TABLE OF CONTENTS

[QUALIFICATIONS 1](#_Toc386540852)

[SUMMARY OF TESTIMONY 1](#_Toc386540853)

[FINANCING OVERVIEW 4](#_Toc386540854)

[CAPITAL STRUCTURE DETERMINATION 4](#_Toc386540855)

[HYPOTHETICAL CAPITAL STRUCTURE 10](#_Toc386540856)

[CREDIT RATINGS 13](#_Toc386540857)

[PREFERRED STOCK REFINANCING 21](#_Toc386540858)

[POWER PURCHASE AGREEMENTS 25](#_Toc386540859)

[FINANCING COST CALCULATIONS 27](#_Toc386540860)

**ATTACHED EXHIBITS**

Exhibit No.\_\_\_(BNW-2)—Fitch Ratings (March 10, 2014)

Exhibit No.\_\_\_(BNW-3)—Moody’s Investor Service (January 30, 2014)

Exhibit No.\_\_\_(BNW-4)—Fitch Ratings (September 16, 2013)

Exhibit No.\_\_\_(BNW-5)—Fitch Ratings (January 6, 2011)

Exhibit No.\_\_\_(BNW-6)—Moody’s Investor Service (May 8, 2013)

Exhibit No.\_\_\_(BNW-7)—Standard & Poor’s Ratings Direct (April 29, 2013)

Exhibit No.\_\_\_(BNW-8)—Standard & Poor’s Ratings Direct (March 31, 2014)

Exhibit No.\_\_\_(BNW-9)—Standard & Poor’s Ratings Direct (October 23, 2012)

Exhibit No.\_\_\_(BNW-10)—Moody’s Investor Service (May 8, 2012)

Exhibit No.\_\_\_(BNW-11)—Preferred Stock Redemption

Exhibit No.\_\_\_(BNW-12)—Cost of Long-Term Debt

Exhibit No.\_\_\_(BNW-13)—Standard & Poor’s Ratings Direct 2007 Report on Power Purchase Agreements

Exhibit No.\_\_\_(BNW-14)—Variable Rate PCRBs

Exhibit No.\_\_\_(BNW-15)—Cost of Preferred Stock

**Q.** **Please state your name, business address, and present position with Pacific Power & Light Company (Pacific Power or Company), a division of PacifiCorp.**

1. My name is Bruce N. Williams. My business address is 825 NE Multnomah Street, Suite 1900, Portland, Oregon 97232. My present position is Vice President and Treasurer.

# QUALIFICATIONS

**Q. Please describe your education and professional experience.**

1. I received a Bachelor of Science degree in Business Administration with a concentration in Finance from Oregon State University in 1980. I also received the Chartered Financial Analyst designation upon passing the examination in 1986. I have been employed by the Company for 28 years. My business experience has included financing of PacifiCorp’s electric operations and non-utility activities, responsibility for the investment management of PacifiCorp’s qualified and non-qualified retirement plan assets, and investor relations.

**Q. Please describe your present duties.**

1. I am responsible for PacifiCorp’s treasury, credit risk management, pension, and other investment management activities. I am also responsible for the preparation of PacifiCorp’s embedded cost of debt and preferred equity and any associated testimony related to capital structure for regulatory filings in all of PacifiCorp’s state and federal jurisdictions.

# SUMMARY OF TESTIMONY

**Q.** **Please provide a summary of your testimony.**

A.My testimony supports the Company’s overall cost of capital recommendation in this case. I provide evidence demonstrating how the Company’s proposed capital structure with a common equity level of 51.73 percent balances safety and economy to the benefit of customers. These benefits include maintaining PacifiCorp’s current credit ratings, which will facilitate continued access to the capital markets, and providing a more competitive cost of debt and overall cost of capital over the long term.

 I also present an alternative cost of capital based on a hypothetical capital structure and demonstrate how a reduction in the equity component increases the costs of long-term debt and equity and produces a higher overall rate of return. I discuss the redemption of a portion of PacifiCorp’s preferred stock and show how this benefits customers. Finally, I support the Company’s proposed cost of long-term debt of 5.19 percent and cost of preferred stock of 6.75 percent.

**Q.** **What is the overall cost of capital that you are proposing in this proceeding?**

A. Pacific Power is proposing an overall cost of capital of 7.67 percent. This cost includes the return on equity recommendation of 10.00 percent from Mr. Kurt G. Strunk and the following capital structure and costs:

**Table 1**

|  |
| --- |
| **PROPOSED OVERALL COST OF CAPITAL** |
| Component | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.19% | 1.73% | 0.00% |
| Long-Term Debt | 48.06% | 5.19% | 2.50% |
| Preferred Stock | 0.02% | 6.75% | 0.00% |
| Common Equity Stock | 51.73% | 10.00% | 5.17% |
| Total | 100.00% |  | 7.67% |

As I will discuss in more detail later in this testimony, by maintaining strong credit ratings, PacifiCorp has been able to continue to lower its cost of long-term debt and moderate rate increases to Washington customers.

**Q. Do you also propose an alternative cost of capital recommendation based on a hypothetical capital structure similar to the one that the Washington Utilities and Transportation Commission (Commission) has adopted in the Company’s recent rate cases?**

A. Yes. While the Company continues to believe that its actual capital structure balances economy and safety, in recognition of the Commission’s adoption of a hypothetical capital structure in the Company’s past cases, I have prepared an alternative cost of capital recommendation using a reduced equity component.[[1]](#footnote-1) The hypothetical capital structure and resulting costs produces a higher overall rate of return of 7.99 percent. As shown in Table 2 below, the reduction in the costs of the equity component is fully offset by the resulting increases in debt and equity costs, for an overall rate of return approximately 32 basis points (0.32 percent) higher than my primary recommendation.

