

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PACIFICORP D/B/A PACIFIC POWER &
LIGHT COMPANY,

Respondent.

DOCKET UE-100749

COMMISSION STAFF RESPONSE
TO PACIFICORP PETITION FOR
RECONSIDERATION

1 PacifiCorp's Petition for Reconsideration (PacifiCorp Petition or Petition) seeks reconsideration of the Commission's Final Order¹ (Order) in this docket on cost of capital, certain net power cost issues, and federal income tax issues. For the most part, PacifiCorp simply repeats the arguments it offered before, making only cursory reference to the Order. The Commission has already considered and rejected those arguments, and it should do so again here, except for one correction that may be immaterial.

I. DISCUSSION

A. Cost of Capital Issues

2 PacifiCorp expends considerable effort challenging the Commission's decisions on both capital structure and rate of return on common equity (ROE). In fact, the record proves the Commission's decisions on these subjects are very generous to the Company. The

¹ Order 06, "Final Order Rejecting Tariff Sheets; Authorizing Increased Rates; and Requiring Compliance Filing" (March 25, 2011).

record also proves the Company's arguments lack merit. The Commission should reject the Company's Petition on these issues.

1. Capital Structure

3 PacifiCorp challenges both the "economy and safety" standard the Commission applied, and the Commission's acceptance of ICNU's adjustments to calculate the Company's actual capital structure. The Commission should reject the Company's Petition on capital structure because PacifiCorp's case is based on the "clear and compelling" standard, which is the wrong legal standard. In fact, that language appears in only two Commission orders in which the Commission applied that language in a completely different context; that language otherwise is without precedent.

4 Moreover, PacifiCorp fails to demonstrate how it is prejudiced by the Commission's decision on capital structure. In fact, the record proves PacifiCorp benefits by that decision, because nowhere did the Company or ICNU prove their proposed actual capital structures were more economical than Staff's proposed capital structure, nor did PacifiCorp or ICNU contend the Company cannot obtain new capital on reasonable terms under Staff's more economical capital structure.

a. The Commission Adopted the Correct Standard, Which is the "Safety and Economy" Standard, not PacifiCorp's "Clear and Compelling" Standard

5 PacifiCorp assails the Order's analysis on capital structure on the basis the Commission failed to impose the burden of proof on Staff and other parties to prove by "clear and compelling" evidence that PacifiCorp's actual capital structure is unreasonable.

PacifiCorp persists in calling this “clear and compelling” language the “legal standard” for capital structure.²

6 Applying the “clear and compelling” capital structure “standard” in this case is improper because it turns PacifiCorp’s statutory burden of proof³ on its head. This is clear from the context of the two PSE cases PacifiCorp relies on for its argument. In those two PSE cases, the Commission found it necessary to impute additional common equity in order to assist PSE in achieving and maintaining investment grade status. As the Commission stated:

We are mindful of our responsibility to set the allowed return on capital at a level “sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.” ... We have carefully examined this evidence and are satisfied to find that the ratios Mr. Gaines calculates for Staff’s case fall within the S&P ranges for a company rated BBB with the excellent business and aggressive financial risk profiles S&P assigns to PSE. Considering that the results of our Order here allow for a higher rate of return and recovery of more revenue than what Staff recommends, we are confident that our decision will allow the Company, with prudent management, to maintain or improve its current credit rating.⁴

7 Thus, in the two PSE cases PacifiCorp relies on, the Commission recognized that to protect the utility’s financial integrity, the Commission might need to use a hypothetical capital structure containing *more* equity, resulting in a *higher* cost of capital than would result from using the utility’s actual capital structure. However, before approving a higher cost of capital and imposing that additional burden on ratepayers, the Commission required the utility to make a “clear and convincing” showing this is appropriate.

8 Surely, the Commission never intended that same “clear and compelling” language to be used as a legal impediment to the Commission’s use of a lower equity ratio than actual,

² PacifiCorp Petition at 28, ¶ 65.

³ RCW 80.04.130(4): At any hearing involving any change to any schedule ... the effect of which is to increase any rate ... the burden of proof to show such increase is reasonable shall be upon the public service company.

⁴ *Utilities and Transp. Comm’n v. Puget Sound Energy*, Dockets UE-090704 and UG-090705, Order 11 at 105 ¶ 303 (April 2, 2010).

when that lower equity ratio is more economical, but still safe and sufficient to enable PacifiCorp to successfully finance on reasonable terms to meet its public service obligations.

9 In other words, in the PSE orders PacifiCorp relies on, the Commission was trying to protect ratepayer and investor interests by assuring the financial integrity of the utility, when PSE's actual capital structure failed to do so. PacifiCorp should not be allowed to use those orders to prevent the Commission from protecting ratepayers when, as here, the utility's actual capital structure is more expensive than necessary.

10 In fact, if there is any "compelling" issue in this case, it is whether under the Company's "standard", the Commission can effectively exercise its duty to determine whether the Company is actually financing its operations in a manner consistent with the *Hope* and *Bluefield* standards.⁵ If accepted, the Company's arguments would effectively and improperly remove a critical Commission ratemaking tool by forcing Staff and other parties to bear a burden found in no Commission law.

11 This explains why it is no surprise the Company cites no case from any jurisdiction requiring "clear and compelling" evidence before a commission can protect ratepayers by using a more economical capital structure than the one employed by the utility. It also explains why, as the Company confirmed in a discovery response, the Commission has used the "safety and economy" standard for PacifiCorp,⁶ including the Company's last contested rate case.⁷

⁵ See Elgin, Exhibit No. KLE-1T at 5:1-11 and 13:3-5.

⁶ Exhibit No. BNW-13 at 2, item (d).

⁷ *Id.*, citing *Utilities and Transp. Comm'n v. PacifiCorp*, Docket UE-050684, Order 04 at 82, ¶ 230 (April 17, 2006).

