BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC V. PACIFICORP D/B/A PACIFIC POWER & LIGHT COMPANY

DOCKET NOS. UE-050684 and UE-050412

DIRECT TESTIMONY OF DAVID J. EFFRON (DJE-1T)

ON BEHALF OF THE

PUBLIC COUNSEL SECTION

NOVEMBER 3, 2005

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DIRECT TESTIMONY OF DAVID J. EFFRON
TABLE OF CONTENTS

		Page
I.	STATEMENT OF QUALIFICATIONS	1
II.	PURPOSE OF TESTIMONY	1
III.	REVENUE REQUIREMENT ISSUES	3
A.	DEFERRED DEBITS	3
B.	ELECTRIC PLANT ACQUISTION ADJUSMENTS	6
C.	PRO FORMA PLANT ADDITIONS	9
D.	OUT OF PERIOD REVENUE ADJUSTMENT	13
E.	CAPITAL STOCK EXPENSE	14
F.	INCENTIVE COMPENSATION	16
G.	IRS TAX SETTLEMENT	18
H.	INCOME TAXES	19

EXHIBITS AND ATTACHMENTS

Exhibit No. ___ (DJE-2) Resume of David J. Effron

Exhibit No. ___ (DJE-3) Revenue Requirement Effect of Adjustments

Exhibit No. ___ (DJE-4) Proposed Adjustments to Rate Base and Operating Income

Exhibit No. ___ (DJE-5) Rate of Return

1 ## I. STATEMENT OF QUALIFICATIONS

2 **Q. Please state your name and business address.**

3 A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield,
4 Connecticut.

5 **Q. What is your present occupation?**

6 A. I am a consultant specializing in utility regulation.

7 **Q. Please summarize your professional experience.**

8 A. I have analyzed numerous electric, telephone, gas and water rate filings in different
9 jurisdictions. Pursuant to those analyses, I have prepared testimony, assisted attorneys
10 in rate case preparation, and provided assistance during settlement negotiations with
11 various utility companies.

12 I have testified in approximately two hundred cases before regulatory
13 commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana,
14 Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey,
15 New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas,
16 Vermont, and Virginia.

17 My other professional experience and educational background are summarized
18 in Exhibit No. ___ (DJE-2) accompanying this testimony.

19 ## II. PURPOSE OF TESTIMONY

20 **Q. On whose behalf are you testifying?**

21 A. I am testifying on behalf of the Public Counsel Section of the Washington State
22 Attorney General's Office.

23 **Q. What is the purpose of your testimony?**

24 A. I am recommending certain adjustments to the rate base and pro forma operating
25 income under present rates of PacifiCorp, d/b/a Pacific Power & Light Company,

1 ("PacifiCorp" or "the Company") in this case. I also quantify the effect on revenue
2 requirements of the rate of return recommendations by Mr. Hill. My testimony
3 does not purport to address all issues affecting the determination of revenue
4 requirements in this case, as I have not reviewed the testimony of Staff and other
5 intervenors, and I take no position on revenue requirement issues addressed in their
6 testimony.

7 Q. **Have you calculated the revenue requirement effects of the adjustments to rate**
8 **base and pro forma operating income that you are proposing?**

9 A. Yes. The effect of my proposed adjustments on the Company's revenue
10 requirement is summarized on my Exhibit No. ___(DJE-3), Page 1. I have used the
11 Company's "Revised Protocol" allocation factors to quantify the effect of my
12 adjustments. My use of the "Revised Protocol" allocation factors should not be
13 construed as an endorsement of those factors for the purpose of determining the
14 Company's Washington cost of service, as I have not evaluated the system of
15 allocation factors that should be used in the present case. I have used the "Revised
16 Protocol" allocation factors only for the purpose of presenting my proposed revenue
17 requirement adjustments on a basis that is comparable to the Company's
18 development of its Washington cost of service.

19 In calculating the effect of adjustments that entail modifications to the
20 Company's proposed rate base, I have used the Company's rate of return on both
21 Pages 1 and 2 of my Exhibit No. ___ (DJE-3). I calculated the effect of the rate of
22 return adjustments proposed by Mr. Hill as the last two adjustments on my Exhibit
23 No. ___ (DJE-3), Pages 1 and 2. To be consistent with my calculation of the
24 revenue requirement effect of the rate base adjustments, I applied the rate of return
25 adjustments to the rate base net of the adjustments that I am proposing.

