REDACTED VERSION

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFICORP, d/b/a Pacific Power & Light Company, Respondent.	DOCKET NO. UE-050684

BRIEF ON BEHALF OF THE STAFF OF THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

February 27, 2006

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CONFIDENTIAL PER PROTECTIVE ORDER

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I. OVERVIEW

1 On October 27, 2004, the Commission approved a settlement giving PacifiCorp $15.1 million in additional revenues: a 7.6 percent increase.[1] Less than seven months later, the Company filed this case, seeking an additional $31.6 million: a 14.4 percent increase.[2] The Company is moving toward another rate case filing in June.[3] This is not happy news for ratepayers.

2 Indeed, the Company's case is particularly aggressive on all fronts. The Company wants a cost allocation method that seeks to recover from Washington ratepayers the cost of new resources the Company has been acquiring to serve growing loads elsewhere. The Company wants a broad ranging power cost adjustment mechanism (PCAM), dollar for dollar recovery of deferred hydro costs, and guaranteed recovery of fixed costs through decoupling. The Company does not stop there; it also wants a 49.5 percent equity ratio and an 11.125 percent return on equity.

3 The Company's case is excessive and one-sided. Indeed, if the Commission adopts a more rational cost allocation method, a more balanced capital structure, and a cost of equity that gives effect to the reality of declining capital costs, a rate decrease is justified. At the same time, the Commission should approve a reasonably crafted PCAM and a reasonable level of deferred hydro cost recovery. Commission Staff's (Staff) case provides the basis for doing this.

4 In the end, the Commission should reject the Company's filing and require the Company to file a 4.7 percent rate decrease[4] consistent with Staff's presentation.

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[1] *Utilities & Transp. Comm'n v. PacifiCorp,* Docket No. UE-032065, Order No. 6 (October 27, 2004).
[2] Exh. No. 225T at 3:19-21 (Wrigley).
[3] Tr. 306:14-19 (MacRitchie).
[4] *See* the tables supplied in the Appendix. Table 6 computes the rate decrease. In addition to the required tables, Staff supplies Table 7 (list of uncontested adjustments) and Table 8 (updated Staff results of operations).

II. INTER-JURISDICTIONAL COST ALLOCATION ISSUES

5 In order to set rates for a multi-jurisdictional utility, one of the Commission's basic tasks is to assure that the utility has accurately assigned and allocated to Washington proper amounts of revenues, rate base and operating expenses.[5]

6 Since the 1989 merger between Utah Power & Light and Pacific Power & Light, the Commission has not been required to decide the merits of the cost allocation issue for PacifiCorp. Merger rate freezes and rate case settlements have delayed that decision until now.

7 PacifiCorp now proposes the Revised Protocol allocation method. However, that method is significantly flawed, and it fails to protect Washington ratepayers from paying costs they did not cause the Company to incur. The Commission should therefore reject the Revised Protocol and order the Company to work with interested Washington parties to develop a control area-based cost allocation method.

A. The Commission's Concern About Washington Ratepayers Paying The Higher Cost Of Utah Power & Light Has Become A Reality Under The Revised Protocol

8 At the time of the Pacific Power & Light – Utah Power & Light merger, the Commission's primary concern was the prospect of PacifiCorp shifting costs from higher cost Utah Power & Light to Washington. Below we briefly describe that history, and explain why the Revised Protocol makes that concern a reality.

1. The Commission was concerned about cost shifting when Pacific Power & Light merged with higher cost Utah Power & Light in 1989

9 The 1989 merger between Utah Power & Light and Pacific Power & Light dramatically changed the allocation issue for PacifiCorp and the Commission. This was a merger between a low cost utility (Pacific Power & Light) and a utility whose costs were 40 percent higher (Utah

[5] Exh. No. 541TC at 184:3-10 (Buckley).

Power & Light).[6] In addition, PacifiCorp promised merger rate reductions in only one state; Utah, totaling 10 percent over the few years following the merger.[7]

10 Obviously, any commission would be extremely wary of the prospect of flowing the costs of the higher cost utility to ratepayers of the lower cost utility. The Commission stated its concerns in its order approving the merger:

11
> Staff witness Folsom correctly points out the discrepancy in average system cost between Pacific Power and Utah Power. The Commission continues to be concerned about the effects on Pacific's ratepayers of merging with a higher cost system, and believes the integration of the power supply function for the two companies should be done in a manner consistent with Pacific's least-cost planning process, now getting underway. In the meantime, the Commission views Pacific's current average system costs as the appropriate basis for rates.[8]

12 In this case, PacifiCorp has come up woefully short of demonstrating that its proposed inter-jurisdictional cost allocation method is fair to Washington ratepayers and is not burdening them due to the acquisition of Utah Power & Light.

2. Cost shifting is just as much a concern today

13 PacifiCorp's service area today is a study in contrasts. For example, in Washington, PacifiCorp serves customers who reside in the area of Yakima, Sunnyside and Walla Walla.[9] Major parts of this area are economically classified as "distressed," featuring 9.9 percent unemployment (41 percent above the state average); low per capita wages (under 75 percent of

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[6] Tr. 843:1-2 (Lott).

[7] *Re Utah Power & Light Co.,* Docket No. 87-035-27, 97 PUR 4th 79, 111-12 (Utah PSC 1988) referring to a two percent immediate rate reduction, plus additional promised rate reductions of "three to eight percent." Exh. No. 764 (Staff Response to Bench Request No. 25) shows that Utah ratepayers enjoyed 10 percent rate reductions over the first few years following the merger, and that Utah rates are lower today than before the merger.

[8] *Utilities & Transp. Comm'n v. Pacific Power & Light Co.,* Docket No. U-87-1338-AT, 2nd Supp. Order at 14 (July 15, 1988).

[9] Exh. No. 6, shaded area in Washington; Tr. 321:4-21 (MacRitchie).

the state average); and slow population growth (only 55-75 percent of the state average).[10] There is no evidence this situation is about to change.[11]

14 Growth in the rest of PacifiCorp's Western Control Area[12] is not much better: Washington and the Western Control Area have no need for new generation resources until 2012. Until then, all Western Control Area load growth can and will be satisfied by only 44 MW of DSM resources by 2008.[13] As Dr. Blackmon concluded: "PacifiCorp has virtually no need for additional resources to serve its Washington customers over the next ten years or more."[14] Indeed, PacifiCorp has issued no Westside RFP in recent years.[15]

15 By contrast, PacifiCorp's Utah service area is in the early stages of explosive growth. Utah is the fifth fastest growing state in the Union.[16] According to the Company, load growth there has "outpaced all forecasts."[17]

16 At the same time, PacifiCorp is severely transmission-constrained between its two control areas. As Mr. MacRitchie stated: "The market in Utah is now very constrained because of the lack of transmission investment across the West."[18] Mr. Duvall echoed this statement: "It would not be practical for the Company to operate as a single control area because of the limited

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[10] Exh. No. 531T at 15:15-20 and Exh. No. 533 at 1 & 2 (Blackmon).
[11] PacifiCorp tried to suggest its Washington service area enjoyed strong economic growth, by alleging there was a "particularly striking rebound" in the Washington economy. *Exh. No. 1T at 8:9-11 (MacRitchie).* This allegation was thoroughly debunked by proof that the data the Company relied on was total Washington data. The Company ultimately conceded at hearing that this data was driven by the economy in the Puget Sound area, where PacifiCorp does not serve. *Tr. 345:15-346:9 (MacRitchie).* Dr. Blackmon's Exh. No. 533 shows the economy in PacifiCorp's Washington service area is moribund.
[12] The Western Control Area consists of Washington, Oregon and California. The Eastern Control Area consists of Utah, Idaho and Wyoming. These areas roughly coincide with the pre-merger service territories of Pacific Power & Light and Utah Power & Light, respectively. *Exh. No. 541TC at 19:1-13 (Buckley).*
[13] PacifiCorp's 2004 IRP, Exh. No. 545 at 178, Table 9.1 (Buckley).
[14] Exh. No. 531T at 18:4-7 (Blackmon).
[15] *See, e.g.,* Exh. No. 541TC at 93:6-19 (Buckley).
[16] April 5, 2005 Salt Lake Tribune article citing United States Census data. *Tr. 328:2-7 (MacRitchie).*
[17] Tr. 327:5-12 (MacRitchie) (statement by Mr. MacRitchie to EnergyBiz Magazine (Fall 2005)).
[18] Tr. 327:7-9 (MacRitchie) (statement by Mr. MacRitchie to EnergyBiz Magazine (Fall 2005)).

transmission rights between its Eastern and Western Control Areas."[19] In other words, the Company does not operate its system as an integrated system because it cannot operate its system that way.[20]

17 The numbers wholly confirm PacifiCorp's limited ability to move power on a firm basis between Utah and Washington, or from the Eastern Control Area to the Western Control Area.[21] Annually, the Company transfers only 175 MW (net), between control areas, and even then, the net flow is West to East, not East to West.[22]

18 The consequences from an electrical energy perspective are what one would expect. PacifiCorp has been aggressively planning, acquiring and siting resources in the Eastern Control Area to meet the rapid load growth that is occurring there.[23] The confirming numbers are impressive. In the Eastern Control Area, PacifiCorp is spending $800 million to add 1400 MW of new generation, over 30 times[24] the amount needed in the West. Each new facility is located in or near Salt Lake City, Utah.[25]

19 The documents from PacifiCorp's project justification processes are consistent with this dynamic load growth. Staff's review of PacifiCorp documents from these processes proves the obvious. PacifiCorp acquired each of these new generating resources to serve Utah loads.[26] As

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[19] Exh. No. 331T at 5:2-4 (Duvall).
[20] *See also* Exh. Nos. 559 and 560, which explains the implications of this for cost allocations.
[21] Exh. No. 541TC at 61:10-65:4 (Buckley); Exh. No. 35:19-39:13 (Falkenburg).
[22] Exh. No. 541TC at 68:14-69:8 (Buckley). Indeed, the fact that PacifiCorp sold its share of the Centralia Power Plant in 2000, and has then proceeded to build 1400 MW of resources in Utah proves both: 1) the Company has no need for new generation resources in Washington or the Western Control Area, and 2) the Company is not well integrated between control areas. *Id.* at 34:17-35:4.
[23] Exh. No. 541TC at 56:16-118:8 (Buckley).
[24] $1400 \div 44 = 31.8$ times.
[25] Exh. No. 541TC at 67:8-11 (Buckley).
[26] *Id.* at 74:6-118:8 (Buckley) and exhibits cited therein.

Mr. Buckley concluded: "in thousands and thousands of pages of documents … there wasn't a mention, if you will, of Washington, let alone the Western Control Area …"[27]

20 It would be as unfair today as it was in 1989 for Washington to pick up the costs the Company is incurring to serve Utah and the Eastern Control Area.

3. The Revised Protocol makes Washington ratepayers pay for the resources PacifiCorp has been acquiring to serve Utah

21 The Revised Protocol allocation method presents the very type of allocation method that made the Commission wary in 1989. With few exceptions, the Revised Protocol "rolls-in" all Company resources, including those located in Utah, and then allocates a portion of them to Washington.[28] The Company does this without demonstrating that Washington or Western Control Area ratepayers caused PacifiCorp to incur these costs, without quantifying the benefits these resources provide to Washington or the Western Control Area, and without showing that such benefits of these projects, if any, equal the costs being allocated to Washington.[29]

22 One result is that the Revised Protocol prevents the Commission from analyzing whether PacifiCorp is meeting Washington ratepayers' needs on a least cost basis:

> I can't use the Revised Protocol to tell my commissioners that Washington's needs … have been met in a least cost fashion.[30]

> I need to be able to track the need[s] of Washington and … how to least cost address it. And just by … running the Revised Protocol and then having a number saying that, oh, your rates don't change, that's not satisfactory to me.[31]

23 While there are plenty of other reasons to reject the Revised Protocol (see below), this alone is ample reason to reject the Company's proposed method.

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[27] Tr. 993:15-18 (Buckley).
[28] *E.g.,* Exh. No. 541TC at 45:12-46:2 (Buckley). *See also* Exh. No. 361T at 13:9-10 (Taylor): "An underlying provision of the Revised Protocol is that all States share in the cost of new resources."
[29] *E.g.,* Exh. No. 541TC at 100:14-102:8 (Buckley addressing West Valley Lease), at 104:14-103:14 (Buckley addressing Gadsby Peaker), and at 107:18-108:8 and 109:1-111:8 (Buckley addressing Currant Creek).
[30] Tr. 982:21-23 (Buckley).
[31] Tr. 982:9-15 (Buckley).

B. The Revised Protocol Is Fundamentally Unsound

24 Commission Staff carefully analyzed the Revised Protocol. The record shows that the principles underlying the Revised Protocol are seriously flawed and fully justify the Commission rejecting that method.

1. The Revised Protocol is flawed by design. Its purpose is to avoid cost shifts and pursue "acceptable" results

25 The Commission should reject the Revised Protocol because it was specifically designed *not to do* what an allocation method *should do*: assign cost responsibility correctly and accurately. As the Company explains, the Revised Protocol was explicitly designed "[t]o ensure that these cost shifts did not occur …,"[32] and to produce revenue requirements impacts "in an acceptable range."[33]

26 In other words, the Revised Protocol intentionally and effectively severs the link between who causes the Company to incur a cost, and who pays for it:

> The focus of the Company's support for the Revised Protocol is the palatability of its results, not whether the method accurately reflects cost causation. This offers the Commission no assurance that Washington ratepayers are properly paying their fair share of the Company's costs.[34]

27 PacifiCorp tries to justify its approach by claiming it reflects the same sort of judgment the Commission makes in rate spread determinations using a cost of service study. The Company supports this claim by relying on the Commission's Order in Cause No. U-78-05.[35]

28 In fact, a review of the Commission's Order in Cause No. U-78-05 proves that the Revised Protocol violates, not satisfies, the policy adopted by the Commission in that case. As

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[32] Exh. No. 1T at 27:7-8 and Tr. 346:23-347:10 (MacRitchie), and Exh. No. 361T at 4:3-7 and at 38:3-4 (Taylor).
[33] Exh. 361T at 38:4 (Taylor). The Company never defines the parameters of what is "acceptable."
[34] Exh. No. 541TC at 56:11-14 (Buckley). *See also* Exh. No. 461T at 41:6-8 (Lott): "under the Revised Protocol all states and divisions are allocated a share of all resources, new and old equally without consideration of the growth which required the addition of new resources."
[35] Exh. No. 361T at 4:4-11 and Exh. No. 371T at 5:8-27 (Taylor).

the Company conceded at hearing, the Commission in its Order in Cause No. U-78-05 said that the results of the cost of service study should be taken as they are, and then if necessary, "the concept of gradualism [may be used] to bridge the gap between cost recovery among classes on a gradual basis."[36] That was the basis for the Commission's statement that it would "avoid mechanical application of results of a given study."[37]

29 In other words, the Commission approved the exact opposite of what PacifiCorp proposes here, *i.e.,* that *the study itself* should employ such concepts of gradualism before it ever comes to the Commission. Indeed, as the Company finally conceded:

> Q. There's nothing in the order in U-78-05 or the quote that you have offered the Commission here that says that the cost of service study itself should seek to avoid disproportionate cost shifts between rate schedules?
>
> A. No, there's nothing in this order that says the study itself should do that.[38]

30 The Company's flawed approach is poor public policy because, as Mr. Buckley explained, it is critical for the Commission to have an accurate cost study so the Commission can properly address the results: "our job is to basically take a balanced approach, it falls out like it is, and then you address the issue of the results."[39]

31 Against the inherent cogency and correctness of this policy, PacifiCorp persists in arguing that the cost allocation study *itself* should avoid cost shifts. According to the Company, this is because PacifiCorp serves six states and thus there is no "common judge" involved."[40] Frankly, this makes no sense. Any study that is explicitly founded on a goal of avoiding cost

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[36] Tr. 709:18-20 (Taylor).
[37] *In re Rate Design and Rate Structure Investigation for Electrical Serv.,* Cause No. U-78-05, Order and Decision at 6 (October 29, 1980), quoted in Exh. No. 371T at 5:11-22 (Taylor).
[38] Tr. 709:22-710-2 (Taylor).
[39] Tr. 969:11-25 (Buckley).
[40] Tr. 710:20-23 (Taylor).

shifts is incapable of providing the Commission the information it needs to accurately determine fair, just and reasonable rates. This is a matter of principle, not the numbers of states.

32 In the end, PacifiCorp has chosen a fundamentally wrong approach in designing the Revised Protocol. Indefensible cost allocations result.

2. The Revised Protocol is inappropriately results-driven

33 The Company implemented its goal of avoiding cost shifts by using results-oriented studies, namely: 1) future revenue requirements studies;[41] 2) studies comparing future Revised Protocol results to other, unapproved methods;[42] and 3) risk sensitivity studies.[43] We address the specifics of these studies in a moment, but the Commission should recognize that as a matter of principle, the Company's approach is wrong-headed. Cost-causation should be the guiding principle, not results.[44] As Mr. Buckley testified:

> that's been something that … has evidently been a surprise to many parties, the Company, the other jurisdictions, is that we would be willing to accept, if it was a principled allocation methodology, the results of that, good or bad. We have repeatedly expressed that, and that this type of [results-driven] analysis should not be used to either develop or fine tune what analysis you have.[45]

34 In spite of Staff's pleas "from the early stages,"[46] this principle was not the focus of PacifiCorp and others who developed the Revised Protocol. As Mr. Buckley summarized:

> Washington Staff has stood alone from the very beginning in this … This type of [results-driven] analysis is simply not acceptable for determining what type of allocation methodology should be adopted or what features within an allocation methodology should be adopted.[47]

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[41] Exh. No. 365 (Taylor).
[42] Exh. No. 366 (Taylor).
[43] Exh. No. 334 (Duvall)
[44] *E.g.,* Exh. No. 541TC at 47:6-53:8 (Buckley).
[45] Tr. 968:16-24 (Buckley).
[46] Tr. 970:4-8 (Buckley, and acknowledged by Company counsel). According to Mr. Buckley, Staff was simply "drowned out by the volume of participants from other states." *Tr. 1028:1-2 (Buckley).* For further examples where Staff's concerns were not heeded, see Exh. No. 567.
[47] Tr. 968:4-8 (Buckley).

> Staff is ready and willing to recommend that Washington customers pay rates that reflect the risks associated with PacifiCorp's Washington operations. However, Staff cannot recommend that costs or risks caused by other jurisdictions be shifted to Washington, or that Washington ratepayers should bear costs the Company cannot demonstrate as being caused by Washington operations, simply because in the Company's opinion, its studies show a "modest" or "acceptable" impact.[48]

35 The Commission should support this important principle and reject the Revised Protocol.

3. The studies PacifiCorp uses to justify the Revised Protocol are inappropriate, and unreliable in any event

36 PacifiCorp attempts to use various studies to justify the Revised Protocol. The facts show these studies are inappropriate and unreliable.

a. PacifiCorp's future revenue requirements studies

37 The first studies used by the Company to justify the Revised Protocol are the future revenue requirements studies. These studies are central to PacifiCorp's case for the Revised Protocol. According to the Company, they "laid the foundation" for the Revised Protocol, as well as the Protocol method before that.[49]

38 Exhibit No. 365 is the future revenue requirements study PacifiCorp relies on in this case. It shows that "[w]hile the Revised Protocol produces somewhat lower revenue requirements for Oregon, Washington, and Wyoming in the early years, the trend reverses and those states see larger revenue requirements in the later years."[50] The Company apparently concludes this is "acceptable," not because it shows cost are being correctly assigned to Washington, but rather how Washington's revenue requirements allegedly might fare compared to other states.

