BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of PACIFICORP for an Order Approving the Sale of its Interest in (1) the Centralia Steam Electric Generating Plant, (2) the Ratebased Portion of the Centralia Coal Mine, and (3) Related Facilities; For a Determination of the amount of and the Proper Ratemaking Treatment of the Gain Associated with the Sale; and for an EWG Determination	)	Docket No. UE-991262 BRIEF OF PACIFICORP

Introduction

On August 10, 1999, PacifiCorp (or the "Company") filed an application ("Application") with the Washington Utilities and Transportation Commission ("Commission") for approval to sell its 47.5 percent interest in the Centralia Steam Generating Plant ("Plant") and the ratebased portion of the Centralia Coal Mine ("Mine") to affiliates of TransAlta Corporation ("TransAlta"). The Company also sought Commission approval of its proposal to share the gain from the sale of the Plant and Mine between its Washington customers and its shareholders based upon the "depreciation reserve method" which would result in approximately 64 percent of the Washington-allocated portion of the gain flowing to customers. The Company further proposed that the share of the gain allocated to customers be used to write off generation-related regulatory assets, thereby reducing the Company's rate- base.

Legal Standard for Review

In its recent decision regarding Puget Sound Energy, Inc.'s ("PSE's") proposed sale of its interest in the Colstrip Plant (Third Supplemental Order, Docket No. UE-990267) ("Colstrip Order") the Commission relied upon a four factor test to determine whether the sale or transfer of utility property is in the public interest. These standards are: 1) the transaction should not harm utility customers by causing rates to increase; 2) the transaction should strike a balance between

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shareholders, customers and the broader public preserving affordable, efficient, reliable and available service; 3) the transaction should not impair the development of competitive markets for the delivery of service; and 4) the transaction should not shift jurisdiction to another forum where Washington customers may be adversely affected. In the Colstrip Order, the Commission also affirmed its finding in Docket UE-981627 (involving PacifiCorp and ScottishPower PLC) that the proper standard for approving the transfer of utility property is whether there is "no harm" to the public interest resulting from the sale.

Summary of Testimony

Testimony was submitted in this case by PacifiCorp, the Commission Staff ("Staff"), the Public Counsel, NW Energy Coalition ("NWEC"), International Union of Operating Engineers, Local 612 ("Local 612") and Industrial Customers of Northwest Utilities ("ICNU").

PacifiCorp's Direct Testimony. PacifiCorp submitted the direct testimony of C. Alex Miller, Rodger Weaver and Matthew Wright (who adopted the pre-filed direct testimony of Anne E. Eakin).

Mr. Miller's direct testimony described the auction process which gave rise to a decision by the eight Plant owners to enter into contracts for the sale of the Plant and Mine to TransAlta for approximately $554,000,000. Mr. Miller also described the significant qualitative factors that contributed to PacifiCorp's decision to sell the Plant and Mine. These included an inability to achieve the required consensus among the eight Plant owners in regard to bringing the Plant into compliance with air emission requirements, the need for substantial capital investments in emission control equipment at the Plant and the substantial risks and uncertainties associated with reclaiming the Mine. Mr. Miller also sponsored the Company's methodology for calculating the net gain on the sale of the Plant and Mine.

Dr. Weaver's testimony described financial analyses that were performed by the Company to determine whether the sale of the Plant and the Mine, on the basis proposed by the Company, would result in net benefits to the Company's customers. He testified that these analyses,

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showing various "Keep" and "Sell" cases, demonstrated that customers could reasonably be expected to enjoy positive net benefits from the sale, reflected in a lower revenue requirement for the Company over the short, medium and long term.

Mr. Wright's direct testimony described how the Company proposed to allocate the approximately $83,000,000 system-wide gain from the sale between its customers and shareholders. He described the "depreciation reserve method" for sharing gain based upon the relationship between net and gross plant shown on the Company's books of account. This relationship establishes the percentage of the capital costs of the Plant that have been recovered over time through customers' prices and the percentage of those costs that remain on the Company's books. Mr. Wright indicated that the proposed method for sharing gain represents a compromise between those who would allocate all of the gain to customers and those who would allocate all of the gain to shareholders. Mr. Wright explained that the depreciation reserve method recognizes that, over time, customers have effectively repaid shareholders for a portion of the up-front investment in Centralia, but that shareholders continue to bear the risk of recovering the un-depreciated portion of the investment. He stated that in the case of Centralia, the depreciation reserve method results in customers receiving 64 percent of the net gain and shareholders receiving 36 percent of the net gain.

Mr. Wright's testimony also describes the Company's proposed ratemaking treatment with respect to the portion of the gain allocated to customers. He testified that the Company proposes to use the customer portion of the net proceeds to write off generation-related regulatory assets, thereby reducing the Company's rate base. This adjustment would occur in the year that the transaction closes. Mr. Wright testified that as a result of this adjustment, the Company's revenue requirement will remain lower than it otherwise would be and upward pressure on customer prices will be mitigated.

