

**BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND)	DOCKET UE-100749
TRANSPORTATION COMMISSION,)	
)	
Complainant,)	ORDER 07
)	
v.)	
)	ORDER DENYING PETITIONS FOR
PACIFICORP D/B/A PACIFIC POWER)	RECONSIDERATION AND
& LIGHT COMPANY,)	GRANTING CLARIFICATION
)	
Respondent.)	
)	
.....)	

Synopsis: The Commission denies the petitions filed by PacifiCorp and Commission Staff requesting reconsideration of the Commission’s decisions in its Final Order regarding capital structure, cost of capital, certain net power costs, and income tax normalization. The Commission clarifies its ruling on arbitrage sales revenues and its policy regarding tax normalization.

MEMORANDUM

I. Background and Procedural History

1 **NATURE OF PROCEEDING:** On March 25, 2011, the Washington Utilities and Transportation Commission (Commission) entered Order 06, Final Order Rejecting Tariff Sheets, Authorizing Increased Rates; and Requiring Compliance Filing. The Order allowed PacifiCorp d/b/a Pacific Power & Light Company (PacifiCorp or Company) to file tariff revisions allowing it to recover approximately \$38 million in additional revenue. On March 30, 2011, PacifiCorp filed the necessary revisions to its tariff. The Commission approved the Company’s compliance filing on April 1, 2011.

2 On April 4, 2011, PacifiCorp and the Commission's regulatory staff (Commission Staff or Staff)¹ timely filed petitions for reconsideration of the Final Order. By Notice issued April 5, 2011, the Commission afforded the parties the opportunity to file answers to both petitions for reconsideration. PacifiCorp, Commission Staff, the Public Counsel Section of the Office of the Attorney General (Public Counsel), and the Industrial Customers of Northwest Utilities (ICNU) timely filed answers to the petitions. In the same notice, the Commission stated that it would enter an order in due course.²

II. Discussion and Decisions

A. Applicable Law

3 According to RCW 34.05.470(1), any party may file, within 10 days of service of a final order, a petition for reconsideration stating the specific grounds upon which relief is requested.³ Each petitioner must clearly identify each portion of the order that it contends is erroneous or incomplete, cite the portions of the record and statute or rule relied on to support its petition, and present argument in support of its petition.⁴ A petition for reconsideration is deemed denied 20 days after the date the petition is filed unless the Commission enters an order resolving the petition or serves notice of the date by which it will act on the petition.⁵

¹ In formal proceedings, such as this, the Commission's regulatory staff participates like any other party, while the Commissioners make the decision. To assure fairness, the Commissioners, the presiding administrative law judge, and the Commissioners' policy and accounting advisors do not discuss the merits of the proceeding with the regulatory staff, or any other party, without giving notice and opportunity for all parties to participate. *See* RCW 34.05.455.

² In order to avoid any ambiguity about the Commission's intent to enter an order rather than have the petitions be denied by force of law, on April 25, 2011, the Commission electronically notified all parties of its intent to enter an order no later than May 20, 2011.

³ WAC 480-07-850 governs the content of petitions for reconsideration.

⁴ WAC 480-07-850(2).

⁵ WAC 480-07-850(5).

4 Generally, a petition for reconsideration is a narrow window of opportunity to bring to our attention matters in which, based on the evidence in the record and applicable law, we may have reached an erroneous decision or failed to fully resolve an issue. It should not be a broad opportunity to relitigate a party's case or to raise new matters that should have been resolved during the adjudicatory process. Thus, our rule specifically requires that a petitioner identify errors or incomplete rulings together with evidentiary and legal citations that support its position.

B. Petitions for Reconsideration

5 PacifiCorp's Petition addresses four topics: (1) capital structure, (2) cost of equity, (3) certain net power costs, and (4) tax normalization. Staff's Petition requests reconsideration of two issues related to the capital structure: rejecting its proposed equity component and excluding short-term debt. We first address the capital structure issues raised by both parties.

1. Capital Structure

6 By Order 06, we adopted the capital structure proposed by ICNU consisting of 49.1 equity, 50.60 percent long-term debt, and .30 percent preferred stock.⁶ We found that a company's capital structure must balance safety and economy and contain sufficient equity to provide financial security but no more than necessary to keep ratepayer costs at a reasonable level.⁷

7 Central to our decision regarding the appropriate capital structure for PacifiCorp was the conclusion that the Company's proposed capital structure contained too much equity.⁸ However, we specifically rejected Staff's proposal regarding the equity

⁶ Order 06 ¶¶ 21 – 43.

⁷ Order 06 ¶ 39; *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1942).

⁸ Order 06 ¶ 39. PacifiCorp's actual equity component represents 52.1 percent of its capital structure.

percentage of the capital structure and the recommendation to impute three percent short-term debt.⁹

8 In its Petition, PacifiCorp argues that we applied the wrong legal standard in adopting a hypothetical capital structure. It argues that, based on past Commission cases, we should accept a company's actual capital structure unless there is a "clear and compelling reason" to do otherwise.¹⁰ It also argues that in adopting the capital structure we failed to consider adequately the impact on the Company's credit metrics.¹¹

9 In contrast, Staff believes that our adopted capital structure endowed the Company with excessive equity. It argues that its proposed equity ratio of 46.5 percent is safe, economical, and consistent with the capitalization of most electric utilities.¹² To reduce equity to this level, Staff imputes three percent short-term debt into the Company's capital structure, and argues that we erred by not ordering this result.¹³ We respond first to the Company's arguments.

10 Contrary to PacifiCorp's contention, our decision on the Company's capital structure applied the appropriate legal standard, which balances the financial integrity of the Company (safety) with its cost to ratepayers (economy).¹⁴ The Company's arguments ignore this basic tenet and, as a result, it is left with contending that we must accept its actual capital structure. In fact, it argues that our precedent dictates this result. We disagree. When our prior decisions are examined in context, they actually undermine the Company's position.