39 Staff does not oppose the use of revenue requirements studies *per se*, but not for the purpose they are offered here: to justify the cost allocation model itself. As Mr. Buckley testified, a results-based analysis should have been carried out after the allocation methodology

[48] Exh. No. 541TC at 56:1-7 (Buckley).
[49] Exh. No. 331T at 9:15-16 (Duvall).
[50] Exh. No. 361T at 38:4-7 (Taylor).

was adopted, but "[i]t should not have been used to determine which allocation methodology was adopted."[51]

40 Apart from violating this basic principle, Company Exhibit No. 365 has significant other problems. This exhibit is a study of *future* revenue requirements looking 15 years out, through 2018. Obviously, predicting revenue requirements in the year 2010, let alone 2018, is bound to be inaccurate, and highly dependent on the assumptions, estimates and projections used. As Mr. Buckley explained, these future revenue requirements estimates "may or may not prove to be accurate, and they are based on a number of pricing and other assumptions which may also drive the results."[52] PacifiCorp has simply not shown that the results are sufficiently robust to justify Commission reliance.

b. PacifiCorp's comparisons between the Revised Protocol and other unapproved methods

41 The Company's next attempt to justify the Revised Protocol was by comparing results from that method to results from the Modified Accord method and a fully "rolled-in" method. The Company's Exhibit No. 366 is the result of this effort.

42 There are major problems with this approach, both in concept and execution. As to concept, neither the Modified Accord nor the fully "rolled-in" allocation method has been adopted by the Commission for ratemaking purposes. Consequently, the Company's attempt fails from the outset. As Staff pointed out: "PacifiCorp is using these two unapproved methods to evaluate yet another unapproved method: the Revised Protocol. That is not a sound approach for evaluating a cost allocation method."[53]

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[51] Tr. 967:8-12 (Buckley).
[52] Exh. No. 541TC at 51:4-8 (Buckley).
[53] *Id.* at 54:2-4 (Buckley).

43 As to execution, ICNU's Mr. Falkenburg showed that PacifiCorp comparisons were highly inaccurate. In just the first year of projections, PacifiCorp overstated savings to Washington under the Revised Protocol compared to Modified Accord by [redacted][54] Comparing Modified Accord and the Revised Protocol is also unfair because Modified Accord "has just an in-built error if the two divisions don't grow at a similar pace."[55]

44 Because the benefits of the Revised Protocol are very small compared to Modified Accord,[56] and Modified Accord allocates too much cost to Washington and the West to begin with,[57] the Commission can have no confidence in the Company's comparative analysis, even assuming it had a well-founded basis in principle.

c. PacifiCorp's "risk analysis" studies

45 The last type of study the Company uses to defend the Revised Protocol is a risk assessment study, contained in Exhibit No. 334. This study purports to compare cost allocation methods based on how well they respond under various scenarios and sensitivities, such as loss of load, new resource additions, water conditions, market prices and load growth. All the problems with projections that infect the other Company studies apply here as well. Moreover:

> inter-jurisdictional cost allocations should be based on a proper set of principles, not whether Washington (or another jurisdiction) is better or worse off 15 years into the future if load loss occurs, market prices vary, different future generating plants are added, or if load growth occurs in Utah.[58]

C. The Revised Protocol Allocates Resources to Washington Ratepayers That They Did Not Cause PacifiCorp To Acquire

46 As Mr. Buckley testified: "Under the Revised Protocol, the basic assumption is any resource that's out there, no matter what, 8 point something percent of it gets allocated to

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[54] Exh. No. 491T at 25:13-16 (Falkenburg).
[55] Tr. 889:24-25 (Lott).
[56] Exh. No. 491T at 25:1-6 and Exh. No. 494C (Falkenburg).
[57] Tr. 890:13-17 (Lott).
[58] Exh. No. 154TC at 55:1-7 (Buckley).

Washington."[59] This is improper because "the level of benefits or the level of need needs to correspond to the level [of cost] that is being allocated,"[60] and the Revised Protocol makes no attempt to do that. In other words, the Revised Protocol does not reflect cost causation because it was never really designed to do so.

47 Indeed, "cost causation" did not even make Mr. MacRitchie's list of principles for an appropriate cost allocation methodology.[61] Though it appears in Mr. Taylor's list,[62] he conceded the principles on his list have "tension among them," and there were differing views as to how the principles on his list should be "balanced."[63]

48 In any event, when the Commission searches the record, it will find only in Staff's case any analysis of which states are causing PacifiCorp to incur which costs. The Commission will find the Company's position that "everyone has a different view of cost causation,"[64] but that is no substitute for the Company to rigorously defend the Revised Protocol based on *the Company's* concept of cost causation.

49 Indeed, the Commission needs to look no further than PacifiCorp's own documents to determine cost causation. These are the documents under which the Company plans its system, acquires new resources, and describes the operational constraints on its system. Staff analyzed these documents. They show that the needs of Utah and the Eastern Control Area are causing PacifiCorp to acquire new resources. They also show PacifiCorp never identified or quantified any benefits to Washington or the Western Control Area from these new resources.

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[59] Tr. 1011:22-25 (Buckley).
[60] Tr. 1011:18-21 (Buckley).
[61] Exh. No. 1T at 26:20-27:8 (MacRitchie).
[62] Exh. No. 361T at 4:13-21 (Taylor).
[63] *Id.* at 4:22-5:1 (Taylor). The Company never explains exactly how each listed principle was "balanced."
[64] Exh. No. 361T at 3:17 (Taylor).

50 PacifiCorp suggested it has been acquiring these resources because they are "least cost for the system as a whole."[65] But as Staff explained, that is just "a play on words." PacifiCorp never issued an RFP in the Western Control Area for these new resources, and consequently, "you can't say that you acquired that on a least cost system basis, you just can't say it."[66] Under these circumstances, the Revised Protocol cannot be justified.

1. The needs of Utah and the Eastern Control Area caused PacifiCorp to acquire the West Valley Lease

51 PacifiCorp's documents prove it was Utah and the Eastern Control area that caused the Company to acquire the output of the West Valley project; a 200 MW gas-fired turbine located near Salt Lake City, Utah:

- PacifiCorp's RFP specified that this resource had to be deliverable to the Eastern Control Area.[67]
- The Company's "goal was to secure cost effective resources to meet its East-side capacity requirements."[68] PacifiCorp had an imbalance in the Eastern Control Area between resources and summer peak load requirements, so the Company acquired West Valley to "allow [the Company] to meet East-side peak demand."[69]
- The PacifiCorp Board approved the West Valley Lease. The Board minutes only describe benefits to the Eastern Control Area. Nowhere in the Board minutes[70] or anywhere else[71] did PacifiCorp consider and/or quantify any benefits of West Valley to Washington or the Western Control Area.

52 Despite these facts, the Revised Protocol "rolls-in" the West Valley Lease and makes Washington responsible for $1.4 million of the $16.5 million annual lease payment, plus about 8.3 percent of the O&M costs.[72] This is plainly unreasonable. Washington ratepayers should not

[65] *E.g.,* Tr. 1006:16-18 (Galloway question).
[66] Tr. 1006:19-1007:12 (Buckley).
[67] Exh. No. 541TC at 99:8-16 (Buckley), citing PacifiCorp's 2001 RFP, Exh. No. 423 at 4-5.
[68] Exh. No. 421T at 3:19-20 (Tallman).
[69] Exh. No. 421T at 3:8-13 (Tallman).
[70] Exh. No. 426C (Tallman).
[71] Exh. No. 541TC at 100:14-102:2 (Buckley).
[72] *Id.* at 99:19-100:2 (Buckley).

be responsible for these costs absent: 1) a description of the specific benefits to Washington and a showing that these benefits (if any) match the costs that are allocated to Washington; and 2) a showing that these costs are the least cost means of providing those benefits. PacifiCorp has established neither of these critical elements.

2. The needs of Utah and the Eastern Control Area caused PacifiCorp to acquire the Gadsby Peaker Project

53 PacifiCorp's documents prove it was Utah and the Eastern Control Area that caused PacifiCorp to build the Gadsby Peaker Project; three 40 MW gas-fired turbines located in Salt Lake City, Utah:

- Gadsby "represented a least-cost, new resource option that was consistent with the demand for summer peak capacity in PacifiCorp's Eastern Control Area."[73]
- A primary attribute of the project is that it provides for power on short notice to meet Eastern Control Area needs when the Company cannot import power to that Area.[74]
- The PacifiCorp Board approved the Gadsby Peaker Project. The Project was presented to the Board as a flexible thermal resource for the Eastern Control Area, and it was necessary due to system transmission constraints.[75] There is nothing in the Board minutes[76] or anywhere else[77] showing that PacifiCorp considered and/or quantified any benefits of West Valley to Washington or the Western Control Area.

54 Despite these facts, PacifiCorp wants Washington ratepayers to pay for $6 million of the Company's $75 million investment in Gadsby, plus 8.3 percent of its operating costs.[78] This is plainly unreasonable absent any showing that this level of contribution matches the benefits (if any) the Gadsby Peaker Project provides to Washington, and that Gadsby is the least cost means of providing those benefits.

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[73] Exh. No. 421T at 17:11-13 (Tallman).
[74] Exh. No. 421T at 18:12-16 (Tallman).
[75] *Id.* at 20:11-17 and Exh. No. 429C at 3-4 (Tallman).
[76] Exh. No. 429C (Tallman).
[77] Exh. No. 541TC at 103:4-105:14 (Buckley).
[78] *Id.* at 102:19-103:2 (Buckley).

3. The needs of Utah and the Eastern Control Area caused PacifiCorp to acquire the Currant Creek Project

55 The Currant Creek Project is a $347 million, 525 MW combined cycle combustion turbine, located southwest of Provo, Utah.[79] As with Gadsby and West Valley, the Company's documents prove Utah and the Eastern Control Area caused PacifiCorp to acquire Currant Creek:

- PacifiCorp's RFP required this resource to be deliverable "to PacifiCorp's network transmission system in PacifiCorp's Eastern Control Area."[80]
- In the Company's bid evaluation process, "[n]owhere did PacifiCorp consider the needs of Washington or the Western Control Area, or potential benefits to those areas. Likewise, there was no discussion or evaluation of the proposals regarding the ability of any project to serve the West."[81]
- In certificate of need proceedings in Utah, PacifiCorp described Currant Creek solely in the context of meeting Eastern Control Area needs. Notably, the Company said it needed to reduce reliance on transmission, and the "Eastern Control Area, in general, requires more physical resources to fulfill PacifiCorp's obligation to serve load."[82]
- The PacifiCorp Board approved the Currant Creek Project. The Board minutes show the Project was justified as being needed to supply Eastern Control Area needs only.[83] There is no evidence showing that PacifiCorp considered and quantified any benefits of Currant Creek to Washington or the Western Control Area.[84]

56 Once again, despite this clear showing that the needs of Utah and the Eastern Control Area are causing PacifiCorp to acquire Currant Creek, the Revised Protocol assigns to Washington $29.4 million of the Currant Creek plant costs, plus 8.3 percent of its O&M costs.[85]

4. The needs of Utah and the Eastern Control Area continue to cause PacifiCorp to acquire new generating resources

57 West Valley, Gadsby and Currant Creek mark the beginning, not the end, of PacifiCorp's aggressive campaign to meet the fast-growing needs of its ratepayers in Utah and the Eastern

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[79] *Id.* at 105:18-106:12 (Buckley).
[80] Exh. No. 432 at 3, 1st ¶ of PacifiCorp's 2003A RFP (Tallman).
[81] Exh. No. 541TC at 107:13-16 (Buckley).
[82] Exh. No. 541TC at 109:1-20 (Buckley).
[83] *E.g.,* Exh. No. 433C at 5, 4th ¶ (Tallman).
[84] Exh. No. 541TC at 106:19-111:8 (Buckley).
[85] *Id.* at 106:9-12 (Buckley).

Control Area. For example, PacifiCorp is in the process of acquiring the $330 million Lake Side Project, a 534 MW gas-fired resource. Once again, the Company has chosen to locate the Lake Side Project in Utah, for familiar reasons:

> Because of transmission constraints, the East portion of the system requires more in-state physical resources to fulfill the Company's obligation to serve load. These constraints limit imports from other electrical systems and create a need to buy or build additional capacity. More recent load forecasts indicate an even larger resource gap for the East than was projected in the 2003 RFP.[86]

58 In sworn testimony in Utah, the Company stated the *raison d'être* for this project is to protect "customers in Utah" from wholesale market volatility, high transmission costs, and "potential adverse impacts on service reliability."[87] The Company makes no similar claims for Washington, or the Western Control Area.

59 The Company is actively pursuing other large resource acquisitions to serve the Eastern Control Area.[88] The Commission must reject the Revised Protocol because if it does not, PacifiCorp will demand Washington ratepayers pay for a significant share of these resources, too, without showing there are any commensurate, least cost benefits to Washington.[89]

5. The presence of power exchanges or other arrangements does not justify the "rolling-in" of resources under the Revised Protocol

60 The Company suggested that the Revised Protocol's system-wide, "rolled-in" allocation of resources is justified because resources in one control area can affect the other control area, such as through use of exchange agreements or other financial arrangements, or by addressing peak diversity or greater access to wholesale markets, even if there is no actual physical movement of energy from one control area to the other.[90]

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[86] *Id.* at 113:15-20 (Buckley), quoting PacifiCorp's certificate of need testimony in Utah.
[87] *Id.* at 113:8-11 (Buckley), quoting PacifiCorp's certificate of need testimony in Utah
[88] *Id.* at 114:8-115:9 (Buckley).
[89] *Id.* at 113:8-11 (Buckley).
[90] *E.g.,* Exh. No. 331T at 39:2-41:18 (Duvall); Tr. 941:19-21 (Blackmon).

61 In theory, such arrangements can benefit both control areas. In practice, a utility claiming such benefits has the burden: 1) to identify and quantify these benefits; and then 2) prove these benefits justify a system-wide, "rolled-in" allocation of resource costs, such as the Revised Protocol.[91] PacifiCorp simply has not sustained that burden.

62 In particular, if PacifiCorp believed these arrangements convey benefits sufficiently extensive enough to justify the Revised Protocol's system-wide, "rolled-in" treatment of all resources, the Company would have analyzed those benefits as an integral part of the acquisition and evaluation phase of its new large resource – Westside or Eastside.

63 More concretely, if the Company wishes to claim it acquired Eastside resources such as the Gadsby Peaker Project, Currant Creek or the West Valley Lease in part to support exchange agreements or to provide other benefits to Washington or the Western Control Area, it should have identified and quantified those benefits, and showed these resources were the least cost way to provide them. The Company's case is devoid of such evidence.

64 Undeterred, Staff dutifully conducted its own search. But, after reviewing thousands of Company documents, Staff could find no such evidence either.[92] As Staff concluded:

> The issue is not whether under some circumstances power "can" move to Washington from the resources PacifiCorp has located in the Eastern Control Area to serve load growth there. The issue is whether the extent to which that can occur justifies a system-wide, "rolled-in" allocation methodology such as the Revised Protocol. Mr. Duvall's testimony provides no facts on that issue. The facts show it does not.[93]

65 In any event, a "rolled-in" cost allocation method is simply not required in order to address the costs and benefits of these arrangements (to the extent benefits exist). For example, a transfer pricing mechanism would more directly match and allocate such costs and benefits, if

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[91] *See e.g.,* Exh. No. 562 (Buckley).
[92] Tr. 993:11-20 (Buckley).
[93] Exh. No. 561 at 1, last ¶ and at 2, last ¶ (Buckley).

any. The Commission should adopt a Simplified Control Area-Based Model as Staff recommends, because it would have such a feature.

D. The Revised Protocol Is Flawed In How It Works

66 Apart from the structural flaws that underlie the Revised Protocol, there are significant problems with the way it works. We identify the major problems below.

1. The Revised Protocol allocates seasonal resources in a manner that penalizes slow growing states

67 Seasonal resources are the catch-all category that comprises the majority of PacifiCorp's resources. As we explained earlier, the Revised Protocol unfairly "rolls-in" these resources and allocates a portion to each state, without considering whether the resource benefits each state, and/or whether each state caused PacifiCorp to acquire that resource.[94] "Rolled-in" treatment imposes a further penalty on slow-growing states. As Mr. Buckley explained:

> while a state with fast-growing loads relative to other states would be assigned a share of new resources acquired to meet its needs, it would also be allocated a larger portion of existing lower cost resources, such as those located in another control area.[95]

68 This feature of the Revised Protocol makes it "difficult, if not impossible, to accurately relate the revenue requirement effects of actual load growth to the jurisdiction that is causing that load growth."[96]

2. The Revised Protocol inappropriately assigns costs and benefits of the Company's Mid-Columbia Contracts to the Eastern Control Area

69 In developing the factors used to allocate the benefits of the Company's Mid-Columbia hydro contracts, the Revised Protocol treats the Priest Rapids contract as 100 percent Oregon.[97]

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[94] ¶¶ 24-65. *See also* Exh. No. 541TC at 119:9-120:11 (Buckley).
[95] *Id.* at 120:16-19 (Buckley).
[96] *Id.* at 120:20-121:3 (Buckley).
[97] Exh. No. 362 at 70 and at 71, "Priest Rapids" column (Taylor).

This treatment is based on wording contained in a contract signed in the 1950s.[98] As Mr. Buckley explained, that wording does not justify this treatment, but in any event, the Priest Rapids contract was renegotiated in 2005 and the current contract does not contain the prior wording.[99] Consequently, the 100 percent Oregon treatment is not currently justified, if it was ever justified.

70 The Revised Protocol also assigns some portion of the Company's Mid-Columbia contract costs and benefits to all states,[100] despite the fact that Staff had "steadfastly maintained" that these contracts needed to remain with the former Pacific Power & Light states. Significantly, this feature was negotiated between Utah, Oregon and PacifiCorp only.[101]

71 The benefits and burdens of these Mid-Columbia contracts need to remain with the Western Control Area. They are operated as Western Control Area resources, they have delivery points here, and transmission constraints prevent them from providing reliable service to meet Eastern Control Area needs.[102] The Company should not be allowed to effectively transfer them (in part) to the Eastern Control Area under the auspices of the Revised Protocol.

3. The Revised Protocol's varying treatment of QF Contracts imposes unfair burdens on other states

72 The Revised Protocol labels a QF[103] contract a "New QF Contract," if it was entered into after May 21, 2004. A QF contract is labeled an "Existing QF Contract," if it was entered into before that date. The Revised Protocol "rolls-in" the costs of "New" QF contracts and allocates

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[98] *Id.* footnotes 1 and 2, and Exh. No. 541TC at 124:5-126:18 (Buckley).
[99] Exh. No. 541TC at 124:5-125:4 and at 126:8-18 (Buckley).
[100] Exh. No. 362 at 70 (Taylor).
[101] Exh. No. 541TC at 123:1-15 (Buckley).
[102] *Id.* at 127:1-20 (Buckley).
[103] "QF" refers to a "qualifying facility" under terms of the Public Utility Regulatory Policies Act of 1978 (PURPA). Under certain conditions, some of which are determined by each state, a utility is required to purchase power from qualifying facilities. *Exh. No. 541TC at 1331:14-18 (Buckley).*

them to all states. However, for "Existing" QF contracts, an adjustment is made based on a comparison between each "Existing" QF's costs to the Company's system embedded costs.[104]

73 One result of this complex arrangement is that Washington receives an unadjusted share of $52.2 million in the Company's "New" Utah QF contracts, even though these contracts exceed the Company's embedded costs. If these Utah QFs were treated like "Existing" QFs, an adjustment would be made to protect Washington ratepayers from these excess costs.[105]

74 PacifiCorp cannot and does not defend this difference in treatment by cost causation principles, *i.e.,* PacifiCorp did not conclude that all states cause the Company to incur the entire cost of "New" QFs but only varying parts of "Existing" QFs. Moreover, each state implements PURPA in the manner that reflects each state's policies. Consequently, absent any showing that one state causes the Company to acquire a QF in another state, it is only fair that each state be responsible for its own QFs. The Revised Protocol fails to accomplish that.