**Table 2**

|  |
| --- |
| **ALTERNATIVE OVERALL COST OF CAPITAL** |
| Component | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.19% | 2.11% | 0.00% |
| Long-Term Debt | 50.69% | 5.80% | 2.94% |
| Preferred Stock | 0.02% | 6.75% | 0.00% |
| Common Equity Stock | 49.10% | 10.28% | 5.05% |
| Total | 100.00% |  | 7.99% |

# FINANCING OVERVIEW

**Q. How does PacifiCorp finance its regulated electric utility operations?**

A. PacifiCorp finances its regulated utility operations with a mix of debt and common equity capital. PacifiCorp forecasts significant capital expenditures in the rate effective period, and bonus depreciation will not be in effect. In addition, Standard & Poor’s (S&P) continues to impute over one-half billion dollars of debt and debt equivalents to the Company. Under these circumstances, PacifiCorp needs a common equity component in excess of 50 percent in the capital structure to maintain its credit rating and finance the debt component of the capital structure at the lowest reasonable cost to customers. This provides more flexibility regarding the type and timing of debt financing, better access to the capital markets, a more competitive cost of debt and—over the long run—more stable credit ratings, all of which assist in financing capital expenditures.

# CAPITAL STRUCTURE DETERMINATION

**Q. How did the Company determine its recommended capital structure in this proceeding?**

A.The Company used an average of PacifiCorp’s five-quarter ends spanning the 12 months ending December 31, 2014, to calculate its proposed capital structure. This approach smoothes volatility in the capital structure, which will fluctuate as PacifiCorp expends capital, issues or retires debt, retains earnings, or declares dividends. The Company has used this same methodology in all of its recent rate case filings in Washington, without objections to the calculation methodology.

**Q. Why does your analysis of capital structure and costs of capital utilize the period ending December 31, 2014?**

A. The test period in this proceeding is the 12 months ending December 31, 2013, with known and measurable changes. Therefore, for the cost of capital determination, the Company has used PacifiCorp’s actual capital structure at December 31, 2013, with pro forma adjustments for known and measurable changes through December 31, 2014. The known and measurable changes represent actual and forecasted capital activity through December 31, 2014.

**Q.** **Did the Company include short-term debt as part of the capital structure in this case?**

A. Yes, I have included projected quarter-end short-term debt balances for the period ending December 31, 2014. The 1.73 percent cost of short-term debt is derived from forward London Interbank Offered Rate (LIBOR) rates plus the contractual borrowing margin in committed credit agreements at PacifiCorp’s current ratings plus related fees and expenses.

**Q. Does the Company remain concerned about the fairness of including short-term debt in the capital structure?**

A. Yes. The Company continues to believe that it is inappropriate and inequitable to include short-term debt in the capital structure for Pacific Power because short-term debt would effectively be double-counted as financing both rate base and construction work-in-progress. The Company will continue to evaluate this issue and may request reconsideration of it in future cases.

**Q. In the final order (Order 05) in the Company’s 2013 general rate case, Docket UE-130043 (2013 Rate Case), the Commission stated that the Company’s capital structure contains too much equity, “which tips the balance too far in favor of investor interests over those of ratepayers.”[[2]](#footnote-2) Is the Company’s proposed equity component lower in this case than in the 2013 Rate Case?**

A**.** Yes. The Company’s proposed 51.73 percent common equity level is approximately 50 basis points (0.50 percent) lower than what was requested in the 2013 Rate Case. As PacifiCorp’s financial metrics have improved, it has been able to gradually reduce the equity component in its capital structure without jeopardizing its credit rating and access to capital.

**Q.** **Does PacifiCorp now make periodic dividend payments to Berkshire Hathaway Energy (BHE),[[3]](#footnote-3) while continuing to retain sufficient earnings to finance capital investments and maintain its credit rating?**

A. Yes. Following its acquisition in 2006, PacifiCorp managed its capital structure through the timing and amount of long-term debt issuances and capital contributions, while forgoing any common dividends for nearly five years. More recently, PacifiCorp has initiated the payment of dividends to BHE to help manage the common equity percentage in its capital structure and expects to make periodic dividend payments for the foreseeable future. The proposed capital structure in this case includes the impact of dividends expected to be declared through the end of December 31, 2014. Without these dividends, PacifiCorp’s capital structure would contain a higher level of common equity than what the Company is proposing in this case.

**Q. Does Pacific Power have an incentive to increase its equity ratio in Washington beyond the minimum equity component that, along with reasonably supportive regulatory treatment, will allow it to maintain its current credit ratings?**

A. No. Pacific Power has not achieved its allowed rate of return in Washington at any point during BHE’s ownership, and the Commission has generally set Pacific Power’s cost of capital below allowed returns in other jurisdictions.[[4]](#footnote-4) For many years, BHE has not recovered the costs of its actual equity investment in PacifiCorp in Washington rates. Under these circumstances, BHE has no financial incentive to provide more equity to Pacific Power than the minimum necessary—indeed the incentives are to the contrary.

**Q.** **In Order 05 in the 2013 Rate Case, the Commission also expressed concern about a lack of low-cost, short-term debt in PacifiCorp’s capital structure. Please respond.**

A. First, as noted above, the Company’s proposed capital structure in this case includes short-term debt. The Company has included the short-term debt reflected in the PacifiCorp’s actual quarter end balances. This is the same treatment as for the longer-term sources of capital. Second, PacifiCorp’s capital structure in this case includes low short-term interest rates through the Company’s $570 million portfolio of variable rate tax exempt bonds. The interest rate on these securities resets daily or weekly and captures the current low interest rate environment. In fact, the cost of these securities is approximately 1.50 percent—a rate lower than the expected short-term debt costs. The amount of these low cost variable rate securities, $570 million, is about four percent of the company’s total capitalization. That level is solidly within the three- to five-percent range for short-term debt that the Commission discussed in Order 05.[[5]](#footnote-5)

**Q. Have you conducted a reasonableness check on your primary capital structure recommendation in this case?**

A. Yes. I reviewed my capital structure recommendation against recent rate case decisions involving other utilities’ proposed capital structures. It is my understanding that of the 42 electric utility rate cases in which a capital structure determination was ordered during 2013, approximately one-half had a common equity component greater than what the Company is proposing. These cases include the following companies:

* + - Kansas City Power & Light
		- KCP&L Greater Missouri Op.
		- Virginia Electric and Power
		- Duke Energy Ohio
		- Duke Energy Progress
		- Maui Electric
		- Northern States Power—Minnesota
		- Duke Energy Carolinas
		- South Carolina Electric & Gas
		- Westar Energy
		- Northern States Power—Wisconsin
		- UNS Electric

Further, of the eight electric utility cases decided during the first quarter of 2014, the average common equity component was 51.08 percent. The Company’s proposed capitalization in this case is in line with the electric utility industry.