<u>Staff Testimony</u>. Staff submitted the direct testimony of Kenneth L. Elgin, Roland C. Martin and Alan P. Buckley.

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Mr. Elgin testified that the Commission should authorize the sale of the Plant and Mine, but only upon the condition that each utility defer the entire gain on the sale and return the gain to customers in a general rate case. Although Mr. Elgin did not perform an independent analysis of the economic consequences of the sale of the Plant and the Mine, he stated that he was able to conclude from the analysis provided by PacifiCorp that the sale would not produce a net benefit to the Company's customers and that it is at best a "push" (Ex. T-400 at page 11). However, notwithstanding his views on the quantitative effects of the transaction, Mr. Elgin concluded that the qualitative concerns associated with PacifiCorp's continued ownership of the Plant and Mine and the benefits of increased competition in wholesale power markets supported a decision to sell (Ex T-400 at page 13). However, in light of his perceived risk of higher energy costs to PacifiCorp's customers if the Plant is sold, Mr. Elgin concluded that all of the gain from the sale must be allocated to customers in order for them not to be harmed by the transaction. He also testified that it is reasonable and sound public policy for all of the gain to be allocated to customers under any circumstances (Ex T-400 at page 15).

Mr. Martin's direct testimony dealt with PacifiCorp's proposed calculation of the gain from the sale, PacifiCorp's proposed sharing of the gain between shareholders and customers and PacifiCorp's proposed ratemaking treatment of the portion of the gain allocated to customers. Mr. Martin noted in calculating the gain on the sale of the Plant and Mine that the Company had provided for reserves (of $2,000,000 and $3,000,000 respectively) to cover future environmental remediation costs at the Plant and Mine. Mr. Martin opposed these reserves and preferred that the Company seek future rate recovery of these costs as they are incurred. He also observed the exclusion from PacifiCorp's gain calculation of excess deferred taxes and recommended that the Commission direct PacifiCorp to seek a revenue ruling from the Internal Revenue Service as to whether passing through the excess deferred taxes to customers would violate normalization requirements. Like Mr. Elgin, Mr. Martin opposed any of the gain being allocated to PacifiCorp's shareholders. However, he indicated that Staff did not necessarily disagree with the

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proposition that the portion of gain allocated to customers be used to reduce regulatory assets that are determined to be recoverable in rates (Ex. T-403 at page 5). Mr. Martin testified that in order to ensure that all the broader aspects of ratemaking are considered, the determination of the appropriate benefit pass-through methodology, as well as the recoverability of regulatory assets to be potentially offset by the gain, are best addressed in a general rate proceeding.

Mr. Buckley's direct testimony dealt only with issues arising from PSE's Application in this proceeding.[1]

Public Counsel Testimony. Public Counsel sponsored the direct testimony of Jim Lazar, a consultant.

Mr. Lazar testified that because his forecast of future replacement power costs is greater than his forecast of the future cost of ownership and operation of the Plant and Mine, the sale is not in the public interest even if all of the gain is allocated to customers. He maintained that the value of the Plant and Mine to customers is far in excess of the price offered by TransAlta in the auction process. He suggested that while qualitative considerations (such as the current ownership structure of the Plant) were "awkward" there was "little cause for concern" and good reason to expect that they would be somehow overcome because the economics of continued operation of the Plant and Mine are so "robust" (Ex. T-500 at page 23).

NWEC Testimony. NWEC sponsored the direct testimony of Nancy Hirsh, its Policy Director.

Ms. Hirsh testified that NWEC does not dispute the market price offered for the Plant. However, she maintained that customers should derive benefits from the sale in addition to the sale price. To that end, she proposed that cash from the sale be invested in cleaner, less polluting resources and that replacement power for the Plant be obtained from a "more environmentally

[1] Except where directly relevant to PacifiCorp's Application, this Brief does not comment on testimony related to PSE's and Avista Corporation's ("Avista's") applications to sell their interests in the Plant offered in this consolidated proceeding. PacifiCorp's silence should not be construed as agreement with such testimony.

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sustainable power mix" (Ex. T-701 at page 3). Ms. Hirsh urged that all of the gain from the sale of the Plant and Mine be allocated to the "benefit of customers and the environment" (Ex. T-701 at page 9).

Local 612 Testimony. Local 612 presented the direct testimony of Gordon Howins, its business manager. Mr. Howins' testimony described TransAlta's excellent safety record in regard to its operation of generating stations, making it one of the safest electric utility companies in Canada.

ICNU Testimony. ICNU sponsored the direct testimony of Lincoln Wolverton, a consultant.