1 I show the effect of Mr. Hill's rate of return recommendation in two parts. I
2 first calculated the revenue requirement effect of Mr. Hill's return on equity
3 proposal. I then calculated the effect of his capital structure proposal assuming his
4 proposed return on equity.

5 On my Exhibit No. ___ (DJE-3), Page 1, I have calculated the revenue
6 requirement effect of my proposed adjustments with the effect of the adjustments
7 on interest synchronization implicitly included in the total revenue requirement
8 impact of those adjustments that affect rate base. On my Exhibit No. ___ (DJE-3),
9 Page 2, I have calculated the revenue requirement effect of my proposed
10 adjustments excluding the effect of the adjustments on interest synchronization, and
11 I show the effect on the interest synchronization of the rate base adjustments in the
12 aggregate as a separate line item. It is my understanding that the method on Exhibit
13 No. ___ (DJE-3), Page 2 is similar to the method customarily used by Staff in its
14 presentation of the revenue requirement effect of rate base adjustments.

15 **Q. What is the sum of your adjustments to the Company's Washington**
16 **jurisdictional revenue requirement?**

17 A. Including the adjustments to rate of return proposed by Mr. Hill, I have quantified
18 total adjustments that have the effect of reducing the Company's jurisdictional
19 revenue requirement by $25,564,000 (Exhibit No. ___ (DJE-3).

20 ## III. REVENUE REQUIREMENT ISSUES

21 ### A. DEFERRED DEBITS

22 **Q. Does the Company include miscellaneous deferred debits in its jurisdictional**
23 **rate base?**

24 A. Yes. The Company includes $7,597,000 of miscellaneous deferred debits in its
25 Washington jurisdictional rate base (Exhibit No. ___(PMW-3), Page 1.1).

1 **Q. What do these deferred debits represent?**

2 A. The deferred debits represent costs that were deferred by the Company at the time
3 they were incurred. The costs include $1,354,000 in Account 182 – Regulatory
4 Assets and $6,243,000 in Account 186 – Miscellaneous Deferred Debits.

5 **Q. Should these costs be included in rate base?**

6 A. No. In response to Public Counsel Data Request No. 37, the Company indicated
7 that it would remove $1,369,000 of deferred costs related to the Trail Mountain
8 Mine when it updates its case during the course of this proceeding. Further, based
9 on the settlement in Docket No. UE-032065, the deferred charges related to the
10 Trail Mountain Mine will be fully amortized in March 2006, when the rates
11 established in this case will go into effect.[1]

12 In addition, as I explain in section III-B of this testimony, $2,390,000 of
13 the deferred costs relate to a transition plan regulatory asset that existed during the
14 test year but will be fully amortized by the time the rates established in this case
15 go into effect. Therefore, the deferred cost related to the transition plan
16 regulatory asset should also be removed from the Company's rate base. Together
17 these two items represent $3,759,000, or nearly half of the deferred charges that
18 the Company has included in its rate base.

19 **Q. What about the remaining $3,838,000 of deferred charges?**

20 A. In Public Counsel Data Request No. 37, the Company was asked to provide
21 authorization by the Commission to include the deferred debits in rate base. The
22 Company responded that the Miscellaneous Deferred Debits included in rate base
23 in Docket No. UE-032065 are essentially the same as those included in this filing

[1] *WUTC v. PacifiCorp*, Order No. 6 Approving and Adopting Settlement Agreement Subject to Conditions; Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing, Docket No. UE-032065 (October 27, 2004) ("Sixth Order").

1 and that the Commission adopted a settlement agreement in that case that stated
2 that except as set forth in specific adjustments, regulatory assets and liabilities
3 were to be recognized in rates for the purpose of the settlement.

4 It is my understanding that the settlement in Docket No. UE-032065 also
5 specified that none of the settling parties should be deemed to have agreed that
6 any provision in the settlement is appropriate for resolving issues in any other
7 proceeding.[2] In other words, as I understand it, the inclusion of regulatory assets
8 in rate base for the purpose of the settlement in Docket No. UE-032065 did not
9 imply agreement that such treatment was appropriate in future cases and the
10 Commission's order approving the settlement in that case did not imply final
11 authorization to include the regulatory assets in rate base and did not create any
12 precedent.