**Q. Did S&P recently reiterate the importance of rate case capital structure determinations as an indicator of regulatory support for a utility’s credit quality?**

A.Yes. In January 2014, S&P stated:

The rates of return and capital structures used to generate the revenue requirement in rate proceedings may not be the primary focus of our assessment, but we still note those and other decisions made in the ratemaking process and assess them based on their relationship to U.S. averages. We consider them to be signals from regulators on their attitude toward credit quality. The capital structure in particular is an indication from the regulator as to whether creditworthiness is an important consideration in its deliberations.[[6]](#footnote-6)

**Q. Would adoption of the proposed capital structure and overall rate of return of 7.67 percent better align Pacific Power with the capital structures and overall rates of return adopted in PacifiCorp’s other jurisdictions?**

A. Yes. As Table 3 below demonstrates, Pacific Power’s allowed common equity component and overall rate of return in Washington are lower than what PacifiCorp is allowed in all other states. The Company’s recommended capital structure and overall rate of return would help close that gap.

**Table 3**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | WashingtonUE-130043 | CaliforniaA.09-11-015 | IdahoPAC-E10-7 | OregonUE 263 | Utah11-035-200 | Wyoming20000-405-ER-11 |
| Common Equity Component | 49.1% | 52.2% | 52.1% | 52.1% | 52.1% | 52.1% |
| Overall Rate of Return | 7.36% | 8.37% | 7.97% | 7.62% | 7.68% | 7.67% |

**Q. How does the Company’s proposed overall rate of return of 7.67 percent compare to authorized and proposed rates of returns for other Washington electric utilities?**

A. As shown in Table 4 below, the Company’s proposed overall rate of return is in line with or below that of other major Washington electric utilities.

**Table 4**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | CompanyProposed | AvistaProposedUE-140188 | AvistaOrderedUE-120436 | PSEOrderedUE-121697 |
| Overall ROR | 7.67% | 7.71% | 7.64% | 7.77% |

**Q. What conclusion can be drawn from this comparison?**

A. The Company’s proposed capital structure meets the Commission’s standard of balancing safety and economy. It provides economy through an overall cost of capital equal to the other major Washington electric utilities and safety through strong credit ratings.

# HYPOTHETICAL CAPITAL STRUCTURE

**Q.** **Is the Company also presenting an alternative cost of capital if the Commission adopts a hypothetical capital structure?**

A. Yes. While the Company’s primary recommendation is based on its actual capital structure, the Company is also proposing an alternative hypothetical capital structure that includes a reduced equity component, but also reflects the impact of that change on the costs of debt and equity.

**Q.** **In general, how does the use of a hypothetical capital structure change Pacific Power’s overall costs of capital?**

A. A fundamental finance principle is that as risk increases so does the required return.[[7]](#footnote-7) If the Commission adopts a hypothetical capital structure with more risk, such as one containing less common equity than PacifiCorp’s actual level of 51.73 percent, an adjustment to increase the capital costs is necessary and appropriate.

**Q. If PacifiCorp actually maintained only 49.10 percent common equity in its capital structure, as in the hypothetical structure previously adopted by the Commission, would its cost of debt be higher?**

A. Yes. It is unrealistic to assume that one element of capital structure can materially change without impacting other elements. With only 49.10 percent common equity in the capital structure, PacifiCorp’s current rating would be lowered. As a consequence, the cost of debt would be higher. A comparison of PacifiCorp to other Washington utilities regulated by this Commission demonstrates this fact.

**Q. How does the Company’s proposed cost of long-term debt compare to Washington utilities, which are capitalized closer to 49.10 percent common equity?**

A.Table 5 below shows that PacifiCorp’s proposed cost of long-term debt is significantly below the currently authorized cost of long-term debt for the other Washington investor-owned electric utilities.

**Table 5**

|  |  |  |
| --- | --- | --- |
|  | ACTUAL | CURRENTLY AUTHORIZED |
|  | PacifiCorp | Avista[[8]](#footnote-8) | Puget Sound Energy[[9]](#footnote-9) |
| Common Equity | 51.73% | 47.00% | 48.00% |
| Cost of Long-Term Debt | 5.19% | 5.72% | 6.16% |

**Q.** **Have you estimated what the impact to the cost of debt would be if PacifiCorp actually financed itself consistent with the hypothetical capital structure approved in the last general rate case?**

A. Yes. Certainly there would be a downgrade in the credit ratings. To provide the magnitude of this increased customer cost, I analyzed PacifiCorp’s debt issuances since its acquisition in 2006 and correspondingly changed the issuance spread to match what a BBB rated utility achieved at about the same point in time that PacifiCorp issued debt. The result is that on the 13 series of debt totaling $5.2 billion, the cost would increase by about 80 basis points to 5.95 percent. Combined with existing pre-acquisition debt, the resulting overall cost of long-term debt would increase to 5.78 percent. That increase in the cost of debt would result in customers paying approximately $41 million more in annual debt service costs.