⁹ Order 06 ¶ 43.

¹⁰ PacifiCorp's Petition ¶ 65.

¹¹ PacifiCorp's Petition ¶¶ 65 – 71.

¹² Staff's Petition ¶¶ 2 – 11.

¹³ Staff's Petition ¶¶ 12 – 20.

¹⁴ Order 06 ¶ 38.

11 PacifiCorp relies on language from a previous Puget Sound Energy (PSE) decision in which the Company had requested a higher than actual equity percentage.¹⁵ There, the Commission declined to increase PSE's equity component, citing the two cases just prior in which the Commission had allowed a hypothetical capital structure containing additional equity in an effort to deleverage the Company's balance sheet¹⁶ In the cited cases the Company requested more hypothetical equity without demonstrating it was necessary to finance the Company's capital program. Balancing safety and economy, the Commission concluded that the Company's actual equity position was sufficient to attract capital. It is in this context, where the financial needs of the Company were contrasted with the cost to ratepayers, that the Commission noted that to do more for the Company would require a "clear and compelling" reason to do so. In other words, the "clear and compelling" language was an application of the stringent burden of proof our state statutes place on the utilities seeking rate increases¹⁷.

12 We also disagree that PacifiCorp's credit rating will be imperiled by adopting an equity ratio three percent below its actual equity ratio. Indeed, our decision on the equity component should have a limited impact on PacifiCorp's credit rating. More significant is PacifiCorp's affiliation with Mid-American Energy Holding Company (MEHC).¹⁸ PacifiCorp admits that its credit metrics "are more consistent on a standalone basis with a 'BBB' category rating" and "absent ownership by MEHC . . . [its] credit rating would likely suffer at least a one rating level downgrade."¹⁹ It is

¹⁵ *Washington Utilities and Transportation Commission v. Puget Sound Energy*, Docket UE-090740, Order 11 at 99 (April 2, 2010), citing *Washington Utilities and Transportation Commission v. Puget Sound Energy*, Docket UE-060266, Order 08 at 27 (January 5, 2007).

¹⁶ "In these prior cases, the Commission was focused on balancing economy and safety by reducing the Company's leverage and improving the safety in its balance sheet." *Washington Utilities and Transportation Commission v. Puget Sound Energy*, Docket UE-060266 at 27 (January 5, 2007).

¹⁷ Furthermore, we agree with the Commission Staff that PacifiCorp's argument that there must be "clear and compelling evidence" to depart from a company's actual capital structure in effect shifts the burden of proof from PacifiCorp to the other parties to this proceeding. Staff's Answer, ¶¶ 5 – 11.

¹⁸ Order 06 ¶ 40.

¹⁹ Standard & Poor's Rating Direct, February 17, 2010, Williams, Exh. No. BNW-3.

MEHC and the ultimate owner, Berkshire Hathaway, that control PacifiCorp's capital structure.²⁰ MEHC's \$990 million equity infusions, elimination of dividends to MEHC, and retirement of short-term debt caused PacifiCorp's equity ratio to expand from 46 percent in 2006 to 52.1 percent in 2009.²¹ In our Order, we categorized this as a "remarkable level of growth in just three years."²² That characterization may well be under-stated. While that expansion of the equity component may serve the interests of the parent company, it is "inconsistent with the ratepayer interest in a capital structure that reflects economy."²³ We concluded that PacifiCorp's capital structure contains too much equity which "tips the balance too far in favor of investor interests over ratepayers."²⁴ Thus, application of the legal standard to balance safety and economy overshadows concern with what would be at most a minimal impact on the Company's credit metrics.

13 In sum on these issues, the Company did not show that it requires a higher equity percentage to operate the business or that such a result would provide benefits to ratepayers commensurate with costs. Without such showings, it cannot support its position on reconsideration.

14 Unlike PacifiCorp which argues that we adopted an equity ratio that is too low, Staff argues that we adopted one that is too high. While Staff contends that our discussion is "fundamentally correct and well-supported" and adopts the "correct standard," it argues that we should have accepted its proposed 46.5 percent equity ratio.²⁵

²⁰ Order 06 ¶ 41.

²¹ Order 06 ¶¶ 40 - 41. As we recognize in the Order in Para. 41, the parent company of PacifiCorp may easily adjust the capital structure of its subsidiary for a variety of economic and financial reasons, some of which may have little to do with PacifiCorp's financing requirements.

²² Order 06 ¶ 40.

²³ *Id.*

²⁴ Order 06 ¶ 39.

²⁵ Staff's Petition ¶¶ 2 - 5.

- 15 As Staff notes in its petition, we recognized that “a substantial part of PacifiCorp’s increased equity financing is being used for capital expenditures . . . that provide value for ratepayers.”²⁶ Staff contends there is no evidence that PacifiCorp could not make these investments if the Company were more economically capitalized with 46.5 percent equity.²⁷ Staff is correct that there are undoubtedly other percentages of the equity component that would allow PacifiCorp to make capital expenditures. A 49.1 percent equity component is not the “magic number” that we must select as the sole level of equity component that will achieve the desired results. Likewise, we do not interpret our Order in Docket UE-050684 as precluding us from imputing short-term debt under appropriate circumstances.²⁸
- 16 On balance, we concluded that ICNU’s capital structure proposal was the most reasonable and well-developed, having based its common equity adjustments on four elements which reduced equity by \$359 million, the largest of which were an acquisition adjustment and temporary cash investments. We found persuasive ICNU’s arguments that the Company was maintaining large temporary cash investments (not “cash deposits”) on its balance sheet that were not being used for utility plant and operations, and therefore should be excluded from common equity. We do not find persuasive the Company’s arguments on reconsideration.
- 17 On the other hand, we found Staff’s proposal to impute short-term debt less persuasive. The attempt to simply estimate an amount of short-term debt based on the overall amount of net plant investment (\$15 billion) is more of a rough approach to

²⁶ Staff’s Petition ¶ 7; Order 06 ¶ 41.