13 **Q. What do you recommend?**

14 A. The deferred charges of $7,597,000 should be eliminated from rate base. Of this
15 total, $3,759,000 will be fully amortized by the time that the rates in this case go
16 into effect. With regard to the remaining $3,838,000, the Company has neither
17 cited any prior authorization by the Commission to include these deferred charges
18 in rate base other than for the purpose of the settlement in Docket No. UE-032065
19 nor provided any reason in this case why these costs should be included in its rate
20 base. Therefore, the remaining $3,838,000 of deferred charges should also be
21 eliminated.

22 **Q. Should the amortization of the deferred charges also be adjusted?**

23 A. Yes. The transition plan regulatory asset represents costs that were incurred in
24 association with early retirement and severance programs for targeted employees.
25 These costs were incurred in 2000. In Docket No. UE-000969, the Commission

[2] *Order No. 6* at Appendix A (Settlement Agreement), p. 10, ¶ 12.d.

1 authorized deferral and amortization of these costs, with the amortization to be
2 complete by December 31, 2005. The Commission also ordered that the cost of
3 the early retirement and severance programs will not be included in rates for any
4 years after December 31, 2005.[3]

5 The twelve months ended September 30, 2004, as adjusted by the
6 Company, includes $1,587,000 of amortization of the transition plan regulatory
7 asset. As noted above, the average balance of transition plan regulatory assets for
8 the test year was $2,390,000, but as of September 30, 2004, only $1,454,000
9 remained to be amortized. At the rate of amortization recorded in 2004, the
10 transition plan regulatory asset would be fully amortized eleven months after the
11 end of the test year, or August 31, 2005. Thus, there will be no amortization of
12 the transition plan regulatory asset when the rates in this case are in effect.
13 Accordingly, the amortization of the transition plan regulatory asset, $1,587,000
14 should be eliminated from pro forma test year operating expenses.

15 **Q. What is the revenue requirement effect of your proposed adjustments to**
16 **miscellaneous deferred debits?**

17 A, The effect is to reduce the Company's jurisdictional revenue requirement by
18 $2,628,000 (Exhibit No. ___ (DJE-3), Page 1).

19 **B. ELECTRIC PLANT ACQUISTION ADJUSMENTS**

20 **Q. Has the Company included electric plant acquisition adjustments in its**
21 **revenue requirement?**

22 A. Yes. The Company has included electric plant acquisition adjustments of
23 $7,969,000 (net of amortization) in its rate base and amortization of plant
24 acquisition adjustments of $473,000 in test year operating expenses.

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[3] final *Order, Docket No. UE-000969*, p. 3, ¶ 4.d.

1 **Q. What do the plant acquisition adjustments represent?**
2 A. The plant acquisition adjustments are the result of acquiring plant from other
3 utilities at a price in excess of the net book value of the plant at the time of the
4 acquisition. The acquired plant is placed on the books of the acquiring company
5 at its original cost net of accumulated depreciation. The difference between the
6 acquisition price and the original cost net of accumulated depreciation is booked
7 as a plant acquisition adjustment. The Company summarized the three
8 transactions giving rise to the plant acquisition adjustments in the response to
9 Public Counsel Data Request No. 114.
10 As a general rule, utility plant is included in rate base at its original cost
11 when first dedicated to public service net of accumulated depreciation, and the
12 related acquisition adjustment is not included in rate base. However, there can be
13 exceptions, for example where it is established that the acquisition of the plant
14 from another utility, even at a cost in excess of the net book value of the plant, is
15 in the best interests of ratepayers.
16 **Q. Has the Company provided any evidence in this case that such exceptions are**
17 **applicable to the plant acquisition premiums that it is seeking to recover?**
18 A. No.
19 **Q. Has the Company cited any authorization to include the plant acquisition**
20 **adjustments in rate base?**
21 A. No. In Public Counsel Data Request No. 38, the Company was asked to provide
22 authorization by the Commission to include the plant acquisition adjustments in
23 rate base. Again, the Company responded that it included the rate base and
24 associated amortization of the Electric Plant Acquisition Adjustment in Docket
25 No. UE-032065, and the Commission included the Electric Plant Acquisition
26 Adjustment in the rates authorized in that case.