**Q. What is the overall rate of return using a hypothetical capital structure and the corresponding higher debt and equity costs?**

A. The overall rate of return is 7.99 percent, approximately 32 basis points (0.32 percent) higher than using PacifiCorp’s actual capital structure and costs of capital. This is the result of an increase in long-term debt costs of approximately 59 basis points (0.59 percent) and, as discussed in the testimony of Mr. Strunk, an increase in the cost of common equity of approximately 28 basis points (0.28 percent).

**Q. What is the revenue requirement impact of using the 7.99 percent rate of return derived from a hypothetical capital structure?**

A. The Company estimates that using the 7.99 percent rate of return derived from a hypothetical capital structure would cost Washington customers approximately $2.2 million more annually compared to the Company’s capital structure and rate of return recommendation.

**Q. In addition to these higher capital costs, would there be other adverse consequences to a ratings downgrade?**

A. Yes. The other adverse consequences includes potential loss of access to the capital markets; increased fees under credit agreements, letters of credit and other banking arrangements; increased collateral requirements to support wholesale energy activities; and possible loss of access to the wholesale energy markets. All of these potential developments would undermine the safety and stability of the Company’s business operations.

# CREDIT RATINGS

**Q.** **What are PacifiCorp’s current credit ratings?**

A. PacifiCorp’s current ratings are:

**Table 6**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Fitch** | **Moody’s** | **Standard****& Poor’s** |
| Senior Secured Debt | A- | A1 | A |
| Senior Unsecured Debt | BBB+ | A3 | A- |
| Outlook | Stable | Stable | Stable |

**Q.** **Why should this Commission be concerned about credit ratings and the views expressed by rating agencies?**

A. Credit ratings and the views of rating agencies are important for several reasons. First, the credit rating of a utility has a direct impact on the price that a utility pays to attract the capital necessary to support its current and future operating needs. Many institutional investors have fiduciary responsibilities to their clients and are typically not permitted to purchase non-investment grade (*i.e.*, rated below BBB‑) securities or, in some cases, even securities rated below single A.

 Second, credit ratings are an estimate of the probability of default by the issuer on each rated security. Lower ratings equate to higher risks and higher costs of debt. But even investment grade rated borrowers have experienced problems accessing the capital markets or have been shut out entirely. The financial crisis of 2008 and 2009 provided clear and compelling evidence of the benefits of PacifiCorp’s credit rating because it was able to issue new long-term debt during the midst of the financial turmoil. Other lower-rated utilities were simply shut out of the market and could not obtain new capital regardless of how much they were willing to pay.

 Further, PacifiCorp has a near constant need for short-term liquidity, as well as periodic long-term debt issuances. On a daily basis, PacifiCorp pays significant amounts to suppliers to provide necessary goods and services, such as fuel, spare parts, and inventory. Being unable to access funds can jeopardize the successful completion of necessary capital infrastructure projects and would increase the chance of outages and service failures over the long term.

**Q.** **Can regulatory actions or orders affect a company’s credit rating?**

A. Yes, in a very significant way. Regulated utilities are fairly unique since they cannot set their own prices for their services. The financial integrity of a regulated utility is significantly affected by how the utility is treated on cost recovery issues and in the rates set by regulators. Rates are established by regulators to permit the utility to recover prudently incurred operating expenses and a reasonable opportunity to earn a fair return on the capital invested. Therefore, rate decisions by utility commissions have a direct and significant impact on the financial condition of utilities.

 Rating agencies and investors have a keen understanding of the importance of regulatory outcomes. For example, S&P writes:

The regulatory framework/regime’s influence is of critical importance when assessing regulated utilities’ credit risk because it defines the environment in which a utility operates and has a significant bearing on a utility’s financial performance.

We base our assessment of the regulatory framework’s relative credit supportiveness on our view of how regulatory stability, efficiency of tariff setting procedures, financial stability, and regulatory independence protect a utility’s credit quality and its ability to recover its costs and earn a timely return.[[10]](#footnote-10)

Similarly, Moody’s states:

An over-arching consideration for regulated utilities is the regulatory environment in which they operate.

\* \* \*

For rate-regulated utilities, which typically operate as a monopoly, the regulatory environment and how the utility adapts to that environment are the most important credit considerations.

\* \* \*

The ability to recover prudently incurred costs on a timely basis and to attract debt and equity capital are crucial credit considerations. The inability to recover costs, for instance if fuel or purchased power costs ballooned during a rate freeze period, has been one of the greatest drivers of financial stress in this sector, as well as the cause of some utility defaults. In a sector that is typically free cash flow negative (due to large capital expenditures and dividends) and that routinely needs to refinance very large maturities of long-term debt, investor concerns about a lack of timely cost recovery or the sufficiency of rates can, in an extreme scenario, strain access to capital markets and potentially lead to insolvency of the utility[.][[11]](#footnote-11)

**Q.** **How does maintaining PacifiCorp’s current credit ratings benefit customers?**

A. The Company is in the midst of a period of capital spending and investing in infrastructure to provide for the needs of customers and to meet regulatory and legislative mandates. If PacifiCorp does not have consistent access to the capital markets at reasonable costs, these borrowings and the resulting costs to build new facilities become more expensive than they otherwise would be. The inability to access financial markets can threaten the completion of these necessary projects, which will, in turn, affect system reliability and customer safety. All of the resulting higher costs are ultimately borne by the customers. Maintaining the current single-A credit rating for senior secured debt makes it more likely that PacifiCorp will have access to the capital markets at reasonable costs, even during periods of financial turmoil. This rating will allow PacifiCorp continued access to the capital markets, which will enable it to fulfill its capital investments for the benefit of customers.

**Q.** **Can you provide an example of how the current ratings have benefited customers?**

A. Yes. One example is PacifiCorp’s ability to significantly reduce its cost of long-term debt primarily through obtaining new financings at very attractive interest rates. These lower debt costs benefit customers via lower overall rate of return and lower revenue requirement.

Table 7 below shows the reduction in the Company’s cost of long-term debt since 2011.