²⁷ Staff’s Petition ¶ 7.

²⁸ Order 06 ¶ 43, quoting *Washington Utilities and Transportation Commission v. PacifiCorp*, Docket UE-050684, Order 04, at 79 (April 17, 2006). In paragraph 43 of Order 06, we quoted the 2006 PacifiCorp rate case, stating that “[t]he Commission has traditionally included a component for short-term debt, based on a company’s actual capital structure.” That statement could be read to indicate that we would not impute short-term debt and would include it in a capital structure only if it was part of the company’s actual structure. To the extent Order 06 may be so interpreted, we modify it. Just as there are circumstances justifying the imputation of a hypothetical equity component for rate-making purposes, there may be circumstances justifying the imputation of short-term debt. We simply choose not to so impute short-term debt in this case.

develop a hypothetical structure. On, balance we found the more comprehensive analysis proffered by ICNU to be more persuasive.

18 We reiterate that, in establishing a capital structure, we strive for a balance between investor interests and ratepayer interests. Achieving that balance is not an exact science. We sifted through the plethora of evidence on this topic and concluded that ICNU provided us with the “most reasonable approach for calculating the equity component.”²⁹ That decision, like the others in our Order, was based not only on the evidence presented by the parties, but on our determination of the appropriate weight to be given any evidence. Given all the foregoing factors, neither PacifiCorp nor Staff has persuaded us that our decision largely adopting the ICNU proposal for capital structure was erroneous. We deny their Petitions for Reconsideration on this topic.

2. Cost of Common Equity

19 In our Final Order, we set the Company’s cost of common equity at 9.80 percent.³⁰ After evaluating the various methods for calculating cost of capital, Discounted Cash Flow (DCF), risk premium, and Capital Asset Pricing Model (CAPM), we favored the analyses of ICNU and Commission Staff of this issue.³¹ However, we did not adopt ICNU’s specific recommendation of 9.50 percent but rather considered the entire extensive record on this issue as well as our informed judgment and established a return on equity (ROE) within the range of reasonableness.³²

20 PacifiCorp raises eight arguments in support of its Petition contending that:

- Our analysis fails to take into consideration market conditions;
- Current interest rates support a higher ROE; Our assumption of a downward trend in ROEs is unsupported;

²⁹ Order 06 ¶ 42.

³⁰ Order 06 ¶¶ 44 – 96.

³¹ Order 06 ¶¶ 81 – 85, 87.

³² Order 06 ¶¶ 93 – 94.

- We improperly discount long-term interest rates in the DCF analysis;
- We do not properly account for security analysts' forecast growth rates;
- Our DCF analysis is based on contradictory economic conclusions;
- Our CAPM analysis is inconsistent with precedent; and
- Our rejection of the Company's regression analysis, based on the alleged correlation between equity risk premiums and interest rates, in its risk premium model is unsupported.³³

21 PacifiCorp's Petition basically presents arguments that we already considered extensively at hearing and in our lengthy discussion of this issue in our Final Order. However, we will briefly address these arguments again.

22 As stated in our Order, estimating the cost of equity for the rate year is the most challenging cost of capital decision. It is traditionally calculated using three principal methods: DCF, risk premium, and CAPM.³⁴ The complexity of this task is compounded by the fact that each method involves complex factors and multiple assumptions. Each method has both advantages and limitations, and can be relatively more useful depending on the economic and capital market conditions at a specific time. Accordingly, we do not select a single method as being the most accurate or instructive but rather found value in each of the methodologies used to calculate cost of equity.³⁵ We turn now to the various contentions raised by PacifiCorp.

23 *Market Conditions.* PacifiCorp argues that we did not consider market conditions and that if market conditions in 2006 were similar to what they are today, then the ROE should be similar as well, stating that the Commission has "traditionally" looked at what has changed. We disagree. As Staff notes, the Company's argument is based on the wrong "tradition" because it cites only one case.³⁶ A ruling in a single case is just that; a ruling based on the evidence presented in that proceeding. To warrant the

³³PacifiCorp's Petition ¶¶ 49 – 71.

³⁴ Order 06 ¶¶ 45 – 94.

³⁵ Order 06 ¶ 91.

³⁶ Staff's Answer ¶ 23.

characterization of “tradition,” a party must demonstrate a pattern of long-standing consistent treatment.

24 In any event, the Company’s criticism that we did not consider current market conditions is unwarranted, and its arguments appear to be overly fixated on overall movements in utility stock prices (although PacifiCorp is not publicly listed and its equity is not publicly traded). Contrary to PacifiCorp’s assertion, our Order considers the significant changes in the market since PacifiCorp’s ROE was set in 2006. We repeatedly referred to the significant economic changes since PacifiCorp’s last litigated rate case and remarked on the turmoil in financial markets that commenced in the fall of 2008.³⁷ We also cited the financial market’s recent return to more normal conditions.³⁸ We cannot imagine what else we could have stated about current market conditions save accepting the Company’s position, an argument we found unpersuasive.

25 *Current Interest Rates.* PacifiCorp contends that interest rates for single “A” rated utilities, at the time of hearing, were 5.56 percent, nearly identical to the rates in 2006 when the Commission approved a 10.2 percent ROE for PacifiCorp and identical to the rates one year ago when the Commission approved a 10.1 percent ROE for PSE.³⁹ It goes on to note that ICNU agreed that interest rates are nearly identical to those in 2006 and that the best estimate of future interest rates is current interest rates.⁴⁰ Then it concludes that if interest rates are the same, then ROEs should also be the same.⁴¹

26 As argued by Staff, there is no “tradition” that somehow creates a presumption that an ROE determined a number of years ago should carry over. This argument resembles the Company’s argument regarding capital structure: it attempts to shift the burden of proof to others to prove that the previously approved ROE is inappropriate, rather

³⁷ Order 06 ¶¶ 76, 80 - 81, 89 - 91.