1 Again, it is my understanding that the Commission in Order 6 adopted a
2 settlement in Docket No. UE-032065, and, as I understand it, the inclusion of the
3 plant acquisition adjustments in rate base and the inclusion of the amortization in
4 operating expenses for the purpose of the settlement in Docket UE-032065 did not
5 imply agreement by the settling parties that such treatment was appropriate in
6 future cases. Nor did the Commission's order approving the settlement in that
7 case imply authorization to recover the plant acquisition adjustments or create any
8 precedent.
9 In its supplemental response to Public Counsel Data Request No. 38, the
10 Company provided a Commission order dated January 15, 1992 in Docket No.
11 UE-911186(P). That order authorized the requested accounting treatment for one
12 of the three transactions, the acquisition of the Craig and Hayden power plants,
13 including the recording of an acquisition premium on the Company's books of
14 account. However, in that order, the Commission explicitly stated that it was not
15 approving any specific ratemaking treatment of the acquired property.[4]
16 **Q. What do you recommend?**
17 A. The plant acquisition adjustments of $7,969,000 should be eliminated from rate
18 base and the amortization of $473,000 should be eliminated from pro forma
19 operating expenses. The Company has neither cited any prior authorization by the
20 Commission to include recovery of the plant acquisition adjustments in its
21 revenue requirement nor provided any reason in this case why these costs should
22 be recovered from ratepayers.
23 **Q. What is the revenue requirement effect of your proposed adjustment to**
24 **eliminate the electric plant acquisition adjustments?**

[4] *Commission order* dated January 15, 1992 in Docket No. UE-911186(P) p. 3.

1 A. The effect is to reduce the Company's jurisdictional revenue requirement by
2 $1,509,000 (Exhibit No. ___ (DJE-3), Page 1).

3 **C. PRO FORMA PLANT ADDITIONS**

4 **Q. Is the Company proposing to adjust its rate base for post-test year additions to**
5 **plant in service?**

6 A. Yes. The rate base adjustment on Company Schedule 8.4 recognizes the effect of
7 what are described as major additions to production plant in service forecasted to
8 take place after the end of the test year. This adjustment, which takes into account
9 plant additions through March 31 2006, increases the Washington jurisdictional
10 plant in service by $39,209,000 on a pro forma basis. In conjunction with this
11 adjustment, the Company has recognized an increase to depreciation expense and
12 an increase in the balance of accumulated depreciation of $1,302,000, which
13 represents the depreciation on the forecasted additions to plant in service. The
14 Company has also recognized the incremental growth in the balance of
15 accumulated deferred income taxes, $1,577,000, related to the plant additions. The
16 net effect of the adjustments being proposed by the Company is to increase its test
17 year rate base by $36,330,000 and to reduce its pro forma net operating income
18 (after income taxes) under present rates by $999,000.

19 **Q. Has of the Company's properly quantified the effect of its proposed rate base**
20 **adjustment to recognize post-test year additions to production plant in**
21 **service?**

22 A. No. The Company's proposed adjustment is selective and one-sided, in that it does
23 not recognize other changes that will be taking place after the end of the test year
24 that will tend to offset the revenue requirement effect of the additions to plant in
25 service. In particular, although the Company recognizes the increase in

1 accumulated depreciation directly related to the forecasted plant additions, it does
2 not recognize the growth in accumulated depreciation on embedded production
3 plant in service that will be taking place as the new plant additions are going into
4 service. Nor does the Company's adjustment recognize growth in the balance of
5 accumulated deferred income taxes on embedded plant. In addition, there is no
6 recognition of growth in sales resulting from customer additions that will be taking
7 place through March 31, 2006 and will tend to mitigate the revenue requirement
8 effect of the plant additions.

