

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

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PACIFIC POWER & LIGHT
COMPANY, d/b/a PACIFICORP,

Respondent.

DOCKET UE-140762 and UE-140617
(*consolidated*)

In the Matter of the Petition of

PACIFIC POWER & LIGHT
COMPANY,

For an Order Approving Deferral of Costs
Related to Colstrip Outage.

DOCKET UE-131384 (*consolidated*)

In the Matter of the Petition of

PACIFIC POWER & LIGHT
COMPANY,

For an Order Approving Deferral of Costs
Related to Declining Hydro Generation.

Docket UE-140094 (*consolidated*)

REPLY BRIEF OF PUBLIC COUNSEL

February 3, 2015

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I. INTRODUCTION

1. Public Counsel's Initial Brief has addressed most of the issues raised by Pacific Power in its Opening Brief. This Reply Brief will emphasize only a few points by way of response. Overall, Pacific Power has failed to carry its burden of proof to support its rate increase request,¹ or to support increased returns for its parent company owners, based on excessive equity capitalization and an increased return on equity. Pacific Power has also failed to justify its proposal for a dramatic increase to the monthly customer charge.

II. COST OF CAPITAL

A. Past Earnings Levels Are Not A Justification For Setting Cost Of Capital In This Case.

2. In support of its proposed rate of return, Pacific Power accuses Staff, Boise White Paper, L.L.C., and Public Counsel of ignoring that "the Company has earned nearly 600 basis points less than its authorized ROR since 2006."² This argument disregards the fact that since 2006 Pacific Power has filed six general rate cases in Washington, all of which have resulted in rate increases.³ Each case considered evidence about the level of revenue necessary for an opportunity to earn what the Commission determined to be a reasonable rate of return. The rate orders in those cases established rates that were "fair, just, reasonable, and sufficient"⁴ as a matter of law. None of the orders were found to be confiscatory or overturned on appeal.

¹ Public Counsel's Initial Brief refers to the Pacific Power rebuttal request of \$31.9 million. As Pacific Power's Opening Brief clarifies, as a result of changes in the last phase of the case, the Company's final revenue request is \$30.4 million. Pacific Power's Opening Brief, ¶ 1 (January 22, 2015) (Company Brief).

² Company Brief, ¶ 11.

³ The instant docket is Pacific Power's ninth general rate request since 2003. The prior dockets are UE-032065, UE-050684, UE-061546, UE-080220, UE-090205, UE-100749, UE-111190, and UE-130043.

⁴ RCW 80.28.020. *See, e.g., Wash. Util. & Transp. Comm'n v. PacifiCorp*, Docket UE-100749, Order 06, ¶¶ 372-378 (¶ 378: "The rates, terms, and conditions of service that will result from this Order are fair, just, reasonable, and sufficient.") (March 25, 2011).

3. Pacific Power's reliance on alleged past under-earning to justify its request is antithetical to fundamental and well-settled ratemaking principles:

Unless there are statutory provisions in place that authorize a subsidy to the regulated company, regulation provides the regulated company with an opportunity to earn a fair return but does not guaranty the company will earn it. The agency gives no guaranty that the company will realize the full amount of revenues requested by or allowed in the rate filing. The filing merely presents the regulated company with an opportunity to earn the return implicit in the filed rate.

The foregoing principle is also a rule of constitutional law. "A regulated [company] has no constitutional right to a profit." Regulation does not insure that the regulated business will produce net revenues. A rate is not necessarily confiscatory if it compels a regulated firm to "operate at a loss" having once given it, or its group of companies, the opportunity to operate at a profit.⁵

4. An important corollary to this principle is the rule against retroactive ratemaking, the "improper recovery of costs that were properly recoverable only in a past period or periods."⁶

As this Commission has stated, "[r]etroactive ratemaking ... is extremely poor public policy and is illegal under the statutes of Washington State as a rate applied to a service without prior notice and review."⁷ As explained in Professor Goodman's treatise:

the primary basis for disregarding past losses is that the investors in regulated companies have already been compensated for the possibility that losses may occur in the return allowance A further allowance after the fact would amount to a guaranty of the company's return, which is normally not available under regulation.⁸

5. Pacific Power is certainly entitled in this case to try to prove that it will need a stated level of revenue, prospectively, during the rate year to cover its costs, including the current cost

⁵ Leonard Saul Goodman, *The Process of Ratemaking*, Public Utility Reports, Inc. (1988) (Goodman) at 31-32 (citations omitted).