³⁸ Order 06 ¶ 81.

³⁹ PacifiCorp’s Petition ¶ 51.

⁴⁰ PacifiCorp’s Petition ¶ 52.

⁴¹ *Id.*

than leaving the burden on the Company, as the law requires. Further, even if there is some comparability between some 2005 economic data and analogous data from 2009, it does not follow that the ROEs should be consistent. As we have noted, determining an appropriate ROE for a utility is complex. The record shows that the economic situation in 2009 is unique. Despite PacifiCorp's summary assertions in its Petition, there is no valid comparison between the two years that should control a decision on ROE.⁴²

27 Further, as Staff notes in its Answer, ICNU's testimony effectively refutes PacifiCorp's narrow focus on a comparison of interest rates over time. The Company's approach is too simplistic. We cannot limit our analysis of an appropriate cost of equity to a comparison of interest rates in different time periods. To effectively establish cost of equity, we must also consider the relationship between the risk a utility faces in financial markets and interest rates.⁴³ Risk, of course, is one factor that affects the cost of equity because, generally speaking, as risk increases so does the rate an investor requires to undertake that risk. ICNU persuasively argued that there is no simplistic inverse relationship between equity risk premiums and interest rates and that the relationship changes over time and is influenced by other factors.⁴⁴

28 *Downward Trend in ROEs.* PacifiCorp criticizes our conclusion that there is a downward trend in ROEs and contends that we did not distinguish our Orders in the Avista and PSE general rate cases.⁴⁵ The Company's Petition is simply wrong. We distinguished the PSE rate case by noting that it was decided a year earlier.⁴⁶ Moreover, we distinguished the Avista rate case by noting that we did not adjudicate

⁴² Of course, even if we were to determine that the economic conditions were identical, it would be just as valid to conclude that our decision in 2006 resulted in an ROE that was too high as to conclude that our decision in 2011 resulted in an ROE that is too low.

⁴³ There are a multitude of other factors that we also consider; factors that were extensively described in Order 06.

⁴⁴ Staff's Answer ¶¶ 25 – 26, Gorman, Exh. No. MPG-1T at 49 – 50.

⁴⁵ PacifiCorp's Petition ¶ 53.

⁴⁶ Order 06 ¶ 92.

that utility's ROE. Rather, we accepted a settlement, which is not a decision on the merits on any given issue.⁴⁷ In our discussion of ROEs, we were simply responding to the Company's effort to demonstrate that Staff's and ICNU's proposed ROEs were inconsistent with those authorized by this and other commissions. We stated, and here reaffirm, that the trend for commission-authorized ROEs is downward, certainly well below the Company's requested 10.6.⁴⁸

29 *Long-term Growth Rates.* The Company's criticism of our "discounting" long-term growth rates in the DCF analysis also misses the mark.⁴⁹ In this case, we were presented with traditional analyses of cost of equity, and asked to apply these analyses to the period's extraordinary market conditions. As we noted in our Order, the complexity of determining the cost of equity was "compounded because the period since the Company's last litigated rate is one marked by the most severe economic recession since the 1930's."⁵⁰ Thus, we used traditional methods in a manner that at least acknowledges the uncertainty in capital markets. Given market uncertainty, we gave more weight to short-term growth rates because those rates will be verifiable in the near future. We found that the Company did not support its assertion of a sustained long-term growth rate of 6.0 percent based on nominal GDP forecasts. As Staff states in its Answer, the use of ICNU's growth rate acted as the "surrogate" for long-term growth rates.⁵¹ Nonetheless, we did not conjure up short-term growth rates; we selected those rates from the evidence in the record.⁵² The crux of PacifiCorp's argument is really disagreement that we found more credible the testimony of another party.

⁴⁷ Order 06 ¶ 92.

⁴⁸ In addition, in its Answer, ICNU cites yet another Northwest case decided shortly before the Avista case setting the ROE for Portland General Electric at 10.0 percent, again an ROE lower than that requested by PacifiCorp. ICNU's Answer *citing Re Portland General Electric Co.*, Docket No. UE 215, Order No. 10-478 (December 17, 2010).

⁴⁹ PacifiCorp's Petition ¶¶ 55 – 56.

⁵⁰ Order 06 ¶ 76.

⁵¹ Staff's Answer ¶ 30, Order 06 ¶ 82.

⁵² Order 06 ¶ 82.

- 30 In any event, as ICNU notes in its Answer, PacifiCorp’s argument on this issue is “strange.”⁵³ ICNU is correct that if we agree with PacifiCorp that the DCF model requires the use of long-term growth rates and we are leery of the sustainability of those rates, we are more likely to lean on the results of the risk premium and CAPM methodologies. The range of risk premium derived ROEs is 9.4 to 9.8 percent and those derived CAPM are as low as 8.8 percent.⁵⁴ A midpoint ROE using either of those methodologies would result in setting PacifiCorp’s ROE well below 9.8 percent.
- 31 *Security Analysts’ Growth Rates.* While PacifiCorp argues that we should not rely on short-term growth rates, if we decide to take that route it contends that we should give more weight to ICNU’s constant growth DCF model which results in a 10.5 percent ROE.⁵⁵ As we stated in our Order, we gave substantial weight to ICNU’s DCF analysis and its criticism of the Company’s DCF analysis concluding that the range of DCF-derived ROEs should be 9.55 to 10.21 percent.⁵⁶ Each of ICNU’s DCF analyses was given equal weight, a process that smooths the variations produced at either extreme of the range of reasonableness. We selected an ROE that is approximately the mid-point of that range. PacifiCorp did not present persuasive argument for us to give greater weight to the DCF analysis that produces a result exceeding the peak of the DCF-derived range.
- 32 *Contradictory Economic Conclusions.* PacifiCorp argues that our DCF analysis is based on contradictory economic conclusions, finding a conflict between our conclusions that conditions in the financial market have returned to a more normal state and that utility stocks are generally safer investments in times of turmoil. As Commission Staff and ICNU point out, these conclusions are not contradictory.⁵⁷ We

⁵³ ICNU’s Answer ¶ 27.