Mr. Wolverton testified that he assumed that the sale price received for the Plant represented its fair market value. He indicated that his testimony was limited to the issue of how the gain from the sale should be allocated between PacifiCorp and its customers. Mr. Wolverton suggested that while he would prefer that the issue of the regulatory treatment of the gain be deferred to the Company's next general rate case, he believed that allocating any portion of the gain to PacifiCorp's shareholders would result in their enjoying "an unjustifiable and excessive return on investment" (Ex. T-600 at page 3). Mr. Wolverton stated that allocating any share of the gain to shareholders would create an incentive for the Company to only propose the sale of its below-market resources, without proper recognition of potential losses associated with remaining above-market resources. He concluded that all of the gain from the sale of the Plant and Mine must be allocated to customers in order for the sale to be in the public interest.

PacifiCorp Rebuttal Testimony. Rebuttal testimony was filed on behalf of PacifiCorp by Mr. Miller, Dr. Weaver and Mr. Wright.

Mr. Miller's rebuttal testimony took strong exception to Mr. Lazar's cavalier attitude toward the risk that the Plant and Mine could not continue to be operated in light of the lack of consensus among the current owners. He indicated that it was by no means certain that construction of the scrubbers would continue if the sale to TransAlta was not consummated,

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noting that PacifiCorp is obligated to terminate the existing scrubber contract if unanimous agreement among the owners cannot be reached in regard to it. He also noted that uncertainty with respect to the scrubber installation is further exacerbated by recently-filed litigation challenging legislation that afforded substantial tax benefits associated with the installation of the scrubbers and the use of coal from the Mine. Mr. Miller further noted that not only does Mr. Lazar's testimony substantially overstate the expected cost of replacement power for the Plant (as documented in Dr. Weaver's rebuttal testimony), it also assumes that the Plant and Mine operate seamlessly for decades to come as assumed in Dr. Weaver's "best case" analysis and that Mine reclamation costs do not exceed current best estimates.

In response to Mr. Wolverton's testimony, Mr. Miller reiterated the fact that PacifiCorp's decision to auction the Plant and Mine was made independent of any larger decisions regarding industry restructuring or vertical disaggregation and should be evaluated on its own merits.

Mr. Miller's rebuttal testimony also noted Staff's proposal to disregard the reserves that PacifiCorp proposes to establish with respect to future environmental remediation costs at the Plant and the Mine and stated that this approach would expose customers to open-ended liability associated with pre-existing environmental contamination for the next 15 years.[2] He also explained that in the event the Commission did not wish to recognize the reserved amounts, any resulting adjustment to the gain calculation should reflect the fact that only 47.5 percent of the Mine is in ratebase (so that only 47.5 of the $ 3,000,000 reserved with respect to the Mine would be affected). In response to Mr. Martin's proposal that the Company be directed to seek a revenue ruling in respect to the excess deferred tax issue, Mr. Miller responded that the Company would be prepared to do so if any of the comparable revenue rulings being sought by other utilities in respect to the issue were successful. Finally, Mr. Miller expressed disagreement with

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[2] During the hearing, Mr. Miller explained that assuming the Company's proposal for gain sharing between customers and shareholders is accepted by the Commission, PacifiCorp's shareholders would insulate customers from any environmental remediation costs exceeding the reserved amounts (Tr. page 392).

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Mr. Martin's proposal to adjust the gain calculation to reflect the accrued Mine reclamation balance. He noted that the amounts accrued to date are well less than those now expected to be required and that TransAlta doubtless reduced the amount of its bid price for the Plant and Mine in recognition of this. Consequently, the burden of underfunded reclamation should proportionately be borne by customers and shareholders by applying the sharing percentage to the full amount of the gain.

Dr. Weaver's rebuttal testimony responded to Mr. Lazar's contentions regarding market price projections for replacement power. In particular, he noted that Mr. Lazar's analysis: 1) fails to redispatch resources and therefore does not reflect how PacifiCorp would actually serve its customers once the Plant is sold,[3] 2) incorrectly assumes that Avista's incremental dispatch value is applicable to PacifiCorp, 3) incorrectly includes a $ 1 per megawatt-hour capacity value adder, 4) is based upon replacement power costs which are not reflective of markets in which PacifiCorp will purchase replacement power and 5) relies on the market price forecasting model of the Northwest Power Planning Counsel ("NWPPC") , which PacifiCorp believes is flawed in a number of respects.

Dr. Weaver observed that the analysis presented with his direct testimony suggested that the sale of the Plant and Mine could be reasonably expected to result in a net present value of $ 42,000,000 of net benefits for PacifiCorp's customers, even if a portion of the gain is allocated to shareholders as proposed by the Company. He indicated that a number of circumstances (such as

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[3] That is to say, Mr. Lazar implicitly assumes that all of PacifiCorp's share of the output of the Plant will be replaced at market prices whereas, in fact, a portion will come from additional operation of PacifiCorp's other generation. Staff witness Buckley observed in his testimony that the dispatch model of the type used by PacifiCorp was appropriate and "better than others that were used"(Ex. T-405 at page 6 and Tr. pages 611, 612).

the sale of the Company's California service territory, which is currently pending) would result in materially increased revenue requirement benefits.[4]

Finally, Dr. Weaver noted that the two-year difference in the expected life of the Plant (2023 versus the 2025 date assumed by Mr. Lazar) was immaterial.

