Sound Energy have cost recovery mechanisms that reduce their operating risk.
[14] Commission Staff Petition for Reconsideration ¶ 7.
[15] *Wash. Utils. & Transp. Comm'n v. Avista Corp.* Docket UE-100467, Order 07 at n. 37 (Nov. 19, 2010); Williams, Exh. No. BNW-1T 10:1-19.

"BBB" since the acquisition by MEHC in 2006, the increased cost of debt attributed to the downgraded rating alone is estimated to be $30 million more in annual interest expense.[16]

10. A comparison to Puget Sound Energy further demonstrates these costs. Puget Sound Energy's long-term debt costs are nearly 100 basis points higher than PacifiCorp's and its credit rating is "BBB," the same credit rating Mr. Elgin argues is sufficient for PacifiCorp.[17] More specifically, Puget Sound Energy issued debt on January 20, 2009, only 15 days after PacifiCorp's January 2009 issuance. Puget Sound Energy paid 6.75 percent for seven year debt, a spread of 480.3 basis points over the corresponding 7-year Treasury rate at the time of their issuance.[18] By comparison, PacifiCorp obtained 10 year debt at 5.50 percent and 30 year at 6.00 percent, a 310 basis point spread over the corresponding Treasury rate when issued.[19]

11. This evidence demonstrates that PacifiCorp's single "A" rating allowed it to achieve a longer maturity at less cost to customers than Puget Sound Energy obtained as a direct result of Puget's lower credit rating. Staff's argument focuses solely on *ability* to finance, not *access* to capital in all circumstances or the *cost* of that capital. And the record here is clear that *access* to capital will be impaired and the *cost* of capital will be greater if the Company is downgraded.

D. The Evidence Does Not Show that MEHC Is Unnecessarily Driving Up Equity in PacifiCorp's Capital Structure.

12. Staff argues that MEHC increased the Company's equity ratio to an excessive level to MEHC's financial advantage.[20] The evidence is to the contrary. The record demonstrates that: (1) the Company's equity ratio has grown in response to more stringent requirements for

[16] Williams, Exh. No. BNW-7T 12:3-9.
[17] Williams, Exh. No. BNW-7T 11:20-23.
[18] *Re Puget Sound Energy, Inc.*, Docket UE-090004, Securities Issuance Filing (Jan. 26, 2009). The Company requests that the Commission take official notice of this document pursuant to WAC 480-07-495.
[19] Williams, Exh. No. BNW-19.
[20] Commission Staff Petition for Reconsideration ¶ 4.

maintaining its "A" credit rating;[21] and (2) the Company's actual ROE during the test period was 3.15 percent, restricting the upside of any equity investment from MEHC.[22] During the economic turmoil of the past several years, MEHC infused over $900 million of equity into PacifiCorp[23] and worked hard to ensure the Company maintained its strong credit rating (to customers' benefit). Nothing in this record demonstrates that MEHC has furthered its own interests at the expense of PacifiCorp's customers.

E. Staff's Argument with Respect to Short Term Debt is Without Merit.

13. Staff argues that the Commission's order in the Company's 2005 rate case does not preclude the imputation of short-term debt and therefore the Commission should impute this debt here.[24] Staff's legal analysis of the Commission's order in that docket, however, is erroneous. The Commission's language in the 2005 rate case was clear and unambiguous—the Commission looks to the Company's actual capital structure and will include short-term debt if the actual capital structure includes short-term debt.[25]

14. Staff admits that the Commission applied the "literal" reading of its past order in this case,[26] but argues that this literal reading is unsupported by precedent.[27] Staff points to no instance, however, where the Commission has imputed short-term debt when the utility's actual capital structure had none. Moreover, the Commission's treatment of short-term debt in the 2005 rate case is consistent with the Commission's decision in Avista's 1999 rate case. There, the utility argued that its capital structure should include no short-term debt.[28] The Commission

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[21] Williams, Exh. No. BNW-1T 4:19-22.
[22] Dalley, Exh. No. RBD-6T 1.0.
[23] Initial Brief on Behalf of Commission Staff ¶ 165.
[24] Commission Staff Petition for Reconsideration ¶ 12.
[25] *Wash. Utils. & Transp. Comm'n v. PacifiCorp*, Docket UE-050684, Order 04 at ¶ 224 (Apr. 17, 2006).
[26] Commission Staff Petition for Reconsideration ¶ 17.
[27] Commission Staff Petition for Reconsideration ¶ 17.
[28] *Wash. Utils. & Transp. Comm'n v. Avista Corporation*, Docket UE-991606, Third Supp. Order at ¶¶ 374-375 (Sept. 29, 2000).

rejected this argument because, "Avista consistently uses short-term debt to finance its operations."[29] Like PacifiCorp's 2005 rate case, in the 1999 Avista case, the Commission included short-term debt over a utility's objection specifically because of the utility's "actual use of short-term debt."[30]

15. Staff argues that the Commission's 2005 order does not stand for the proposition that the Commission should exclude short-term debt when there is none, but rather that the Commission should use historical short-term debt levels to determine the level of short-term debt.[31] Logically, if the Commission should use actual short-term debt as an indication of the correct level of short-term debt for rates, then if the historical levels demonstrate the absence of any short-term debt, the Commission should exclude short-term debt altogether.

16. Finally, with respect to this issue, the Commission need not address Staff's legal argument because the Order was not based solely on the application of the 2005 order. Rather, paragraph 43 of the Order sets forth both factual and policy justifications for the Commission's decision to not impute short-term debt. These considerations are sufficient to support its decision.

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[29] *Wash. Utils. & Transp. Comm'n v. Avista Corporation*, Docket UE-991606, Third Supp. Order at ¶ 375 (Sept. 29, 2000).

[30] *Wash. Utils. & Transp. Comm'n v. Avista Corporation*, Docket UE-991606, Third Supp. Order at ¶ 374 (Sept. 29, 2000).

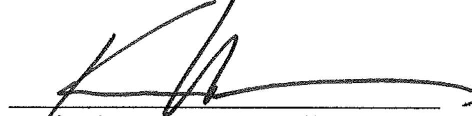
[31] Commission Staff Petition for Reconsideration ¶ 14.

III. CONCLUSION

17. For the reasons stated above, PacifiCorp requests that the Commission deny Staff's Petition for Reconsideration.

DATED: April 14, 2011.

Respectfully Submitted,



Katherine A. McDowell
Amie Jamieson
McDowell Rackner & Gibson PC
419 SW 11th Ave., Suite 400
Portland, OR 97205
Telephone: (503) 595-3924
Facsimile: (503)595-3928
Email: katherine@mcd-law.com

Jordan A. White
Senior Counsel
Pacific Power
1407 W. North Temple, Suite 320
Salt Lake City, Utah 84116
Phone: (801) 220-2279
Facsimile: (801) 220-4615

Attorneys for PacifiCorp