⁵⁴ Order 06 ¶ 93.

⁵⁵ PacifiCorp’s Petition ¶¶ 57 -59.

⁵⁶ Order 06 ¶ 93.

⁵⁷ Staff’s Answer ¶¶ 38 – 41, ICNU’s Answer ¶¶ 30 – 31.

must view both halves of the equation and recognize that while utility stocks have not rebounded like non-utility stocks, neither did they sink as low as the general financial market during the worst times of the financial crisis. In other words, utility stocks are less risky than non-utility stocks. This is not a novel concept precipitated by the financial crisis. Utility stocks are generally considered safer, although lower-earning, than investments in non-utility enterprises.⁵⁸

33 *CAPM Analysis.* The Company argues that our reliance on CAPM was inconsistent with our precedent in the PSE rate case where we gave CAPM results diminished weight.⁵⁹ PacifiCorp is incorrect. We acknowledged that “while the CAPM results seem abnormally low those results, *at a minimum*, reflect a reason to be skeptical about the need for higher ROEs for investors in this stagnant economy.”⁶⁰ Our use of the phrase “at a minimum” clearly indicates that this method was not given substantial weight but rather, was used more as a gauge of the reasonableness of the results of other methods.⁶¹ We went on to note that while Staff and ICNU used this method as a “check” of the results of the other methodologies, PacifiCorp chose to not even present this methodology because the results were “artificially low” or would not pass the “smell test.”⁶²

34 The foregoing discussion only emphasizes the importance of considering a variety of methodologies to determine cost of equity. PacifiCorp rejected outright the use of the CAPM. This results-oriented approach had the effect of driving up the cost of equity promoted by the Company. While we openly stated that we gave substantial weight to ICNU’s DCF analysis,⁶³ we adopted the approach promoted by Staff and ICNU and used the CAPM analysis as a “check” on our range of reasonableness.⁶⁴ We

⁵⁸ ICNU’s Answer ¶ 31, Staff’s Answer ¶¶ 39 – 40.

⁵⁹ PacifiCorp’s Petition ¶ 62.

⁶⁰ Order 06 ¶ 90. (emphasis supplied).

⁶¹ Order 06 ¶¶ 90 – 91.

⁶² Order 06, ¶ 91, n. 130.

⁶³ Order 06 ¶ 93.

⁶⁴ Order 06 ¶¶ 88 -90.

reiterate that using each of the various methods to calculate cost of equity produces a more balanced approach and has a leveling effect on the limitations of any particular model.⁶⁵

35 *Rejection of Regression Analysis.* Finally, the Company contends that there is no evidentiary basis for rejecting its regression analysis in its risk premium model and the effective conclusion that the equity risk premium is constant in all economic circumstances.⁶⁶ That is incorrect: ICNU and Staff opposed PacifiCorp’s regression analysis, explaining that the alleged inverse relationship between equity risk premiums and interest rates should not occur during times of low inflation without significant interest rate volatility.⁶⁷ There was substantial evidence in the record opposing this analysis and it was reasonable to reject the Company’s analysis on the basis of that evidence. Moreover, we reiterate our conclusion that we are skeptical that precise results can be derived from future estimated projections.⁶⁸ By their very definition, “estimates” and “projections” have a degree of imprecision that can only be verified by hindsight.

36 *Conclusion.* For the foregoing reasons, we deny PacifiCorp’s Petition on the appropriate cost of equity.

3. Net Power Costs

a. Arbitrage Sales Margin

37 By Order 06, we adopted Staff’s and ICNU’s proposal to include arbitrage sales revenues in our calculation of net power costs (NPC). We selected ICNU’s calculation of arbitrage sales revenues favoring the four-year average of actual operations over the proxy sales in the Company’s Generation and Regulation

⁶⁵ Order 06 ¶¶ 91.

⁶⁶ PacifiCorp’s Petition ¶¶ 63 – 64.

⁶⁷ ICNU’s Answer ¶ 35, Gorman, Exh. No. MPG-1T at 50, Staff’s Answer ¶¶ 25, 35 – 37.

⁶⁸ Order 06 ¶ 86.

Initiatives Decision tools model (GRID).⁶⁹ Our decision rejected Staff’s proposal to “share” 10 percent of the arbitrage sales revenues with the Company thereby increasing operating revenues by \$585,784.⁷⁰

38 In its Petition, the Company contends that we erroneously concluded that it did not argue that Staff’s and ICNU’s numbers are not representative of arbitrage sales revenues.⁷¹

39 In support of its argument, the Company provides reference to testimony regarding trading transactions and its cross-examination of ICNU’s witness, Mr. Randall Falkenberg. Specifically, in response to inquiry by the Company regarding whether including trading transactions would reduce arbitrage revenues, Mr. Falkenberg agreed.⁷² And, in response to inquiry regarding whether the adjustment would be lower if based on the most recent year of historical data, Mr. Falkenberg also agreed that there was a downward trend through the recession.⁷³

40 Because we specifically rejected the GRID model’s system of balancing sales and purchases in favor of the four-year average of actual sales, we believed that it was apparent that we were not persuaded to include trading transactions. Moreover, we believe that Mr. Falkenberg effectively deflected the Company’s cross-examination regarding the downward trend in arbitrage sales revenues during the last historical year by stating that “one of the reasons for using [a] four-year average is to normalize out things that happen in a single year.”⁷⁴ Finally, the Company did not propose an arbitrage sales adjustment that included trading transactions. Instead, it relied on the GRID model’s results to serve as a proxy for these sales. Thus, we reached the

⁶⁹ Order 06 ¶¶ 106 – 13.