⁶ Goodman at 165-166.

⁷ *In the Matter of the Application of Puget Sound Energy for Authorization Regarding the Deferral of the Net Impact of the Conservation Incentive Credit Program*, Docket UE-010410, Order Denying Petition to Amend Accounting Order, 2001 WL 34797261, ¶ 7 (citations omitted).

⁸ Goodman at 293.

of capital, and earn a reasonable return. However, remedying alleged past under-earning between 2006 and 2014 may not lawfully be considered as support for a rate increase in this case.

B. Pacific Power's Interest Coverage Ratio Is A Metric Considered By Investors To Evaluate The Company's Financial Condition.

6. The Company brief argues that “Mr. Hill’s analysis showed a stronger credit metric under his revised ROR of 7.01 percent than under his original ROR of 7.32 percent, a facially unreasonable result.”⁹ The Company draws a wrong conclusion. When debt costs are reduced, in this case from the inflated 5.80% to the actual debt cost of 5.19%, the pre-tax interest coverage increases. This is because the same amount of operating revenues is divided by a smaller interest amount. What the Company characterizes as being “facially unreasonable” is a simple matter of arithmetic.¹⁰ Moreover, Public Counsel witness, Stephen G. Hill shows that the pre-tax interest coverage is higher than that enjoyed by PacifiCorp in the past five years and, thus, would reasonably support the Company’s financial condition.¹¹

7. Pacific Power also asserts that use of the interest coverage metric is “outdated.”¹² Mr. Hill is comparing the result of his ROE recommendation and PacifiCorp’s actual capital structure (i.e., the pre-tax interest coverage it produces) with the actual historical interest coverage of PacifiCorp, which is reported and available to the public in the Company’s Securities and Exchange Commission (SEC) Form-10K.¹³ Pacific Power implies that the metric

⁹ Company Brief, ¶ 56.

¹⁰ Mr. Hill’s step-by-step calculation of the interest coverage ratios under his initial and revised (corrected) rates of return are shown in Exhibits SGH-15 and SGH-15r.

¹¹ Revised Direct Testimony of Stephen G. Hill, Exh. No. SGH-1CTr at 58:10-19.

¹² Company Brief, at ¶ 56.

¹³ PacifiCorp 2013 Form 10-K, Exhibit 12.1 (p. 120 of 127). The 10-K was filed with the Company’s initial rate case filing in this docket.

is not used by investors because credit analysts use cash flow coverage of debt costs, rather than interest coverage. The SEC, however, requires reporting of the metric and investors are aware of it. Therefore, it is incorrect to imply that pre-tax interest coverage is not used or is not a proper comparator for financial strength.

C. Mr. Hill's Discounted Cash Flow (DCF) Growth Rate Analysis is Reasonable.

8. Pacific Power's brief questions the reliability of Mr. Hill's DCF growth rate analysis in the case, citing criticism by Puget Sound Energy's (PSE) witness in the 2009 general rate case (GRC), which the Commission found persuasive.¹⁴ Although this point was raised on cross-examination and brief by the Company, Mr. Strunk did not present his own independent analysis of Mr. Hill's growth rates in his rebuttal or identify it as a concern.¹⁵

9. Mr. Hill explained at the hearing why he has used this methodology for 30 years and continues to believe it is reliable. He testified that his approach is based on the Myron Gordon sustainable growth rate methodology along with other growth measures such as projected earnings, projected dividends, book value and other factors. Looking at these multiple factors is more comparable to what investors consider than a mechanistic "plug and play" approach based on analyst growth rate projections.¹⁶ In this case, Mr. Hill's testimony and exhibits provide a thorough and detailed explanation of his growth rate analysis.¹⁷ In Exhibit No. SGH-4, Mr. Hill provides an example and detailed explanation of the basic methodology for determining a sustainable growth rate. He describes the process he used in this case, which included use of

¹⁴ Company Brief, ¶ 40.

¹⁵ Rebuttal Testimony of Kurt Strunk, Exh. No. KGS-17T at 4:2-13 (not included in list of "key deficiencies"); *Id.* at 27:11-28:12 (one page covering analyst growth rates, Hill methodology not addressed).