**Table 7**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **2014 Rate Case****December 2014** | **UE-130043 Order****December 2013** | **UE-111190 Order****March 2012** | **UE-100749 Order March 2011** |
| Cost of Long-Term Debt  | 5.19% | 5.29% | 5.76% | 5.89% |

 The Company’s customers have benefited from a 70 basis points (0.70 percent) reduction in the Company’s cost of long-term debt since 2011. I estimate that this reduction in the average cost of debt since 2011 results in a decrease of approximately $3.1 million in the revenue requirement in the current case.

**Q.** **Are there other identifiable advantages to a favorable rating?**

A. Yes. Higher-rated companies have greater access to the long-term markets for power purchases and sales. This access provides these companies with more alternatives when attempting to meet the current and future load requirements of their customers. Additionally, a company with strong ratings will often avoid having to meet costly collateral requirements that are typically imposed on lower-rated companies when securing power in these markets.

In my opinion, maintaining the current ratings provides the best balance between costs and the continued access to the capital markets that is necessary to fund capital projects for the benefit of customers.

**Q. Did Moody’s recently change PacifiCorp’s credit ratings?**

A. Yes. On January 30, 2014, Moody’s upgraded the ratings of PacifiCorp, including upgrading first mortgage bonds to A1 (from A2), senior unsecured debt to A3 (from Baa1), and preferred stock to Baa2 (from Baa3).

**Q. Please explain why Moody’s made these rating changes.**

A.The upgrades were primarily driven by Moody’s more favorable view of the relative credit supportiveness of the United States regulatory environment.

**Q. Was the upgrade solely to PacifiCorp or were other utilities also upgraded at this time?**

A. The upgrade was not exclusive to PacifiCorp.[[12]](#footnote-12) Moody’s actions were part of an industry-wide event in which the majority of utilities were upgraded one level. Before the upgrade, Moody’s placed the ratings of most regulated utilities and utility holding companies in the United States on review for upgrade, affecting approximately $400 billion of debt. At that time, Moody’s noted: “These companies have been placed on review because Moody’s has adopted a generally more favorable view of the relative credit supportiveness of the US regulatory environment.”

**Q. Does Moody’s express an opinion on PacifiCorp’s specific regulatory treatment?**

A. Yes. Moody’s wrote: “In the context of Moody’s more favorable view of US utility regulation, Moody’s assesses PacifiCorp’s overall regulatory treatment as average.”[[13]](#footnote-13) Moody’s continued: “Although PacifiCorp has been filing rate cases every year or so in its largest jurisdictions and getting reasonable outcomes, regulatory lag remains an ongoing challenge.”[[14]](#footnote-14)

**Q. Has S&P recently described the Washington regulatory climate as “challenging”?**

A.Yes. For example, S&P recently commented that “Avista faces some challenges in Washington, which remains a somewhat challenging jurisdiction.”[[15]](#footnote-15) Similarly, S&P stated:

Puget Sound’s “strong” business risk profile reflects operations as a sole provider in its service territories of essential electricity and natural gas distribution services that remain regulated by the state of Washington. This regulation provides some support and insulation from market challenges, though historically the jurisdiction has been challenging.[[16]](#footnote-16)

**Q.** **Do rating agencies share a view concerning the need for supportive rate case outcomes?**

A. Yes, quite clearly. Fitch stated: “Ratings stability is predicated on reasonable outcomes in pending and future rate proceedings to recover anticipated, significant capital investments…. A key rating concern is the execution of a large capital plan and timely recovery of related costs.”[[17]](#footnote-17) Fitch further stated:

Given the size of its planned capital investment, timely recovery of capital and related operating and maintenance costs is crucial for PPW’s creditworthiness. Therefore, currently unanticipated adverse developments in PPW’s six regulatory jurisdictions, leading to greater regulatory lag or lower recoveries, and resulting weaker coverage ratios compared with Fitch’s projections could lead to future deterioration in PPW’s creditworthiness and lower credit ratings.[[18]](#footnote-18)

Likewise, Moody’s lists “Reasonably supportive regulatory environment” as one of the ratings drivers, stating: “The stable outlook incorporates Moody’s expectation that PacifiCorp will continue to receive reasonable regulatory treatment for the recovery of its capital expenditures[.]”[[19]](#footnote-19) Moody’s further stated that one of the factors that could cause the rating to be lowered is “adverse regulatory rulings on current and future rate cases such that we would anticipate a sustained deterioration in financial metrics[.]”[[20]](#footnote-20) Moody’s notes that “[r]egulatory lag is a challenge for PacifiCorp, which has long maintained large capital programs to meet load growth as well as regulatory requirements for emissions control, renewable standards, and reliability.”[[21]](#footnote-21)

S&P concurs, stating: “A key ongoing challenge for PacifiCorp is whether it will be able to achieve rate relief at levels necessary to sustain the company’s capital investment program.”[[22]](#footnote-22) S&P also commented: “The stable rating outlook reflects our expectation that management will continue to focus on utility operations and reach constructive regulatory outcomes to avoid any meaningful increase in business risk.”[[23]](#footnote-23)

**Q. Have the rating agencies commented on the Company’s lack of a power cost adjustment mechanism (PCAM) in Washington?**

A. Yes, they are very aware of it and have noted it as a risk in their reports on PacifiCorp. For example, recent reports include the following:

Fuel adjustment mechanisms exist for all states but Washington.[[24]](#footnote-24)

\* \* \*

Over the past two years, the Company has now been granted energy cost adjustment mechanisms in all its jurisdictions except Washington. Such mechanisms to recover fuel and purchased power costs—a large, volatile expense—are more established in other parts of the country.[[25]](#footnote-25)

\* \* \*

Rate constructs in five of the six jurisdictions include power cost adjustments, the State of Washington being the exception.[[26]](#footnote-26)

**Q. Are the Company’s capital structure and cost of capital recommendations in this case designed in part to respond to rating agency concerns and maintain PacifiCorp’s current credit rating to the benefit of customers?**

A. Yes. As I have explained above, the benefits of maintaining PacifiCorp’s current ratings outweigh the costs and justify the reflection of these costs in rates.