⁷⁰ Order 06 ¶ 113.

⁷¹ PacifiCorp’s Petition ¶ 33.

⁷² Falkenberg, TR. 667.

⁷³ *Id.*

⁷⁴ *Id.*

conclusion that the Company “did not argue” that Staff’s and ICNU’s numbers are not representative of the sales the Company would anticipate during the rate year. We now see that our ruling was not clear and that it would have been more transparent had we stated that the Company did not *effectively* or *persuasively* argue that the sales were not representative. Accordingly, we clarify our ruling.

41 In our ruling we intentionally did not consider trading transactions because we believe that Staff persuasively argued against including such transactions.⁷⁵ Moreover, we believe that ICNU convincingly demonstrated the need to use a four-year average to normalize the effect of aberrant years’ data. Accordingly, we clarify that PacifiCorp did not persuasively argue that Staff’s and ICNU’s adjustments are not representative of anticipated arbitrage sales for the rate period.

42 Moreover, while the Company argues that a lesser arbitrage sales revenue adjustment may be warranted, it did not provide any evidence in support of such an adjustment. For the foregoing reasons, we deny the Company’s Petition regarding this issue.

b. Wind Intra-Hour Integration Cost

43 In our Final Order, we accepted Staff’s and ICNU’s proposal to remove the intra-hour wind integration costs for non-owned facilities for two reasons. First, we determined that the Company failed to meet its burden of proof that the costs are known and measurable.⁷⁶ Second, we determined that the Supremacy Clause of the United States Constitution does not require that we pass through these costs.⁷⁷ Rejecting these costs reduced net power cost expense by \$518,692.⁷⁸

44 In its Petition, PacifiCorp argues that we erred in both conclusions. The Company argued further that should the Commission reject this request, the Company requests

⁷⁵ Buckley, Exh. No. APB-1CT at 6 – 7.

⁷⁶ Order 06 ¶125.

⁷⁷ Order 06 ¶ 126.

⁷⁸ *Id.*

the Commission to recalculate the impact of rejecting these costs because they are overstated by approximately \$46,418.⁷⁹

45 However, as we noted in our Order, we accepted Staff's and ICNU's proposal to remove these costs for non-owned facilities concluding that "[A]ll costs for which a utility seeks recovery must be known and measurable."⁸⁰ We concluded that PacifiCorp failed to satisfy that burden.

46 The record on this issue is clear. Staff recommended that we remove all wind integration costs because the Company's costs failed to pass the known and measurable standard.⁸¹ Specifically, Staff questioned the reliability of the Company's data showing the cost increase since the last rate case.⁸² Staff was reasonable to question the reliability of the data because the cost increase was significant. The Company asserts that its costs for wind integration increased from \$1.15 per megawatt hour (MWh) to \$6.97 per MWh – a six-fold increase in just one year.⁸³ If updated, the cost would reflect an even greater increase, \$9.01 MWh.⁸⁴

47 Moreover, although the Company filed for rate relief in May 2010, Staff noted that the study updating these costs was anticipated in August 2010, but not actually completed until September 2010.⁸⁵ Staff and Intervenor testimony was due in October. Staff contended that it did not have the opportunity to review and analyze the updated study because it was filed late, shortly before Staff's testimony was due, and because of its complexity and numerous revisions.⁸⁶ We concluded that

⁷⁹ PacifiCorp's Petition ¶¶ 42 - 45.

⁸⁰ Order 06 ¶ 125.

⁸¹ Order 06 ¶ 119. ICNU also opposed recovery of these costs contending that they were inaccurate and high. Order 06 ¶¶ 121 – 22.

⁸² Order 06 ¶ 120.

⁸³ Order 06 ¶¶ 118, 125.

⁸⁴ Order 06 ¶¶ 120, 125.

⁸⁵ Order 06 ¶ 120.

⁸⁶ *Id.*

PacifiCorp failed to satisfy its burden to demonstrate that these costs are known and measurable.

48 We further concluded that the Company could not “evade its evidentiary burden by claiming that the costs are associated with a FERC tariff. A utility cannot use a federal tariff to justify its failure to quantify the costs for which it seeks recovery in a state proceeding.”⁸⁷

49 In its Supremacy Clause argument, the Company makes the blanket statement that “[t]he Commission is preempted from disallowing wind integration costs associated with non-owned facilities.”⁸⁸ This argument fails for at least two reasons. First, taken to its logical extreme, it would mean that we must allow recovery of these costs even if the utility does not present sufficient evidence supporting these costs and even if these costs are not known and measurable. This is an absurd conclusion. In any event, the Company does not demonstrate that there is federal intent to supplant all evidentiary and regulatory standards regarding costs submitted for state commission approval. Accordingly, we will continue to require substantial evidence in the record to support a request for cost recovery and will continue to require a demonstration that costs are known and measurable.

50 Second, as Staff aptly points out in its Answer, the cases cited by PacifiCorp in its Petition do not support its contention that we are preempted from excluding these costs.⁸⁹ We establish rates for *intrastate* electric service provided to Washington ratepayers. The cases cited by the Company involve the provision of intrastate services using resources governed by FERC.⁹⁰ These cases are distinguishable from the current circumstance because PacifiCorp is not using these resources to provide

⁸⁷ Order 06 ¶¶ 125 – 26.

⁸⁸ PacifiCorp’s Petition ¶ 38.

⁸⁹ Staff’s Answer ¶¶ 56 – 58.

⁹⁰ *Nantahala Power & Light Co. v. Thornberg*, 476 U.S. 953 (1986); *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354 (1988).

intrastate service to Washington retail customers.⁹¹ And we note that, if it were, we would apply the applicable regulatory and evidentiary standards. PacifiCorp's Petition is denied.