9 **Q. Will growth in the accumulated reserve for depreciation on production plant**
10 **provide a significant offset to the revenue requirement effect of the post-test**
11 **year additions to production plant?**

12 A. Yes. As noted above, the Company is proposing to include additions to production
13 plant out to March 31, 2006 in its pro forma rate base. March 31, 2006 is two years
14 after the mid-point of the test year. In the twelve months ended September 30,
15 2004, the Company recorded $13,467,000 of depreciation expense on Washington
16 jurisdictional production plant. Thus, over two years, the Company will record
17 depreciation expense on the test year embedded production plant in service of
18 $26,934,000 (Exhibit No. ___ (DJE-4), p.3). The effect of the depreciation
19 expense, which is included in the cost of service, will be to increase the
20 accumulated reserve for depreciation by that amount. As the accumulated reserve
21 for depreciation is deducted from plant in service in the determination of rate base,
22 this increase in the depreciation reserve will reduce rate base by $26,934,000.

23 As the future additions take place and increase the balance of gross plant,
24 the accumulated reserve for depreciation will also continue to grow as a result of
25 recording depreciation expense on total plant in service. The net plant in service
26 will not increase by an amount equal to future additions. When growth in the

1 balance of the accumulated reserve for depreciation is taken into account, the
2 effect of growth in rate base due to plant additions will be mitigated significantly.
3 This highlights the selective nature of the Company's proposed adjustment to
4 recognize the effect on rate base of post-test year additions to plant in service. It
5 makes little sense to allow a selective pro forma adjustment to increase rate base
6 for post-test year plant additions when the Company's actual growth in the net
7 plant in service will be substantially less.

8 **Q. If the Commission allows the Company to adjust its rate base for post-test**
9 **year additions to production plant in service, should the Company's**
10 **adjustment be modified?**

11 A. Yes. At a minimum, there should be at least two modifications to the pro forma
12 adjustment being proposed by the Company.

13 First, the Company has provided updates to the forecasted spending on each
14 of the construction projects that it has included in its adjustment for post-test year
15 additions to production plant. The adjustment should be modified to reflect the
16 updated forecasts. The effect of the updates is to reduce the forecasted additions to
17 production plant by $4,557,000 on a Washington jurisdictional basis (Exhibit No.
18 ___ (DJE-4), p. 4).

19 Second, if rate base is to be adjusted for post-test year additions to
20 production plant, then the effect of the growth in the balance of the accumulated
21 reserve for depreciation should also be taken into account. Before any adjustments,
22 the accumulated reserve for depreciation reflects the thirteen month average
23 balance for the test year. The thirteen month average balance is roughly equivalent
24 to the balance as of the mid-point of the test year, March 31, 2004. The Company
25 is proposing to recognize post-test year additions to production plant through March
26 31, 2006, two years after the mid-point of the test year. Consistent with this

1 adjustment, the accumulated reserve for depreciation on production plant should be
2 adjusted to reflect an additional two years of test year depreciation expense on
3 production plant. As shown on my Exhibit No. (DJE-4, p.4), this equates to an
4 increase of $26,934,000 to the accumulated reserve for depreciation.

5 **Q. Should the depreciation expense associated with the plant additions also be**
6 **adjusted?**

7 A. Yes. The reduction to the forecasted plant additions requires a reduction to the
8 pro forma adjustment to depreciation expense. On my Exhibit No. ___ (DJE-4),
9 p.3, I have calculated that the reduction to the depreciation expense adjustment
10 results in an increase of $281,000 in pro forma operating income under present
11 rates.

12 **Q. Are you taking a position on whether it is appropriate to include the post test**
13 **year additions to production plant in the Company's Washington**
14 **jurisdictional rate base?**

15 A. No. As noted above, I am only proposing modifications to the Company's
16 adjustment *if* the Commission determines that there should be an adjustment to
17 recognize the effect of these additions. I have not investigated the prudence or
18 necessity of the additional production plant, whether that plant is used and useful
19 in the providing service in Washington, or whether the any of the cost of that
20 plant is properly allocable to the Washington jurisdiction.

21 **Q. What is the revenue requirement effect of your proposed modification to the**
22 **Company's adjustment for post-test year plant additions?**

23 A. The effect is to reduce the Company's revenue requirement by $4,441,000
24 (Exhibit No. ___ (DJE-3), p.1).

1 **D. OUT OF PERIOD REVENUE ADJUSTMENT**

2 **Q. Have you analyzed the Company's pro forma adjustments to test year**
3 **operating revenues?**

4 A. Yes. The Company has adjusted the actual revenues for the twelve months ended
5 September 30, 2004 to annualize the effect of rate changes and to normalize other
6 factors affecting test year revenue, such as weather. Included in the normalization
7 adjustments is a reduction of $1,439,000 to adjust the effect of out of period
8 corrections to test year revenue. In the response to Public Counsel Data Request
9 No. 41, the Company explained that the purpose of this adjustment was to
10 eliminate the effect of billing corrections booked during the test year that applied
11 to invoices rendered prior to the test year and to include the effect of billing
12 corrections booked after the test year that applied to invoices rendered during the
13 test year.