# PREFERRED STOCK REFINANCING

**Q. Please provide background on PacifiCorp’s recent refinancing of its preferred stock.**

1. During 2013, PacifiCorp redeemed all remaining outstanding shares of six series of redeemable preferred stock at stated redemption prices. These six series totaled approximately $38 million in stated value and were the entirety of all preferred stock that had a redemption feature. PacifiCorp funded the redemption with cash and completed the permanent refinancing with proceeds of the March 2014 long-term debt financing.

 Following these redemptions, PacifiCorp now has two series of non-redeemable preferred stock outstanding with an aggregate stated value of $2.4 million. These two remaining series do not have a redemption feature that would allow retirement.

**Q.** **Are these actions included in the Company’s proposed capital structure?**

A. Yes. I have removed the preferred stock that was redeemed from the proposed capital structure and included the March 2014 long-term debt issuance in the capital structure.

**Q.** **How does the Company propose to recover the redemption premiums and stock issuance expenses?**

A. As background, under General Instruction 17C, *Long Term Debt: Gain or Loss on Reacquisition, with Refunding,* of the Federal Energy Regulatory Commission Uniform System of Accounts (USOA), in the event of a debt refunding, where PacifiCorp is required to pay a premium to redeem its outstanding long-term debt, that premium as well as the unamortized issue costs of the refunded series would be amortized over the life of the new long-term debt issue. In contrast, the USOA does not provide special accounting for the recording of regulatory assets involving preferred stock redemptions with debt refunding.

Pacific Power is requesting that the Commission authorize the Company to defer to FERC Account 182.3 (Other Regulatory Assets) the premium to redeem the preferred stock, as well as the related unamortized stock expense balance from FERC Account 214 (Capital Stock Expense) and the amounts debited to FERC Account 439 (Adjustments to Retained Earnings)to the extent they exceeded the balance in FERC Account 210 (Gain on Resale or Cancellation of Reacquired Stock). Pacific Power requests an amortization period for this regulatory asset consistent with the new long-term debt issuance of March 2014. This requested accounting would be similar to the regulatory accounting treatment already provided under General Instruction 17 with FERC Account 189 (Unamortized Loss on Reacquired Debt). For a detailed description of the accounting treatment the Company is requesting, see Exhibit No.\_\_\_(BNW-11).

The Company proposes recovery of these charges through the weighted average cost of debt as currently reflected on page 2, line 14, in the cost of long-term debt exhibit (Exhibit No.\_\_\_(BNW-12)) as redemption expenses associated with the March 2014 long-term debt issuance.

**Q.** **Have you estimated the impacts on customers?**

A. Yes. Table 8 below shows the Company’s proposed capital structure and costs of each component, and Table 9 below shows a pro forma capital structure with the impact of the preferred stock refinancing removed.

**Table 8**

|  |
| --- |
| **Proposed Capital Structure and Costs With Refinancing** |
|  | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.193% | 1.7312% | 0.0033% |
| Long-Term Debt | 48.062% | 5.1944% | 2.4965% |
| Preferred Stock | 0.016% | 6.7527% | 0.0011% |
| Common Stock Equity | 51.729% | 10.0000% | 5.1729% |
| Total | 100.000% |  | 7.6738% |
| *WACC Benefit of Preferred Refinancing* | 0.0028% |

**Table 9**

|  |
| --- |
| **Pro Forma Capital Structure and Costs Without Refinancing** |
|  | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.193% | 1.7312% | 0.0033% |
| Long-Term Debt | 47.802% | 5.1994% | 2.4854% |
| Preferred Stock | 0.276% | 5.4274% | 0.0150% |
| Common Stock Equity | 51.729% | 10.0000% | 5.1729% |
| Total | 100.000% |  | 7.6766% |

The preferred stock redemption and refinancing provides a lower overall cost of capital which translates into a revenue requirement savings. This savings arises by redeeming preferred stock with a weighted average after-tax dividend rate of 4.925 percent with new long-term debt that has a 2.65 percent after-tax rate, including amortization of preferred stock redemption costs. The cost of preferred stock increases because the surviving preferred stock, which is not redeemable, carries higher dividend rates than the callable preferred stock that was redeemed. The cost of long-term debt decreases as the cost of debt to refinance the preferred stock is lower than the pro forma average cost of long-term debt without the preferred stock redemption and refinancing.

Also, the cost of long-term debt now includes the unrecovered costs related to certain hybrid debt securities, Exhibit No.\_\_\_(BNW-12), page 3, lines 87 and 88, which were previously recovered through the cost of preferred stock. This shift has no impact on customer rates and is appropriate given the small amount of remaining preferred stock and is consistent with accounting treatment for these unamortized costs.

 To better show the beneficial impacts of this refinancing, Tables 10 and 11 are the same as Tables 8 and 9, respectively, except calculated using the after-tax cost of debt. Because interest expense is deductible, this better captures the full benefit of redeeming the preferred stock and refinancing with lower after-tax cost of debt.