4. The Revised Protocol unfairly allocates administration and general expenses

75 Administration and General (A&G) expenses must be allocated to the states because they cannot be directly assigned to a specific state or function.[106] As we described earlier, consistent with Utah's status as the fifth fastest growing state in the nation,[107] PacifiCorp has been adding generating resources in the Eastern Control Area at a rapid pace. But that is not the only impact of load growth. For example, PacifiCorp increased its investment in Utah distribution facilities by an amazing 26 percent over the 2001-05 period; no other state even comes close.[108] Utah's

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[104] Exh. No. 362 at 6-7 and 18-20 (Taylor).
[105] Exh. No. 541TC at 171:13-19 (Buckley).
[106] One example of an A&G expense is the cost of PacifiCorp's corporate headquarters. *Exh. No. 631T at 62:12-18 (Schooley); Tr. 716:1-9 (Taylor).* More *apropos* are the many overhead costs incurred by the Company to plan for growth: financial, least cost planning, transmission planning, etc. As Mr. Lott observed, "a state with large growth would be the cost causer of many of these overhead costs." *Exh. No. 461T at 39:21-40:2 (Lott).*
[107] Tr. 328:2-7 (MacRitchie).
[108] Exh. No. 374, last line, "Utah" column.

number of customers also increased 11 percent over the same period; the second highest percentage in PacifiCorp's service area.[109]

76 An appropriate A&G allocator would take these activities into account. However, the Revised Protocol allocates A&G expenses using the "SO factor," based almost exclusively on gross plant as allocated or assigned to each state by the Revised Protocol.[110] The result is that the Company gives a significant weighting to existing generation (63.2 percent) and situs-assigned plant (35.9 percent), and virtually no weighting to customer counts (0.9 percent).[111] By focusing almost exclusively on existing plant to allocate A&G costs, the Company gives weight to past management investment decisions, rather than how current management incurs A&G costs to address current challenges.

77 Staff's "3-Factor allocator" is based on an equal weighting of each state's percentage of customers, net distribution plant, and system generation.[112] Therefore, it is designed to reflect management's attention to the challenges facing current management.

78 The Company defends its SO factor by saying that no state has challenged the method, and that Utah distribution plant investment was "lumpy" because it needed reinforcing.[113] These arguments are irrelevant, and also wrong. Indeed, the Company conceded that challenges to the SO factor were presented during the PITA discussions, which resulted in changing the Accord Method to the Modified Accord Method.[114] And Utah's distribution plant has consistently grown at roughly double the overall rate of Utah's customer growth for each of the last five

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[109] *Id.*, first shaded line, "Utah" column.
[110] Exh. No. 193, at Tab 10:10.13 (Wrigley).
[111] From Exh. No. 193 at Tab 10:10.10-13. Plant allocated using generation-based factors SE, SG, SSGCT, and SSGCH equals $8,036,391,754 (63%) of the $12,718,443,078 "total gross plant (less SO Factor)" on page 10.13. General and Intangible plant allocated on the customer factor (CN) represents only $120,526,623 (0.9%) of the $12.7 billion total. Situs assigned plant is $4,561,524,699 (36%) of the $12.7 billion total.
[112] Exh. No. 631T at 66:11-67:5. The calculation is shown in Exh. No. 640.
[113] Exh. No. 371T at 21:2-3 and Tr. 735:4-10 (Taylor).
[114] Tr. 717:2-16 (Taylor).

years.[115] Thus, what the Company calls "lumpy," the evidence proves is typical of the explosive growth in Utah. The Company supplies no evidence suggesting this situation is about to change.

79 Prudent management should direct its attention to the current needs of the corporation. The Company's SO Factor does not measure this well because it is not designed to do so. The Commission should therefore reject the SO factor. If the Commission uses Staff's Amended Revised Protocol method for allocating costs, it should use Staff's 3-Factor allocator for allocating A&G costs.[116]

E. The Company Has Yet To Prove Its New Resources Are Both Prudent For The "System" And Prudent For Washington

80 The Company claims a resource should be considered prudent for Washington if it has been determined to be prudent for the "system," and that this concept supports the system-wide, "rolled-in" treatment of resources featured under the Revised Protocol. In particular, the Company suggests that if it acquired a resource on a least cost system-wide basis, it should be considered least cost for Washington.[117]

81 However, the Company cannot even claim that a resource it chose to locate in one control area to serve loads there is least cost for "the system" unless and until the Company has considered resource alternatives in both control areas. For the Gadsby Peaker Project, the Currant Creek Project and the West Valley Lease, the Company did not seek, evaluate or analyze any alternative resources in the Western Control Area. As a result, "you can't discuss whether something was least cost for the system and at the same time not even bring up what the cost might have been in the Western [part of the] system."[118]

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[115] Exh. No. 374, comparing data in "Utah" column above each shaded line.
[116] Staff estimates the impact of the 3-Factor allocator in Adjustments 8.16-8.18. *Exh. No. 633 at 18-19 (Schooley).* These adjustments are fair and reasonable.
[117] *E.g.,* Tr. 1005:8-10 (question by Mr. Galloway, Company counsel).
[118] Tr. 1005:16-19 (Buckley).

82 Until the Company provides a thorough consideration of potential Westside resource options, the Company cannot prove that new Eastside resources are least cost for the system or least cost for Washington.

F. The Solution Is For The Commission To Require The Use Of A Simplified Control Area-Based Model

83 The Revised Protocol cannot be used to set fair, just and reasonable rates for Washington because it improperly allocates costs to Washington. The answer is not for the Commission to accept the Revised Protocol but then add conditions, as many states have done. As Mr. Buckley testified: "I could not stand here and recommend something that I thought was inappropriate and then try to correct it by conditions."[119] The Commission should also stand on principle and reject the Revised Protocol.

84 The answer is not to adopt the "Hybrid" model ordered by the Oregon commission, either. A primary goal of some parties to that effort was to design the model to match the Revised Protocol results.[120] Obviously, that is not acceptable.

85 The answer is for the Commission to require PacifiCorp to use a control area-based cost allocation methodology that is not based on results-driven analyses.[121] A simplified control area-based allocation model is the best chance for the Commission to determine PacifiCorp's costs to serve Washington customers, and to better address factors affecting those costs, such as differential load growth, varying state legislative actions, and individual state regulatory and economic environments.

[119] Tr. 1000:24-1001:1 (Buckley).
[120] Tr. 1024:24-1025:2 (Buckley); Exh. No. 753.
[121] Exh. No. 541TC at 155-159:7 (Buckley). In its Order, the Commission should require that the Control Area-Based Model should not be justified by results, or adjusted based on how it compares to the Revised Protocol or any other method that has not been approved by the Commission. The reasons were addressed earlier at ¶¶ 33-65 of this brief.

86 As Mr. Buckley explained in great detail, because of the significant East to West transmission constraints on PacifiCorp's system, the Company consistently plans, acquires, and operates it resources based on its two control areas.[122] The Company's planning and acquisition-related documents thoroughly prove this.[123] As the Company conceded: "It would not be practical for the Company to operate as a single control area because of the limited transmission rights between its Eastern and Western Control Areas."[124]

87 A simplified control area-based allocation model need not be burdensome to develop. For example, the initial assignment of resources could be based on those utilized primarily within each control area. The costs and benefits of energy transfers between control areas, or other financial or non-physical inter-control area arrangements, could be identified and captured through a simplified mechanism that estimates costs and benefits on average throughout the year. Transmission-related costs should be consistent with a control area-based approach, until a regional transmission entity is formed and its effects can be evaluated.

88 The Commission should order PacifiCorp to work with Staff and other Washington parties to develop a simplified control area-based allocation model, preferably using widely available software (*e.g.,* the Aurora model), if production cost modeling is required. Meanwhile, the Commission can use Staff's "Amended Revised Protocol" to set rates in this case.[125]

G. The Commission Can Use Staff's Amended Revised Protocol To Set Rates In This Case

89 Because PacifiCorp has not satisfied its burden of proving the Revised Protocol is appropriate, Staff offers an "Amended Revised Protocol" method for use in this case only, as a

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[122] Exh. No. 541TC at 56:16-118:8 and exhibits cited therein (Buckley). *See also* Exh. No. 343, the Company's November 2005 IRP document, which continues to show how the Company carefully, and separately reviews the needs of its two different control areas. *E.g., Tr. 658:24-660:24 (Duvall).*

[123] *Id. See* Mr. Buckley's summary in Exh. No. 541TC at 116:9-118:8.

[124] Exh. No. 331T at 5:2-4 (Duvall).

[125] Exh. No. 541TC at 159-185 (Buckley).

transition to a control area-based method. This transitional method makes five adjustments to address some of the major infirmities in the Revised Protocol:

- The New Eastside Resource Allocation Adjustment 8.15[126] is a compromise by including some but not all of the costs of new resources built to serve Utah load growth. The deficiencies of the Revised Protocol in this regard were addressed in ¶¶ 46-65;

- The Mid-Columbia Contract Allocation Adjustment 5.5[127] fairly allocates these resources to the Western Control Area. The deficiencies of the Revised Protocol in this regard were addressed in ¶¶ 69-71;

- The Seasonal Contract Allocation Adjustment 5.6[128] reduces Washington's allocated share of resources PacifiCorp acquired to serve Utah. The deficiencies of the Revised Protocol in this regard were addressed in ¶¶ 67-68;

- The QF Contract Allocation Adjustment 5.7[129] allocates QF contracts on a situs basis. The deficiencies of the Revised Protocol in this regard were addressed in ¶¶ 72-74; and

- Staff's 3-Factor A&G allocator[130] more accurately allocates A&G costs than the SO factor PacifiCorp uses. The deficiencies of the Revised Protocol in this regard were addressed in ¶¶ 75-79.

1. Staff's Amended Revised Protocol does not provide "free" benefits to Washington customers

90 The Company criticized Staff's Eastside Resource Adjustment and Seasonal Contract Allocation Adjustment by claiming they provide Washington "free" benefits while inappropriately removing higher cost Eastside resources.[131] These criticisms lack merit. First, they presume it is appropriate to "roll-in" all resource costs in the first place. It is not. Second, Staff's Eastside Resource Adjustment only removes the fixed costs, not the variable costs associated with certain large, newly acquired Eastside resources inappropriately allocated to

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[126] The New Eastside Resource Allocation Adjustment 8.15 is described in detail in Exh. No. 541TC at 159:16-19 and 162:15-165:19 and it is calculated in Exh. No. 552 (Buckley).
[127] The Mid-Columbia Contract Allocation Adjustment 5.5 is described in detail in Exh. No. 541TC at 161:1-4 and 166:1-167:15 and it is calculated in Exh. No. 553 (Buckley).
[128] The Seasonal Contract Allocation Adjustment 5.6 is described in detail in Exh. No. 541TC at 161:5-8 and 167:17-169:17 and it is calculated in Exh. No. 554 (Buckley).
[129] The QF Contract Allocation Adjustment 5.7 is described in detail in Exh. No. 541TC at 161:9-11 and 1174:18 and it is calculated in Exh. No. 555 (Buckley).
[130] The 3-Factor A&G Allocator is addressed in Exh. No. 631T at 62:13-69:10, and in Exh. No. 640 (Schooley).
[131] *E.g.,* Tr. 996:1-997:18 and Tr. 1014:4-9 (Buckley); Exh. No. 371T at 17:4-17 (Taylor).

Washington under the Revised Protocol.[132] The Company ignores the significant amount of costs Staff's transitional Amended Revised Protocol still allocates to Washington.

91 Moreover, the Company failed to appreciate that these adjustments were simply a "compromise position," offered by Staff to provide the Commission a basis for setting rates in this case only.[133] Staff justified these adjustments by the timing of these large, newly-acquired Eastside resources.[134] The goal was to provide a form of "transfer price" based on the (still to be proven) assumption these resources may have some benefits to Washington.[135] Staff's Amended Revised Protocol still allocates to Washington a significant number of Eastside resources, again, for purposes of this case only.

III. OTHER COST RECOVERY ISSUES

92 In addition to seeking resolution of a highly contentious cost allocation issue, the Company seeks a Power Cost Adjustment Mechanism (PCAM), decoupling, and dollar for dollar recovery of certain deferred hydro costs. For the reasons stated below, the Commission should support a reasonable version of a PCAM, once an allocation method is established, and it should support a balanced and reasonable measure of hydro deferral cost recovery. However, the Commission should reject decoupling because there has been no showing of ratepayer benefits.

A. The Company's PCAM Proposal, As Filed, Is Not Appropriate

93 The Company has plainly overstated its case for a PCAM. First, as Exhibit No. 395 shows, while there was large power cost volatility in the 2000-01 time frame, since mid-2001, "market price volatility has been relatively smooth, … and does not reflect the volatility of the

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[132] Exh. No. 541TC at 163:12-165 and Tr. 1014:14-1015:16 (Buckley).
[133] Exh. No 541TC at 164:7-19 (Buckley). PacifiCorp placed Staff in this position by the Company's own failure to offer an appropriate cost allocation method in this case.
[134] Tr. 1014:4-13 and Exh. 563 at 2 (Buckley).
[135] Tr. 997:5-18 (Buckley).

Energy Crisis years that provides much of the 'exposure' claimed by the Company."[136] Second, it has been five years since the Western energy crisis. If the problem were as severe as PacifiCorp suggests, it would have pursued a PCAM to implementation long before now, particularly in its larger jurisdictions. Finally, normalized power supply costs in base rates reflect a range of water year conditions, fuel price scenarios, and market price levels.[137] The Company's PCAM fails to take this into account.[138]

94 Indeed, there are many different causes of high power costs, *e.g.,* unexpected load growth in Utah and the Company's willing participation in wholesale markets.[139] No PCAM should force Washington ratepayers to guarantee cost recovery related to these factors.

95 The Company contests Staff's claim that the Company has increased its exposure to higher net power costs due to wholesale transactions, on the basis that the wholesale market is necessary to optimize any utility system.[140] The Company's criticism is misdirected. Staff's suggestion that the Company's involvement in the wholesale market may result in increased exposure to higher net power costs is directed only to long-term, wholesale transactions, not the short-term, day-to-day transactions PacifiCorp uses to balance the system. Clearly, short-term, day-to-day transactions are an important resource to the Company. However, long-term wholesale transactions can, unless matched with corresponding purchases and sales, result in increased exposure to higher net power costs.

96 The Company's PCAM also has several structural flaws. First, a PCAM must match the inter-jurisdictional allocation method that is used. PacifiCorp's PCAM fails this standard: "The

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[136] Exh. No. 541TC at 188:4-7 (Buckley).
[137] Exh. No. 541TC at 189:1-190:4 (Buckley).
[138] On rebuttal, the Company argued that Staff's point about normalized power costs was "only partially correct." *Exh. No. 381T at 3:10 (Omohundro).* However, whether "partially correct" or "entirely correct," the fact is that the Company's proposed PCAM does take into account the level of variations already reflected in base rates.
[139] Exh. No. 541TC at 188:12-20 (Buckley).
[140] Exh. No. 398T at 11 (Widmer).

PCAM does not appear to match the inter-jurisdictional allocations [PacifiCorp] used to determine base costs with the new load growth causing the increase in power costs … which shifts new costs from faster growing states to slower growing states."[141] Indeed, if PacifiCorp has its way, ratepayers in Washington will be burdened by a wide array of costs they should not be responsible for, including these:

> the effects of market price variations in the Desert Southwest and Four Corners market; increased gas prices for the Company's new large, gas-fired generating projects it acquired to serve the Utah bubble; coal price exposure for a significantly greater share of coal-fired generating resources; exposure to wholesale market transactions related to activities outside the Western Control Area; and even the immediate higher power costs to serve faster growing jurisdictions outside Washington, that may not be recovered in a timely manner through base rates.[142]

97 Second, the Company's proposed earnings test as a threshold for PCAM-related rate increases or rate credits is based on "actual" returns, which raises a host of issues regarding precisely how that "actual" return is measured. The Company offers no formula.

98 Third, the Company's hypothetical run of the PCAM calculates a $211.5 million cost variation, $160.6 million of which is explained as "all other."[143] Such a loosely-described "catch-all" cost category presents an unfair audit burden to the Commission and the parties.[144]

99 Staff is aware of the interest in this case to compare the features of the cost adjustment mechanisms of Avista and PSE to a PCAM for PacifiCorp. However, there is no strong policy need to develop power cost adjustment mechanisms that are equal, either in approach or implementation. There is a long-term advantage for the Commission to be able to evaluate a number of different approaches to power cost adjustment mechanisms. They are relatively new

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[141] Exh. No. 541TC at 194:3-7 (Buckley). Mr. Falkenburg also concluded that the PCAM was inconsistent with the Company's allocation method. *Exh. No. 491T at 51:6-52-7 and at 53:4-54:2*. He also showed that while Washington is responsible for 1 percent of PacifiCorp's load growth, the PCAM shifts over 2.5 times that amount of load growth to this state. ($4.9 m ÷ $178 m = 2.75%; figures are from Exh. No. 491T at 51:21-52:4 (Falkenburg)).
[142] Exh. No. 541TC at 191:10-17 (Buckley).
[143] Exh. No. 397, line 21. (Widmer)
[144] Exh. No. 541TC at 192:6-14 (Buckley).

tools for setting rates for electric utilities in Washington. Different mechanisms that recognize the specific characteristics of each utility's system, will allow the Commission to evaluate a number of approaches before considering a single, long-term methodology, if indeed that is the appropriate response to the evaluation.

100 Despite the many infirmities in the Company's proposal, Staff can support a PCAM that is more reasonable in scope and more reasonable to administer, once the Commission adopts an appropriate cost allocation method.[145] The PCAM should address only variations in power costs the Company cannot control, and it should include only those costs that do not reflect the variations in normalized power supply costs already included in base rates. It should also include a "dead-band."[146] Staff is willing to work with the Company and parties to develop a mechanism consistent with these principles. One goal could be to present the results during the Company's 2006 rate case.

B. The Company's Hydro Deferral Petition Does Not Strike A Proper Balance Between Investor And Ratepayer Interests

101 Docket No. UE-050412 is PacifiCorp's petition to defer power costs related to declining hydro generation.[147] Staff analyzed the data and concluded that PacifiCorp's Western Control Area hydro resources were affected by the 2005 drought "to an extraordinary degree."[148] Staff calculates a one-time, fixed amount of $2,103,823 as the level of deferral for Washington that is

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[145] The Company agrees an approved allocation method is a prerequisite to a PCAM. *Exh. No. 38T at 7:14-17 and at Tr. 531:15-19 (Omohundro).* This is especially important because the Company's PCAM would inappropriately force Washington ratepayers to pay for power costs of the Company's Eastern Control Area, including the gas costs to serve the new gas-fired generating projects the Company built to serve Utah. *Exh. No. 541TC at 191:2-17 (Buckley).*
[146] Exh. No. 541TC at 194:9-20 (Buckley).
[147] A Commission order is necessary before a utility may defer such costs for later recovery from ratepayers. *E.g., Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Docket Nos. UE-920433, 920499 and 921262 11th Supp. Order at 53 (1993) (rejecting deferred accounting of costs without a Commission order approving same) and *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Cause Nos. U-82-12 and U-82-35, 4th Supp. Order at 23-24 (February 2, 1983) (rejecting deferred accounting of expenses into capital accounts to the extent the Company failed to achieve its authorized return).
[148] Exh. No. 541TC at 206:17-208:20 and Exh. No. 556 (Buckley).

fair to both ratepayers and investors.[149] This amount reflects three adjustments: 1) Eastern Control Area hydro generation is removed, because it does not benefit Washington; 2) a 15 percent "band" is implemented to recognize that existing base rates reflect risks associated with some level of hydro variation; and 3) Staff's allocation factors were applied to be consistent with Staff's case on allocations.[150]

102 By contrast, PacifiCorp wants ratepayers to pay every penny of what it has deferred: $8.26 million by year-end 2005.[151] The Company also opposes Staff's 15 percent "band." The Company claims it is under-recovering its total power costs, and that a "substantial" portion of the under-recovery is due to low hydro.[152]

103 Obviously, any utility would covet guaranteed, 100 percent cost recovery in rates, but that misses the point. Ratemaking is a balancing of ratepayer and investor interests,[153] and it is not appropriate to insulate the utility from all risks. The issue here is the degree to which these hydro costs are extraordinary, and what amount of recovery appropriately balances ratepayer and investor interests. 100 percent recovery from ratepayers is unbalanced and inappropriate.

104 Staff's analysis considered that existing rates already encompass a degree of hydro variation, and adjusted for that. The fact PacifiCorp made no such adjustment is another reason the Commission should reject PacifiCorp's 100 percent rate recovery approach.