12 In sum, the Commission was eminently correct to reaffirm the “safety and economy” standard and again apply it to PacifiCorp here.⁸

b. The Commission Should Continue to Reject PacifiCorp’s Case on Capital Structure Because it Fails to Satisfy the “Safety and Economy” Standard

13 Because PacifiCorp based its case on the wrong standard for evaluating capital structure, the Commission is fully justified in rejecting PacifiCorp’s Petition on capital structure. In fact, the Company’s careful avoidance of the proper standard is showcased again in its Petition, where the Company admits to justifying its proposed capital structure solely on maintaining its A- credit rating,⁹ i.e., not on the overall safety and economy of that capital structure.

14 To be sure, PacifiCorp is quick to point to the Commission’s recognition of the customer benefits of a very high equity ratio,¹⁰ but under the “economy” part of the Commission’s “safety and economy” standard, that is not enough; the Company also bears the burden to prove those “benefits” meet or exceed the cost of that high equity ratio.

15 PacifiCorp offered nothing at hearing or in its Petition on that score,¹¹ nor could it. With Standard & Poor’s recognizing that the “predominance” of utilities in this country are rated BBB, and any electric company with a 46.5 percent common equity ratio is “firmly investment grade”,¹² there is no way PacifiCorp can satisfy the “economy” part of the

⁸ Staff Initial Brief at 39-40, ¶¶ 159-162; Staff Reply Brief at 3-4, ¶¶ 9-11.

⁹ PacifiCorp Petition at 30, ¶ 71.

¹⁰ Id.

¹¹ PacifiCorp tried to rely on a “study” (Mr. Williams’ Exhibit No. BNW-19), but it did not withstand scrutiny. See Staff Initial Brief at 50-51, ¶¶ 202-07.

¹² Williams, Exhibit No. BNW-17 at 1 (per S&P): “predominance of ratings is in the ‘BBB’ category, firmly investment grade.”

“safety and economy” standard using even the 49.1 percent equity ratio the Commission allowed, let alone the 52.1 percent equity ratio the Company advocates now.¹³

16 The Commission properly applied the correct principles in the PSE Order we quoted above,¹⁴ where the Commission recognized that a BBB rating is sufficient to enable a utility to successfully finance to meet its public service obligations. No more is necessary, particularly when that “more” is an A- rating purportedly justifying a bloated, 52.1 percent equity ratio that increases the cost of capital unnecessarily and clearly benefits PacifiCorp’s owner, MEHC.

c. PacifiCorp’s Challenges to ICNU’s Proposed Capital Structure Adjustments Emphasize How Far PacifiCorp has Strayed From the Commission’s Capital Structure Standard

17 The Company challenges the Commission’s acceptance of ICNU’s proposed 49.1 percent equity ratio by questioning ICNU adjustments that remove certain items from PacifiCorp’s capitalization. For example, the Company bickers with ICNU because its witness, Mr. Gorman, took out acquisition adjustments associated with generating plants serving the east control area, but not pollution control bonds associated with east control area plants.¹⁵

18 But, this just exposes the problem: ICNU’s adjustment-based capital structure analysis can be very controversial and it turns the analysis into an allocation exercise, when the focus should be on compliance with the Commission’s “safety and economy” standard. This problem materialized in this case: like PacifiCorp, nowhere did ICNU’s witness address the economy of its recommended capital structure compared to other proposals.

¹³ Actually, nowhere in its Petition does PacifiCorp state the equity ratio it recommends the Commission adopt on reconsideration. We assume it is 52.1 percent.

¹⁴ See ¶ 6, supra.

¹⁵ PacifiCorp Petition at 29, ¶ 68.

19 In sum, the Commission should reject PacifiCorp's Petition on capital structure: The Commission applied the correct standard; PacifiCorp's case is based on the wrong standard; the Company failed to prove its proposed capital structure is safe *and* economical; and the Company is benefited, not prejudiced, by the Commission's decision.

2. The Commission's Decision on Return on Common Equity is Well-Supported by the Record

20 PacifiCorp seeks reconsideration of the Commission's decision that PacifiCorp's ROE is 9.8 percent, but nowhere in its Petition does PacifiCorp state what the ROE should be. This is significant (and not surprising), because most of the arguments the Company now advances would, if accepted, justify an ROE much lower than the 10.6 percent ROE the Company tried (and failed) to support at hearing. The lack of a specific ROE recommendation in the Company's Petition forces Staff to respond to the Company's arguments without being able to respond to the specific remedy sought by PacifiCorp.

21 In any event, like the Commission's decision on capital structure, the Company is benefited, not prejudiced, by the Commission's ROE determination in this case. For example, the Commission rejected Staff's cost of equity case on the basis that Staff did not demonstrate its proxy group was statistically reliable,¹⁶ yet the Commission used ICNU's and PacifiCorp's proxy group without requiring those parties to demonstrate that group is statistically reliable. PacifiCorp also insisted the Commission discount ICNU's 210 basis point range of ROEs as "of little practical use".¹⁷ If a 210 basis point range is a proper basis to discount ROE results, the Commission is fully justified in discounting PacifiCorp's own

¹⁶ Order at 33, ¶ 78. It is not surprising that neither PacifiCorp nor ICNU defended the statistical reliability of their sample group. As Staff testified: "I don't believe a statistical study is an appropriate analysis, and indeed, Dr. Hadaway did not perform any statistical analysis either. ... It's just something you can't do." Elgin, TR 720:15-18. He went on to explain it is important to carefully evaluate the critical financial information of a company, as an investor would. Only Staff provided such an evaluation in this case.