Mr. Wright's rebuttal testimony responded to concerns expressed by Staff, Public Counsel and ICNU regarding the depreciation reserve method for allocating the gain from the sale of the Plant between customers and shareholders. Mr. Wright stated that the depreciation reserve method represents an objective method for sharing gain between customers and shareholders.[5] He explained that future risks, as well as historic risks, associated with the Company's investment, are important factors in considering how the gain should be shared. Mr. Wright discussed the historic and future risks borne by shareholders and customers with respect to the Plant and Mine. He acknowledged that customers will bear the risk of future market prices to the extent they are included in rates, but that customers will not bear 100 percent of the risk of future market purchases because shareholders will also bear risk with those purchases.

Mr. Wright also noted the importance of the Commission providing appropriate incentives for the Company to do what it did here -- structure the transaction and the sale process in a manner that maximizes sales price. Mr. Wright also responded to the recommendations of ICNU to defer to a future rate case the decision as to how the gain from the sale should be

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[4] As explained during his cross-examination, notwithstanding the quantitative benefits reflected in his modeling, Dr. Weaver believes that it is the qualitative factors described in Mr. Miller's testimony that compel the conclusion that the sale of the Plant and Mine are in the public interest.

[5] Contrary to contentions by Staff and ICNU witnesses in this proceeding that it is never appropriate for shareholders to receive a dollar of gain, in the Colstrip Order, the Commission acknowledged that where (as here) a sale produces positive net benefits for customers, it may well be appropriate to share those benefits between customers and shareholders. In that Order, the Commission emphasized the importance of dealing with each case on its own facts (Colstrip Order at page 22). Mr. Wright's testimony points out important distinctions between the proposed sale of the Plant and PSE's proposed sale of Colstrip. Notably, the sale of the Plant is principally motivated by a desire to mitigate risks to all parties, whereas the Colstrip sale was the direct result of industry restructuring in Montana (Tr. page 430).

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allocated between customers and shareholders. He acknowledged that it will not be possible to establish the precise ratemaking adjustments in this proceeding because, among other reasons, the precise amount of the gain will not be known until after the sale closes. However, Mr. Wright indicated that it is unreasonable to expect the Company to decide whether to proceed with the sale without knowing what policy this Commission, and other commissions, will apply with respect to allocation and ratemaking treatment of the gain.

Finally, Mr. Wright proposed that the gain allocated to customers be used to write-off the "Yampa" acquisition premium associated with the acquisition of the Colorado-Ute generation assets. He pointed out that this approach matches the gain from a sale of steam generation against a premium paid for steam generation assets, matches the undepreciated life of the Yampa assets against the estimated remaining life of the Plant, and provides accounting ease with respect to inter-jurisdictional allocation issues.

Issues

The primary issues to be decided by the Commission are:

A. Is the transaction, as proposed by the Company, consistent with the public interest?

B. How should the amount of the gain from the sale of PacifiCorp's interest in the Plant and Mine be allocated among its various jurisdictions?

C. How should the amount of the gain allocated to Washington be shared between PacifiCorp's Washington customers and its shareholders?

D. How should the portion of the gain allocated to PacifiCorp's customers be accounted for ratemaking purposes?

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Argument

A. The Proposed Transaction is Consistent with the Public Interest.

PacifiCorp has proposed to sell its interest in the Plant and the Mine and to allocate approximately $8.2 million of gain to its Washington customers. PacifiCorp believes that the issue of how the gain from the sale will be allocated between customers and shareholders is not separable from the determination of whether the sale is consistent with the public interest. The sale of the Plant and Mine and the handling of the resulting gain constitute a single transaction being proposed by the Company.

The Company has established that from the standpoint of financial analyses of various "Keep" versus "Sell" scenarios, Washington customers will most likely benefit from the transaction, even if qualitative factors are not considered. Moreover, the Company established that if the qualitative factors, which are not reflected in Dr. Weaver's analyses, are taken into account, there are significant benefits to customers from selling the Plant and Mine as proposed.

PacifiCorp has from the outset emphasized these qualitative factors as important considerations in the decision to sell the Plant and Mine. Those factors – the risk of the substantial investment in scrubbers necessary to meet RACT requirements, the risk of early mine closure (which would accelerate mine reclamation costs), the risk of Plant closure, both temporary and permanent, and other risks attendant to the joint ownership of the Plant all present risks to customers and shareholders alike, and must be given considerable weight in the Commission's decision in this case.