**Table 10**

|  |
| --- |
| **Proposed Capital Structure and Costs With Refinancing and After-Tax Cost of Debt** |
|  | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.193% | 1.0742% | 0.0021% |
| Long-Term Debt | 48.062% | 3.2231% | 1.5491% |
| Preferred Stock | 0.016% | 6.7527% | 0.0011% |
| Common Stock Equity | 51.729% | 10.0000% | 5.1729% |
| Total | 100.000% |  | 6.7252% |
| *After-Tax WACC Benefit of Preferred Refinancing* | 0.0070% |

**Table 11**

|  |
| --- |
| **Pro Forma Capital Structure and Costs Without Refinancing and With After-Tax Cost of Debt** |
|  | Percent of Total | Cost | Weighted Average |
| Short-Term Debt | 0.193% | 1.0742% | 0.0021% |
| Long-Term Debt | 47.802% | 3.2262% | 1.5422% |
| Preferred Stock | 0.276% | 5.4274% | 0.0150% |
| Common Stock Equity | 51.729% | 10.0000% | 5.1729% |
| Total | 100.000% |  | 6.7322% |

Overall, these actions result in a reduction in the overall weighted average cost of capital and provide an approximate $0.2 million reduction in revenue requirement for this case. The deferral treatment for the redemption premium and stock expense as a refunding cost of the new long-term debt refunding issuance results in a lower overall pre-tax and post-tax weighted average cost of capital, compared to a scenario without the redemptions of preferred stock. Reducing the cost of capital through redemption of the preferred stock is a benefit to customers. Absent the preferred stock refinancing, Washington rates would be $0.2 million higher annually.

# POWER PURCHASE AGREEMENTS

**Q.**  **Is PacifiCorp subject to rating agency debt imputation associated with power purchase** **agreements (PPAs)?**

A. Yes. Rating agencies and financial analysts consider PPAs to be debt-like and will impute debt and related interest when calculating financial ratios. For example, S&P will adjust PacifiCorp’s published financial results and impute debt balances and interest expense resulting from PPAs when assessing creditworthiness. They do so to obtain a more accurate assessment of a company’s financial commitments and fixed payments. Exhibit No.\_\_\_(BNW-13) is a publication by S&P detailing its view of the debt aspects of PPAs.

**Q.**  **How would the inclusion of this PPA-related debt and these other adjustments affect PacifiCorp’s capital structure as S&P reviews the credit metrics?**

A. By including the imputed debt resulting from PPAs and these other adjustments, PacifiCorp’s capital structure has a lower equity component as a corollary to the higher debt component, lower coverage ratios, and reduced financial flexibility than what might otherwise appear to be the case from a review of the book value capital structure. For example, if one were to add the $543 million of debt adjustments that S&P makes to PacifiCorp’s capital structure in this case, the resulting common equity percentage would decline from 51.73 percent to 49.90 percent.

**Table 12**



**Q. What would the impact of this adjustment be on the hypothetical capital structure?**

A. If PacifiCorp were financed consistent with the hypothetical capital structure, the rating agency adjustments would produce a capital structure with 47.36 percent common equity, as outlined in Table 13 below. The resulting 47.36 percent equity ratio falls below S&P’s published expectations for PacifiCorp. Such a structure and the resulting financial metrics would not support the Company’s current ratings.

**Table 13**



# FINANCING COST CALCULATIONS

**Q.** **In addition to reducing the average cost of debt through favorable new issuances, has PacifiCorp taken other financing actions to benefit Washington customers?**

A. Yes, through a number of measures. Since the acquisition in 2006, PacifiCorp has been able to negotiate reduced underwriting fees at various times when issuing new long-term debt. I have calculated savings to customers from reduced underwriting fees of over $9.3 million in total.

In addition, PacifiCorp has completed the refinancing of all redeemable preferred stock as I discussed earlier. This refinancing provides annual savings to Washington customers of approximately $0.2 million in the current rate case.

Further, PacifiCorp has periodically refinanced higher cost debt before maturity with lower cost debt such as the 2012 refinancing of tax exempt debt. The Company estimates this refinancing alone provides customers with annual saving of approximately $2.4 million.

The Company’s recommended cost of capital in this case passes all of these savings on to customers.

**Q.** **How did you calculate PacifiCorp’s embedded costs of long-term debt and preferred stock?**

A. I calculated the embedded costs of debt and preferred stock using the methodology relied upon in the Company’s previous rate cases in Washington and other jurisdictions.

**Q.** **What is PacifiCorp’s embedded cost of long-term debt?**

A. The cost of long-term debt is 5.19 percent at December 31, 2014, as shown in Exhibit No.\_\_\_(BNW-12).

**Q.** **Please explain the cost of long-term debt calculation.**

A. I calculated the cost of debt by issue, based on each debt series’ interest rate and net proceeds at the issuance date, to produce a bond yield to maturity for each series of debt. It should be noted that if a bond was issued to refinance a higher cost bond, the pre-tax premium and unamortized costs, if any, associated with the refinancing were subtracted from the net proceeds of the bonds that were issued. Each bond yield was then multiplied by the principal amount outstanding of each debt issue, resulting in an annualized cost of each debt issue. Aggregating the annual cost of each debt issue produces the total annualized cost of debt. Dividing the total annualized cost of debt by the total principal amount of debt outstanding produces the weighted average cost for all debt issues. The result is PacifiCorp’s cost of long-term debt of 5.19 percent.

**Q.** **A portion of the securities in PacifiCorp’s debt portfolio bears variable rates. What is the basis for the projected interest rates?**

A. PacifiCorp’s variable rate long-term debt in this case is in the form of tax-exempt debt. Exhibit No.\_\_\_(BNW-14) shows that, on average, these securities have been trading at approximately 90 percent of the 30-day LIBOR rate for the period January 2000 through December 2013. Therefore, the Company has applied a factor of 90 percent to the forward 30-day LIBOR rate and then added the respective credit enhancement and remarketing fees for each floating rate tax-exempt bond. Credit enhancement and remarketing fees are included in the interest component because these are costs which contribute directly to the interest rate on the securities and are charged to interest expense. This method is consistent with the Company’s past practices when calculating the cost of debt in previous Washington general rate cases and in PacifiCorp’s other jurisdictions.