¹⁷ PacifiCorp Initial Brief at 12-13, ¶ 32, quoting *Utilities and Transp. Comm'n v. PacifiCorp*, Docket UE-050684, Order 04 (April 17, 2006) at 93, n. 384..

case, which exhibited an ROE range of an alarming 598 basis points (had Dr. Hadaway not removed the results for Edison International, the range would have been a full 730 basis points).¹⁸

22 Indeed, if any study is not “statistically reliable”, surely it is PacifiCorp’s, because it produces such divergent results. In short, PacifiCorp’s Petition on ROE is as weak as the Company’s hearing evidence on that subject. For the reasons that follow, the Commission should again reject the Company’s case on ROE.

a. PacifiCorp Bases its Petition on the Wrong “Tradition”

23 PacifiCorp begins its argument by citing a single case to support a claim that the Commission “traditionally” has looked to what has changed since the last cost of capital determination.¹⁹ This tactic of citing a single order to support “tradition” is identical to PacifiCorp’s failed argument regarding the capital structure “standard”.

24 This time, in addition to the fact the Company has simply not justified the existence of a “tradition” of any sort, the last PacifiCorp rate case where parties contested ROE was decided six years ago. By comparison, there was only an eighteen month gap between the cost of capital analyses offered by the parties in the sole case the Company says constitutes a “tradition”. Staff knows of no instance in which the Commission has required an examination of changed circumstances in a case such as this, where many years have elapsed between ROE determinations.

¹⁸ See the evidence described in Staff Reply Brief at 2, second bullet (the figure “201” is a typographical error; it should read “210”).

¹⁹ PacifiCorp Petition at 21, ¶¶ 49-50.

b. PacifiCorp's Single-Minded Focus on Interest Rate Comparisons Between Periods is Flawed Because Market Risk Premiums Can Change Over Time

25 In its ROE arguments, PacifiCorp places almost exclusive reliance on the similarity between interest rates for bonds today compared to 2006, in arguing that a reduction from the 10.2 percent ROE the Commission granted in 2006 is inappropriate.²⁰ PacifiCorp's arguments are flawed because the Company presupposes that risk premiums are constant through time. In fact, interest rates may be the same in different periods but the market risk premium for utility stocks may have declined. As Mr. Gorman testified:

A simplistic inverse relationship between equity risk premiums and interest rates is not supported by academic research...researchers have found that the relationship changes over time and is influenced by changes in perception of risk of bond investments relative to equity investments, and not simply changes to interest rates.²¹

Mr. Gorman went on to explain that:

a relative investment risk differential cannot be measured simply by observing nominal interest rates. Changes in nominal interest rates are highly influenced by changes to inflation outlooks, which also change equity return expectations. As such, the relevant factor needed to explain changes in equity risk premiums is the relative changes to the risk of equity versus debt securities investments, not simply interest rates.²²

26 This evidence refutes the major thrust of PacifiCorp's ROE arguments in its Petition, and exposes the Company's single-minded, unjustified reliance on interest rate/ROE comparisons.

27 Furthermore, because PacifiCorp does not state the specific remedy it seeks if this is indeed the proper analysis, we do not know whether the Company is implicitly asserting here that the Commission should now accept 10.2% as a fair ROE for PacifiCorp. If so, the

²⁰ PacifiCorp Petition at 21-22, ¶¶ 51-52.

²¹ Gorman, Exhibit No. MPG-1 Tat 49:18 to 50:2.

²² Gorman, Exhibit No. MPG-1 Tat 50:11-16.

Commission should reject such an assertion for the additional reason that the Company is impeaching its own witness, and its own case.

c. The Commission Was Eminently Correct to Reject Dr. Hadaway's 6.0 Percent Dividend Growth Rate

28 Having come up well short in its overall attempt to justify Commission reconsideration of ROE, PacifiCorp questions the details of the Commission's analysis of growth rates in considering DCF evidence.²³

29 Once again, PacifiCorp identifies an issue but states no specific remedy. In any event, the Company's arguments here are off base, because the Commission was well within its discretion to reject PacifiCorp's 6.0 percent GDP growth rate. Dr. Hadaway offered no proof that a 6.0 percent growth rate was sustainable over the long term.²⁴ And, while he wanted to give more weight to more recent data,²⁵ nowhere will the Commission find any rationale for his weighting selection, or why his weighting section is better than any other.

30 PacifiCorp goes on to criticize the Order for not using long-term growth rates in its decision. However, Staff reads the Order differently. First, the Commission rejected Dr. Hadaway's use of historical growth rates in nominal GDP as a reasonable estimate of long-term growth rates, and then, because the Commission was uncertain if such a growth rate can be sustained over the long-term,²⁶ the Commission accepted Mr. Gorman's use of *Blue Chip Financial Forecast* as the surrogate for long-term growth rates.²⁷

²³ PacifiCorp Petition at 23, ¶¶ 55-56.

²⁴ Order at 35, ¶ 82.

²⁵ Hadaway, Exhibit No. SCH-5.

²⁶ Order at 35, ¶ 82.

²⁷ Id.

31 PacifiCorp should not be seen to complain when its use of historical data was clearly lacking, and the Commission then accepted other evidence in the record to determine a reasonable forecast for long-term growth.

d. The Commission Properly Gave Diminished Weight to CAPM Results

32 PacifiCorp goes on to challenge the Commission's use of CAPM results, which the Company thinks is inconsistent with a recent PSE rate order where the Commission said it would give CAPM results "diminished weight", due to unusual financial circumstances.²⁸

33 PacifiCorp is attempting to make something out of nothing here, because the Commission clearly stated in Order Paragraph 93 that it was giving "substantial weight" only to ICNU's DCF analysis and its critique of the Company's analysis. The Commission did not say it was giving "substantial weight" to CAPM results. Rather, the Commission said CAPM results give "further weight to a lower adjustment".²⁹ This simply reflects the "diminished weight" the Commission said it would give to CAPM results.