If the proposed sale is not completed, at least temporary shutdown of the Plant is virtually certain. With only a minimal cushion in the installation schedule for the first scrubber, and a required termination of the scrubber installation contract if the sale is not completed, installation of the first scrubber by December 31, 2001 will simply not be achievable (Ex. T-215 at page 2). Without that installation, the Plant will have to shut down – for how long, nobody knows.

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Only one party to this proceeding, Public Counsel, takes the position that (independent of how the gain is shared) it is not in the public interest for the Plant to be sold. Public Counsel would apparently have the Commission disregard the independent business judgments of three different Washington jurisdictional utilities whose managements are intimately familiar with the operations of the Plant and Mine and accept Mr. Lazar's conclusions that: 1) the Plant and Mine are worth more than twice the amount of the high bid obtained in a competitive auction[6] and 2) that the qualitative concerns voiced by all three Applicants are "little cause for concern."

Both Mr. Lazar's quantitative analysis and his breezy dismissal of the qualitative risks associated with PacifiCorp's continued ownership of the Plant and Mine should be disregarded. His quantitative analysis, as it relates to PacifiCorp has the following flaws:

1. His analysis does not account for the redispatch of PacifiCorp's system in the absence of Centralia and assumes that all required replacement power will be purchased on the open market and not generated from PacifiCorp's other resources (Ex. T-216 at page 4).

2. His analysis incorrectly assumes that Avista's incremental dispatch value is applicable to PacifiCorp (Ex. T-216 at page 5).

3. His analysis incorrectly included a $1 per megawatt-hour capacity value adder (Ex. T-216 at page 5).

4. His analysis incorrectly assumes that PacifiCorp will acquire replacement power in western Oregon and Washington markets (Ex T-216 at page 4).

5. His analysis includes increased transmission costs that would be incurred if the Plant did not operate, even though those costs would be borne by the Bonneville Power Administration and not the current Plant Owners (Tr. pages 361, 701).

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[6] Any suggestion that changes in perceptions of long-term electricity market prices that have occurred during the last nine months have caused a roughly $500,000,000 discontinuity between TransAlta's bid and the results of Mr. Lazar's analyses appears farfetched (Tr. pages 733-736).

6. His analysis uncritically accepts the long-term power price forecasts of the NWPPC without regard to potential institutional biases in those forecasts (Tr. page 712) and without regard to questionable assumptions underlying its conclusions (Ex. T-216 at pages 6-8).[7]

7. His analysis flies in the face of the results of the auction for the Plant and Mine.

8. His analysis assumes that the Plant and Mine will operate more or less seamlessly for the next 25 years with no extraordinary cost increases (Ex. T-500 at page 5 and Tr. page 762).

However, perhaps the greatest defect in Mr. Lazar's analysis is the period of time he deems relevant to his analysis.[8] Dr. Weaver's analysis demonstrates, under his medium price case, continuing positive benefits to PacifiCorp's customers through 2014 (Tr. pages 640, 683). Mr. Lazar would have the Commission implicitly base its decision on a conclusion that during the next 25 years, cost-of-service regulation will remain in place and there will be no major technological changes in the industry -- all this from someone who once carried the torch for the proposition that new power plants would not be required in this Century (Tr. page 715).

Even more troubling is Mr. Lazar's willingness to dismiss on behalf of PacifiCorp's customers and shareholders the qualitative risks associated with the Company's continued ownership of the Plant and Mine. Mr. Lazar seems to assume that his economic conclusions will automatically be shared by all seven remaining Plant owners and because his projections are so "robust," a means will be found to resolve disagreements and all will be well (Tr. page 719). There is ample reason to conclude that Mr. Lazar simply does not know what he is talking about. If the economics of the Plant and Mine were so compelling, why would sophisticated entities like Portland General Electric Company and Snohomish County PUD leap at the chance of selling

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[7] It is notable that Staff witness Buckley finds the NWPPC results sufficiently unreliable that he "hardwired" an adjustment to the early years of its forecast for purposes of calculating PSE's near-term replacement power costs because he believed the Aurora Model's predicted prices are too high (Tr. page 594).

[8] Mr. Lazar acknowledged that the single-most important factor differentiating his conclusions from those of the applicants was the length of his analysis period (Tr. page 703).

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their interests at book value (a fraction of the value that Mr. Lazar would assign to the Plant)? If the Plant were such a jewel, why would the owners only permit construction of scrubbers to occur in the context of the proposed sale to TransaAlta and require the contract to be terminated if the sale were not proceeding? Mr. Lazar was prepared to venture his opinions, notwithstanding his absolute lack of knowledge regarding the contractual arrangements associated with the ongoing scrubber construction (Tr. page 708). He also stated that he knew nothing about the legal requirements related to the timing of Mine reclamation and therefore was unphased by the prospect of closing the Plant at such time as it becomes uneconomic (Tr. pages 765, 766). The depth of Mr. Lazar's misunderstanding of the perils facing the Plant is perhaps best reflected in his erroneous assumption (based upon three-year old facts) that the Plant could be operated indefinitely at current levels without scrubbers on low-sulphur Powder River Basin coal (Tr. pages 709, 764).