105 The Company suggested Staff might have double-counted certain adjustments.[154] Upon reflection, however, there is no double count. The 15 percent "band" proposed by Staff for purposes of maintaining an appropriate risk sharing balance is unrelated to what water years are

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[149] Exh. No. 557 (Buckley). This amount would be recovered over three years. *Exh. No. 541TC at 214:8-11 (Buckley)*. Staff's recommendation is not affected by the improved hydro generation conditions of the 2005/2006 winter.
[150] Exh. No. 541TC at 210:1-212 (Buckley).
[151] Exh. No. 398T at 4:16-21 (Widmer).
[152] *Id.* at 4:1-13 (Widmer).
[153] *E.g., POWER v. Utilities & Transp. Comm'n,* 104 Wn.2d 798, 808, 711 P.2d 808 (1985).
[154] *See* Tr. 966:1-2 (Buckley).

included in base rates. The base rates used in both the Company's and Staff's deferral calculations remove some level of extreme wet and dry water years from the normalized base power supply level calculation. In both the Company's and Staff's methodologies related to this petition, extraordinary costs associated with 2005 water conditions are estimated by comparing actual hydro generation to base rate levels and a "replacement" cost determined.

106 Staff's proposal incorporates what is nothing more than a 15 percent "deadband," which limits the Company's recovery of retroactive power costs to those estimates that reflect truly extraordinary variations in hydro generation from base rate levels, and maintains an appropriate level of risk sharing between investors and ratepayers. Staff's proposal does not result in a double counting of adjustments, as the Company is allowed to recover a significant portion of increases in power costs due to the 2005 drought.

107 In sum, the Commission should grant the petition in Docket No. UE-050412, to the extent of allowing the Company to defer $2,103,823 in extraordinary power costs due to low hydro, and to recover that amount in rates over three years in the manner proposed by Staff.[155]

C. Decoupling Should Not Be Approved Because The Company Has Demonstrated No Quantifiable Ratepayer Benefits

108 NRDC proposes a decoupling mechanism that computes PacifiCorp's fixed costs on a revenue per customer basis, adjusted for weather, and then guarantees PacifiCorp will recover these costs through annual rate changes. Rate impacts are limited to not more than 2 percent annually, but any excess over 2 percent is deferred for later recovery from ratepayers.[156] PacifiCorp filed no decoupling proposal in its case. Not surprisingly, the Company supports NRDC's proposal.[157]

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[155] Exh. No. 541TC at 214:8-18 (Buckley).
[156] Exh. No. 671T at 16:3-22 (Cavanagh).
[157] Exh. No. 383T at 8:14-19 (Omohundro).

109 According to NRDC and PacifiCorp, decoupling is necessary to eliminate an alleged "disincentive" for a utility to aggressively pursue energy efficiency because the utility would make less money (without decoupling) as a result of lower energy sales.[158] However, the Company made no attempt to quantify any effect the proposed mechanism may have on risks associated with recovery of fixed costs. The Bench offered PacifiCorp another opportunity to quantify the impacts of the mechanism, but instead of providing the Commission simulated results of the mechanism under various assumptions or scenarios, the Company demurred.[159]

110 The result is a record that lacks not only the tariffs and accounting rules that would implement the proposed mechanism,[160] it also lacks a thorough evaluation of the potential consequences. What the record does show is that the proposed mechanism reduces risk for shareholders, while offering no corresponding quantified benefit for ratepayers.[161]

111 In particular, PacifiCorp has not identified or committed to any new benefit for ratepayers to compensate them for the shift in risk. For instance, there is no evidence that with decoupling, the Company will accomplish any DSM[162] beyond what it already acquires.[163] Indeed, the Company is currently capturing all cost-effective DSM identified in its integrated resource plan (IRP), which is the tool used to guide and set DSM acquisition targets.[164] The Company's DSM targets are consistent with the levels recommended in the Northwest Power and Conservation Council's Fifth Power Plan.[165]

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[158] Exh. No. 1T at 21:19-22:4 (MacRitchie); Exh. No. 671T at 3:13-18 (Cavanagh); and Exh. No. 701T at 4:2-15 (Steward).
[159] Exh. No. 752 (PacifiCorp Response to Bench Request No. 18).
[160] Tr. 1069:7-10 (Cavanagh).
[161] Exh. No. 701T at 6:2-7:2 (Steward); Exh. No. 691T at 17:8-22:19 (Lazar).
[162] "DSM" means "demand side management," and refers to energy efficiency measures.
[163] Tr. 1138:20-25 and 1146:14-1147:9 (Omohundro).
[164] Exh. No. 701T at 8:10-12 (Steward).
[165] Tr. 1156:5-8 (Steward); Exh. No. 691T at 21:16-20 (Lazar).

112 There also is no evidence that PacifiCorp is or will be negatively impacted financially for its energy efficiency programs. Public Counsel argues that the Company is more than compensated for any lost retail sales through wholesale sales of energy "freed-up" by energy efficiency efforts.[166] Also, the Company is in a period of frequent rate cases, and expects to file another rate case this summer.[167] Frequent rate cases minimize any potential disincentive, or lost revenue from DSM, because billing determinants are reset.[168]

113 It is the Company's burden to prove decoupling provides clear and tangible benefits to ratepayers.[169] On this record, the Company has failed to sustain that burden. The Commission should not approve decoupling in this case.

IV. RATE OF RETURN

114 The cost of money has been declining, as evidenced by the well-documented decline in interest rates.[170] This has particular significance for regulated utilities such as PacifiCorp, which are capital intensive by nature. Just as the return element of rates increased when capital costs increased, it is fair that the return element of rates decrease when capital costs are declining. Staff developed a comprehensive evaluation of current capital markets and investor rate of return requirements, and showed investors today have lower rate of return requirements.

115 The Staff concurs in the Company's cost of long-term debt, short-term debt and preferred stock.[171] There are three contested rate of return issues: 1) capital structure; 2) cost of equity; and 3) the impact of the MEHC acquisition on PacifiCorp's capital structure and cost of equity.

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[166] Exh. No. 691T at 22:22-31:22 (Lazar).
[167] Tr. 306:14-19 (MacRitchie); Tr. 556:10-14 (Omohundro).
[168] Exh. No. 701T at 9:16-10:2 (Steward).
[169] *Id.* at 5:16-7:17 (Steward).
[170] *See* tables and accompanying text in Exh. No. 151T at 7:13-8:4 and at 69:16-70:3 (Rothschild).
[171] Staff accepted as reasonable the Company's 6.427 percent cost of long-term debt (*see* Exh. No. 151T at 21:5-15 (Rothschild)); and its 6.59 percent cost of preferred stock (*see* Exh. No. 151T at 3:19 and at 22:14-23:3 (Rothschild), and Exh. No. 65 (Williams)). Staff also accepts the Company's updated 4.50 percent cost of short term debt (*see* Tr. 1309:24-1310:5 (Williams)).

A. Rate Of Return Before MEHC's Acquisition Of PacifiCorp

116 As Appendix Table 3, Part B shows, the fair rate of return for PacifiCorp is 7.45 percent, before adjustments related to MidAmerican Energy Holdings Company's (MEHC) acquisition of PacifiCorp.

1. Capital structure

117 The appropriate ratemaking capital structure for PacifiCorp is the one proposed by Staff, containing 43.5 percent equity, 55.3 percent debt (51.3 percent long-term debt plus 4.0 percent short-term debt), and 1.2 percent preferred equity, before MEHC-related adjustments.[172]

118 "The Commission determines the appropriate balance of debt and equity in the capital structure on the basis of economy and safety."[173] Staff's proposed capital structure meets that standard. The Company's proposed capital structure does not.

a. Staff's proposed capital structure balances safety and economy

119 Staff's proposed capital structure is safe. It contains virtually the same 54.9 percent median debt ratio achieved by utilities that Standard and Poor's has rated "A," and it is "well within the range of acceptability for investment grade."[174] It is the capital structure the Company used at year-end 2004, and it is consistent with the capital structure the Company has used over the past decade to successfully finance its operations with its current bond rating.[175]

120 Staff's proposed capital structure is economical. Exhibit No. 153 shows that PacifiCorp's proposed 49.5 percent equity ratio[176] is too expensive, costing Washington ratepayers between $1.4 million and $2.6 million annually, without any quantification of offsetting benefits to justify

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[172] Exh. No. 153, top table (Rothschild).
[173] *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.,* Docket Nos. U-89-2688-T and 2955-T, 3rd Supp. Order at 62 (January 17, 1990).
[174] Exh. No. 151T at 11:14-15 (Rothschild).
[175] Exh. No. 151T at 12:7-15 (Rothschild).
[176] Exh. No. 153, bottom table (Williams). ICNU recommends a 47.1% equity ratio. *Exh. No. 121T at 16 (Gorman).* That is also an excessive level of equity, and our analysis applies equally to ICNU's recommendation.

it.[177] In other words, the Company's proposed 49.5 percent equity ratio may be safe, but there is no proof it is economical. Moreover, while PacifiCorp plans to have a 49.5 percent equity ratio by March 2006, after some $500 million in equity infusions,[178] this large increase in the equity ratio is atypical. It is the largest one-year increase in equity ratio in the last decade,[179] and it results in an atypical common equity ratio; the highest the Company has had since 1997.[180]

121 Any company can increase its safety by increasing its common equity ratio. However, an appropriate ratemaking capital structure must satisfy the economy standard as well. The Company made no attempt to meet its burden to quantify how its proposed capital structure meets the Commission's standard of balancing safety *and* economy.[181] The Commission should therefore use Staff's proposed capital structure for ratemaking purposes, before adjusting for MEHC's use of debt to finance its equity investment in PacifiCorp.

b. PacifiCorp's ratemaking capital structure should include 4.0 percent short-term debt

122 Short-term debt is unquestionably the lowest cost source of funds available to the Company, and it should comprise a reasonable level in the Company's overall capital structure for ratemaking purposes. The Company has always used short-term debt to fund its operations. In this case, it is appropriate to include 4.0 percent short-term debt in the capital structure for ratemaking purposes.[182] This is the level the Company used at year-end 2004, and it is within

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[177] Exh. No. 151T at 20:1-16 (Rothschild).
[178] Exh. No. 61T at 5:3-6:5 (Williams).
[179] Exh. No. 151T at 17:1-15 (Rothschild).
[180] *See* Exh. No. 155 (Rothschild).
[181] PacifiCorp quotes the recent Commission Order in *Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.,* (*PSE*), Docket No. UG-040640 and UE-031471 *et al.*, Order No. 6 (February 18, 2005) for the proposition that the Commission uses the utility's actual capital structure. *Exh. No 66T at 85-7 (Williams).* However, the Company had to concede that the Commission said in that order that the acceptable capital structure properly balanced safety and economy. *Tr. 1285:2-19 (Williams).* Indeed, Order No. 6 in *PSE* at 8 states: "We find that Staff's approach, with two modifications, brings us to the right balance between safety and economy …"
[182] Public Counsel agrees short-term debt should be included, but at a 3 percent level, which is too low. *See Exh. No. 107, "PERCENT" column (Hill).*

the range of short-term debt the Company has maintained over the last 10 years. It is well below the average 6.44 percent short-term debt ratio of the comparative group of electric utilities.[183]

123 The Company hopes the Commission will exclude this low cost capital from the ratemaking capital structure. The Company ultimately[184] argues that under FERC rules, the allowance for funds used during construction (AFUDC) accrued on construction work in progress (CWIP) is computed by using short-term debt first,[185] and because no CWIP is in rate base, placing short-term debt in the capital structure creates a "mismatch."[186]

124 The Company is wrong.[187] Even assuming its AFUDC argument is valid, that argument does not apply here because the Commission requires the Company to accrue AFUDC at the fair return, not the short-term debt rate.[188] In any event, use of short-term debt is appropriate regardless of how AFUDC is accrued.[189] As Mr. Rothschild explained: even if short-term debt "is needed and is used for [CWIP], you're still left with another piece you should expect to see above that."[190] Finally, PacifiCorp's AFUDC argument should be rejected because it rests on the fiction that PacifiCorp uses short-term debt exclusively to fund construction. In fact, the Company finances construction using all sources of funds: depreciation, deferred taxes, and net

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[183] Company 10-year average is shown in Exh. No. 155 at 3, fourth line: "ST Debt." (Rothschild). The 6.44% is the average of the figures in the "ST Debt column" on page 4 of Exh. No. 155. The 6.6 percent average shown in the exhibit excludes CH Energy and MGE Energy.

[184] Initially, the Company defended its exclusion of short-term debt on the basis that this is what occurred in the last (settled) rate case here, and in other states. *Exh. No. 79 at 1, part (a) (Williams).* The Company did not mention the AFUDC issue until rebuttal. In PacifiCorp's last contested rate case here, Cause No. U-86-02, the Commission included short-term debt over the Company's objection. *See Exh. No. 151T at 15 (Rothschild).*

[185] Exh. No. 66T at 1:23-2:10 (Williams).

[186] *Id.* at 1:23-2:4 (Williams).

[187] ICNU excludes short-term debt for the same reason as PacifiCorp. *Exh. No. 141 at 2 (Gorman).* Consequently, Staff's analysis applies equally to ICNU's capital structure recommendation.

[188] *Utilities & Transp. Comm'n v. Pacific Power & Light Co.,* Docket No. U-82-12 and 35, 4th Supp. Order at 26 (February 2, 1983): "We reiterate the order that the Company utilize its fair rate of return for calculation of AFUDC …" Note also that WAC 480-100-203 adopts FERC accounting rules, but that "does not supersede any Commission order regarding accounting treatments." *WAC 480-100-203(4).*

[189] Tr. 1380:14-24 (Rothschild). Moreover, the comparative group shows utilities with as much as 11.0-15.2 percent short-term debt. *Exh. No. 155 at 4, "ST Debt" column (Rothschild).*

[190] Tr. 1335:2-6 (Rothschild).

income, not just short-term debt.[191] The Commission should therefore include 4.0 percent short-term debt in the ratemaking capital structure.

2. Cost of common equity

125 Staff's cost of capital expert Mr. Rothschild carefully and consistently evaluated the evidence. He used both the simplified Discounted Cash Flow (DCF) and complex DCF methods.[192] He checked his results with a risk premium/Capital Asset Pricing Model (CAPM) analysis.[193] Based on all his analyses, he showed the appropriate return on common equity (ROE) for PacifiCorp is 8.95 percent.[194] As we demonstrate below, an 8.95percent ROE is very reasonable and reflects investor expectations.

a. The DCF estimates in this record produce a consistent ROE, when GDP growth is properly excluded

126 The Commission places heaviest reliance by far on the DCF method to determine the ROE for utility companies. For example, in *Utilities & Transp. Comm'n v. Gen. Tel. Co. of the Northwest Inc.*, (*GTE*), Docket No. UT-931591, a rate of return only docket, the Commission stated its clear preference for DCF:

> The Commission will continue to rely on the [DCF] analysis as the best and most satisfactory method … The results of all other methods are interesting for the Commission to see as points of comparison. However, those methods are not relied upon in this order to reach a decision on rate of return.[195]

127 In essence, the DCF method measures ROE by adding the estimated dividend yield to the estimated growth in dividends.[196] While the experts disagree primarily on how to properly

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[191] Tr. 1379:25-1381:13 (Rothschild). *See also* Exh. No. 71 at 3:2-5 (PacifiCorp's Utah certificate of need testimony where the Company stated that PacifiCorp finances new construction with operating cash flows, debt and equity, which Mr. Williams confirmed at Tr. 1295:16-1296:11).
[192] Exh. No. 151T at 34:1-43:6 (Rothschild).
[193] *Id.* at 43:8-53:9 (Rothschild).
[194] *Id.* at 53:11-55:2 and Exh. No. 154 (Rothschild).
[195] 3rd Supp. Order at 8 (December 21, 1994).
[196] Exh. No. 151T at 34:3-15 (Rothschild).

estimate growth in the DCF formula, in the end, their DCF results are remarkably close. As the following table shows, the average DCF results of the cost of capital witnesses in this case is 8.86 percent, after dividend growth based on gross domestic product (GDP) is properly excluded (we explain later why it is a mistake to use GDP growth in the DCF formula):

Witness	**DCF Results**[197]
Rothschild	8.66%
Hill	9.23%
Gorman	8.9%
Hadaway	8.63% (w/o GDP Growth)
Average:	8.86%

128 Dr. Hadaway tried to downplay DCF results because he thinks analysts' lower growth rate and inflation rate forecasts are overly pessimistic.[198] In fact, these DCF results are consistent with investor expectations.[199] For example, Dr. Ibbotson (whom Dr. Hadaway relies on in his own testimony[200]) finds the cost of equity for an average risk company in today's economy is 9.27 percent.[201] Because electric utilities enjoy lower risk compared to the average company, Mr. Rothschild's ultimate 8.95 percent ROE recommendation is very reasonable.

129 There are other "checks" of reasonableness for Staff's 8.95 percent estimate. One is to add Dr. Hadaway's estimate of the current equity risk premium of 3.01 percent to Moody's current average utility bond yield of 5.79 percent. This produces a cost of equity of 8.80 percent, again consistent with Mr. Rothschild's 8.95 percent ROE estimate, but inconsistent with the 10.95 percent ROE advanced by the Company based on its risk premium analysis.[202]

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[197] 8.66% - Exh. No. 158 at 2 (Rothschild); 9.23% - Exh. No. 102 (Hill); 8.9% - Exh. No. 121T at 29, Table 3 (Gorman); 8.63% - Exh. No. 151T at 59:7-20 and Exh. No. 161 (Rothschild).
[198] *See e.g.* Tr. 1201:7-19 (Hadaway).
[199] Mr. Hill and Mr. Gorman also explain why Dr. Hadaway was wrong to distance himself from his own DCF results. *Exh. No. 91T at 56:25-57:21 (Hill); Exh. No. 121T at 32:19-33:12 (Gorman).*
[200] *E.g.*, Exh. No. 21T at 26:18-27:7 (Hadaway).
[201] Tr. 1378:16-1379:24 (Rothschild).
[202] Exh. No. 151T at 6:17-7:11 (Rothschild).

b. The Commission should reject Dr. Hadaway's use of GDP growth in the DCF formula

130 "Dr. Hadaway's DCF results depend upon the propriety of using GDP growth in the growth component of the DCF formula."[203] He weights GDP growth 25 percent in his Traditional Constant Growth DCF Model,[204] and 100 percent in his Constant Growth DCF Model.[205] In his Two-Stage Growth DCF Model, he uses 6.6 percent GDP growth exclusively for the second stage growth estimate.[206]

131 However, GDP growth should not be used in the DCF method at all, because GDP growth "has no relationship whatsoever with estimating investor growth expectations within the DCF model."[207] Mr. Rothschild explained why GDP growth as a proxy for long term growth artificially inflates Dr. Hadaway's DCF estimate:[208]

> The growth rate that is required for the DCF model is the growth in cash flow PER SHARE. As I explained earlier, cash flow growth experienced by stock investors comes in the form of dividend growth and/or stock price growth. Both dividend and stock price growth are derived from earnings per share growth. Measures of growth of the United States economy such as GDP might have some, albeit imprecise, relationship to total earnings of a particular Company or industry. However, and especially for the regulated electric utility industry, overall GDP growth is not related to the dividends PER SHARE growth, earnings PER SHARE growth, or stock price growth that are the crucial growth factors used in the DCF method.
>
> While GDP growth can influence total kwh sales levels, it might or might not influence total earnings levels of the electric utility industry, and it does not influence earnings per share levels, especially for a regulated industry such as the electric utility industry.[209]

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[203] *Id.* at 57:5-7.
[204] Dr. Hadaway's Exh. No. 24 at 2, col. 12, entitled "GDP Growth" is one of 4 values averaged to derive growth in col. 13.
[205] *Id.* at 3, col. 18 (Hadaway).
[206] *Id.* at 4, col. 29 (Hadaway). *See also* Exh. No. 151T at 56:18-57:7 (Rothschild).
[207] Exh. No. 151T at 57:18-58:1 (Rothschild).
[208] Mr. Hill provides additional reasons why the Commission should reject GDP growth as a measure of long term growth in the DCF method. *Exh. No. 91T at 58:8-59:10 (Hill).*
[209] Exh. No. 151T at 58:6-59:2 (Rothschild) (emphasis in text).