34 In other words, "diminished weight" does not mean "no weight whatsoever". If the Commission feels the need to say that more clearly to satisfy the Company, it can do so.

e. The Commission Properly Rejected Dr. Hadaway's Risk Premium Analysis Because it is Based on the Flawed Conclusion That Equity Risk Premium is "Constant in all Economic Conditions"

35 PacifiCorp points to Dr. Hadaway's regression analysis in his risk premium model in his attempt to prove an inverse relationship between interest rates and equity risk premiums.³⁰ From this, PacifiCorp concludes this equity risk premium is "'constant' in all

²⁸ PacifiCorp Petition at 25, ¶ 62, quoting *Utilities and Transp. Comm'n v. Puget Sound Energy*, Docket UE-090704, Order 11 at 105, n. 369 (April 2, 2010).

²⁹ Order at ¶ 93.

³⁰ PacifiCorp Petition at 27, ¶¶ 62-64.

economic conditions” and argues the Commission erred in not accepting that as uncontroverted fact.³¹

36 This remarkable argument by PacifiCorp is just another example of what happens when the Company focuses exclusively on a single aspect of its own evidence. As we explained earlier, Mr. Gorman offered substantial evidence explaining why PacifiCorp is wrong to conclude that equity risk premium is constant.³² The Commission was eminently justified to reject Dr. Hadaway’s risk premium study.

37 In fact, the Company cannot reconcile its new, mechanistic use of risk premium with its witnesses’ use of more than one method to evaluate ROE, and his testimony that the determination of ROE is a “matter of informed judgment”.³³ The Commission was absolutely correct to reject Dr. Hadaway’s overly-mechanical application of risk premium analysis as purporting to offer “precision” based on future estimated projections.³⁴

f. The Company’s Market Analysis Contradicts the Record

38 The Commission correctly concluded that financial markets have stabilized since the financial crisis and the evidence is that utility stocks are less volatile and are safer investments.³⁵ The record amply supports these statements,³⁶ which are also consistent with the Commission’s conclusion in an earlier, post-financial crisis rate order in Docket UE-090704.³⁷

³¹ PacifiCorp Petition at 27, ¶ 63.

³² See ¶ 25, *supra*.

³³ Hadaway, Exhibit No. SCH-1T at 4:11-12.

³⁴ Order at 36, ¶ 86.

³⁵ Order at 34-35, ¶ 81.

³⁶ E.g., Elgin, Exhibit No. KLE-1T at 8:11-17 and at 9:17-22.

³⁷ *Utilities and Transp. Comm’n v. Puget Sound Energy*, Docket UE-090704, Order 11 at 100, ¶ 281 (April 2, 2010): “Our record also shows that the capital markets have substantially recovered from the distortions caused by the financial crisis and now again reflect cost characteristics similar to, if not lower than, those extant before the onset of the crisis.”

39 Nonetheless, PacifiCorp says it is “contradictory” for the Commission to accept that utility stocks are less volatile now than before, and to also accept that markets have returned to more normal conditions.³⁸ Apparently, PacifiCorp thinks the fact that utility stock prices have lagged the overall market means they are “riskier”, but the Company is looking at only half of the equation: while utility stocks may not have rebounded like the market, they also did not “crater” like the general market, either. This is an unambiguous indication utility stocks are less risky than non-utility stocks.

40 In fact, PacifiCorp’s myopic view of the record leads the Company incorrectly to posit “investors can obtain a greater return now and in the near future by investing in non-utility stocks of equal risk...”³⁹ Because non-utility stocks have more risk, as the Commission correctly observed in Paragraph 81 of its Order: “... (the) evidence is clear that utility stocks are less volatile than non-utility stocks...” Less risk requires less return.

41 In short, the Order is consistent and true to the record, while PacifiCorp’s Petition is the exact opposite. For each of the foregoing reasons, the Commission should reject PacifiCorp’s Petition on cost of capital issues.

B. Net Power Cost Issues

42 PacifiCorp seeks reconsideration on four net power cost (NPC) issues, including the DC Intertie adjustment, the adjustment for Arbitrage Revenues, and the exclusion of intra-hour wind integration expenses.⁴⁰ For the reasons that follow, the Commission should reject PacifiCorp’s Petition on these issues, except for the calculation on NPC of removing intra-hour wind integration costs. PacifiCorp’s point is well taken that the adjustment the

³⁸ PacifiCorp Petition at 25-26 ¶¶ 60-61, referring to the Order at 34-35, ¶ 81.

³⁹ PacifiCorp Petition at 25, ¶ 61.

⁴⁰ PacifiCorp also challenges the Minimum Loading and Derating adjustment. Staff takes no position on that issue.

Commission accepted is overstated by \$46,418. If the Commission considers this amount material,⁴¹ it should grant the Petition to that extent.

1. DC Intertie – Actual Use is not the Issue: PacifiCorp’s Problem is That the Company Quantifies the Costs of the Intertie, But None of the Benefits

43 PacifiCorp argues the Commission erred in accepting Staff’s adjustment removing of the DC Intertie, because the Company actually uses that contract on occasion. PacifiCorp therefore argues the Commission’s statement in the Order that “the contract is not expected to be used during the rate year” is wrong.⁴² While PacifiCorp concedes GRID does not model DC Intertie transactions, the Company also argues the Commission would be “inconsistent” if it failed to ignore the Company’s actual use of the Intertie.⁴³

44 The Company misses the entire point of the DC Intertie adjustment, because whether the Company may actually carry out an occasional transaction on the Intertie disregards the key fact that in determining power supply costs in this case, PacifiCorp included no normalized benefits whatsoever associated with the annual expenses of the Intertie: Zero.

45 As Staff testified, PacifiCorp wanted to pass on the entire costs of the Intertie to ratepayers without quantifying a single benefit.⁴⁴ That is an unfair mismatch of egregious proportions. A proper adjustment would match the quantifiable benefits of the DC Intertie on a normalized basis (i.e., transactions utilizing the Intertie that would result in lower costs for customers) to the annual costs of the Intertie.