14 **Q. Do you agree that such a normalizing adjustment is appropriate?**

15 A. I agree such an adjustment is appropriate in theory. That is, I agree that invoice
16 corrections booked in the test year that apply to invoices before the test year
17 should be eliminated and that test year revenue should be adjusted for corrections
18 booked after the test year that apply to invoices during the test year. This would
19 assure that the pro forma test year revenues under present rates reflect the
20 normalized usage and billing determinants experienced during the test year.

21 **Q. Has the Company adequately substantiated its out of period normalizing**
22 **adjustment?**

23 A. No. In response to Public Counsel Data Request No. 41, the Company provided
24 an analysis of the out of period normalizing adjustment by rate class, and in
25 response to Public Counsel Data Request No. 117, the Company provided a
26 description of the computer program used to generate the normalizing adjustment

1 related to the out of period corrections. However, in response to Public Counsel
2 Data Request No. 118, the Company was not able to provide any analysis of the
3 factors causing the out of period adjustment to result in the shown decrease to test
4 year revenues. In effect, this adjustment emanates from a "black box" with no
5 explanation of what causes the adjustment for out of period invoice corrections to
6 result in a reduction to test year revenues of $1,439,000.

7 Q. **Should test year revenues be adjusted to incorporate the out of period**
8 **normalizing adjustment proposed by the Company?**

9 A. Not unless the Company can provide additional substantiation of the adjustment
10 that it is proposing. As it exists now this adjustment is little more than a number
11 that appears on a piece of paper. In the response to Public Counsel Data Request
12 No. 118, PacifiCorp noted that when the out of period corrections are netted the
13 result may be an overall increase or an overall decrease to revenues. Thus, as
14 explained by the Company, the effect of the out of period corrections should be
15 approximately neutral.

16 The Company has not been able to identify or describe the factors that
17 lead to the out of period corrections resulting in a decrease of $1,439,000 to test
18 year revenues. Given the atypical magnitude of this adjustment, it has not been
19 adequately supported by the Company. Unless the Company can better explain
20 this adjustment, it should be eliminated, and pro forma revenues under present
21 rates should be increased by $1,439,000.

22 **E. CAPITAL STOCK EXPENSE**

23 Q. **What is capital stock expense?**

24 A. When common stock is issued, certain costs, such as underwriting, legal, and
25 accounting fees, will be incurred. These capital stock expenses are elements of

1 flotation costs, which can also include other items such as pressure on the market
2 price from a new issuance. The effect of capital stock expenses is that the actual
3 proceeds to the issuer of the common stock will be somewhat less than the gross
4 price of the stock to the public.

5 **Q. Are capital stock costs treated as operating expenses?**

6 A. No. Capital stock expense is charged directly to Account 214, which is a
7 reduction to the equity accounts. The uniform system of accounts specifies that
8 Account 214 may be amortized to Account 425 – Miscellaneous Amortization or
9 charged to Account 439 – Adjustments to Retained Earnings. Both Accounts 425
10 and 439 are non-operating accounts, sometimes referred as "below the line"
11 accounts.

12 **Q. How is the Company proposing to treat capital stock expense in this case?**

13 A. The Company is proposing to amortize the capital stock expense over twenty
14 years and to treat the amortization as a pro forma adjustment to Account 930 –
15 Miscellaneous General Expense. The effect of this treatment is to increase the pro
16 forma test year Washington jurisdictional operating expenses by $171,000.