132 Dr. Hadaway did not directly respond to these criticisms.[210] Instead, he relied on a 1999 general treatise entitled *Financial Management*, which he says supports his use of 6.6 percent GDP growth.[211] However, in the passage he relies on, the authors merely observe that "one might expect the dividend of an average, or 'normal' company to grow at a rate of 6 to 8 percent a year," which the authors say is the long term rate of GDP growth.[212]

133 Obviously, relying on such a generalized and cautious observation (*i.e.,* "might expect," not "can expect," with no definition of "normal") is a problem for which Dr. Hadaway has no solution. Moreover, the authors did not apply their observation to a select group of electric utilities, which is the issue here. Finally, the authors' estimate of 6 to 8 percent GDP growth is not even indicative of the five years since the book was written, when GDP grew at only a 4.84 percent rate, let alone the last 10 or 20 years, when average GDP growth has been 5.2 percent and 5.6 percent respectively; all below the 6.6 percent Dr. Hadaway used.[213]

134 Simple arithmetic also confirms why investors cannot reasonably expect dividends to grow at the rate of 6.60 percent for the proxy group. Dr. Hadaway's DCF studies in his Exhibit No. 24 presume investor cash flows come from dividends and retained earnings to support growth. On page 2 of that exhibit, columns 4-9 show the various growth estimates based on "b times r = g." The group average retention rate "b" is 32.81 percent (col. 6). If the investors' growth rate expectation "g" is 6.60 percent as Dr. Hadaway suggests, then investors expect this comparable group to earn over 20 percent on book equity "r."[214] Obviously, this is neither

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[210] These criticisms apply also to Mr. Gorman's use of GDP growth, though he does point out that Dr. Hadaway's GDP numbers are excessive. *Exh. No. 121T at 32:19-36:2 (Gorman).*
[211] Exh. No. 26T at 10:16-26 and Exh. No. 38 (Hadaway).
[212] Exh. No. 38 at 2 (page 335 of *Financial Management*) (Hadaway).
[213] Tr. 1178:19-1180:8 and Exh. No. 32 (Hadaway).
[214] If $b \times r = g$, then $r = g \div b$. Thus 6.6% (g) ÷ 32.81% (b) = 20.11% (r).

reasonable nor sustainable, but it proves Dr. Hadaway's growth estimate based on GDP is excessive.

135 Yet another reason Dr. Hadaway's growth rate is excessive is because he relied on retention rate projections Value Line made in 2001 for three to five years in the future. For 13 of the companies in Dr. Hadaway's comparative group, Value Line predicted they would retain 41.72 percent of earnings, yet those predictions were way too high. In fact, those 13 utilities retained only 29.66 percent of earnings.[215] Growth in dividends can be expected to be lower based on these facts, which Dr. Hadaway failed to take into account.

136 The Commission should reject Dr. Hadaway's GDP growth analysis. As shown earlier, if GDP growth is removed, the experts' DCF average estimate is 8.86 percent.

c. Other methods for estimating ROE confirm Staff's 8.95 percent ROE

137 Each cost of equity witness also used the risk premium and/or CAPM method to estimate ROE. In general, this method calculates a risk free rate of return, and then an inflation premium which, when added together, gives an investor's required return for a particular investment.[216] Again, pursuant to the Commission's *GTE* decision, these methods produce useful "points of comparison," but they are no substitute for cogent DCF analysis.

138 Mr. Rothschild's risk premium/CAPM analysis maximizes the accuracy obtainable from the risk premium approach because: 1) he used the geometric averaging method to quantify historic actual returns; 2) he quantified the downtrend in the risk premium that has been occurring for decades, and 3) he showed that the risk premium in excess of the inflation rate is a much more reliable predictor of the risk premium than risk premiums in excess of the cost of

[215] Tr. 1187-1190:25 (Hadaway, discussing Exh. No. 39 and Exh. No. 24).
[216] *E.g.,* Exh. No. 151T at 31:1-9 (Rothschild).

debt.[217] Based on these analyses, Mr. Rothschild concluded that the risk premium method is indicating a cost of equity of between 9.15 percent and 9.55 percent, with a mid-point of 9.35 percent for equities of average risk and 7.66 percent for electric utilities.[218]

139 Dr. Hadaway also presented a risk premium analysis, but his study has major flaws.[219] First, his use of forecasted interest rates for utility bonds biased his results upward.[220] While the facts show interest rates have been in a steep decline since at least 1992,[221] interest rate forecasts persistently and incorrectly predicted interest rates would increase throughout that period.[222] As Mr. Gorman noted: "treasury bonds have not increased as Dr. Hadaway suggested …"[223]

140 Second, Dr. Hadaway compared returns allowed by regulatory agencies to actual interest rates at the time of the allowance, to develop an "indicated risk premium," which he added to a projected interest rate for an "A" rated utility bond.[224] However, it is fatally inconsistent to develop a risk premium based upon a comparison of allowed to actual returns, and then switch to forecasted rates for determining the cost of equity.[225] Staff asked for a consistent comparison; but Dr. Hadaway could not provide one.[226]

141 Third, Dr. Hadaway further adjusted his risk premium results based upon the erroneous proposition that risk premiums go up when interest rates drop. In fact, the study he relied on for that proposition found this "risk premium inversion" applied only in the extreme markets from

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[217] Exh. No. 151T at 43:8-48:16 (Rothschild).
[218] *Id.* at 44:1-53:9 and Exh. No. 154 (Rothschild).
[219] These are explained in detail in Exh. No. 151T at 67:14-83:2 (Rothschild).
[220] Exh. No. 151T at 68:17-69:14 (Rothschild).
[221] *See* graph on page 70 of Exh. No. 151T (Rothschild).
[222] Exh. No. 151T at 70:1-71:16 (Rothschild).
[223] Tr. 1674:23-25 (Gorman).
[224] Exh. 25 at 1 (Hadaway).
[225] *E.g.,* if it is correct to use forecasted interest rates now, then the risk premium he quantified should be based upon a comparison of allowed returns to interest rate forecasts as of the time of the allowance. Alternatively, if allowed returns are to be compared to actual interest rates at the time, then actual interest rates should be used to determine what return to allow today. Dr. Hadaway did neither, and his figures are overstated as a result.
[226] Exh. No. 40 at 6.

the late 1970's and early 1980's; not any other periods.[227] Indeed, both financial theory and subsequent studies confirm no inverse relationship between interest rates and risk premiums.[228]

142 The result: Dr. Hadaway's risk premium analysis is not credible and the Commission should not consider it.[229]

143 ICNU witness Mr. Gorman presents a risk premium method that produces a 10.3 percent ROE.[230] However, he too made a fundamental error, by using the arithmetic average (*i.e.,* non-compounded) of historic returns in his analysis. Mr. Rothschild's Exhibit No. 162 provides a detailed explanation why the arithmetic average is inappropriate. The geometric average method was used by both Dr. Hadaway and Mr. Rothschild, and it is the correct approach. Mr. Gorman's risk premium analysis merits no weight.

144 Public Counsel Witness Mr. Hill shows the results of three different methods in addition to the DCF method.[231] If the highs and lows of these three methods are averaged, the result is 8.92 percent, which fully confirms Mr. Rothschild's 8.95 percent cost of equity recommendation.

3. Conclusions

145 Staff's recommended 7.45 percent rate of return before MEHC-related adjustments is reasonable. It is based on a balanced capital structure that is safe and economical. It uses an 8.95 percent ROE based on well thought out, consistent analysis. This ROE is lower than average allowed returns from prior years, which it should be, given the continued decline in the

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[227] Exh. No. 151T at 72:13-75:13 (Rothschild).
[228] *Id.* at 77:8-82:2 (Rothschild). Dr. Hadaway does not offer a basis in financial theory for "risk premium inversion." *Exh. 40 at 1, Item c.*
[229] Mr. Hill also exposes the basic flaws in Dr. Hadaway's arguments for an inverse relationship between interest rates and risk premiums. *Exh. No. 91T at 62:12-67:21 (Hill).*
[230] Exh. No. 121T at 24:15-20 (Gorman).
[231] Exh. No. 91T at 51:8-9 (Hill).

cost of capital.[232] It is also supported by the DCF estimates of all return witness in this case, once GDP growth is correctly eliminated. The Commission should accept Staff's analysis and find the fair rate of return is 7.45 percent, before MEHC-related adjustments.

B. Rate Of Return After MEHC's Acquisition Of PacifiCorp

146 MidAmerican Energy Holdings Company proposes to acquire Scottish Power's book equity in PacifiCorp for $5.1 billion.[233] The purchase price includes an acquisition premium of $1.2 billion.[234] MEHC plans to finance the acquisition with $3.4 billion in equity from MEHC's primary owner, Berkshire Hathaway, and $1.7 billion of new unsecured debt.[235]

147 PacifiCorp, however, asks the Commission to ignore this new debt and set rates as if MEHC had, instead, issued common equity to finance the acquisition. The Company will then recover excessive return allowances and associated income taxes on more equity than is actually invested in the utility. MEHC, in turn, will recover its entire investment in PacifiCorp, including an acquisition premium that does not benefit ratepayers. Instead of paying dividends to utility shareholders, PacifiCorp's dividends to MEHC will service parent Company debt.

148 To address these problems, Staff proposes a double leverage adjustment to reflect the actual cost of new ownership of PacifiCorp by MEHC.[236] Staff's adjustment ensures that rates will be just, fair, reasonable and sufficient, as required by of RCW 80.28.010(1).

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[232] Exh. No. 151T at 7:13-8:4 and at 69:16-70:3 (Rothschild).
[233] Exh. No. 791T at 5:14-18 (Elgin). MEHC will also assume the Company's outstanding debt obligations of $4.3 billion. Thus, the total transaction is valued at $9.4 billion. *Id.*
[234] Exh. No. 791T at 11:2-6 (Elgin).
[235] Exh. No. 791T at 5:19-6:4 (Elgin).
[236] Staff's adjustment has three components. *Exh. No. 791T at 27-29 (Elgin).* First, Staff increased the Company's equity return from 8.95 percent to 9.60 percent to recognize MEHC's increased leverage to finance the acquisition. Second, Staff applied MEHC's incremental cost of debt to the equity in PacifiCorp's capital structure that is financed with new debt. This component reduces Staff's recommended equity ratio from 43.5 to 28 percent, with a corresponding 15.5 percent increase in debt ratio. Third, Staff adjusted PacifiCorp's interest and tax expense to reflect the new weighted cost of debt. This gives ratepayers the tax advantages of debt issued by MEHC to finance its equity investment in PacifiCorp.

1. The Company failed to carry its burden to prove that the MEHC acquisition will have no impact on PacifiCorp's cost of capital

149 The burden of proof to justify an increase in rates is on PacifiCorp.[237] This means the Company must show that its acquisition by MEHC will have no impact on its cost of capital. PacifiCorp failed to make that demonstration.

a. Staff's double leverage adjustment is consistent with applicable case law and regulatory precedent

150 Staff evaluated the cost of capital impacts of the PacifiCorp acquisition using the most fundamental indicator of MEHC's financial management and performance: the balance sheet and income statement of MEHC both before and after its acquisition of PacifiCorp. Staff's analysis demonstrates the following un-rebutted conclusions:

- MEHC issues lower cost debt to finance its equity investment in its existing subsidiary utilities. It will continue this use of double leverage with PacifiCorp.[238]
- The significant and stable cash flows from customers of MEHC's subsidiary utilities allow MEHC to use double leverage.[239] This ability will be enhanced by the acquisition of PacifiCorp, which will "add another source of stable, regulated cash flows to MEHC's portfolio of domestic electricity and pipeline assets."[240]
- Double leverage allows MEHC to earn high returns on its equity investment in its subsidiary utilities.[241] MEHC's equity investment includes the premiums it paid to

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Staff's double leverage adjustment reduces the Company's overall rate of return from 7.45 percent to 7.06 percent. *Exh. No. 798 (Elgin) and Appendix Table 3, Part A.* Staff's adjustment reduces the Company's revenue requirement by about 3 percent. *Appendix Table 6 line 9.*

[237] RCW 80.04.130(4).

[238] Exh. No. 791 at 2:18-3:2, 6:5-10, 9:17-10:18, 12:17-19, 14:1-8 and 16:4-17:3 (Elgin). PacifiCorp argues that double leverage will not exist with PPW Holdings LLC (PPW), a 100 percent equity-financed Company between MEHC and PacifiCorp. *Exh. No. 811T at 18:16-21 (Vander Weide).* However, MEHC will carry on its balance sheet the debt that will appear as equity on PacifiCorp's balance sheet. Thus, PPW is only an intermediary. Its capital structure is irrelevant. *Exh. No. 791T at 35:4-11 (Elgin).*

[239] Exh. No. 791T at 14-8:2 (Elgin). MEHC's current subsidiary utilities are Kern River Transmission Company, Northern Natural Gas Company and MidAmerican Energy Company. These businesses already provide 90 percent of MEHC's gross operating income. *Exh. No. 807 at 3; See also Tr. 1512:4-12 (Elgin).*

[240] Exh. No. 806 at 1; *See also* Exh. Nos. 803 at 1 and 805 at 2.

[241] Exh. No. 791T at 3:3-6, 8:9-11 and 40:1-7; Tr. 1523:3-9 (Elgin). MEHC's current return on total equity of $3.1 billion is 17 percent. *Exh. No. 791T at 19:5 and Exh. No. 797 at 1:6 (Elgin).* MEHC's total equity will increase to $6.5 billion and is expected to earn 14 percent once MEHC acquires PacifiCorp. *Exh. No. 791T at 19:4 and Exh. No. 797 at 1:23 (Elgin).*

> acquire its existing subsidiary utilities.[242] MEHC's equity investment will grow by the $1.2 billion premium MEHC will pay Scottish Power even though that intangible asset is irrelevant to the provision of utility service by PacifiCorp.[243]

Thus, Staff's double leverage adjustment is necessary to reflect in rates the net-of-tax cost of debt MEHC actually incurs to own PacifiCorp, rather than a cost of equity capital not actually provided by MEHC and the cost of income taxes not actually paid by MEHC.

151 PacifiCorp ignores Staff's balance sheet analysis.[244] Instead, the Company argues generally that a double leverage approach violates the principle of *Hope Natural Gas* that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[245]

Through cross-examination Exh. No. 810-A, PacifiCorp tried to show that MEHC's return on equity would be only 7.07 percent. Errors in that exhibit depress the resulting equity return. The exhibit incorrectly states that PacifiCorp's book equity is $3.4 billion, when PacifiCorp's book equity at closing is estimated to be $3.9 billion. *Exh. No. 791T at 11:5-6 (Elgin).* The exhibit incorrectly uses 8.95 percent return on equity, when MEHC could expect to earn 11 percent on book equity with the acquisition of PacifiCorp. *Tr. 1509:12-1510:2, 1513:10-1514:2, and 1555:7-21 (Elgin).*

Indeed, the investment community shares Staff's conclusion that double leverage results in high returns:

> "[Berkshire] has $25 billion in cash assets earning a 3% return, which is depressing Berkshire's return on equity. A regulated public utility, even a weak one like PacifiCorp, can earn 8% to 9%, return on income. Put a little parent leverage on that and you can get returns up in the low teens. It's unexciting, but certainly a big improvement."

Tim O'Brien, portfolio manager for Evergreen Utility and Telecommunications Fund in Boston. *Exh. No. 791T at 40, n. 4 (Elgin).* Berkshire's current cash position is approximately $47 billion. *Id.*

Finally, MEHC controls PacifiCorp's capital structure. Thus, MEHC can change the financial parameters that drive its equity returns, if it believes those returns are insufficient. *Tr. 1559:5-24 (Elgin).*

[242] Exh. No. 791T at 20:18-21:6 (Elgin).

[243] Exh. No. 791T at 3:12-14, 12:2-11, 13:5-8, 20:3-6, 21:10-14, and 22:8-12 (Elgin). The Company admits that its acquisition by MEHC will not produce sufficient synergies or cost reductions to justify paying the $1.2 billion acquisition premium. *Exh. No. 791T at 25, n. 1 (Elgin), citing MEHC testimony in Docket No. UE-051090.* Thus, double leverage allows MEHC to compensate shareholders for their total investment in PacifiCorp, including the acquisition premium. *Tr. 1648:8-20 (Vander Weide).* PacifiCorp is incorrect in claiming that the acquisition premium is not recovered because it is not included in rate base. *Exh. No. 811T at 17:10-13 (Vander Weide).*

[244] This point is best illustrated by Company cross-examination Exh. No. 810-B. The exhibit fails to reconcile the balance sheet of "HoldCo" because it excludes both the acquisition premium and income tax impact of the debt HoldCo issues to fund the acquisition. *Exh. No. 791T at 6:5-10, 12:4-11 (Elgin); Tr. 1530:12-1531:8, 1533:15-25, 1538:17-21 and 1543:6-10 (Elgin).* Thus, the exhibit does not accurately depict Staff's approach. A proper illustration is shown in Exh. No. 794 (Elgin), as described in Exh. No. 791T at 8:13-9:14 (Elgin).

[245] Exh. No. 811T at 5:6-7 and 7:11-12:9 (Vander Weide), *citing*, *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

152 It is, however, fundamental that a utility's rate of return should not be higher than is necessary to provide commensurate equity returns. Otherwise, customers will pay excessive prices, which is something regulation seeks to prohibit.[246]

153 This threshold principle has expressly arisen when holding companies have unsuccessfully challenged double leverage adjustments under *Hope Natural Gas*.[247] A critical factor in these and other cases has been the need to avoid excessive returns to the ultimate stockholder that would occur at the expense of ratepayers, if the cost of capital for the utility is set without regard to the double leverage used by the parent:

> Appellant cites *Bluefield Water Works and Improvement Co. v. Public Service Commission* [citation omitted] and *Federal Power Commission v. Hope Natural Gas Company* [citation omitted], contending that neither of these decisions permits inquiry into either the source or the cost of the investor's capital. The Company further contends, because Hope was a wholly-owned subsidiary of Standard Oil Company of New Jersey and because a leveraging analysis was not used in determining its return, the U.S. Supreme Court has concluded recognition of the parent-subsidiary relationship is inappropriate and confiscatory in determining return. We do not agree.
>
> Neither the issue of the propriety of leveraging techniques used by the parent to acquire the junior equity in the subsidiary, nor the question of whether such techniques produced excessive returns to the common stockholder was before the Supreme Court in either of those cases.[248]

154 Indeed, the very nature of the parent-subsidiary relationship has been the focus of courts in upholding double leverage adjustments as proper for determining the true cost of capital to the utility. In a case involving General Telephone Company of the Northwest and its parent, General Telephone and Electronics Corporation, the court stated:

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[246] *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92 (1968).
[247] *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n of Mo.*, 706 S.W.2d 870 (Mo. 1985); *Gen. Tel. Co. of the Northwest, Inc. v. Idaho Pub. Serv. Comm'n*, 712 P.2d 643 (Idaho 1986); *Gen. Tel. Co. of the Southwest v. Pub. Util. Comm'n of Tex.*, 628 S.W.2d 832 (Tex. 1982); *Potomac Edison Co. v. Pub. Serv. Comm'n*, 369 A.2d 1035 (Md. 1977); *Gen. Tel. Co. of the Southwest v. Ark. Pub. Serv. Comm'n*, 616 S.W.2d 1 (Ark. 1981).
[248] *Gen. Tel. Co. of the Southwest v. Pub. Util. Comm'n of Tex.*, 628 S.W.2d at 842. *See also State ex rel. Associated Natural Gas Co.*, *supra*, 706 S.W.2d at 876; *Gen. Tel. Co. of the Southwest v. Corp. Comm'n*, 652 P.2d 1200, 1205 (N.M. 1982); *Mountain States Tel. and Tel. Co. v. Dep't of Pub. Serv. Reg.*, 624 P.2d 481, 483 (Mont. 1981).