46 This is not an instance where “actual” should be given greater weight than GRID model results, as PacifiCorp tries to categorize it. Rather, this is an instance where

⁴¹ On page 7 of its Petition, ¶ 15, last two lines, PacifiCorp considers amounts greater than this to have “negligible rate impact”.

⁴² PacifiCorp Petition at 13-14, ¶ 31, quoting the Order at 55, ¶ 149.

⁴³ PacifiCorp Petition at 14, ¶ 32.

⁴⁴ Buckley, Exhibit No. APB-1CT at 19:1-13.

PacifiCorp offered a gross mismatch between costs and (no) benefits, and the Commission was correct in declining that offer.

47 In sum, at the core, PacifiCorp's arguments reflect an unfair reading of the Order. First, the Commission's statement that "the contract is not expected to be used during the rate year" is eminently correct, because the GRID model runs sponsored by PacifiCorp reflect that precise expectation. Second, the Commission is "consistent" in its Order by requiring a showing of benefits matching costs. No utility should expect recovery of any cost unless it can show the benefits to the ratepayer match the cost. PacifiCorp is no exception.

2. Arbitrage Revenues – There is No Reason to Modify Arbitrage Revenues by Considering Dissimilar Transactions or Otherwise Changing the Amount

48 PacifiCorp also takes exception to the Commission's acceptance of Staff and ICNU's adjustment to include revenues from arbitrage transactions. According to the Company, the Commission also should have included revenues from trading transactions, and/or it should have reflected a lower level of arbitrage revenues based on lower revenues in the recent past.⁴⁵

49 The Commission should reject both of PacifiCorp's arguments. First, there is good reason for the Commission to include arbitrage transaction and exclude trading transactions. As Staff thoughtfully explained,⁴⁶ trading transactions are a completely different type of transaction than arbitrage transactions. Arbitrage transactions are very low risk, non-speculative transactions that take advantage of different prices at various trading locations that can be reached using the Company's transmission system. The detailed data shows

⁴⁵ PacifiCorp Petition at 14-15, ¶¶ 33-34.

⁴⁶ Buckley, Exhibit No. APB-1CT at 6:3 to 9:2.

there is an immediate matching of sales to purchases or purchases to sales related to these arbitrage transactions.⁴⁷

50 By contrast, trading transactions may be risky, speculative transactions based on PacifiCorp's present and future energy positions, and these transactions may not be related to a delivery point arbitrage at any particular time. If PacifiCorp wants to enter into these trading transactions, the Company should remain responsible for both the costs and benefits.⁴⁸ In sum, there is good reason to include arbitrage transactions, but not trading transactions.

51 As to the appropriate level of arbitrage transactions, PacifiCorp opposes a four-year average. However, the Company fails to offer the Commission an alternative calculation, or any rationale for what it thinks are "low sales numbers for the most recent year".⁴⁹ Instead, the Company simply asks the Commission to "reconsider its adoption of Staff's and ICNU's proposal on this issue."⁵⁰

52 The Commission deserves better. PacifiCorp had every opportunity to support its recommendation with an actual calculation so the Commission and the other parties could consider that alternative. Because PacifiCorp offers no alternative calculation, Staff cannot respond further, other than to recommend the Commission reject PacifiCorp's Petition on this adjustment as simply inadequate.

⁴⁷ Buckley, Exhibit No. APB-1CT at 7:19-22 (Total MWhs bought generally match total MWhs sold).

⁴⁸ Buckley, Exhibit No. APB-1CT at 8:17-22.

⁴⁹ PacifiCorp Petition at 15, ¶ 34.

⁵⁰ Id.

3. OATT-related Wind Integration Costs

53 PacifiCorp effectively ignores the Commission's finding that the Company has not proven intra-hour wind integration costs are known and measurable,⁵¹ and insists the Commission has violated the Constitution by failing to award the Company these costs, as they relate to the Company's wholesale customers who are wind generators (i.e., non-owned wind generation).⁵² For the reasons that follow, PacifiCorp is wrong on both counts.

a. The Wind Integration Costs at Issue are Not Known and Measureable

54 PacifiCorp does not contest the Commission's finding that the Company has not demonstrated these costs are known and measureable. Instead, the Company asserts the Commission did not reject the costs on that ground.⁵³ However, Paragraph 128 of the Order plainly refutes the Company's assertion, and the record amply supports the Order in that regard; the Company's portrayal of these costs was a moving target, with little opportunity for the parties to review them, thus failing the known and measurable standard.⁵⁴ This remains an independent basis for the Commission to reject these costs.

b. The Commission's Order Does Not Violate the Constitution Because PacifiCorp Does Not Use Intra-Hour Wind Integration Service to Serve Washington Retail Customers

55 If the Commission decides to reach PacifiCorp's constitutional issue, focusing on the nature of the costs at issue will lead the Commission down the correct legal path for resolving this issue.

56 The wind integration costs at issue here are costs PacifiCorp incurs to serve third-party wind generators in transporting their energy to the customers of those generators' own

⁵¹ PacifiCorp Petition at 15, ¶ 35.

⁵² PacifiCorp Petition at 15-18, ¶¶ 35-41.

⁵³ PacifiCorp Petition at 15, ¶ 36, first sentence.

⁵⁴ E.g., Buckley, Exhibit No. APB-1CT at 22:8 to 23:2.

choosing. While PacifiCorp's FERC-approved OATT tariff governs PacifiCorp's provision of those services, the key fact is that PacifiCorp does not use the services of any of these wind generators to provide intrastate services, and that instantly distinguishes this case from *Nantahala*⁵⁵ and *Mississippi Power & Light*.⁵⁶

57 In *Nantahala*, the utility was using low cost power from TVA to provide service to its intrastate customers. The Court barred North Carolina from using more low cost power than FERC had allocated to the utility. In *Mississippi Power & Light*, the utility was using power under a contract with Grand Gulf to provide service to its intrastate customers. The Court barred Mississippi from assuming the utility was obligated to purchase less Grand Gulf power than FERC had ordered the utility to purchase.⁵⁷

58 In short, in each case, the Constitution was implicated only because the utility was using a FERC-regulated service or contract to provide intrastate service. By contrast, PacifiCorp does not use any of the FERC-regulated services it provides to the third-party wind generators at issue here to provide service to Washington retail customers, and therefore no constitutional issue is presented.⁵⁸ Therefore, the Commission should reject PacifiCorp's Petition on this issue.