51 Finally, in the event we do not set aside our ruling, PacifiCorp requests that we correct an error in the calculation of the intra-hour wind integration adjustment and reduce the adjustment by \$46,418 to \$472, 274. Staff agrees that the Commission should so reduce the adjustment if we deem this amount material.⁹²

52 We agree that there may be an error in this calculation. However, given the magnitude of the overall rate increase, the impact of this recalculation would have a *de minimis* impact on the resulting rates. This, coupled with the fact that it was PacifiCorp's error, leads us to conclude that we should not order a rate recalculation to give effect to the correction of this error. The Company had an adequate opportunity in rebuttal testimony to quantify the appropriate level of adjustment. It failed to do so. While the amount of the error would have *de minimis* impact, we concur with ICNU that it is inappropriate to allow companies to correct their errors on reconsideration because it may deprive other parties of the opportunity to evaluate and respond.⁹³ As we stated earlier in this Order, raising new adjustments on reconsideration denies the other parties due process and does not comply with our rules governing the adjudicative process.

c. Direct Current (DC) Intertie

53 In Order 06, we accepted Staff's and ICNU's proposal to remove the DC Intertie from the calculation of net power costs.⁹⁴ We did so because PacifiCorp failed to demonstrate that the contract would provide a benefit to Washington ratepayers during the rate year. The adjustment reduced net power cost expense by \$1,057,130.⁹⁵

⁹¹ Staff's Answer ¶ 58; Order 06 ¶ 126.

⁹² Staff's Answer ¶ 61.

⁹⁴ Order 06 ¶¶ 148 – 52.

⁹⁵ Order 06 ¶¶ 148, 152.

- 54 The Company argues, in its Petition, that the record shows that the contract will be used during the period rates will be in effect.⁹⁶ It specifically cites oral testimony that the Company uses the line for over 200 transactions a year and at a rate that compares favorably with the Bonneville Power Administration's capacity charge.⁹⁷
- 55 We deny PacifiCorp's Petition on this point for two related reasons. First, we agree with Staff's argument that 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."⁹⁸ In other words, the issue is not simply whether there existed in the test year at least one transaction on the Intertie but whether the Company also included benefits. It did not.⁹⁹
- 56 Second, the evidence in the record of use of the Intertie was less than robust. The evidence cited was the oral testimony of Company witness, Mr. Gregory Duvall, regarding the Company's rebuttal testimony that the contract should be judged on the basis of information known at the time the contract was entered into in 1994, Mr. Duvall testified:

⁹⁶ PacifiCorp's Petition ¶¶ 30 -32.

⁹⁷ PacifiCorp's Petition ¶ 31, *citing* Duvall, TR. 304.

⁹⁸ Staff's Answer ¶ 44.

⁹⁹ *See* Staff's Answer ¶¶ 43-47. Indeed, in its Petition, PacifiCorp notably ignores the language in our Order regarding a Company's obligation to demonstrate benefits. Specifically, we noted the Company's "ongoing obligation to manage the resource . . . to provide a benefit to . . . its ratepayers." Order 06 ¶ 148. We concluded that "PacifiCorp failed to demonstrate that the DC intertie contract would provide benefits to Washington ratepayers during the rate year." Order 06 ¶ 152. In its Answer, Staff accurately notes that a utility must demonstrate benefits that at least equal costs if a utility expects cost recovery. Staff's Answer ¶ 47. As we stated earlier, the Company did not cite ratepayer benefits but rather relied on the results of its GRID model (which do not reflect any transactions) and its argument that we should consider whether the contract was prudent when entered into. This reliance led to the obvious conclusion that the Company failed to demonstrate any benefits or, stated differently, meet its burden of proof.

[A]s I read Mr. Falkenberg's testimony, it looks like he's concerned with the used and useful aspect of it in the *current day*. And I believe that it is used and useful in that we - - it's connected to a *California market* which is the Nevada-Oregon border, and we do about 200 transactions a year at the Nevada-Oregon border, 75,000 megawatts a year.¹⁰⁰

So the evidence of use is only from cross-examination. There was no evidence of use in the Company's prefiled testimony and exhibits. While connection to a California market, with some transactions, could conceivably provide benefit to Washington in the form of reduced-cost power purchases, the entirety of the Company's evidence does not support such a conclusion. The Company's prefiled testimony and exhibits relied on the output of its GRID model. The GRID model does not reflect either these or *any* other energy transactions at the Nevada-Oregon border utilizing PacifiCorp's DC intertie transmission rights. In addition, according to other parties, no information on these transactions was provided during discovery.¹⁰¹ Thus, even generously construing Mr. Duvall's oral testimony, we can only conclude that the Company presented conflicting evidence on this issue. Moreover, the Company's rebuttal testimony focused not on these, or any other transactions, but rather on viewing the prudence of the contract at its inception.

57 We deny the Petition for Reconsideration on this point.

d. Minimum Loading and Deration Adjustment

58 By Order 06, we accepted ICNU's minimum loading and deration adjustment to lower both the maximum capacity of a plant and the lower end of the unit's operating range to account for forced outages in the GRID model.¹⁰² ICNU's adjustment also

¹⁰⁰ Duvall, TR. 303 – 04 (emphasis supplied).

¹⁰¹ ICNU's Answer ¶¶ 6 – 7, 9.

¹⁰² Order 06 ¶¶ 190 – 91.

modified the heat rate curve to reflect the de-rated capacity of the plant.¹⁰³ Our acceptance of this adjustment reduced NPC expense by \$299,897.¹⁰⁴

59 In its Petition, PacifiCorp argues that the minimum loading and deration adjustment adopted by the Commission is erroneous and not supported by substantial evidence in the record.¹⁰⁵ Specifically, it contends that we did not consider its evidence that the deration adjustment will only apply if a unit is dispatched at its maximum capacity and that there are many hours of dispatch below the derated maximum capacity during which the adjustment would understate the heat rate.¹⁰⁶ In addition, it argues that the adjustment reduces the minimum generation of units below their technical capability resulting in unrealistic reductions to NPC.¹⁰⁷ It concludes that our decision did not address all of its arguments.