¹⁶ Hill, TR. 248:14-19, 264:17-266:3.

¹⁷ Exh. No. SGH-1CTr at 36:7-46:22. *See also*, Exhibit No. SGH-4 (methodology); Exhibit No. SGH-6 (DCF Growth Rate Parameters, Value Line); Exhibit No. SGH-7 (DCF Growth Rate Comparisons with Zacks, Value Line, IBES); Exhibit No. SGH-8 (narrative detail describing development of each sample company growth rate).

published data regarding both historical and projected growth rates in earnings, dividends, and book values for the sample group of companies. Through an examination of all of these data, which are available to and used by investors, he estimated investors' long-term growth rate expectations. He then added an additional growth rate attributable to investor expectations regarding the ongoing sale of stock for each of the companies under review to arrive at a final growth rate.¹⁸

10. The reasonableness of Mr. Hill's growth rate is apparent from the comparison he provides with other publicly available sources, as shown in Exhibit No. SGH-7, page 2. That exhibit compares Mr. Hill's growth rate result with the five-year historic and projected earnings, dividends and book value growth rates from Value Line, earnings growth rates from Zacks or IBES, the average of Value Line and Zacks or IBES growth rates, and the five-year historical compound growth rate for earnings, dividends, and book value for each company under study.¹⁹ Mr. Hill's result of 5.09% falls between the projected Value Line growth rates (4.24% - 4.69%) and the IBES and Zacks growth rates (5.35% and 5.11%), thereby providing a reasonable estimate of the long-term growth rate investors expect.²⁰

11. While Pacific Power challenges Mr. Hill's DCF result, Mr. Strunk's own updated traditional (primary) DCF result is 9.0% -- only 11 basis points higher than Mr. Hill's result. Moreover, Mr. Strunk's DCF analysis is skewed upward by several factors. He places excessive reliance on earnings growth projections that incorporate sell-side analyst bias, omits companies

¹⁸ *Id.* at 36:16-37.

¹⁹ *Id.* at 42:10-17.

²⁰ *Id.* at 42:17-43:2. As an added comparison, Mr. Gorman derived the following DCF growth rates: constant growth of 5.21 %, Revised Direct Testimony of Michael Gorman, Exh. No. MPG-1Tr at 26:1-4; sustainable growth rate of 4.92 %, *id.* at 28:8; multi-stage DCF growth rate of 4.6 % to 4.8 %, *id.* at 32:4-14.

with zero or negative earnings growth expectations, and includes statistical outliers.²¹ He also uses a historically-oriented dividend yield that overstates forward-looking expectations. If these items are corrected, his traditional (primary) DCF result would be 8.75% -- below that of Mr. Hill.²²

12. Public Counsel respectfully submits that Mr. Hill's analysis should be reviewed on its own merits in the context of the evidence of this case. He explains his analysis in careful detail in testimony, including why he differs from the approach of the Company.²³ The fundamental parameters used by Mr. Hill to develop growth rates are based on publicly available²⁴ data and the results are corroborated by comparison with other public information. As the Commission has itself explained:

[M]uch of the dispute among the experts testifying [on cost of capital] involves "analytic judgment" concerning key data assumptions and model application. These disputes are not resolvable on the basis of objective tests – their resolution requires the application of considerable judgment when we review the expert testimony. In our experience, there is no precise or right answer.²⁵

13. Pacific Power's implication that cost of capital analyses must be free of subjective expert judgment makes no sense in this context. Essentially, Mr. Hill's analysis involves looking at all information available to stockholders, assessing that information, and distilling it into the long-term growth called for in the DCF model. Mr. Strunk, by contrast, relies heavily on published analyst-projected earnings growth rates, using them exclusively for his "Yield-Plus-

²¹ *Id.* at 60:1-64:2.

²² *Id.* at 68:5-14.

²³ *Id.* at 43 (explaining why primary reliance on analyst growth rate projections is insufficient).

²⁴ Pacific Power's brief misleadingly characterizes Mr. Hill's testimony as "admitting" that his growth rates are not based on publicly available data. Company Brief, ¶ 40, n.93. The testimony cited only states that "the reasonableness of the growth rate estimates for each company are checked against other publicly available sources in Exhibit No. 7, page 2[.]" Exh. No. SGH-1CTr at 42:8-16. Mr. Hill's own growth rate analyses parameters, presented in Exhibit No. SGH-6, are derived from Value Line.