The Commission should find that the transaction, as proposed by the Company, is not detrimental to ratepayers and is in the public interest, and approve it accordingly.

B. <u>The Gain From Sale of the Plant and Mine Should be Allocated Among PacifiCorp's State Jurisdictions Based Upon the "Modified Accord" Method</u>.

PacifiCorp proposes that the gain from the sale of the Plant should be allocated among its various jurisdictions in a manner that reflects each jurisdiction's respective historic contribution to depreciation expense associated with the Plant (Tr. page 584). This method results in approximately $13,000,000 or 15.4 percent of the total gain being allocated to Washington (Tr. pages 622, 623). This approach is consistent with the "Modified Accord" method of interjurisidictional allocations (Tr. page 622). It is important that the Commission establish in this proceeding, at least as a matter of principle, the basis upon which it believes the gain from the sale should be allocated among states. Contrary to Staff's view that the Company should just "take its chances" if the Commission declined to articulate a policy, it would result in an

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unreasonable level of uncertainty for the Company in evaluating whether to go forward with the transaction.[9]

C. The Washington Share of the Gain From the Sale of the Plant Should be Allocated Between Customers and Shareholders Based Upon the Depreciation Reserve Method.

As indicated in Mr. Miller's direct testimony, the sale of the Plant and Mine was not proposed in anticipation of industry restructuring legislation in Oregon or elsewhere, and the Company's proposals in respect to Centralia are not indicative of the positions that the Company might take on broader restructuring issues (Ex. T-215 at page 3). The depreciation reserve method is a previously-accepted and reasonable method for allocating gain from the sale of the Plant and Mine between customers and shareholders. It accomplishes both an equitable sharing of very substantial newly-created value and provides an appropriate incentive for the Company to maximize such value.

PacifiCorp and other Parties presenting testimony in this case are in agreement with at least one proposition: reward should follow risk (Tr. pages 419, 458 and 506). PacifiCorp believes that in the present case, neither customers nor shareholders can legitimately claim to have borne all the historic risk associated with the Plant or that either customers or shareholders are assuming all the future risk associated with the transaction if the Plant is sold. That is why PacifiCorp proposed a sharing of the gain.

In respect to historic risk, PacifiCorp bore all the risk during the construction phase of the Plant and bore risks associated with capital additions until they were reflected in prices. Further, cost-of-service regulation is imperfect. Even in respect to assets that are included in ratebase, there are numerous reasons, well understood by the Parties, why entirely prudent utilities do not

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[9] Staff acknowledges that given unresolved issues regarding interjurisdictional allocations, the Company faces the risk of sharing more than 100 percent of the gain with customers (Tr. pages 624, 625).

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consistently earn their full allowed rate of return. These include decisions to moderate or forego price increase requests out of concern for customer impact, unexpected expense increases or revenue decreases, changes in regulatory policy (such as interjurisdictional cost allocation practices) and regulatory lag. As a consequence of such factors, PacifiCorp has borne material historic risk with respect to the Plant and Mine along with its other assets dedicated to providing electric service.

The other Parties fail to give recognition to future risks to PacifiCorp associated with the Plant and Mine. PacifiCorp will continue to bear material risks of nonrecovery, whether or not the Plant and Mine are sold. If the Plant is not sold, PacifiCorp will likely be required to invest substantial sums in pollution control equipment. PacifiCorp, and its customers, face the risk of Plant and Mine closure if the governance issues associated with the Plant are not resolved. There is considerable uncertainty in regard to the cost and timing of Mine reclamation costs and no assurance of the recoverability of those costs. Furthermore, PacifiCorp has apparently created additional regulatory risk for itself just by proposing the sale. Staff witness Elgin testified that if the Company declined to go forward with the sale because of the lack of any incentive to do so, the Commission could "treat Centralia as if sold" in future rate cases (Tr. page 566). Mr. Wolverton testified that a failure to go forward might reduce the amount of stranded costs that the Company is permitted to recover (Tr. page 461).

If the sale of the Plant and Mine is consummated, PacifiCorp has continuing risks associated with the transaction. It will face replacement power costs which will have to be recovered through its prices. Under the Plant and Mine sale agreements, PacifiCorp is responsible for environmental remediation costs for the next 15 years. *See Section 1.1(g) of the Centralia Plant Purchase and Sale Agreement and Section 1.1(j) of the Centralia Coal Mine Purchase and Sale Agreement which are Exhibits 1 and 2 to the Company's Application.* PacifiCorp has proposed that assuming its gain-sharing proposal is adopted, it will assume any liability for such costs to the extent they exceed the amount proposed to be reserved for them (*see*

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footnote 2, infra). PacifiCorp has no guarantee that TransAlta will honor its contractual obligation to reclaim the Mine and no guarantee that TransAlta will remain in business so that it is able to honor its obligations. None of the other Parties to this proceeding have offered any firm assurance that PacifiCorp can expect to be held harmless by this Commission or the Company's customers in respect to any of these matters (Tr. pages 512, 513, 463 and 464). Nonetheless, their approach is based upon the erroneous view that customers bear all the risks going forward if the sale is completed.