⁵⁵ *Nantahala Power & Light Co. v. Thornberg*, 476 U.S. 953 (1986).

⁵⁶ *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354 (1988).

⁵⁷ In *Mississippi Power & Light*, 487 U.S. at 373, the Court focused on the essence of the constitutional problem as follows: "In *Nantahala*, the state court attempted to approve retail rates based on the assumption that Nantahala was entitled to more low-cost power than FERC had allocated to it. Here the state court seeks to permit the State to set rates based on an assumption that MP&L is obligated to purchase less Grand Gulf power than FERC has ordered it to purchase." Because PacifiCorp does not use the OATT-related wind generation costs at issue to serve its retail customers in Washington, no similar problem faces the Commission in this case.

⁵⁸ As we mentioned in Staff's Reply Brief at 23, n. 106, it may well be that, sometime in the future, the Company will need to allocate the costs and revenues for this activity to interstate, similar to how utilities in the telecommunications industry use accounting separations to address these jurisdictional issues.

c. The Company Correctly Adjusts the Impact on NPC of the Commission's Rejection of Intra-Hour Wind Integration Costs

59 PacifiCorp seeks reconsideration on the Commission's calculation of the impact on NPC of removing intra-hour wind integration costs. PacifiCorp states the adjustment the Commission adopted should have been \$472,274, a reduction of \$46,418 from the \$518,692 adjustment the Commission accepted.⁵⁹

60 This small correction to the intra-hour integration cost adjustment in the Order appears appropriate to Staff. The Staff adjustment the Commission accepted was based on amounts from the Company's original filing. Since then, the parties accepted (and the Commission approved) an ICNU adjustment to recalculate the integration costs using a GRID methodology. A portion of this adjusted amount relates to non-owned, intra-hour wind integration costs. Therefore, those costs have already been reduced by a small amount via the ICNU adjustment.

61 The Company's calculation of the \$46,418 uses ratios associated with each project's energy amounts to estimate the portion of the accepted adjustment that is related to the non-owned, intra-hour wind integration costs. This approach seems reasonable to Staff, and therefore, Staff recommends the Commission grant reconsideration and reduce the \$518,692 adjustment by \$46,418, to \$472,274, as recommended by PacifiCorp, should the Commission deem this amount material.

C. Federal income Tax Issues

62 PacifiCorp seeks Commission reconsideration on federal income tax issues. "At a minimum", the Company seeks only a clarification of Commission policy on flow-through versus normalization, although the Company apparently hopes the Commission will also

⁵⁹ PacifiCorp Petition at 19, ¶ 45.

modify its Order to: 1) allow the Company to move to full normalization, or 2) mandate a policy of flow-through, with the sole exception being when normalization is required by the Internal Revenue Code (IRC).⁶⁰

63 PacifiCorp declares the Order unfairly penalizes the Company and fails to establish a clear and consistent tax policy.⁶¹ Staff strongly disagrees with these declarations, which are based on misstatements and an unfair and biased reading of the record. For the reasons that follow, the Commission should reject the Company's Petition on tax issues.

1. The Company's Core Assertions in its Petition Are Incorrect

64 Overall, PacifiCorp challenges the Order on tax issues by claiming the Order creates "serious policy issues", "results in significant new uncertainty", and fosters an "ad hoc" approach.⁶² The Company further states that the so-called "change" in the tax treatment of regulatory assets associated with Chehalis and other deferred accounts (from flow-through to normalized) will require the Company to unexpectedly record income tax expense of approximately \$5.4 million.⁶³

65 These statements simply are not true. First, the \$5.4 million is a rate base reduction, representing a portion of the ratemaking treatment in Staff Adjustment 7.9 to reflect flow-through tax treatment consistent with Commission policy and consistent with PacifiCorp adjustments in prior general rate cases. The tax expense and net operating income portion of the adjustment is correctly reflected in the Order as \$0.3 million.⁶⁴

⁶⁰ PacifiCorp Petition at 2, ¶ 4.

⁶¹ Id.

⁶² PacifiCorp Petition at 4, ¶ 8.

⁶³ Id. and at 5, ¶ 9.

⁶⁴ Order at 127, line 45 (Appendix A).

Second, the Order reflects a clear and consistent policy for federal income tax⁶⁵

- The general Commission policy calls for flow-through accounting for federal income taxes when permitted by the IRC, except;⁶⁶
- Commission approval of deferred costs (which includes tax), is consistent with normalization. In particular, normalization accounting for regulatory assets deferred by a utility pursuant to RCW 80.80.060(6) and WAC 480-100-435 is consistent with normalization; and⁶⁷
- The Commission will consider appropriate federal tax accounting when an item, such as the Repairs Deduction, has a very significant impact on ratepayers and the utility.

PacifiCorp chooses to call the third element above an “ad hoc” policy, but the Company itself chose to bring the Repairs Deduction to the Commission for resolution. It is therefore difficult to give credence to the Company’s tactics.

2. The Commission’s Policy Works

Only PacifiCorp seems to have issues with the Commission’s policy. The following information from both Avista’s and PSE’s most recent general rate cases confirms that all existing regulatory assets and liabilities authorized in prior Commission decisions include deferred taxes relative to the deferred revenue or cost, consistent with normalization. Staff is unaware of any problems for Avista or PSE due to application of Commission policy on deferred taxes:⁶⁸

Avista Docket UE-100467: In this docket, Avista reflected adjustments for existing regulatory assets including their associated accumulated deferred income tax related to three major deferrals CDA settlements, Spokane River Relicensing and Montana Riverbed Lease. Avista witness Ms. Andrews described this treatment in her testimony, Exhibit No. EMA-1T at 14-20 and Exhibit No. EMA-2 at 6-7. Staff includes these excerpts in Attachment A at 1-11.