²⁵ *Wash. Util. & Transp. Comm'n v. Puget Sound Energy*, Docket UE-090704/UG-0907058, Order 11, ¶ 293 (April 2, 2010) (PSE GRC 2009).

Growth” DCF.²⁶ The choice to use only one type of growth rate, when many others are available to stockholders, is itself highly subjective.

14. In the same *PSE 2009 GRC* order section cited by the Company, the Commission disapproved this approach, rejecting PSE’s DCF results because “they rely solely on analysts’ forecasts of earnings growth, without benefit of historical rates of growth or other information published by the analysts or other reputable financial sources.”²⁷ Mr. Hill’s testimony explains the multiple problems with Mr. Strunk’s over-reliance on analyst growth projections.²⁸ Mr. Strunk does not respond to most of these concerns in rebuttal, commenting primarily that analyst conflicts of interest and “rosy” sell-side bias in predictions are now a thing of the past.²⁹

D. Pacific Power Unfairly Characterizes Mr. Hill’s Debt Cost Error.

15. As it did at hearing, Pacific Power continues to suggest some sort of improper intent in Mr. Hill’s correction of his inadvertent use of the Company’s requested cost of debt figure in his rate of return calculation. Mr. Hill acknowledged that he mistakenly used Pacific Power’s 5.8% cost of debt in his original calculations instead of his recommended 5.19% (the actual debt cost).³⁰ Although the wrong number was inserted in the calculation, Mr. Hill’s initial narrative testimony contained a full rationale for his support of the 5.19% debt cost, expressly referencing that figure, and also included a critique of the Company’s proposal to use an inflated debt cost of 5.8%.³¹ No changes to his substantive narrative testimony were necessary.³² Mr. Hill’s

²⁶ Direct Testimony of Kurt G. Strunk, Exh. No. KGS-1T at 11:12-14. Mr. Strunk’s primary DCF is based on analyst projections and the estimated sustainable growth rate. His “Yield-Plus-Growth” DCF Model uses only analyst projections. *Id.* at 12:20 and Exh. No. KGS-11.

²⁷ *PSE GRC 2009*, Order 11, ¶ 299 (agreeing with Mr. Hill’s critique of Morin DCF analysis).

²⁸ Exh. No. SGH-1CTr at 43:6-46:20.

²⁹ Rebuttal Testimony of Kurt G. Strunk, Exh. No. 27:16-28:7.

³⁰ Hill, TR. 241:6-9.

³¹ Exh. No. SGH-1CT and Exh. No. SGH-1CTr at 32:12-33:18 (stating “5.19 %, I believe that is also reasonable for ratemaking purposes”), and at 27:3-28:16 (critique of Williams’ 5.8 % recommendation).

³² Hill, TR. 262:14-263:4.

testimony was revised only to input the corrected results of his calculations. The mistake was remedied less than eight business days after the error was discovered in reviewing Mr. Williams' rebuttal testimony.³³ Pacific Power received the relief it sought to address the error, by providing live supplemental rebuttal at the hearing. Pacific Power's continued references to this issue after the hearing are merely an effort to distract from the flaws in its own cost of debt and capital structure request and should be given no weight.

III. REVENUE REQUIREMENT

A. Wages and Labor.

16. Pacific Power's brief highlights, again, the Company's desire to include speculative future costs in rates. The Company attempts to argue that its pro-forma wage and salary expense adjustment is consistent with the Commission's direction in the last Pacific Power case, allowing pro-forma adjustments for such costs for 12 months after the end of the test year. Simultaneously, Pacific Power acknowledges that its "adjustments in this case extend farther" than the December 31, 2014, period allowed in the last order.³⁴ In addition, the Company includes recovery for increases that are only "planned."³⁵
17. The Company opposes Public Counsel's conservative recommendation to reflect that Pacific Power's employee count has been declining for over three years.³⁶ The Company brief

³³ Hill, TR. 241:10-14. Mr. Hill stated he did not review the Williams rebuttal until some days after the November 14 filing. The full time period between the Company rebuttal filing on November 14 and Mr. Hill's revised testimony filing encompassed eight business days and the Thanksgiving Holiday. Ms. Donna M. Ramas' testimony also had to be revised and refiled during this period to reflect the Hill change. Public Counsel filed the Hill and Ramas revised testimony on December 1, the first business day after the Thanksgiving Holiday. Mr. Hill and Public Counsel were also preparing testimony filings for the PSE Rate Plan Remand docket for filing on December 3.