It is by no means PacifiCorp's position that its customers have been or will be insulated from past or future risks associated with Centralia. That is why it has proposed a sharing. Neither does PacifiCorp contend that the "depreciation reserve" method for allocating the gain reflects relative risk sharing with mathematical precision.[10] However it does provide an objective method for sharing gain that has been accepted by other commissions. Consistent with the principle that "gain should follow risk" the proposal that all gain should be allocated to customers would only be supportable if PacifiCorp's shareholders have been and will be insulated from *all* risk associated with the Plant and its sale. That is manifestly not the case.

It is also not the case that the amount of the gain is an appropriate proxy for the magnitude of the replacement power risk faced by the Company's customers if the Plant is sold. PacifiCorp does not contend that the economic analysis of future Centralia replacement power costs presented in Dr. Weaver's testimony compels a decision to sell the Plant and Mine. Dr. Weaver's analysis, like any long-term forecast, involves an element of uncertainty (Tr. page 681). Under Dr. Weaver's "base case," customers are moderately benefitted by the sale (when only the quantitative analysis is taken into consideration). However, under circumstances of relatively low future electricity market prices, customers could be substantially benefitted. Under circumstances of high market prices, the analysis shows the potential for customers to be worse

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[10] In the Colstrip Order, this Commission observed that this sharing is not amenable to mathematical calculation (Colstrip Order at page 22).

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off (if one only considers replacement power costs). The other parties wish to ignore the qualitative factors which are the direct motivation for PacifiCorp's proposal to sell the Plant and choose to focus only on the "down side" of Dr. Weaver's analysis. They use this potential for harm as a justification for customers capturing all of the gain from the sale.

Staff and ICNU witnesses clearly misread the Colstrip Order to the extent that they believe it stands for the proposition that gain from a sale should never be allocated to shareholders. Because in the Colstrip Order, the Commission concluded that the full amount of the premium was necessary to insulate customers from replacement power costs, Messrs. Elgin and Wolverton apparently concluded that a naked assertion of that same proposition would win the day in this proceeding. Both Messrs. Elgin and Wolverton acknowledge that they performed *no* independent review of the risks associated with replacing the power from the Plant (Tr. pages 471, 508). However, both were quick to claim that whatever the magnitude of those risks was, the full amount of the gain was necessary to cover it. Their lack of understanding of the Commission's intent in the Colstrip Order is clearly demonstrated by their testimony to the effect that they would claim the full amount of the gain regardless of its magnitude (Tr. page 512). Their concerns about replacement power costs appear to be nothing more than a thin disguise for their real perspective – that shareholders should never get a dollar of any gain (Tr. page 484, Ex. T-400 at page 16).

Notwithstanding the Parties' understandable zeal to capture all the gain from the sale for customers, it is unreasonable to focus on the potential harm to customers from the sale without considering the more than equal likelihood of benefit and without considering the magnitude of risks to customers from PacifiCorp's continuing ownership of the Plant and Mine. The proposed transaction is decreasing customer risk, not increasing it. Because overall customer risk is being reduced, there is no basis for awarding all of the gain from the sale to customers as some form of compensation for some "new" risk being forced upon them. Furthermore, if the sale to TransAlta is not consummated and the Plant closes on a temporary or permanent basis, not only will

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customers face the replacement power risks that are at least as great[11], they will have no proceeds from the sale to mitigate any increased costs or provide for a return of PacifiCorp's capital.

ICNU's witness, Mr. Wolverton, suggested that adopting the depreciation reserve method for sharing gain was undesirable because it would create perverse incentives for utilities like PacifiCorp to only propose to sell their "good" plants and to hang on to their above-market cost assets. While establishing appropriate incentives is indeed an important element of this proceeding, Mr. Wolverton's view of them is flawed in two respects. First, it assumes that PacifiCorp is free to sell whatever plants it chooses, without the need to demonstrate to the Commission that a proposed sale is in the public interest (Tr. page 468). Second, it fails to recognize that denying shareholders any portion of the gain creates a strong incentive for a utility, during a time that many people believe that industry restructuring is desirable, to not propose the sale of any of its generation.[12]

In the present case, PacifiCorp took the initiative to identify the Plant and Mine as a significant source of risk for its customers and shareholders. PacifiCorp persuaded a largely dysfunctional group of co-owners to finance an auction process. PacifiCorp competently conducted the auction and structured the transaction in a manner that accomplished material tax savings. PacifiCorp has invested substantial energy, talent and resources in the sale process. At the same time that it is the process of implementing a major merger and attendant merger commitments, PacifiCorp has submitted itself to regulatory processes in six states related to the sale which have given rise to hundreds of data requests and days of hearings. It has apparently

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[11] If the Plant ceased operations, all else being equal, it would have the effect of increasing power prices in the region.