⁶⁵ Breda, Exhibit No. KHB-1T at 7:8 to 8:14; Exhibit No. KHB-5T at 1:14-21; See also Staff Initial Brief at 31-32, ¶¶ 127-131.

⁶⁶ Order at 94, ¶ 277.

⁶⁷ Id. at 95, ¶ 281.

⁶⁸ Staff request the Commission take official notice of this information.

PSE Docket UE-090704. In this docket, PSE reflected regulatory assets net of accumulated deferred tax. In Exhibit No. JHS-1T at 49 to 53, PSE witness Mr. Story discusses regulatory assets previously authorized by the Commission, as well as regulatory assets newly proposed by the Company, each reflecting assets net of accumulated deferred income tax. Staff includes this excerpt of Mr. Story's testimony in Attachment A at 12-17.

69 As shown in these examples, the Commission's policy has been clear and consistently applied by both Avista and Puget Sound Energy. If there is any confusion, it is of PacifiCorp's own making.

70 In fact, PacifiCorp has deferred regulatory assets net of accumulated deferred income tax, i.e., using normalization consistent with Commission policy, including Adjustment 3.4, SO2 Emission Allowance (Docket UE-940947) and Adjustment 8.3, Environmental Remediation (Docket UE-031658).

71 Moreover, two other regulatory assets are before the Commission in this case, Adjustment 8.7 - Powerdale, with a revenue requirement of \$0.1 million⁶⁹, and Adjustment 8.10 - Chehalis, with a revenue requirement of \$4.2 million.⁷⁰ These regulatory assets produce a \$6.4 million decrease to rate base for accumulated deferred income tax. Both PacifiCorp and Staff include this \$6.4 million rate base reduction for accumulated deferred income tax, consistent with normalization, for these regulatory assets, and the Order confirms this treatment of taxes is consistent with normalization.⁷¹ No adjustment was necessary to PacifiCorp's revenue requirement to reflect the Commission's decision.

⁶⁹ Order at 127, line 58 (Appendix A).

⁷⁰ Id. at 127, line 61 (Appendix A).

⁷¹ Order at 96, ¶ 281.

3. The Order is Complete; PacifiCorp's Contrary Argument Defies the Definition of "Flow-Through"

72 PacifiCorp suggests the "Order is incomplete because it did not address whether a deferral under RCW 80.80.060 is *also* consistent with flow-through."⁷² However, no explanation is necessary, because federal income taxes deferred pursuant to that statute cannot, by definition, constitute flow-through, because flow-through means the utility is recognizing those taxes in the period they are incurred. Deferring those taxes makes that impossible. In short, deferral of the cost of an asset and its related taxes is inconsistent with flow-through accounting for income taxes, and the Order correctly reflects this basic principle.

4. Normalization for the Repairs Deduction is An Excellent Example Why the Commission's Policy is Reasonable

73 The crux of the issue regarding the Repairs Deduction relates to the benefit the Company received by making this tax accounting change for years 1999 to 2009 and how the benefit should be recognized for ratemaking purposes. The result would be a one-time, \$29.6 million tax benefit for ratemaking purposes if the Commission were to include it in the test year on a flow-through basis. Obviously, an item of that magnitude merits particular consideration, and the Company recognized this by bringing the matter to the Commission.

74 Yet, PacifiCorp somehow presumes the Company would simply enjoy 100 percent of these benefits, and the ratepayers would get nothing.⁷³ It is far more realistic to expect the Commission would do what it did in this case, and evaluate this extraordinary item to determine proper ratemaking treatment.

⁷² PacifiCorp Petition at 9, ¶ 21.

⁷³ PacifiCorp Petition at 2-3, ¶ 5.

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As to the merits, both Staff and Company proposed normalization treatment for the federal taxes associated with the Repairs Deduction, and the Commission was eminently reasonable to accept that proposal. Normalization for the Repairs Deduction allows the Company to recognize the deferred tax in rate base, and amortization through net operating income over the life of that asset. That treatment is also consistent with the Commission's decision in Docket UE-090705,⁷⁴ where the Commission stated that Puget Sound Energy should include an adjustment to accumulated deferred income tax for the methodology change following its IRS audit. PacifiCorp has no reason to complain about the same, consistent treatment.

5. The Commission Was Correct to Reject PacifiCorp's Request for Full Normalization

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PacifiCorp once again tries to persuade the Commission to adopt full normalization on the basis it has zero impact on customers.⁷⁵ Then, the Company does an about-face, and asserts the rate impact is \$1.6 million.⁷⁶ PacifiCorp fails to explain this obvious discrepancy, but, even assuming the \$1.6 million is correct, and even if the corresponding rate impact could be "negligible",⁷⁷ that means the status quo (i.e., continuation of flow-through" for most items) has no impact, either. Put another way, the Company's evidence fails to provide substantial reasons for going to full normalization.

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In fact, full normalization will adversely impact ratepayers. In general rate case filings over time, PacifiCorp has offered an adjustment, similar to Adjustment 7.9, to deferred income tax to recognize the Commission policy of flow-through tax treatment

⁷⁴ *Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 12 at 70, ¶ 197 (April 8, 2010).

⁷⁵ PacifiCorp Petition at 6 ¶ 14

⁷⁶ PacifiCorp Petition at 7, ¶ 15.