³⁴ Company Brief, ¶ 130.

³⁵ *Id.* ("The adjustment relies on union contracts, as well as known, committed, or planned increases for the non-union workforce." (emphasis added)).

³⁶ The recommendation is conservative because it is based on the June 2014 FTE count, even though the employee level continued to decline for the remainder of the year (except for a small increase in November).

does not dispute the data showing that the actual full time equivalent (FTE) employee count is declining, but argues that rates should be based on an “updated business plan” for the end of 2015 and a “budgeted complement” of staffing that is “likely” to be incurred.³⁷ The Commission has been clear, however, that reliance on this type of projection is not a sufficient basis for rate setting.³⁸

B. Adjustments Based On The IHS Global Insight Escalation Indices Should Be Rejected.

18. Pacific Power challenges Public Counsel’s position on the IHS factors by arguing that Public Counsel “supports numerous pro-forma adjustments to the historical test year.”³⁹ The statement is true, but not relevant, since the Commission’s own rules expressly allow for pro-forma adjustments to test year expense as long as they are for known and measurable items.⁴⁰ In this case, Public Counsel indeed supports a number of pro-forma adjustments, but only for items that are known and measurable.⁴¹ The Company does not and cannot represent that IHS Global Insight indices, which are merely estimates or projections, reflect known and measurable costs. Moreover, as Staff’s Brief explains, the IHS estimates are industry-wide, not tied specifically to PacifiCorp or its service territory.⁴²

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³⁷ Company Brief, ¶ 132.

³⁸ *PSE 2009 GRC*, Order 11, ¶ 26 (A known and measurable change “typically cannot be an estimate, a projection, the product of a budget forecast, or some similar exercise of judgment – even informed judgment – concerning future revenue, expense or rate base.”).

³⁹ Company Brief, ¶ 136.

⁴⁰ WAC 480-07-510(3)(b)(ii).

⁴¹ *See, e.g.*, Major Plant Additions, Revised Direct Testimony of Donna M. Ramas, Exh. No. DMR-1TCr at 12:19 -17:18; Post Test-Year Wage Increases, *id.* at 19:10-21:23.

⁴² Initial Brief on Behalf of Commission Staff (Staff Brief), ¶ 139 (citing Company testimony).

IV. RATE SPREAD AND RATE DESIGN ISSUES

A. Pacific Power Misunderstands Public Counsel Testimony Regarding Energy Sales and Peak Load.

19. Pacific Power takes issue with Public Counsel witness, Glenn A. Watkins on the issue of Company energy sales and peak loads. The Company appears to misunderstand Mr. Watkins' testimony on this topic. Mr. Watkins responds to Staff witness Jeremy Twitchell's argument that, absent decoupling, Pacific Power is in need of a substantially increased monthly basic charge to deal with declining loads.⁴³ In support of this argument, Mr. Twitchell offered the statement that "[s]ince peaking in 2005, the Company's *annual load* in Washington declined by an average of 0.67 percent per year through 2013."⁴⁴ In response, Mr. Watkins testimony presented data showing that Pacific Power's Washington retail energy sales in fact increased between 2010 and 2014,⁴⁵ and suggested that Mr. Twitchell was confusing energy sales with peak load. To further illustrate this point, Mr. Watkins went on to cite the Company's own recently updated Integrated Resource Plan (IRP) projections that residential sales are forecasted to increase slightly between 2014 and 2023, and that residential peak demand (load) was projected to decrease in the near term.⁴⁶

20. Mr. Watkins's testimony does not argue that residential energy sales are seeing robust growth, but simply points out an apparent error in Staff testimony, making the point that Pacific Power does not appear to be facing a crisis of declining energy (kWh) sales, which are the basis

⁴³ Cross Answering Testimony of Glenn A. Watkins, Exh. No. GAW-6T at 16:10-18 (quoting Jeremy B. Twitchell, Exh. No. JBT-1T at 26:15-22).