> The stock of GTNW is held solely by its parent GTE. GTNW urges that the Commission should have ignored this fact and looked only to the actual capital structure of GTNW, thus treating it as it would treat a publicly-owned facility. However, the commission reasonably and correctly noted that GTNW is not comparable to a publicly-held company. The capital structure of GTNW is totally manipulated by its parent, GTE. GTNW is easily distinguished, in its financial structure, from non-subsidiaries. The imputation of the parent's capital structure to GTE "recognizes [that] the financing of equity for a subsidiary does not result from the impersonal forces of the financial market [as it does in the case of a publicly-held company], but rather from boardroom decisions made by a parent corporation which controls, to a great extent, the ultimate cost of a subsidiary's equity." [citation omitted.] It is clear that the commission's classification of companies, between wholly-owned subsidiaries and publicly-held facilities, advances the legitimate goal of achieving telephone rates that fairly and reasonably reflect the company's cost and risk of doing business, allowing GTNW a fair return on its investments and those of its parent, while not imposing upon Idaho customers unreasonably high costs for their telephone services.[249]

These same factors will apply here. PacifiCorp will not be a stand-alone, publicly-traded utility that can be compared to utilities that do fit that category. The Company's capital structure will be controlled by MEHC, which will issue $1.7 billion of debt to buy PacifiCorp, but will not place a corresponding amount of equity at risk in capital markets.[250]

155 Finally, double leverage adjustments are not unconventional. They have been widely upheld by other courts[251] and commissions.[252] For example, the Iowa Utilities Board rejected the

[249] *Gen. Tel. Co. of the Northwest, Inc. v. Idaho Pub. Serv. Comm'n*, *supra*, 712 P.2d at 647-48. *See also Gen. Tel. Co. of the Midwest v. Iowa State Commerce Comm'n*, 275 N.W.2d 364, 369 (Iowa 1979); *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n of Mo.*, 706 S.W.2d at 876-77; *Gen. Tel. Co. of the Southwest v. Pub. Util. Comm'n of Tex.*, 628 S.W.2d at 838.

[250] Exh. No. 791T at 4:14-16, 8:7-8 and 38:18-39:2; Tr. 1559:5-17, Tr. 1581:18-22 and Tr. 1584:15-1588:3 (Elgin); Tr. 1647:2-11 (Vander Weide).

[251] *New England Tel. & Tel. Co. v. Pub. Utilities Comm'n*, 448 A.2d 272 (Me. 1982); *Bristol Cy. Water Co. v. Harsch*, 386 A.2d 1103 (R.I. 1978); *S. Cent. Bell Tel. Co. v. La. Pub. Serv. Comm'n*, 352 So.2d 964 (La. 1977); *Ohio Suburban Water Co. v. Pub. Utilities Comm'n*, 402 N.E.2d 539 (Ohio 1980); *City of Pittsburgh v. Pa. Pub. Serv. Comm'n*, 126 A.2d 777 (Pa. 1956).

[252] *Re S. Bell Tel. & Tel. Co.*, 35 PUR 4th 1 (S. Car. PSC 1980); *Re Cent. Tel. Co. of Va.*, 25 PUR 4th 422 (Va. SCC 1978); *Re Wisc. Tel. Co.*, 25 PUR4th 508 (Wis. PSC 1978); *Re S. Cent. Bell Tel. Co.*, 22 PUR4th 257 (Tenn. PSC 1977); *Re United Tel. Co. of N.J.*, 2 PUR 4th 299 (N.J. PUC 1974); *Re Cont'l Tel. Co. of Minn.*, 14 PUR 4th 310 (Minn. PSC 1976).

same arguments now raised by PacifiCorp's witness when he testified for an existing MEHC subsidiary utility.[253] The academic literature also supports double leverage adjustments.[254]

b. Staff's double leverage adjustment addresses MEHC's risk of additional leverage by increasing the Company's return on equity

156 PacifiCorp's overall criticism is that sponsors of double leverage adjustments do not account for the additional risk of debt coverage for the parent when setting rates for the subsidiary utility.[255] That criticism does not apply to Staff's proposal because Staff increased PacifiCorp's return on equity to recognize the increased leverage of MEHC.[256] Staff also captured the cost of debt MEHC will issue to support its equity investment in PacifiCorp.

157 The Company then argues that a subsidiary's equity return with double leverage is the same as the return on equity for a stand-alone utility, if the parent's cost of debt and equity are correctly adjusted for the additional risk of debt coverage at the parent level.[257] The Company produced no analysis to support this claim; it simply assumed that the cost of equity increases proportionally to the change in debt ratio in order to hold the overall cost of capital constant.[258]

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[253] *Re Interstate Power and Light Co.*, 225 PUR 4th 265 (Iowa 2003), *rehearing denied*, 225 PUR 4th 487 (2003); Tr. 1623:5-1624:17 (Vander Weide). The Iowa Utilities Board makes a "narrow exception" to the rule favoring double leverage adjustments when the parent's debt does not support the subsidiary's common equity. *Re Iowa Power & Light Co.*, 112 PUR 4th 374, 398-99, *affirmed* 118 PUR 4th 179 (Iowa 1990). However, even assuming the Commission will adopt all aspects of Iowa's policy, the Iowa exception does not apply here because Berkshire Hathaway will infuse equity through MEHC to acquire PacifiCorp. *Tr. 1557:1-3 (Elgin).* Debt issued by MEHC to finance PacifiCorp will also be recorded on PacifiCorp's books as equity. *Exh. No. 791T at 8:7-9 (Elgin).*

[254] 1 L. Goodman, *The Process of Ratemaking* 610-11 (1998); *See also* 1 A. Priest, *Principles of Public Utility Regulation* 214 (1969) ("In any event, the underlying capital structure of the system must be considered in any parent-subsidiary situation.")

[255] *E.g.*, Exh. No. 811T at 4:12-16, 9:13-19, 16:20-17:6 and 17:15-17 (Vander Weide).

[256] Exh. No. 791T at 28:3-16 (Elgin). Mr. Rothschild evaluated the impact of changing capital structure on investor return requirements. *Exh. No. 151T at 54:6-9 (Rothschild).* His study shows that each 1 percent increase in debt ratio requires a 3-4 basis point increase in the return on equity. This required a 65 basis point increase in the cost of equity in Staff's double leverage adjustment. *Exh. No. 791T at 28:3-14 and Exh. No. 798 at 1:29 (Elgin).*

[257] Exh. No. 811T at 10:1-12:9 and at 18:6-10 and Exh. No. 814 (Vander Weide).

[258] Exh. No. 815, column (e), lines 2 and 9.

In fact, MEHC's cost of equity does not change proportionally when it issues debt to fund its equity investment in its subsidiaries.[259] Staff's double leverage adjustment captures that reality.

158 The Company argues that double leverage is similar to any investor's purchase of utility shares with debt.[260] However, this "margin purchase" analogy breaks down when applied to a holding company like MEHC that is purchasing the entire utility and will control the capital structure of the utility. In contrast, individual investors may buy a few hundred utility shares, but they do not control the utility's capital structure and they cannot use the utility to absorb other risks. For example, an individual investor who faces a margin call cannot direct the utility to borrow funds and use the proceeds to pay a dividend to cover the call. Also, unlike MEHC, individual investors do not carry the entire investment, including an acquisition premium, on a consolidated balance sheet nor can they use the consolidation process to collect income taxes from ratepayers to earn a return on the acquisition premium.[261]

159 Staff's double leverage adjustment does nothing more than recognize the source of funds actually utilized by MEHC to support its investment in the common equity of PacifiCorp. The Commission should adopt Staff's adjustment as a proper means to reflect in rates the true cost of capital to the Company in this parent-subsidiary relationship.

c. Staff's approach captures the benefits of diversification for ratepayers

160 Staff's double leverage approach assumes that MEHC funds its equity investment in each of its subsidiary operating companies, including PacifiCorp, with equal proportions of debt.[262]

161 PacifiCorp contends this violates the principle that the required rate of return on an investment depends only on the risk of that investment, rather than the risk of the owner's other

[259] Exh. No. 791T at 34:18-20 and Tr. 1500:22-1501:9 (Elgin).
[260] Exh. No. 811T at 3:15-4:21 (Vander Weide).
[261] Tr. 1583:17-1588:3 (Elgin).
[262] Exh. No. 798 (Elgin).

investments.[263] However, a business's decision to finance a project is independent of its initial decision to invest at all. The core objective of the utility's financing decision is to minimize the cost of capital.[264] Staff's double leverage adjustment reflects MEHC's satisfaction of that goal by financing its equity investment in PacifiCorp with lower cost debt.

162 The Company's argument also ignores the effects of diversification. Fundamental principles of finance provide compensation only for non-diversifiable risk.[265] The Commission has applied this principle to PacifiCorp, stating that rates should reflect diversification only if that reduces the cost of capital. Ratepayers should be held harmless if diversification increases the cost of capital.[266] Staff's double leverage adjustment meets this core premise.

d. Ring-fencing does not eliminate the impact of double leverage on PacifiCorp's cost of capital

163 The Company argues that double leverage does not impact its cost of capital because "ring-fencing" provisions will be in place after the acquisition closes.[267] This argument should be rejected because it inaccurately describes the underlying purpose of ring-fencing.

164 The purpose of ring-fencing is to erect structural barriers that isolate the Company from MEHC or any other MEHC affiliate or subsidiary. However, these barriers only seek to prohibit MEHC or its affiliates and subsidiaries from drawing on PacifiCorp's financial resources in times of serious financial distress.[268] They do not allow the Company to otherwise control how

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[263] Exh. No. 811T at 5:8-10 and at 12:10-15:4 (Vander Weide).
[264] Exh. No. 791T at 7:9-11 and 36:15-37:2; Tr. 1565:16-24 (Elgin).
[265] Exh. No. 791T at 37:6-10 (Elgin).
[266] *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Cause No. U-84-65, 4th Supp. Order at 16 (June 7, 1985); Tr. 1560:15-1561:11 (Elgin).
[267] Exh. No. 811T at 5:21-6:3 (Vander Weide).
[268] For example, no diversified holding or investment of MEHC can be held by PacifiCorp. *In re Application of MidAmerican Energy Holding Co. and PacifiCorp*, Docket No. UE-051090, Order No. 07, Appendix A at Commitment 11(a) (February 22, 2006). PacifiCorp also cannot make loans or transfer funds to, or assume any obligation or liability for, MEHC, Berkshire Hathaway, or their subsidiaries. *Id.* at Commitment 20. Other provisions separate PPW from MEHC and its other affiliates. They include appointment of an Independent Director

it is financed. Those decisions will be made for PacifiCorp exclusively by MEHC.[269] Staff's double leverage adjustment addresses MEHC's control over PacifiCorp and its decision to finance its equity investment in PacifiCorp with debt.

e. A double leverage adjustment is unnecessary under Scottish Power ownership

165 PacifiCorp criticizes Staff for not applying a double leverage approach with Scottish Power.[270] The Commission is not precluded from considering the capital structure of the parent even though it previously used another method for setting the utility's rate of return.[271]

166 Moreover, in PacifiCorp's first rate case under Scottish Power ownership, the Commission established a multi-year rate plan recommended by the parties.[272] Cost of capital was not litigated.[273] The only other prior rate case under Scottish Power ownership was also settled without litigating cost of capital.[274]

167 More recently, Scottish Power is financed with less debt than PacifiCorp.[275] Thus, a double leverage adjustment is now unnecessary because double leverage does not exist in the current corporate relationship between PacifiCorp and Scottish Power.

2. Staff's double leverage adjustment is fair and protects PacifiCorp's access to capital markets on reasonable terms

168 Other approaches were available to Staff with greater impacts on the Company's cost of capital. When the transaction closes, MEHC's equity investment in intangible assets will

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whose consent is required before PPW can institute or consent to bankruptcy proceedings, or sell substantially all of PPW's assets. *Id.* at Commitment 11(b), *citing* Appendix 1.

[269] Exh. No. 791T at 38:6-39:6; Tr. 1595:17-1596:7 (Elgin).

[270] Exh. No. 811T at 6:4-14 (Vander Weide).

[271] *S. Cent. Bell Tel. Co. v. La. Pub. Serv. Comm'n*, 352 So.2d 964 (La. 1977); *Re Application of Peoples Natural Gas Co.*, 413 N.W.2d 607 (Minn. 1987).

[272] *Utilities & Transp. Comm'n v. PacifiCorp.*, Docket No. UE-991832, 3rd Supp. Order (August 9, 2000).

[273] Tr. 1596:16-1597:1 (Elgin).

[274] *Utilities & Transp. Comm'n v. PacifiCorp.*, Docket No. UE-032065, Order No. 06 (October 27, 2004).

[275] Exh. No. 114T at 5:1-10 (Hill); Exh. No. 97.

increase to $5.5 billion with $6.5 billion of total book equity.[276] Staff could have removed the $5.5 billion and assumed that MEHC has only $1.0 billion in real equity with all tangible assets financed with debt. This approach would have resulted in a larger adjustment, but was not adopted by Staff.

169 Staff's adjustment is also consistent with Commission practice to determine an appropriate capital structure that balances the competing interests of safety and economy.[277] This case involves a holding company but, as always, earned returns on equity will be impacted materially as the ratemaking capital structure diverges from the actual capital structure the holding company elects to finance utility assets.

170 PacifiCorp asserts that Staff's double leverage adjustment would be "very damaging" because PacifiCorp's credit rating would drop from A- to BBB.[278] However, the Company analyzed only Washington stand-alone results even though it finances its operations on a total-company basis.[279] PacifiCorp also used an interstate cost allocation methodology never accepted by the Commission.[280] Thus, the Company overstates the impact of Staff's proposal.[281] PacifiCorp also ignores that credit ratios do not alone determine a company's bond rating.[282]

171 Even PacifiCorp's prediction of a BBB credit rating maintains investment grade credit with access to capital on reasonable terms.[283] Thus, Staff's adjustment will ensure that:

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to

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[276] Exh. No. 791T at 19:3-19 and 30:5-6 (Elgin).
[277] Exh. No. 791T at 31:9-17 (Elgin). Staff's adjustment may be re-calculated should the Commission adopt a different return or capital structure than Staff proposes. *Exh. No. 791T at 30:14-31:6 (Elgin).*
[278] Tr. 1478:25-1479:13 (Williams).
[279] Tr. 1481:24-25 (Williams), Tr. 1494:22-1495:4 (Elgin).
[280] Tr. 1494:7-19 (Elgin).
[281] Tr. 1494:18-21 (Elgin).
[282] Tr. 1706:5-1707:24 (Hill). This is understood by Moody's, which does not publish the credit ratios cited by PacifiCorp. Tr. 1706:12-16 (Hill).
[283] Tr. 1495:18-1496:2 (Elgin).

> maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[284]

Indeed, under Staff's approach, all three credit ratios, as measured by PacifiCorp, exceed historical data (2001-2005) when PacifiCorp maintained an A- credit rating.[285]

172 Finally, Staff's double leverage adjustment uses a cost rate of 5.25 percent for the debt MEHC will issue to buy PacifiCorp. The Company implied that that cost rate is low.[286] Staff's debt cost assumes current long-term Treasury rates of 4.5 percent with a 75 basis point adjustment for current spreads and costs.[287] It is a reasonable estimate of current market prices.

3. The Commission should not delay its decision on cost of capital impacts until the Company's next general rate case

173 Chairman Sidran asked whether it would be prudent to resolve the double leverage issue in the next rate case since MEHC's current plan to finance the acquisition may change.[288]

174 The Commission should not postpone a decision on double leverage. The investment community expects the financing plan to be implemented,[289] and the accuracy of an adjustment will not be improved sufficiently to warrant delay.[290] This Commission and the commissions of all other relevant states have also approved the acquisition,[291] as has the Federal Energy Regulatory Commission.[292] Thus, it is likely the acquisition will close on time.

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[284] *Bluefield Water Works & Imprv. Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692-93 (1923).
[285] Exh. No. 74. Between 2001 and 2005, the Company's FFO Interest Coverage ranged from 2.5x times to 3.5x. PacifiCorp calculates that ratio at 3.8x under Staff's double leverage approach. *Tr. 1479:5-6 (Williams)*. The Company's Total Debt Ratio was 55 and 58 percent. The ratio would be 58.5 percent with the Staff adjustment. *Tr. 1479:9-10 (Williams)*. Historically, FFO to Total Debt was 9.5 to 16.6 percent. PacifiCorp calculates that ratio as 18.8 percent with the Staff double leverage adjustment. *Tr. 1479:11-13 (Williams).*
[286] Tr. 1517:19-1518:15 (Elgin).
[287] Exh. No. 791T at 27:14-19 (Elgin).
[288] Tr. 1591:22-1592:6 and 1595:1-7 (Elgin).
[289] Exh. No. 803 at 2; Exh. No. 804 at 2; Exh. No. 805 at 2.
[290] Tr. 1592:7-16 (Elgin).
[291] Washington: *In re Application of MidAmerican Energy Holding Co. and PacifiCorp*, Docket No. UE-051090, Order No. 07 (February 22, 2006); Oregon: *In re Application of MidAmerican Energy Holdings Co*., Docket No UM 1209, Order (February 24, 2006); Utah: *In re Application of MidAmerican Energy Holdings Co. and PacifiCorp*, Docket No. 05-035-54, Report and Order (January 27, 2006); Idaho: *In re Joint Application of MidAmerican Energy Holdings Co. and PacifiCorp,* Docket No. PAC-E-05-8, Order No. 29973 (February 13, 2006); California: *In re*

175 Finally, the Commission held that the acquisition may have a material and immediate impact on PacifiCorp's cost of capital.[293] The next rate case, however, will not be decided until mid-2007. Thus, if the Commission does not resolve the double leverage issue now, rates may be unjust and unreasonable for a long time. The next rate case can "fine-tune" an adjustment, if necessary.[294]

4. Conclusion on double leverage

176 The Commission's obligation is to regulate in the public interest and set rates that are just, fair, reasonable and sufficient.[295] Staff's double leverage adjustment meets those obligations by reflecting in rates no more than the actual cost of ownership under MEHC.[296] The Commission should adopt the Staff recommendation by setting the Company's overall rate of return at 7.06 percent[297] and adjusting the Company's interest and tax expense accordingly.

V. ACCOUNTING ADJUSTMENTS

177 After careful analysis, Staff was able to accept many of the Company's proposed accounting adjustments, but contested others. A list of Company adjustments Staff does not contest is in Appendix Table 7. The remaining contested adjustments are analyzed below.

Application of PacifiCorp and MidAmerican Energy Holdings Co., Application 05-07-101, Decision Granting Conditional Approval, (February 16, 2006); Wyoming: *In re Application of PacifiCorp and MidAmerican Energy Holdings Co.*, Docket No. 20000-EA-05-226, http://psc.wy.us/htdocs/news/html.

[292] *MidAmerican Energy Holdings Co., et al.*, Docket No. EC05-110-000, Order Authorizing Disposition of Jurisdictional Facilities (December 15, 2005).

[293] Tr. 228:7-10.

[294] Tr. 1592:17-1593:5 (Elgin).

[295] RCW 80.01.040(3); RCW 80.28.010(1).

[296] The Commission can reopen its order to reverse a double leverage adjustment, in the apparently unlikely event that the acquisition is called off. This can be done through RCW 80.04.210. The Commission could instead maintain jurisdiction after its order is issued and render a further order that eliminates the double leverage adjustment.

[297] *See* Table 3, Part A for the calculation of the 7.06% rate or return.

A. Adjustment 4.1, Capital Stock Expense

178 PacifiCorp is seeking retroactive recovery of $41.3 million in common stock issuance costs it incurred years before the test period in this case. These "flotation costs" consist of fees the Company paid to financial institutions and others who helped sell the stock to the public.[298] PacifiCorp paid these costs from the late 1800's through 1998.[299] Now, starting in 2006, the Company wants ratepayers to contribute $2,054,697 (system), $171,200 (Washington),[300] each year for the next twenty years, to pay these prior period costs.

179 The Company's adjustment is a classic example of invalid retroactive ratemaking.[301] The Company did not incur these costs in the test period. It is not appropriate to reach from six to over 100 years outside the test period, and require today's ratepayers to pay these costs now.