⁷⁷ PacifiCorp Petition at 7, ¶ 15.

when lawful.⁷⁸ The Company typically makes this adjustment because, on a book basis, the Company reflects non-property related tax-book differences on a normalized basis. Thus, an adjustment is necessary to reflect flow-through treatment. This can be seen in past rate case filings in addition to Adjustment 7.9 in this case (dollars in millions)(official notice requested):

<u>Docket</u>	<u>NOI</u>	<u>Rate Base</u>	<u>Rev Req</u>	<u>Adjustment</u>
UE-100749	\$0.3	\$(5.4)	\$(1.2)	7.9 ⁷⁹
UE-090205	\$2.1	\$(2.9)	\$(4.2)	PacifiCorp 7.5/6 ⁸⁰
UE-061546	\$1.2	\$(10.5)	\$(3.3)	PacifiCorp 7.5 ⁸¹

78 These dollars reflect the amounts removed to reflect flow-through treatment, when such treatment was consistent with the IRC. The Commission's acceptance of Staff Adjustment 7.9 in this case is consistent with this policy. It is also evident, in each of the cases shown above, that ratepayers benefit from the use of flow-through income tax treatment based on the accompanying revenue requirement reduction. If a full normalization policy existed, these adjustments would not have been made.

7. PacifiCorp is Wrong to Claim the Order Will Require an Unexpected \$5.4 Million in Income Tax Expense

79 Throughout its Petition, PacifiCorp refers to a \$5.4 million income tax expense adjustment it must endure related to regulatory assets.⁸² The Company is mistaken. The \$5.4 million represents the rate base decrease included in Staff Adjustment 7.9. This

⁷⁸ Regulatory assets and liabilities are then treated by the Company as separate ratemaking adjustments.

⁷⁹ Order at 127, line 45 (Appendix A).

⁸⁰ Attachment A at 18-22: Docket UE-090205, Testimony of Bryce Dalley, Exhibit No. RBD-1T, pages 1 and 26, and Exhibit No. RBD-3, page 7.0.

⁸¹ Attachment A at 23-28: Docket UE-061546, Testimony of Paul M. Wrigley, Exhibit No. PMW-1T, pages 1, 18 and 20, and Exhibit No. PNW-4, page 7.0.

⁸² E.g., PacifiCorp Petition at 5, ¶ 9, at 9, ¶ 20 and at 10, ¶ 23.

adjustment recognizes flow-through for book-tax differences that are lawful and not deferred by Commission order.⁸³ It represents taxes related primarily to recurring accrued liabilities which create book-tax differences because these liabilities are accrued for book purposes but not paid or recognized for tax purposes. The net operating income amount is \$0.3 million with a revenue requirement of \$1.2 million.⁸⁴

80 In short, regulatory assets simply are not included in that \$5.4 million rate base portion of this adjustment. As stated above, both PacifiCorp and Staff have consistently included the regulatory assets and their related deferred taxes in this case, including Adjustment 8.10 – Chehalis, and Adjustment 8.7 - Powerdale. The Order confirms this treatment is consistent with normalization, and no adjustment by the Company is necessary to reflect these regulatory assets.

81 Put more simply, the Company’s \$5.4 million claim is from the perspective of Commission adoption of full normalization, which is not the correct perspective.

8. The Company Mischaracterizes the Grid West Loan

82 In its Petition, the Company repeatedly refers to the Grid West Loan is an example of flow-through tax treatment of a regulatory asset⁸⁵, but the Company is wrong. The Commission authorized PacifiCorp to defer the Grid West Loan in Docket UE-060703. PacifiCorp included an adjustment for the deferral in the ensuing rate case, Docket UE-061546. As Company witness Mr. Wrigley described this adjustment: “This adjustment includes the rate base, expenses and taxes associated with the Grid West loan.”⁸⁶ The Company’s own adjustment in that case included the tax benefit of the amortization expense

⁸³ Order at 95 ¶ 279.

⁸⁴ PacifiCorp Petition at 127, line 45 (Appendix A).

⁸⁵ E.g., PacifiCorp Petition at 9, ¶ 20.

⁸⁶ Docket UE-061546, Wrigley, Exhibit No. PMW-1T at 20. Staff requests the Commission take official notice of this document, which is excerpted in Attachment A at 31.

which is indicative of normalization, because the costs being amortized were incurred in a prior period. Under flow-through, there would have been no tax effect on the adjustment.

83 In any event, the Company's Grid West Loan adjustment in Docket UE-061546 was uncontested, so however federal income taxes were treated in that adjustment cannot constitute a Commission decision on the merits. Moreover, the tax effect is negligible. While the Company did not include an adjustment for Grid West in this case (even though it is amortized through July 2011), the tax effect is negligible; deferred income tax expense of \$16,430 and accumulated deferred income tax of \$33,636.⁸⁷

9. Staff's Comments on Exhibit 1 to PacifiCorp's Petition

84 In Docket UE-061546, the Company offered Adjustment 7.5, Flow-Through Deferred Tax, reflecting flow-through for all other adjustments, where normalization is neither required by the IRC or by the Commission. This adjustment is provided in the chart above, comparing the effect of flow-through among rate cases. PacifiCorp uses this adjustment to support its discussion about the Grid West Loan and regulatory assets.⁸⁸ That is not proper, because Exhibit 1 of PacifiCorp's Petition represents the restatement made by the Company, as in all past general rate cases, to reflect Commission policy of flow-through treatment of those items PacifiCorp normalizes in its unadjusted results of operations.

85 In other words, Exhibit 1 is comparable to Staff Adjustment 7.9 in this case, and it is not related to the Grid West Loan or any other regulatory asset.

⁸⁷ Fuller, Exhibit No. RF-15.

⁸⁸ PacifiCorp Petition, Exhibit 1.

II. CONCLUSION

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For the reasons stated above, the Commission should deny PacifiCorp's Petition for Reconsideration, except for the \$46,418 reduction related to the intra-hour wind integration cost disallowance, should the Commission deem that amount material.

DATED this 14th day of April 2011.

ROBERT M. MCKENNA
Attorney General



DONALD T. TROTTER
Assistant Attorney General
Counsel for Washington Utilities and
Transportation Commission Staff