[12] Mr. Elgin stated that he thought that the sale of utility-owned generation and resulting increased competition in wholesale markets was desirable. Yet, he was steadfast in his view that incentives that provide *any* additional return to a utility are unacceptable (Tr. page 565). Mr. Wolverton indicated that ICNU also was of this view, but did not have in mind what incentives might cause utilities to divest their generation (Tr. page 470).

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even created a new regulatory risk for itself in the minds of at least Messrs. Elgin and Wolverton (*see page 17, infra)*.

It is both critical and instructive to contrast the views of Messrs. Wright and Elgin on the subject of incentives. Mr. Wright testified that while he believed the Company had conducted a very professional and well-run auction for the Plant and Mine, not knowing what the regulatory treatment of the resulting gain would be, it was nonetheless important for the Commission to provide utilities with a "stake in outcomes." He testified, "If you have a process that awards 100 percent of the gain to customers, then arguably, the Company has no incentive to seek the best price for auctions on a going-forward basis. It's simply cut out of the whole process" (Tr. pages 405 and 406). When Commissioner Hemstad probed the issue of appropriate incentives with Mr. Elgin, and suggested the possibility of a "human factor," a harsh and uncompromising view of the regulatory process was revealed in which any "carrots" are viewed as excessive return to shareholders, with the Commission's role only being one of applying "sticks" to the backs of utilities to cause them to do what is in customers' interests (Tr. pages 526 to 538). When Chairwoman Schowalter suggested that this might result in utility decisions that benefitted neither customers nor shareholders, Mr. Elgin's only response was to suggest a new and bigger "stick" – treating the Plant and Mine "as if sold" in future rate cases (Tr. page 566). If this view were to prevail, why would any Washington utility be so foolhardy as to exercise any initiative?

This is a case where ideology is appearing to overcome good sense. But, the incentives created by the Commission's decision are indeed important.

Staff and ICNU maintain that if *any* of the gain from the sale is allocated to PacifiCorp's shareholders, it will result in the Company earning an "excessive" return. PacifiCorp believes that this view is misplaced. The concept of allowed rate of return is appropriately employed in rate case proceedings and is applied to the totality of the Company's operations over a test period. Those operations inevitably consist of a large number of discrete transactions. Some of them will be profitable, some not. The expectation is that *on balance,* the Company will have a

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reasonable opportunity to earn its allowed rate of return. It is inappropriate to contend that, because the Company has an opportunity to enjoy additional earnings on a single transaction, it is "overearning" any more than it would be appropriate to contend that the Company is the victim of confiscatory regulation if a single transaction loses money.

Staff apparently does not oppose determining in this proceeding how the gain should be allocated between customers and shareholders (Tr. page 626). Deferring the decision on the allocation of the gain, as proposed by ICNU would be unfair to the Company, as it would require the Company to decide whether to move forward with the sale without knowing the implications of that decision for its shareholders. The Commission should decide in this case the ratemaking principles to be applied to the gain allocated to Washington customers.

D. The Portion of the Gain Allocated to Customers Should Be Used to Write Down Generation-Related Regulatory Assets.

PacifiCorp believes that it is both prudent and sensible to use the portion of the Centralia gain allocated to customers to write down generation-related assets in its rate base, specifically, the Yampa acquisition adjustment.[13] This method best matches, from a timing standpoint, the flow of benefits associated with the sale with the potentially-higher replacement power costs that may be incurred by the Company over the long-term. It also matches the gain from a sale of steam generation against a premium paid for steam generation assets and provides accounting ease with respect to inter-jurisdictional allocation issues (Ex. T-226 at page 9).

Conclusion

The Commission should find that the proposed sale of PacifiCorp's interest in the Plant and Mine, with 64 percent of the gain allocated to Washington customers pursuant to the proposed depreciation reserve method, meets the "no harm" test and is in the public interest.

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[13] Staff does not object in principle to using the customers' share of the gain to write down regulatory assets (Tr. page 620).

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The Commission should approve: (a) the sale of PacifiCorp's interest in the Plant and Mine to TransAlta, (b) the Company's proposed methodology for calculating the gain from the sale, (c) the Company's proposed method for allocating the gain to among its state jurisdictions, (d) the Company's proposed method of allocating the Washington share of the gain between customers and shareholders based upon the depreciation reserve method and

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(e) the proposed use of customers' share of the gain to write down generation-related regulatory assets.

DATED: January 28, 2000.

Respectfully submitted,

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