180 These costs are also unrecoverable because they are non-recurring; the Company will not incur flotation costs for the foreseeable future.[302] But even if these costs were somehow recoverable, the adjustment is overstated because the Company has already recovered flotation costs through increments added to the Company's allowed return on equity.[303] PacifiCorp agrees this is a proper way to recover flotation costs,[304] but fails to reflect prior compensation.[305]

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[298] Exh. No. 621T at 3:6-8 (Ward); Tr. 453:25-454:10 (Wrigley).
[299] Exh. No. 621T at 3:17 to 4:3 (Ward); Tr. 454:11-20 and Tr. 457:24-458:3 (Wrigley).
[300] Exh. No. 621T at 6:194 (Ward); Exh. No. 191T at 10:9-11, and Exh. No. 193 at 4.1 (Wrigley).
[301] Exh. No. 621T at 6:10-14 (Ward).
[302] This is because PacifiCorp's common stock is no longer publicly traded. *Tr. 454:22-455:1 (Wrigley).*
[303] Some examples from prior Commission decisions for PacifiCorp: In Cause No. U-76-18, the Commission accepted Staff's ROE estimate, which included a "financing and pressure factor." *2nd Supp. Order at 12-13 (December 29, 1976).* The Commission adopted the same ROE in the following two cases, and recognized the analysis in Cause No. U-76-18 as the source: Cause No. U-77-25, 2nd Supp. Order at 8-9 (January 19, 1978), and Cause No. U-78-52, 2nd Supp. Order at 4 (June 4, 1979). In Cause Nos. U-82-12 and -35, the Commission accepted Staff's ROE estimate, which included an increment to "prevent dilution from costs of financing." *4th Supp. Order at 28-29 (February 2, 1983*). In Cause No. U-84-65, the Commission accepted the Staff ROE estimate, which included an adjustment for "selling costs and market pressure." *4th Supp. Order at 13 and 17 (August 2, 1985).* In Cause No. U-86-02, the Commission appears to include an increment for flotation costs, because it accepted an ROE figure 50 basis points higher than Staff's recommended ROE that had included an increment "to cover financing costs and market pressure." 2nd *Supp. Order at 30-31 (September 19, 1986*).
[304] Exh. No. 195T at 22:6-9 (Wrigley).
[305] Tr. 459:17-20 (Wrigley).

181 The Commission should reject Adjustment 4.1 for these reasons.

B. Adjustment 4.10a, Employee Compensation Issues

182 The three Staff/Company differences on employee compensation are: 1) incentive pay; 2) IBEW Local 57 pension expense; and 3) employee medical insurance expense.

183 *Incentive Pay*. PacifiCorp proposes to include over $30.3 million (system) of incentive pay in test year operating expenses: $27,977,130 under the Company's Annual Incentive Plan, and $2,331,516 payable in stock under the Long Term Incentive Plan.[306]

184 The Annual Incentive Plan is PacifiCorp's primary incentive pay plan, open to all employees who do not participate in other incentive plans. The Annual Incentive Plan is comprised of three weighted components: 10 percent PacifiCorp Scorecard Objective, 30 percent Business Unit Balanced Scorecard, and 60 percent Individual Performance.[307]

185 The first two components contain elements based on meeting financial targets and objectives. Accordingly, of the $30.3 million in Annual Incentive Plan and Long Term Incentive Plan payments, the Commission should disallow $6,943,841 (system), $540,820 (Washington), which represents incentive pay based on achieving certain financial goals, or paid in the form of common stock.[308] The $6,943,841 amount consists of 15 percent ($4,132,625) of the Annual Incentive Plan payments and 100 percent ($2,331,516) of the Long Term Incentive Plan amounts

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[306] Exh. No. 635 at 2:17-21 (Schooley). "Incentive pay" is compensation PacifiCorp pays to an employee if the employee and/or the Company meet certain established results or goals. "At-risk" compensation refers to the portion of an employee's salary that is paid only if certain established goals are achieved. The $33.3 million of total incentives in Exh. No. 193, Tab 4, at 4.10.5 (Wrigley), also includes $3 million in other bonuses and accrual adjustments, which Staff does not contest in this proceeding.

[307] Exh. No. 631T at 11:17-19 (Schooley)

[308] Exh. No. 631T at 11:5-8 (Schooley). Both Public Counsel and ICNU propose larger disallowances of incentive pay. Public Counsel witness Mr. Effron proposes to disallow one-half of the test year incentive pay proposed by the Company. *Exh. No. 291T at 17:15-21 (Effron)*. ICNU witness James Selecky proposes to disallow all of the test year incentive pay. *Exh. No. 301T at 15:1-7 (Selecky).* While Staff believes its adjustment is a measured response to Commission policies in this area, Staff's adjustment is the minimum adjustment the Commission should accept.

payable in stock. These are the portions of the plans that directly benefit shareholders, not ratepayers.[309] Staff did not remove payouts tied to customer service or safety, for example.[310]

186 The Company confirms Staff's calculations,[311] but opposes Staff's adjustment in theory. The Company claims its compensation package is "competitive," and incentives based on financial performance targets should be allowed, because they motivate employees to "see the big picture" and "earnings and hard work go hand-in-hand."[312]

187 These claims fail to satisfy the Commission's policy that to be recoverable from ratepayers, incentive payments must be tied to service-oriented goals, not just financial goals.[313] As the Commission ruled in 1996 in *Utilities & Transp. Comm'n v. US WEST Communications, Inc.*: "Plans which do not tie payments to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings."[314] (Emphasis in text). Obviously, the Company has known since 1996 what structure of plans ratepayers can be called upon to support, but elected to structure its Annual Incentive Plan differently. It is fair the Company should accept the consequences, as measured by Staff's adjustment.

188 The Company's stock-based incentive payments should receive the same treatment because they are based on the same financial performance targets as the Annual Incentive Plan payments Staff removed. Undeterred, the Company defends its stock incentive payments

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[309] Exh. No. 631T at 8-23 (Schooley); Exh. No. 635 at 2:17 and 21 (Schooley). Both are system figures.
[310] Exh. No. 631T at 13:9-14 and at 18:3-10 (Schooley).
[311] Exh. No. 271T at 7:17-19, where Mr. Wilson states that if the Commission agrees that incentive pay tied to financial targets should be excluded, Staff's 15 percent calculation is "not far off the mark."
[312] *Id.* at 7:12-13 and 7:5 (Wilson).
[313] *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.,* Docket Nos. UE-920433, 920499 & 921262, 11th Supp. Order at 61-62 (September 21, 1993); *Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.,* Docket Nos. UG-040640, UE-040641, UE-031471 & UE-032043, Order No. 6 at 55, ¶ 144 (February 18, 2005); *Utilities & Transp. Comm'n v. Avista Corp.,* Docket Nos. UE-991606 & UG-991607, 3rd Supp. Order at 73-74, ¶ 268-73 (September 29, 2000).
[314] Docket No. UT-950200, 15th Supp. Order at 48 (April 11, 1996).

because they are not "long-term,"[315] and speculates that employees hold the stock because they "believe they can collectively exceed expectations and increase the value of their shares."[316]

189 These rationales contradict both the Company's direct case and responses to Staff data requests.[317] For example, the Company called its stock-based incentive payments "Long Term Incentive," and said the stock constituted "deferred shares… that are ... deferred for a period of three years."[318] The Commission is entitled to rely on this evidence.

190 Ultimately, however, the Company simply misses the point. The point is that ratepayers should not bear responsibility for 100 percent of incentive compensation. Staff's adjustment is based on the principle enunciated by the Commission: actions that reward shareholders are often at cross-purposes with actions benefiting ratepayers.[319] Like incentive pay that is tied to financial performance targets, incentive pay in the form of stock also reflects this financial incentive element, placing shareholders at cross-purposes with ratepayers. Therefore, this form of compensation should not be included in setting rates. Staff's adjustment should be accepted.

191 *IBEW Local 57 Pension Expense.* The Company included $3,000,000 (system), $249,845 (Washington) in test year expenses as its estimated payment to union pensions in February 2006.[320] Staff removed these amounts because they are not known and measurable, and they are inconsistent with the zero pension contribution the Company negotiated in 2005.[321]

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[315] Exh. No. 271T at 9:9-10 and at 10:4-9 (Wilson).
[316] Exh. No. 271T at 9:21-22 (Wilson).
[317] Exh. Nos. 274 and 275 (Wilson).
[318] Exh. No. 274, Response Part (a) (1) (Wilson).
[319] Exh. No. 631T at 16:6-18:10 and at 21:1-12 (Schooley).
[320] Exh. No. 231T at 6:13-14; Exh. No. 237T at 5:10-15 (Rosborough).
[321] Exh. No. 631T at 33:19-34:4 (Schooley).

192 The Company now wants the Commission to use the projected $3,000,000 expense, but adjust it later to the amount the Company says it will soon negotiate.[322] However, the record is now closed, and it supports no adjustment.

193 *Medical Insurance Costs.* PacifiCorp proposes to increase test year medical plan costs by $5,245,913 (system), $398,794 (Washington) on a pro forma basis,[323] based on two incorrect assumptions: 1) that the Company would cover 90 percent of the cost of the medical plan; and 2) that medical plan costs would increase at a 12 percent annual rate.[324]

194 By contrast, Staff's adjustments reflect the fact that going forward, the Company will cover 85 percent, not 90 percent, of the medical plan cost, so the Commission should accept this known and measurable change.[325]

195 Staff's adjustments also reflect a more reasonable 10 percent rate of increase in medical costs ("trend").[326] For example, while PacifiCorp argued its cost increase projections compare favorably with nationwide averages,[327] it conceded that changes to its own medical plan will mitigate cost increases.[328] The evidence also shows Company projections of medical cost

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[322] Exh. No. 237T at 5:13-18 (Rosborough).
[323] Exh. No. 193, Tab 4, page 4.10.5 at Account 501125 (Wrigley). The $398,794 figure is computed by applying the ratio of Washington Allocated to Total Company columns of Exh. No. 193, Tab 4, at 4.10 of 7.602% to the $5,245,913 Company pro forma adjustment.
[324] Exh. No. 631T at 34:15-19 (Schooley).
[325] The Company does not contest the fact that as of January 2006, it will be paying 85 percent for plan coverage, not 90 percent. *Exh. No. 237T at 7:4-15 (Rosborough).* The 85 percent level used by Staff comports with the electric industry average, according to survey data supplied by the Company, so the 85 percent payment level is appropriate in any event. *Exh. 237T at 7:10-11 and Exh. No. 241 (Rosborough).* Finally, Mr. Rosborough erroneously states that Staff relied on surveys from Hewitt Associates and Towers Perrin. In fact, Staff did not rely on either survey.
[326] Exh. No. 631T at 38:2-8 (Schooley). The $259,600 figure is shown in Exh. No. 635 at 1:16.
[327] Exh. 237T at 8:20-9:5 and Exh. No. 236 (Rosborough).
[328] Exh. No. 231T at 9:6-10:14 (Rosborough).

increases have been consistently higher than actual experience,[329] and industry-wide, medical cost inflation is expected to continue to decline during the rate period.[330]

196 On rebuttal, PacifiCorp offered Exhibit No. 240 in an attempt to support its 12 percent trend estimate. That exhibit suggests that electric and gas utilities experience higher medical inflation rates than industry in general,[331] which directly contradicts the Company's testimony that its own medical cost inflation is less than the national average.[332] Moreover, Exhibit No. 240 supports Staff's contention that medical cost increase trend rates are declining over time.

197 Finally, PacifiCorp tried to support its case by asserting its employees are older than utility employees in general.[333] However, the Company failed to demonstrate that the age of PacifiCorp's employees relative to other employees justifies a specific inflation rate.

198 Staff's analysis is fully supported. The Company's is not. The Commission should accept the Staff's adjustment to medical expenses for this proceeding.

C. Adjustment 4.18, Miscellaneous General Expenses (EEI dues)

199 The remaining contested part of this adjustment relates to PacifiCorp dues to the Edison Electric Institute (EEI), an association of investor-owned electric utilities. Staff removes 43.6 percent of the dues ($362,025 system; $30,150 Washington), relating to lobbying, as well as portions relating to "advertising," "marketing" and "public relations."[334]

200 The Company agrees to remove 25 percent of the dues, related to lobbying only.[335] However, the facts show well over 25 percent of the EEI dues are unrecoverable because they

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[329] Compare PacifiCorp's 12 percent trend rate with the "change" column in Exh. No. 236 (Rosborough). *See also* Exh. No. 242 at 3, Table 3 (Rosborough), which shows that projections of medical care cost increases have been persistently higher than what actually occurred.
[330] Exh. No. 242 at 1 (Rosborough).
[331] Exh. No. 237 at 6:8-17 and Exh. 240 (Rosborough). Again, Mr. Rosborough erroneously states that Staff relied on surveys from Hewitt Associates and Towers Perrin.
[332] Exh. No. 231T at 8:20 through 9:5 and Exh. No. 236 (Rosborough).
[333] Exh. No. 237 at 6:18-23 (Rosborough).
[334] Exh. No. 621T at 19 and Exh. No. 622 at 2:1-18 (Ward).
[335] Exh. No. 195T at 7:18-21 and Tr. 460:8-14 (Wrigley)

reflect non-regulatory, promotional, political or image building activities.[336] For example, Exhibit No. 224 shows that under the cost categories of "advertising" and "marketing," EEI includes expenses related to promoting electric consumption and image building.[337] Image building costs also infest EEI's "public relations" category, which includes costs for developing and promoting EEI and its members before various public entities and the media.[338]

201 While the Company correctly observed that EEI's non-lobbying cost categories also include acceptable purposes such as demand management,[339] the Company had the burden to segregate the costs associated with these specific activities. It made no such segregation. Consequently, the Company did not bear its burden to show the unrecoverable amount of EEI dues is only 25 percent. Staff's adjustment should be accepted.

D. Adjustment 4.19, RTO Expenses

202 The Company seeks to recover $2.6 million (system) in test year expenses it incurred in furtherance of a Regional Transmission Organization (RTO). These costs relate to the GRID West RTO concept.[340] RTO-related expenses cannot be justified by generalized notions about a utility's participation on transmission issues. Rather, the facts require RTO costs to be excluded. There is no RTO currently operating in Washington.[341] The RTO is not necessary for PacifiCorp to operate[342] or to comply with any FERC order.[343] Moreover, the Company has not shown an RTO would improve transmission reliability.[344]

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[336] WAC 480-100-233 excludes promotional costs; WAC 480-100-213 excludes political or legislative costs; and *Jewell v. Utilities & Transp. Comm'n,* 90 Wn.2d 775, 777 (1978) excludes image building costs. *See* Exh. No. 621T at 7-8 (Ward).
[337] Exh. No. 224 and Tr. 498:11-499:11 (Wrigley).
[338] Tr. 498:11-499:1-11, and Exh. No. 224 at VII-4 (Wrigley).
[339] Tr. 465:5-20 (Wrigley).
[340] Tr. 501:8-20 (Wrigley). The $2.6 million ($226,000 Washington) is from Exh. No. 317 (Selecky), reflecting the Company's calculation of the amount. Staff's Exh. No. 623 identifies an amount of $.905 million (system), $75,329 (Washington), based on an analysis of fewer accounts. The $2.6 million figure is therefore more comprehensive.
[341] Exh. No. 195T at 24:23 to 25:1 (Wrigley).
[342] Tr. 502:4-7 (Wrigley).

203 Expenses for actual regional transmission coordination of reliability, planning, and expansion functions are already included in the test period.[345] The Company has made no showing it provided any more efficient or better service by incurring additional, RTO-related costs.[346] For all these reasons, the test period RTO costs should be removed.

E. Adjustment 7.2, Property Taxes

204 The Company wants to recover $1,215,888 (system), $101,262 (Washington), which reflect the amount PacifiCorp thinks its property tax bill might increase due to new plant additions.[347] The Company's adjustment is "based on management's judgment,"[348] so it fails the "known and measurable" standard in WAC 480-07-510.[349]

205 In rebuttal, the Company suggested that taxing authorities could assess even higher property taxes, perhaps up to $4 million in additional taxes.[350] However, this simply confirms the Company's adjustment is wholly unsupported. Taxing authorities set tax rates to recover a set amount of dollars. Individual levy rates are calculated by dividing the total amount of a statutorily authorized levy of a taxing district by the total assessed property values.[351] Consequently, if a taxpayer adds property, its total property tax bill could be the same, higher, or lower, depending on the total assessed value of property in the tax district or area, and the total authorized levy amount for the tax year.

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343 Tr. 502:18-503:2 (Wrigley).
344 Tr. 504:7-11 (Wrigley).
345 Exh. No. 749, PacifiCorp Response to Bench Request No. 15.
346 Exh. No. 621T at 21:17-22:7 (Ward).
347 Exh. No. 603, line 12 (system) (Kermode); $1,215,888 times 8.3282% GPS allocation Factor (Washington) = $101,262.
348 Exh. No. 601T at 7:5-7 (Kermode), quoting a Company data request response.
349 *Id.* at 7:9-8:12.
350 Exh. No. 195T at 19:14-20 (Wrigley); Tr. 584:23-25 to 585:1-2 (Kermode).
351 *See, e.g.,* WAC 458-19-005(o). The taxing authority may also be subject to statutory rate limits. *See, e.g.,* WAC 458-19-005(n)(i).

206 It is therefore inappropriate for the Company to focus solely on the change in the gross value of its assets. Indeed, the Company conceded its rebuttal examples were offered "absent other considerations,"[352] yet it is precisely these "other considerations" that prove the Company's adjustment is untenable. The Commission should reject Adjustment 7.2.

F. Adjustment 7.4, IRS Settlement Amortization

207 PacifiCorp wants current ratepayers to pay for additional taxes the IRS assessed for tax years 1991-1998. According to the Company, ratepayers would pay these amounts over the period 2006-2010, and also pay a return on the unamortized balance.[353] The Commission should reject Adjustment 7.4 as invalid retroactive ratemaking.

208 The Company concedes, as it must, that the taxes at issue are attributable to prior periods.[354] As Mr. Kermode explains: "these amounts originated in prior periods and they are applicable to the service the Company provided in those prior periods," so this adjustment qualifies as retroactive ratemaking because it creates "additional charges applied after the service was provided or consumed."[355]

209 In essence, the Company is seeking to recover from current ratepayers the cost of mistakes the Company made on its tax returns six to 14 years ago. This is confirmed by the fact that had the Company reported the correct tax amount to the IRS in 1991-1998 in the first place, there would be no adjustment.[356] This situation is the same as if a utility charged a customer $1000 for electricity provided in 1995, but mistakenly failed to collect that $1000 until the test

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[352] Exh. No. 195T at 19:19 (Wrigley).
[353] Exh. No. 601T at 10:15 to 11:14 (Kermode).
[354] Exh. No. 181T at 20:9-11 (Martin). Note: while Mr. Martin refers to tax returns for 1991-93, 1994-98 and 1999-2000, the Company's response in Exh. No. 184 correctly explains that the test period only involves the 1991-98 tax returns. In any event, the Company's 2004 SEC Form 10K clearly states that income tax payments in the test period include "amounts paid in settlement of *prior year's liabilities*." *Exh. No. 183 at 2, 2nd complete ¶ (emphasis added).*
[355] Exh. No. 601T at 13:8-9 and at 12:15-16 (Kermode) (quoting *Utilities & Transp. Comm'n v. Puget Sound Energy, Inc., Inc.,* Docket No. UE-010401, Order at 2 (November 9, 2001).
[356] Exh. No. 601T at 13:3-4 (Kermode).

period in this case. It would be just as inappropriate to include that additional $1000 in revenue now (and reduce rates accordingly) as it is to include the additional expense in Adjustment 7.4 (and increase rates accordingly). In each instance, the dollars are attributable to prior periods and retroactive ratemaking precludes recovery now.

210 The Company tries to avoid a common sense retroactive ratemaking analysis by suggesting that because the IRS audits the Company each year, the tax assessments at issue are a "current" event, and an "ongoing" expense. [357] The Company also posits that its tax return is only a "best estimate."[358] These arguments ignore the undisputed fact that the tax assessments at issue are attributable to prior period tax years. Moreover, like any taxpayer, when the Company signs its tax return it is stating, under penalty of perjury, that it believes the tax return is "true and correct as to every material matter."[359] The Company is not simply providing a "best estimate."

The Commission should therefore reject Adjustment 7.4.

G. Adjustment 7.5, Malin Midpoint

211 In 1981, the Company gained $44 million by selling to Amoco the Company's Malin Midpoint transmission line, which it then leased back from Amoco. Staff and Company agree the Commission has consistently ordered that the gain on the sale be amortized over 30 years.[360] Accordingly, ratepayers have been credited with a pro rata share of the gain on the sale, thus

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[357] Exh. No. 181T at 24:9-23 (Martin). The sole support for the tax settlement adjustment offered by PacifiCorp in its direct case was that the adjustment was "consistent with the treatment that was adopted for purposes of the [Settlement Agreement in Docket No. 032065]." *Exh. No. 191T at 21:1-3 (Wrigley).* The Company reiterated this point in rebuttal. *See e.g.,* Exh. No. 181T at 19:15-18 (Martin). This is no support at all because by its terms, that Settlement Agreement cannot be used as support for adjustments in this case. *See* Tr. 348:20-349:4 (MacRitchie), *see also* Exh. No. 291T at 18:14-21 (Effron).