17 **Q. Is the Company's proposed treatment appropriate?**

18 A. No. In the response to Public Counsel Data Request No. 46, the Company stated
19 that in Docket No. UE-991606, the Commission included an allowance for
20 flotation costs in the authorized return on common equity. If an allowance for
21 flotation costs is necessary and appropriate, that is the proper means to recover
22 capital stock costs. If such an allowance is not necessary, then there should be no
23 recovery. In either case, the amortization of capital stock expense should not be
24 treated as operating expense in the determination of the Company's revenue
25 requirement. Elimination of the amortization of capital stock expenses reduces

1 pro test year operating expenses by $171,000 and the Company's revenue
2 requirement by $179,000 (Exhibit No. ___(DJE-3), p.1).

3 **F. INCENTIVE COMPENSATION**

4 **Q. Is incentive compensation included in test year operation and maintenance**
5 **expense by the Company?**

6 A. Yes. Total company pro forma test year operation and maintenance expense
7 includes approximately $33,297,000 of incentive compensation. The incentive
8 compensation consists of Bonus/Incentive, Long Term Incentive Plan, and
9 Incentive (Performance Plan). Incentive compensation represents awards to
10 employees for achieving specified goals designated in the programs.

11 **Q. Has the Company established that the incentive compensation expense is**
12 **properly includable in its revenue requirement?**

13 A. No. The Company has not demonstrated that the all of the goals employees are
14 expected to achieve would benefit ratepayers and that the related incentive
15 compensation should therefore be recoverable from ratepayers.

16 **Q. Should all of the Company's the incentive compensation expense be included**
17 **in the cost of service?**

18 A. No. I would consider the achievement of goals such as quality of service,
19 reliability, public safety, reducing absenteeism, and cost containment to be in the
20 interest of ratepayers and includable in the cost of service. However, I consider
21 incentive compensation based on financial goals such as maximizing profitability
22 and growth, increasing earnings per share, or increasing return on equity to be
23 beneficial only to shareholders, and not properly recoverable from ratepayers.
24 For example, if all else is equal, higher rates will result in higher revenues, which
25 in turn will result in higher earnings and return on equity. Thus, including

1 incentive compensation related to such goals in the revenue requirement would, in
2 effect, require customers to reward company management on a contingency basis
3 for getting them to pay higher rates. If the incentive compensation program is
4 successful in increasing earnings, the shareholders should be happy to reward
5 management accordingly and absorb the cost of the program. As shareholders are
6 the primary beneficiaries of increases to earnings and return on equity, it should
7 be those shareholders, not customers, who bear the cost of the incentive
8 compensation related to such financial goals.

9 **Q. What is the effect of removing incentive compensation related to shareholder**
10 **goals from the cost of service?**

11 A. The Company provided certain details of its pro forma incentive compensation
12 expense in the responses to Public Counsel Data Request Nos. 121, 124, and 125.
13 However it is not possible to tell from those responses how much of the incentive
14 compensation is related to customer oriented goals and how much is related to
15 financial goals. Without further detail, I recommend that one-half of the pro
16 forma test year incentive compensation be eliminated from the Company's
17 revenue requirement as being related to shareholder goals. Elimination of one-half
18 of the incentive compensation reduces pro forma test year operating expenses by
19 $936,000 and increases pro forma operating income under present rates by
20 $581,000 (Exhibit No. ___ (DJE-4), p.5)). This adjustment to expenses reduces
21 the Company's revenue requirement by $979,000 (Exhibit No. ___(DJE-3), p.1).

1 G. IRS TAX SETTLEMENT

2 Q. **Is the Company proposing to recover prior settlement payments made to the**
3 **Internal Revenue Service ("IRS") as part of its revenue requirement in this**
4 **case?**

5 A. Yes. In previous years, PacifiCorp made settlement payments of approximately
6 $64.2 million (total Company) to settle the treatment of certain disputed tax issues
7 from the 1990's. Of that amount, $3,876,000 (net of timing differences on which
8 deferred taxes were recorded) was allocated to Washington. The Company is
9 proposing to amortize that amount over five years and include 50% of the
10 unamortized balance, or $1,551,000, in rate base and 50% of the annual
11 amortization, or $388,000, in pro forma test year federal income tax expense. As
12 justification for this proposed treatment, the Company cites the agreement of the
13 parties to the stipulation in Docket No. UE-032065.