**Q.** **What is PacifiCorp’s embedded cost of preferred stock?**

A. Exhibit No.\_\_\_(BNW-15) shows the embedded cost of preferred stock at December 31, 2014, to be 6.75 percent.

**Q.** **How did you calculate the embedded cost of preferred stock?**

A. The embedded cost of preferred stock was calculated by first determining the cost of money for each issue. I begin by dividing the annual dividend per share by the per share net proceeds for each series of preferred stock. The resulting cost rate associated with each series was then multiplied by the total par or stated value outstanding for each issue to yield the annualized cost for each issue. The sum of annualized costs for each issue produces the total annual cost for the entire preferred stock portfolio. I then divided the total annual cost by the total amount of preferred stock outstanding to produce the weighted average cost for all issues. The result is PacifiCorp’s embedded cost of preferred stock.

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

A. Yes.

1. The proposed hypothetical capital structure includes the 49.10 percent equity allowed in the currently approved capital structure, but updates the allowed capital structure for the refinancing of certain preferred stock and the addition of short-term debt. The increase in equity costs using the hypothetical capital structure is analyzed by Mr. Strunk. His conclusion is that a 49.10 percent equity ratio in the capital structure would increase the Company’s required cost of equity by 28 basis points. [↑](#footnote-ref-1)
2. *Wash. Utils. & Trans. Comm’n v. PacifiCorp d/b/a Pacific Power & Light Company,* Docket UE-130043, Order 05, ¶ 40 (Dec. 12, 2013). [↑](#footnote-ref-2)
3. On April 30, 2014, MidAmerican Energy Holdings Company (MEHC) changed its name to Berkshire Hathaway Energy. [↑](#footnote-ref-3)
4. For example, Fitch Ratings commented on Order 05, stating: “The allowed return, in Fitch’s opinion, is lower than the sector average of around 10%.” Fitch Ratings, Mar. 10, 2014 (a copy is attached as Exhibit No.\_\_\_(BNW-2)). Regulatory Research Associates (RRA) similarly observed that the “authorized 9.5% return on equity (ROE) is significantly below the average of returns authorized electric utilities nationwide during 2013.” SNL Energy’s RRA Regulatory Focus, Final Report on Docket No. UE-130043 (Jan. 17, 2014) (emphasis added). The RRA report is more extensively quoted in Mr. Strunk’s testimony. [↑](#footnote-ref-4)
5. Docket UE-130043, Order 05, ¶41. [↑](#footnote-ref-5)
6. Standard & Poor’s, *Assessing U.S. Investor-Owned Utility Regulatory Environments* at 5 (Jan. 7, 2014) (emphasis added). [↑](#footnote-ref-6)
7. *See, e.g.,* R. Morin, *New Regulatory Finance*, 63 (2006). [↑](#footnote-ref-7)
8. *See* *Wash. Utils. & Trans. Comm. v. Avista*,Dockets UE-110876/UG-110877 and UE-120436/UG-120437, Order 09, ¶ 32 (Dec. 26, 2012). Avista’s cost of debt includes both long-term and short-term debt. The cost of only long-term debt would be higher than 5.72 percent. [↑](#footnote-ref-8)
9. *See Wash. Utils. & Trans. Comm. v. Puget Sound Energy,* Dockets UE-121697/UG-121705 and UE-130137/UG-130138, Order 07, ¶ 220 (June 25, 2013). [↑](#footnote-ref-9)
10. Standard & Poor’s Ratings Direct, *Key Credit Factors for the Regulated Utilities Industry* (Nov. 19, 2013). [↑](#footnote-ref-10)
11. Moody’s Investors Service at 4, 9, 15 (Dec. 23, 2013). [↑](#footnote-ref-11)
12. Other utilities upgraded include Avista Corp.; Black Hills Corp. and Black Hills Power; CenterPoint Energy and CenterPoint Energy Houston Electric; Consolidated Edison and its subsidiaries, Alliant Energy and Wisconsin Power & Light; PNM Resources and subsidiaries, Pinnacle West Capital Corporation and Arizona Public Service; Public Service Electric & Gas; Virginia Electric and Power Company; Dominion Gas Holdings; Portland General Electric Company; Sempra Energy’s subsidiaries, San Diego Gas & Electric and Southern California Gas; TECO Energy and Tampa Electric; Edison International and Southern California Edison; Exelon's subsidiaries, Baltimore Gas & Electric, Commonwealth Edison and PECO Energy; Florida Power & Light; and Puget Energy and its subsidiary, Puget Sound Energy. [↑](#footnote-ref-12)
13. Moody’s Investors Service (Jan. 30, 2014). A copy is attached as Exhibit No.\_\_\_(BNW-3). [↑](#footnote-ref-13)
14. *Id.* [↑](#footnote-ref-14)
15. S&P Capital IQ (Nov. 6, 2013). [↑](#footnote-ref-15)
16. S&P Capital IQ (Dec. 6, 2013). [↑](#footnote-ref-16)
17. Fitch Ratings (Sept. 16, 2013), attached as Exhibit No.\_\_\_(BNW-4). [↑](#footnote-ref-17)
18. Fitch Ratings (Jan. 6, 2011), attached as Exhibit No.\_\_\_(BNW-5). [↑](#footnote-ref-18)
19. Moody’s Investors Service (May 8, 2013), attached as Exhibit No.\_\_\_(BNW-6). [↑](#footnote-ref-19)
20. *Id*. [↑](#footnote-ref-20)
21. *Id*. [↑](#footnote-ref-21)
22. Standard & Poor’s Ratings Direct (Apr. 29, 2013), attached as Exhibit No.\_\_\_(BNW-7). [↑](#footnote-ref-22)
23. Standard & Poor’s Ratings Direct (Mar. 31, 2014), attached as Exhibit No.\_\_\_(BNW-8). [↑](#footnote-ref-23)
24. Standard & Poor’s Ratings Direct (Oct. 23, 2012), attached as Exhibit No.\_\_\_(BNW-9). [↑](#footnote-ref-24)
25. Moody’s Investor Service (May 8, 2012), attached as Exhibit No.\_\_\_(BNW-10). [↑](#footnote-ref-25)
26. Fitch Ratings (Mar. 10, 2014), attached as Exhibit No.\_\_\_(BNW-2). [↑](#footnote-ref-26)