⁴⁴ Exh. No. GAW-6T at 16:25-26 (quoting JBT-1T at 23:18-21) (emphasis added).

⁴⁵ Exh. No. GAW-6T at 17 (Table II).

⁴⁶ *Id.* Pacific Power, in footnote 417 of the Company Brief, cites sales information not in the record and not previously referenced. No request was made for official notice and the record closed prior to the filing of the Company Brief.

of residential volumetric rates and revenues. To the extent that Pacific Power seeks to reduce its risk due to any possibility of declining revenues per customer, the Commission has approved use of a decoupling mechanism to address the issue. The Company's lack of interest in this remedy calls into question the magnitude of the problem in the case of Pacific Power.

B. The Company Fails To Establish That Fixed Costs Must Be Recovered Via The Monthly Customer Charge.

21. Pacific Power's advocacy for an 81% increase in its basic charge is based largely on the premise that fixed costs, such as distribution costs, should be recovered through fixed monthly charges, rather than variable energy rates.⁴⁷ The Company brief cites no authority for this premise, and ignores clear Washington precedent to the contrary.

22. Pacific Power's position is incorrect. To summarize Mr. Watkins' testimony, in order to emulate efficient competitive market pricing, utility ratemaking should recognize the economic principle of long-run marginal costs, where all costs are variable or volumetric in nature.⁴⁸ Efficient competitive pricing results from the incremental variability of costs, even though a firm's short run cost structure may include a high percentage of fixed costs. Utility marginal costs fall into three separate categories: demand, energy and customer charges.⁴⁹ Marginal customer costs include only those costs that vary directly with the change in the number of customers: service lines, meters, and billing and accounting costs.⁵⁰

⁴⁷ Company Brief, ¶¶ 150-151.

⁴⁸ Direct Testimony of Glenn A. Watkins, Exh. No. GAW-1T at 21:14-22.

⁴⁹ Exh. No. GAW-1T at 9:15-22.

⁵⁰ Exh. No. GAW-1T at 20:1-6.

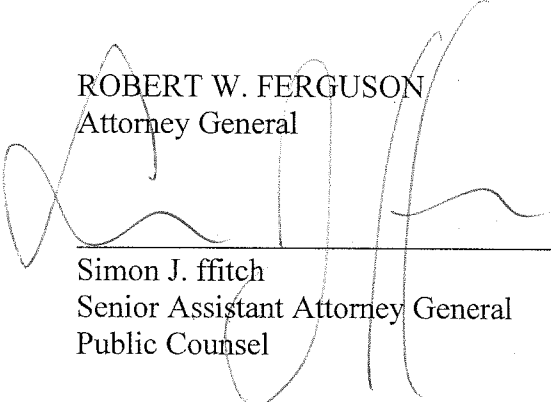
23. Consistent with this economic pricing theory, the Commission has strongly rejected the inclusion of distribution costs in the basic customer charge.⁵¹ Pacific Power has cited no subsequent authority that has reversed this ruling. Consistent with this analysis, Mr. Twitchell accepts treatment of distribution costs as 100% demand-related in his cost of service study.⁵² Nevertheless, in order to find cost justification for an increased monthly charge, Mr. Twitchell includes line transformer costs in his customer charge calculations. Not only was this approach rejected by the Commission, but the 1992 Commission decision states that these pricing principles apply regardless of the presence or absence of decoupling, further undermining Staff's rationale for a high customer charge in this case.⁵³

V. CONCLUSION

24. For the foregoing reasons, Public Counsel respectfully requests that the Commission reject the Pacific Power rate request in this case, and establish just, fair, reasonable, and sufficient rates, based on Public Counsel's recommendations.

DATED this 3rd day of February, 2015.

ROBERT W. FERGUSON
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Simon J. Ffitch
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Public Counsel

⁵¹ *Wash. Util. & Transp. Comm'n v. Puget Sound Power & Light Co.*, Docket UE-920433, Ninth Supplemental Order on Rate Design Issues, at 11 (*PSE 1992 Rate Design Case*). See also, Exh. No. GAW-6T at 18:1-20:6.

⁵² Exh. No. GAW-6T at 19:25-20:6.

⁵³ *PSE 1992 Rate Design Case*, Ninth Supplemental Order, at 11.