14 Q. **Is the agreement of the parties to the stipulation in Docket No. UE-032065**
15 **adequate justification for the Company's proposed treatment of the IRS**
16 **settlement payments in this case?**

17 A. No. Again, it is my understanding that the settlement in Docket No. UE-032065
18 specified that none of the settling parties should be deemed to have agreed that
19 any provision in that agreement is appropriate for resolving issues in any other
20 proceeding and the Commission's order approving the settlement in that case did
21 not imply authorization of any particular ratemaking treatment and did not create
22 any precedent.

23 Q. **Should the settlement payments to the IRS be included in the revenue**
24 **requirement in this case?**

25 A. No. The Company has not established that the settlement payments relate to any
26 income tax deductions (or other disputed income tax items) that were flowed

1 through to the benefit of Washington ratepayers. That is, if the Company could
2 establish that 1) it took an income tax deduction in a given year and that tax
3 deduction was reflected in the determination of the total income tax expense
4 included in its cost of service as a reduction to its income tax expense; and 2) that
5 particular income tax deduction was subsequently challenged by the IRS and
6 ultimately resulted in additional income tax payments being made by the
7 Company; then I would agree that the Company had at least established some
8 justification for recovering the settlement payments in its revenue requirement.
9 However, the Company has not made any attempt to establish that the settlement
10 payments related to tax deductions that had inured to the benefit of ratepayers. If
11 the settlement payments related to tax deductions that were never of any benefit to
12 ratepayers in the first place, then the Company has no legitimate claim to recover
13 those settlement payments from ratepayers.

14 **Q. What is the effect of eliminating the settlement payments to the IRS from the**
15 **Company's revenue requirement?**

16 A. The effect is to reduce the Company's rate base by $1,551,000 and to decrease its
17 pro forma federal income tax expense by $388,000, which increases its pro forma
18 operating income under present rates by the same amount. The adjustments to
19 rate base and operating income result in a reduction to the Company's revenue
20 requirement of $852,000 (Exhibit No. ___ (DJE-3), p.1).

21 **H. INCOME TAXES**

22 **Q. Have you analyzed the Company's calculation of pro forma income taxes**
23 **under present rates?**

1 A. Yes. The current income tax expense included in the cost of service consists of
2 state income taxes[5] and federal income taxes. The calculation of state and federal
3 income taxes is shown on Exhibit No. ___(PMW-3), Page 2.22 of the Company's
4 filing.

5 **Q. Are you proposing any adjustments to the Company's calculation of current**
6 **state and federal income taxes?**

7 A. Yes. I am proposing adjustments to both current state income tax expense and
8 current federal income tax expense.

9 The Company calculates taxable income on Exhibit No. ___(PMW-3),
10 Page 2.22. Included in the "Operating Deductions" from operating revenues is a
11 decrease of $611,699, described as "Interest & Dividends (AFUDC Equity)."
12 This item reduces the operating deductions, thereby increasing taxable income
13 and income tax expense. In its response to Public Counsel Data Request No. 123,
14 the Company stated that this item should have no effect on Washington taxable
15 income and is removed from book income to arrive at taxable income. I agree
16 with this explanation. However, as presented by the Company, this item has the
17 effect of increasing taxable income by reducing the available income tax
18 deductions. To achieve the intended effect expressed in the response to Public
19 Counsel Data Request No. 123, this item should be eliminated.

20 In addition, on Page 2.22, the Company shows state taxable income of
21 $1,366,454 after pro forma adjustments to revenue and expenses. This page also
22 shows state income tax expense of $378,740 on that taxable income of $1,366,454
23 equating to an effective state income tax rate of nearly 28%. The Company has
24 calculated its combined effective state income tax rate to be 4.54%. The state

[5] Although Washington itself does not have a state income tax, PacifiCorp allocates the state income taxes that it incurs across all the states in which it operates, based on the income before taxes in each of the states.

1 income tax expense should be calculated by applying the state income tax rate to
2 the state taxable income.

3 **Q. What is the effect of your proposed adjustments to the calculation of income**
4 **taxes?**

5 A. As I show on my Exhibit No. ___ (DJE-4, p.6), the effect of my proposed
6 adjustments is to reduce state income tax expense by $344,000 and to reduce
7 federal income tax expense by $94,000. The combined effect of this adjustment
8 is to reduce the Company's revenue requirement by $739,000 (Exhibit No.
9 ___(DJE-3), p.1).

10 **Q. Does this conclude your testimony?**

11 A. Yes.