[358] Exh. No. 181T at 21:14-16 (Martin).

[359] 26 U.S.C. § 7206(1) includes in the definition of tax fraud a taxpayer who signs a return that is required to be verified "under the penalties of perjury, and which he does not believe to be true and correct as to every material matter." 26 C.F.R. § 1.6065-1(a) requires federal income tax returns (such as the ones filed by PacifiCorp) to be "verified by the person signing it" as "made under penalties of perjury."

[360] Company: Exh. No. 191T at 21:11-12 (Wrigley); Staff: Exh. No. 607: Cause No. U-82-12 and -35, 4th Supp. Order at 18-19 (February 2, 1983); Exh. No. 608: Cause No. U-83-33, 2nd Supp. Order at 17 (February 9, 1984); Exh. No. 609: Cause No. U-86-02, 2nd Supp. Order at 21 (September 19, 1986). These orders are analyzed by Mr. Kermode in Exh. No. 601T at 30:1-32:11.

reducing revenue requirements. That is precisely what Staff's adjustment proposes to continue.[361] By contrast, rather than crediting ratepayers with a pro rata share of the gain, the Company wants to *increase* test year expenses by $156,972 and *increase* rate base by $582,787 (Washington amounts).[362]

212 This difference is caused by how the parties treat the Malin Midpoint transaction. Staff treats the Company's sale of the transmission line as what it was: a tax basis sale of an asset.[363] Thus, there is no reason to impute income tax effects or create deferred taxes.[364]

213 By contrast, PacifiCorp treats the sale as what it was not: a sale of tax benefits which, under PacifiCorp's theory, is subject to normalization requirements. Based on this flawed approach, the Company says for ratemaking it must impute income tax effects of the sale and create deferred taxes.[365]

214 Staff's treatment is correct. Under 26 U.S.C. § 168(f)(8)(A)(ii), the Tax Code requires that for tax purposes, the lessor (Amoco in this instance) "shall be treated as the owner of the property …"[366] In other words, for tax purposes, the Tax Code names Amoco as the owner of the property, not simply the "owner of the tax benefits."[367] The result of the transaction confirms this. Amoco depreciates the transmission line assets for tax purposes, which is exactly what happens whenever assets are purchased.[368]

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[361] Exh. No. 610 (Kermode) and Exh. No. 633 at 12-13, col. 7.5 (Schooley).
[362] Exh. No. 193, Tab 7, page 7.0, col. 7.5, lines 28 and 55 (Wrigley).
[363] Exh. No. 601T at 22:1-23:13 and at 27:4-19 (Kermode).
[364] Exh. No. 601T at 25:9-29:16 (Kermode).
[365] Exh. No. 281T at 2:9-10 (Elliott): "The $44 million in cash that PacifiCorp received *was for payment of the income tax benefits* associated with putting the Malin property in service in 1981" (emphasis added); and Exh. No. 601T at 1-4 (Kermode).
[366] The full text of this code section is contained in Mr. Kermode's Exh. No. 605.
[367] Congress confirmed this plain meaning in the Congressional Report contained in Exh. No. 606 (Kermode). On page 4, 5th new ¶ of that Report, Congress states that "the transaction is treated as a sale to Y and a leaseback to X." On page 5, 1st ¶, Congress makes clear that the sale and leaseback applies to "section 38 property," which, as noted on page 4, last two ¶¶, means physical property, not tax benefits.
[368] A result of the sale and leaseback transaction was that Amoco, as the owner of the line for tax purposes, was able to depreciate the Malin Midpoint property and take investment tax credits related to the property. As Mr. Kermode

215 Rather than relying on the plain language and effect of the statute, PacifiCorp elects to rely on a 1985 Internal Revenue Service Private Letter Ruling and a public accounting firm newsletter that relied on that Ruling.[369] Private Letter Rulings cannot be used or cited as precedent,[370] and an accounting newsletter has no precedential value either.[371] By comparison, the Ninth Circuit's decision in *Papago Tribal Utility Authority v. FERC,*[372] has precedential value. In that case, the court affirmed FERC's treatment of a safe harbor lease consistent with this Commission's historical treatment of the Malin Midpoint transaction, and rejected the arguments PacifiCorp is making in this case.[373]

216 The Commission should accept Staff's Adjustment 7.5.

H. Working Capital Adjustments: Adjustment 8.1, Update Cash Working Capital; Adjustment 8.1a, Remove Current Assets; Adjustment 8.2,Trapper Mine Rate Base; Adjustment 8.3, Jim Bridger Mine Rate Base; And Adjustment 8.7, Dave Johnston Mine Closure

217 Working capital can be supplied by many entities, not just investors: *e.g.,* ratepayers, trade creditors, and the government.[374] In ratemaking, when working capital is allowed to be recovered through rates, it is an addition to rate base. Consequently, as a matter of principle, it is critical to measure the working capital that *investors supply*; otherwise*,* investors would improperly earn a return on capital they did not supply.[375] Over the last 25 years, the

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explained, nowhere in § 168(f)(8) is there any statement that the transaction is a sale of tax benefits; rather, § 168(f)(8) describes leases of property. *Exh. No. 601T at 43:3-6.*

[369] Exh. Nos. 282 and 283, and Exh. No. 281T at 2:14-16 (Elliott).

[370] "Q. Mr. Kermode in his testimony states that a private letter ruling cannot be used or cited as precedent. Is he correct? A. He is technically correct." *Exh. 281T at 2:17-19 (Elliott).*

[371] This newsletter is neither a "brief" nor an "interpretation," as those terms are used by Mr. Elliott in his testimony to describe precedential tax documents. *Exh. No. 821T at 3:4 and 3:14 (Elliott).*

[372] 773 F.2d 1056, 1062-65 (9th Cir. 1985), *cert. denied,* 475 U.S. 1515 (1986).

[373] This ruling affirming the FERC accounting treatment also voids the Company's assertion in Exh. No. 611(a) that any Commission order requiring the Staff recommended methodology would "violate FERC accounting rules," though the Commission would not be bound by this sort of FERC rule in any event.

[374] Exh. No. 631T at 47:1-7 (Schooley).

[375] Exh. No. 631T at 45:1-3, at 46:14-16, and at Tr. 619:21-620:11 (Schooley).

Commission has preferred the investor supplied working capital analysis[376] because it satisfies this principle:

a. We accept Staff's working capital analysis as providing a reliable measurement of the amount of working capital upon which investors are entitled to earn a return.

b. The Commission accepts the Commission Staff working capital analysis as providing an accurate measurement of the working capital upon which investors are entitled to earn a return.

c. The Commission accepts the Commission Staff approach (the investor-supplied working capital methodology) to working capital in this proceeding.

d. We accept the Staff investor-supplied working capital allowance calculation method, as we have done in many prior proceedings, because it is shown here to represent the better and more accurate calculation of the actual investor-supplied contribution to the working capital needs of the Company.

e. We have consistently in recent years expressed our belief that the investor-supplied working capital approach constitutes a sound method of gauging the working capital needs of the Company which require ratepayer support.[377]

218 The investor supplied working capital analysis compares invested capital to investments. Any excess of invested capital over investments constitutes investor supplied working capital. If there is no such excess, investors are not supplying working capital.[378] As Staff Exhibit No. 637 shows, because PacifiCorp investors have not provided positive working capital to PacifiCorp, no working capital addition to rate base is justified.[379]

219 PacifiCorp made two challenges to the Commission's investor supplied working capital method, but failed each time. The Company's first challenge was its attempt to apply generic

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[376] Tr. 628:21-24 (Schooley).

[377] **a**. *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Cause No. U-81-17, 2nd Supp. Order at 5 (December 16, 1981); **b**. *Utilities & Transp. Comm'n v. Pacific Power & Light Co.,* Cause No. U-82-12 & U-82-35, 4th Supp. Order at 23 (February 2, 1983); **c**. *Utilities & Transp. Comm'n v. US WEST Communications, Inc.*, Docket No. UT-950200, 15th Supp. Order at 68 (April 11, 1996); **d**. *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Cause No. U-81-41, 2nd Supp. Order at 9 (March 12, 1982); **e**. *Utilities & Transp. Comm'n v. Gen. Tel. Co. of the Northwest, Inc.*, Cause No. U-81-61, 5th Supp. Order at 17 (April 8, 1982).

[378] Exh. No. 631T at 46:6-16 (Schooley).

[379] *Id.* at 48:7-19 (Schooley).

comments from a textbook that discussed a "balance sheet" working capital method.[380] This challenge failed because the Company could not show how these generic comments, even if valid, applied to the specific method Staff used in this case.

220 PacifiCorp started by quoting the textbook's statement that the "balance sheet" method wrongly assumes that all non-utility, non-jurisdictional assets are investor supplied.[381] Yet the Company could neither explain that statement, nor identify where the stated assumption was manifested in Staff's analysis.[382]

221 Next, PacifiCorp offered the textbook's point that the "balance sheet" method is problematic if the utility does not record unbilled revenues.[383] However, the Company admitted PacifiCorp records unbilled revenues,[384] so this point does not apply in this case, even assuming it is a valid point.

222 Finally, the Company noted the textbook's criticism that a "balance sheet" method only takes a "snap shot of current liquidity … at a point in time."[385] Again, even if valid, this criticism does not apply because Staff used monthly average data, not data as of a point in time.[386]

223 PacifiCorp's second challenge was to offer certain "corrections" to Staff's Exhibit No. 637, to conform it to a Staff exhibit filed in the last (settled) PacifiCorp rate case.[387] However, analysis clearly shows PacifiCorp has no investor supplied working capital in this case:

- Several of the Company's "corrections" are immaterial because they make no change to the bottom line.[388]

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[380] Exh. No. 195T at 12, quoting *Accounting for Public Utilities*, by Mr. Hahne (Wrigley).
[381] Exh. No. 195T at 12:8-12 (Wrigley).
[382] Tr. 470:16-472:18 (Wrigley).
[383] Exh. No. 195T at 12:16-20 (Wrigley).
[384] Tr. 473:1-22 (Wrigley).
[385] Exh. No. 195T at 12:12-15 (Wrigley).
[386] Exh. No. 637 at 1 (Schooley), indicating that the average balances of monthly averages were used.
[387] Exh. No. 195T at 13-14 and Exh. No. 199 (Wrigley). The Company admitted its use of the term "corrections" was not apt. *Tr. 475:12-22 (Wrigley).*

- The Company improperly excludes Accounts 132, 134 and 136.[389] The Company realizes earnings from these accounts,[390] so they qualify as investments.

- The Company improperly excludes Account 183, Preliminary Surveys and Investigations, because this account represents tied-up funds not available as working capital.[391] The Commission has specifically ruled "preliminary survey costs should be treated as investment [in the analysis]."[392]

- The Company improperly excludes Account 182.2, which is associated with the Trojan nuclear plant and the Trail Mountain Mine. Because both Staff and Company agree these projects should be removed from rate base asset accounts, they need to be included in the working capital calculation because otherwise, rate base would be increased by these amounts.[393]

224 The Company also proposed to include Accounts Receivable and Accounts Payable to Associated Companies.[394] However, even if this change was made, investor supplied working capital remains negative.[395]

225 In sum, PacifiCorp failed in its challenges to the Staff's investor supplied working capital analysis. The record proves the Company has no working capital supplied by investors. Moreover, Prepayments, Fuel Stock, and Materials & Supplies are properly classified as working capital, so Staff's Adjustment 8.1a properly removes these accounts as direct rate base items.

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[388] This applies to the "corrections" made on Mr. Wrigley's Exh. No. 199, lines 27, 30, 82, 83, 48, 51, 93 and 94. *See Tr. 478-24-480:4 and 481-6-24 (Wrigley).*
[389] Exh. No. 199, lines 87 and 89.
[390] Tr. 481:25-482:10 (Wrigley).
[391] Tr. 478:2-23 (Wrigley).
[392] *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Docket Nos. U-89-2688 and U-89-2955, 3rd Supp. Order at 54 (January 17, 1990).
[393] *See* Tr. 476:15-477:16 (Wrigley).
[394] Exh. No. 195T at 13 (revised) (Wrigley), first bullet. In PacifiCorp's specific case, these should not be included either in invested capital (because the Company does not pay interest) or in investments (because the Company does not receive interest on these items). *Tr. 475:25-476:8 (Wrigley).* Hence, they should be classified as working capital, similar to trade receivable and payable accounts.
[395] *Ibid*. Including the net of receivables ($4.7 million) and payables ($17.2 million) to associated companies increases invested capital by $12.5 million, but investor supplied working capital remains negative: -$3.7 million.

226 For its part, the Company proposes to add $4.42 million to Washington's rate base, via a lead lag study.[396] The last time the Commission needed to choose between an investor supplied working capital study and a lead lag study, it rejected the lead lag study:

> The Commission believes [the investor supplied working capital method] is more comprehensive and more accurate than the lead-lag approach. It allows the calculation to take place in the context of a balance sheet analysis of Company performance rather than examining limited factors.[397]

227 The same holds true today. In addition, the Company has not shown its lead lag calculation is appropriate. As Staff testified:

> there is a difference between how the Company is trying to calculate cash working capital versus our use of investor supplied working capital. Cash working capital does not necessarily mean investors are supplying that cash …[398]
>
> the [issue] is to figure out what working capital the investors supply, not just what's the difference between cash receipts and cash payments.[399]

228 The Company's study also contains several flaws. For example, the Company applied a 13.56 day lag to all payroll expenses, in spite of the fact that certain payroll items are either paid annually, or are not cash payments at all.[400] More fundamentally, the lead lag analysis gives wrong incentives to the Company. To pick just one example, PacifiCorp identifies a "lag" of 6 days between the time it receives payments for sales and the time it makes payments for expenses.[401] To close this gap, the Company could be more efficient in collecting payments from customers, and/or it could negotiate longer terms for its payments to vendors and other

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[396] Exh. No. 193, Tab 2, page 2.2, line 45 (Wrigley).
[397] *Utilities & Transp. Comm'n v. US WEST Communications, Inc.*, Docket No. UT-950200, 15th Supp. Order at 68 (April 11, 1996).
[398] Tr. 616:16-20 (Schooley).
[399] Tr. 617:21-24 (Schooley).
[400] *See* Tr. 487:14-488:15 (payroll lag and application of that lag), Exh. 206 and Tr. 489:11-15 (incentive pay is paid once per year) (Wrigley). Also, the lead lag study includes several numbers that are actuarially determined, such as pension expense. *Exh. 193, Tab 4:4.10.19 (Wrigley) and Exh. 231T at 2:23 and Exh. 232 (Rosborough).* Because no cash is involved in determining this expense, it does not belong in "cash" working capital.
[401] Exh. No. 195 at 11:14-17 and Exh. No. 193, Tab 8, Adj. 8.1 (Wrigley).

creditors. If the Company receives a return on that lag through its calculation of working capital, it has no incentive to close that gap.

229 In sum, the Commission should follow its precedent, appropriately calculate investor supplied working capital, and find that no investor supplied working capital should be added to rate base.

I. Adjustment 8.5/8.5a, Environmental Settlement (PERCO) and Adjustment 8.13, Remove Deferred Environmental Remediation

230 PERCO is a PacifiCorp subsidiary involved in cleaning up of toxic waste sites. It manages an insurance settlement for PacifiCorp relating to specific sites covered by that settlement. Adjustment 8.5, which PacifiCorp initially filed and defended,[402] was reversed on rebuttal in Company Adjustment 8.5a.[403] The Company justifies Adjustment 8.5a by claiming its original Adjustment 8.5 was "the Company's proposed procedure dealing with environmental expenses," but this procedure was "rejected by the Commission in Docket No. UE-031658."[404]

231 In fact, the Commission did not reject any Company procedures relating to PERCO in Docket No. UE-031658. The Commission simply stated that the costs of PERCO-administered projects will not be included for regulatory accounting,[405] because those expenses are already recovered through an insurance settlement. The Company is allowed either to defer current remediation expenses not covered by the insurance settlement, or recover them as a current period expense.[406]

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[402] Adjustment 8.5 is explained in Exh. No. 191T at 24:7-14 and Exh. No. 193, Tab 8 at 8.5 (Wrigley).
[403] Exh. No. 195T at 4:2-7 (Wrigley).
[404] *Id.* at 4:4-5 (Wrigley).
[405] *Utilities & Transp. Comm'n v. PacifiCorp,* Docket No. UE-031658, Order No. 01 at 4, ¶ 12a (April 27, 2005).
[406] It is important to understand that the environmental remediation costs covered by the insurance settlement now administered by PERCO are only a portion of the total environmental remediation costs the Company incurred. The Commission's order in Docket No. UE-031658 addressed both PERCO-related and non-PERCO-related environmental remediation expenses. *See* Order No. 01 at 4, ¶ 12, Docket No. UE-031658 (April 27, 2005).

232 Staff's Adjustment 8.13 implements the Commission's order in Docket No. UE-031658 by removing unapproved regulatory assets and related expenses. The Commission should accept Staff's Adjustment 8.13 and the Company's Adjustment 8.5, and reject Adjustment 8.5a.

J. MEHC Acquisition-Related Adjustments: Adjustment 4.17, Property Insurance; Adjustment 4.21, West Valley Lease; Adjustment 4.22, Affiliate Management Fees; And Adjustment 4.23, A&G Stretch Goals

233 These adjustments relate to the Settlement Stipulation in Docket No. UE-051090, which provides for possible rate credits occasioned by the MEHC acquisition of PacifiCorp. Based on Staff's case, these credits are worth $30,000 to Washington.

234 *Adjustment 4.17*[407] *Property Insurance.* This item places a cap on property insurance expense. Property insurance expense is below the cap in this case, so no adjustment is warranted.[408]

235 *Adjustment 4.21, West Valley Lease.* This item potentially reduces non-fuel O&M costs for the West Valley Lease by $5 million (system) and $432,000 (Washington).[409] Staff's Amended Revised Protocol removes the fixed cost lease payment for West Valley, so again, no adjustment is warranted.[410]

236 *Adjustment 4.22, Affiliate Management Fees.* This item sets management fees affiliates pay to PacifiCorp at $1.5 million (system), which is $350,000 more than the test year. The adjustment is Washington's share of the $350,000, or $30,000.[411]

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[407] Note that this Adjustment was mistakenly labeled "4.18" in Mr. Schooley's Exh. No. 642T at 2 and at 7-8.
[408] Exh. No. 642T at 7:17-8:14 (Schooley); Exh. No. 225T at 2:16-3:2 (Wrigley).
[409] Exh. No. 642T at 4:7 (Schooley).
[410] Staff initially thought this adjustment applied to non-fuel, non-fixed cost O&M (Exh. No. 642T at 3:10-4:18 (Schooley)), which is not correct. *See Tr. 1458:11-24 (Wrigley).* This adjustment would apply if the Revised Protocol method is used. *Exh. 225T at 2:2-8 (Wrigley).*
[411] Exh. No. 642T at 5:1-11 (Schooley); Exh. No. 225T at 2:9-15 (Wrigley).

237 *Adjustment 4.23, A&G Stretch Goals.* This item provides a credit to the extent system A&G costs exceed $222.8 million. This threshold is not exceeded under Staff's case, so no adjustment is warranted.[412]

VI. CONCLUSIONS

238 For the reasons stated above, PacifiCorp has not sustained its burden of proving its requested 14.44 percent rate increase request is justified. The Commission should reject the tariffs the Company filed in this docket and order the Company to file tariffs to effect a 4.7 percent rate decrease, spread on an equal percentage basis.[413]

DATED this 27th day of February, 2006.

Respectfully Submitted,

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[412] Exh. No. 642T at 5:13-7:11 and Exh. No. 643 (Schooley).
[413] Exh. No. 711T at 3:3-4 and at 9:5-8 (Steward, Iverson, Lazar).