60 The Company accurately notes that our Order did not cite each and every argument it presented. We do not believe that we have an obligation to do so. As we stated in Order 06, “[u]ltimately, the Company has the responsibility to develop a computer model to determine NPC and the burden to demonstrate that the model is well-designed.”¹⁰⁸ In other words, the Company has the burden of proof. Our conclusion on this issue was simply that, while it was a “close call,” we concluded that the Company did not meet that burden and its evidence was effectively rebutted by ICNU’s proposal regarding an effective method to account for the usable range of generation unit’s variable output.¹⁰⁹ In other words, we based our decision on evidence in the record – that offered by ICNU which we found to be the more credible approach for modeling minimum loading and deration adjustments for

¹⁰³ Order 06 ¶ 188.

¹⁰⁴ Order 06 ¶ 191.

¹⁰⁵ PacifiCorp’s Petition ¶¶ 46 - 48.

¹⁰⁶ PacifiCorp’s Petition ¶ 47.

¹⁰⁷ *Id.*

¹⁰⁸ Order 06 ¶ 190.

¹⁰⁹ Order 06 ¶ 191.

thermal units in this case. Having found one reason to reject the Company's proposal (albeit the one essential for PacifiCorp to prevail), failure to meet the burden of proof, we do not believe it is necessary to systematically reject each and every other argument posed by PacifiCorp. The Petition for Reconsideration on this issue is denied.

4. Federal Income Tax: Normalization or Flow-Through

61 In our Final Order, we rejected PacifiCorp's proposal to move to full income tax normalization accounting for regulatory rate-setting purposes.¹¹⁰ We noted that a decision to allow full normalization is a significant policy decision because we have "used flow-through accounting for income taxes generally since liberalized depreciation was first introduced into tax law."¹¹¹ We concluded that PacifiCorp failed to meet its burden of proof to demonstrate that full income tax normalization is the most beneficial to the company and ratepayers, and we upheld our long-standing policy of flow-through accounting.¹¹² We also adjusted rate base to revise the accumulated deferred income tax (ADIT) amount to reflect normalization of \$6.4 million in taxes associated with certain regulatory assets deferred by Commission decisions.¹¹³

62 In its Petition, the Company argues that the Commission essentially approved an *ad hoc* approach that directs PacifiCorp to use flow-through accounting in certain circumstances and normalized accounting in others.¹¹⁴ It contends that the Commission did not set forth standards regarding when each approach would be used creating uncertainty for utilities. Finally, PacifiCorp objects to the Commission's ruling that the Company did not meet its burden of proof because it did not quantify the effect of its proposal. PacifiCorp now estimates that adoption of full income tax

¹¹⁰ Order 06 ¶¶ 277 - 281.

¹¹¹ Order 06 ¶ 277.

¹¹² Order 06 ¶ 278.

¹¹³ Order 06 ¶¶ 279 – 281.

¹¹⁴ PacifiCorp's Petition ¶¶ 8 – 11.

normalization for flow-through effects from past periods would create a regulatory asset of \$1.6 million, which would be negligible if amortized over a 5 or 10 year period.¹¹⁵ At a minimum, the Company sought clarification of the Commission’s policy on this issue.

63 Ironically, the Company’s Petition now provides us for the first time with PacifiCorp’s calculation of the rate impact of full income tax normalization – the very information that PacifiCorp previously argued that it could not quantify “without our approval to fully normalize taxes, a situation it explains as a ‘regulatory Catch-22.’”¹¹⁶ Providing such information in a petition for reconsideration, however, is too late in the process to be considered. PacifiCorp had every opportunity to include this information in its testimony, and presenting new evidence at this stage in the proceeding implicates the due process rights of other parties, as they were not provided with notice and an opportunity to be heard.

64 We nevertheless will grant the Company’s request for clarification. Staff’s Answer does an excellent job of summarizing our policy on income tax treatment.¹¹⁷ Our general policy requires flow-through accounting for federal income taxes when permitted by the Internal Revenue Code, except in two circumstances when tax normalization treatment is more appropriate. The first exception is in circumstances in which we approve cost deferral particularly when such treatment for regulatory assets (including federal income taxes) deferred by a utility pursuant to RCW 80.80.060(6) and WAC 480-100-435 is consistent with normalization. The second exception is where a particular item, such as the repairs deduction, has a significant impact on ratepayers and the utility. Our treatment in this case was entirely consistent with the foregoing policy. We continued our long-standing use of flow-through accounting except in the prescribed circumstances that warrant normalization. We deny reconsideration of this issue.

¹¹⁵ PacifiCorp’s Petition ¶¶ 13 – 15.

¹¹⁶ Order 06 ¶ 278.

¹¹⁷ Staff’s Answer ¶ 66. Staff’s Answer also notes that neither of the other two major electric utilities within our jurisdiction appears to share PacifiCorp’s confusion with that policy. Staff’s Answer ¶¶ 68 – 69.

ORDER

THE COMMISSION ORDERS:

- 65 (1) The Petition for Reconsideration filed by PacifiCorp d/b/a Pacific Power &
Light Co. on April 4, 2011, is denied.
- 66 (2) The Petition for Reconsideration filed by the Commission Staff on April 4,
2011, is denied.
- 67 (3) PacifiCorp's request for clarification of the Commission's policy on income
tax normalization is granted.

DATED at Olympia, Washington, and effective May 12, 2011.

WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

JEFFREY D. GOLTZ, Chairman

PATRICK J. OSHIE, Commissioner

PHILIP B. JONES, Commissioner