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March 6, 2006

VIA ELECTRONIC MAIL (records@wutc.wa.gov)
AND OVERNIGHT DELIVERY

Ms. Carole J. Washburn
Executive Secretary
Washington Utilities & Transportation Commission
1300 S Evergreen Park Drive SW
Olympia, WA 98504-7250

Re: Docket No. UE-050684

Dear Ms. Washburn:

I enclose for filing in the above proceeding an original and 18 copies of PacifiCorp's Post-hearing Reply Brief. A copy of this filing has been served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,

Jason B. Keyes for

Marcus A. Wood

MW:knp
Enclosures
cc: Service List

Oregon
Washington
California
Utah
Idaho

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 Docket No. UE-050412 ***(Consolidated)*** REPLY BRIEF OF PACIFICORP

DATED: March 6, 2006.

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I. OVERVIEW OF THE INITIAL BRIEFS

1. In its Initial Brief to the Washington Utilities and Transportation Commission (the "Commission"), PacifiCorp (or the "Company") noted the marked disconnect in this proceeding between various rate adjustment proposals and economic reality. The initial briefs of the Commission's Staff ("Staff"), Public Counsel, and the Industrial Customers of Northwest Utilities ("ICNU") confirmed this flight from reality.

2. In this proceeding, the Commission faces the question of the appropriate level of rates for a utility whose earned return on equity ("ROE") from Washington operations has declined to 3.5 percent. Exh. No. 1-T at 2:2-3 (MacRitchie); Exh. No. 191-T at 2:5-11 (Wrigley). The Commission also faces the question of the proper response to Washington-allocated power cost shortfalls in recent years that are equivalent to PacifiCorp's providing its Washington customers with free electricity for a seven-month period. Exh. No. 398-T at 8:19 – 9:1 (Widmer). These questions are raised in the context of a need for PacifiCorp to improve its financial condition so as to support capital expenditure requirements that will exceed $1 billion per year by FY 2006. Exh. No. 1-T at 12:1-4 (MacRitchie).

3. And what are the measured responses of Staff and Intervenors to these conditions? Staff recommended that the Company's rates be <u>reduced</u> by 4.7 percent ($10.4 million). Staff Initial Br. at 1. ICNU recommended that the Company's rates be <u>reduced</u> by $13.7 million. ICNU Initial Br. at 4. Each of Staff, ICNU, and Public Counsel recommended continuing PacifiCorp's position as the only Washington electric utility without a power cost adjustment mechanism ("PCAM"), thereby continuing the Company's disproportionate exposure to massive power cost losses in providing Washington utility service. Staff Initial Br. at 27-30; ICNU Initial Br. at 21-26; Public Counsel Initial Br. at 43-51. These positions do not reflect reasoned and balanced analyses; they instead constitute a rate disallowance feeding frenzy.

4. PacifiCorp seeks only fair and balanced regulatory treatment. It explains below why the disallowances advocated by Staff, Public Counsel and ICNU are neither fair nor balanced.

II. ARGUMENT

A. The Commission Should Join PacifiCorp's Other Regulatory Jurisdictions in Adopting the Revised Protocol.

5. In its Initial Brief, PacifiCorp demonstrated why it is in the public interest for the Company to achieve a uniform system of inter-jurisdictional allocations. PacifiCorp Initial Br. at 4-5. The Company further demonstrated that the Revised Protocol is reasonable, consistent with Commission precedent, and beneficial to its Washington customers. PacifiCorp Initial Br. at 6-12.

6. Staff's and Public Counsel's briefs accurately observed that transmission constraints limit the Company's ability to transmit power between its Eastern and Western control areas. Staff Initial Br. at 4-6; Public Counsel Initial Br. at 33-37. The Company had acknowledged these limitations in its direct testimony. Exh. No. 331-T at 3:21 (Duvall).[1] Staff and Public Counsel asserted that because of these operational limitations, the Commission should not adopt an allocation method that reflects the costs of operating PacifiCorp's entire system. The record in this proceeding demonstrates that Staff and Public Counsel's conclusion is misplaced for a number of reasons:

(a) Transmission constraints are faced by all utility systems, yet there is no precedent nationally for adopting anything other than a "single-utility" approach to cost allocations. Tr. 687:17 (Duvall); 942:2-3 (Blackmon); 733:18-23 (Taylor); 970:11-14 (Buckley).

(b) Transfer capacity is but one consideration in evaluating whether a utility system is integrated. There are many other ways that PacifiCorp's integrated system provides benefits to all of its customers. Tr. 664-65 (Duvall).

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[1] However, contrary to Public Counsel's brief, Mr. Duvall testified that, notwithstanding transmission constraints, PacifiCorp's system is dispatched as a single system from a single location. Exh. No. 331-T at 4:6-7 (Duvall); *see* Public Counsel Initial Br. at 33-34.

(c) For decades (and preceding the Pacific Power/Utah Power merger) the Company operated two control areas with load and generation in Montana and Wyoming. This was never viewed by the Commission as a basis for allocating costs on other than a single-system basis. Tr. 734:4-14 (Taylor).

(d) Even Dr. Blackmon testified that a utility need not track generation from individual plants to load in order to justify cost recovery. Tr. 941:9-10 (Blackmon).

(e) Tracking energy from individual plants to load would produce absurd results. For example, it would suggest that the Company's Lewis River hydro-electric facilities be deemed not to be serving its Washington customers, because the Company does not have transmission rights between those facilities and its Washington service territory. Tr. 406:11-13 (MacRitchie).

7. Staff and Public Counsel accurately observed that in recent years the Company has (i) experienced higher load growth in Utah and (ii) constructed substantial new generation in Utah. Based on these observations, Staff and Public Counsel would have the Commission conclude that (i) the Company's Utah customers are somehow "causing" the need for new resources and (ii) Washington customers are being unfairly burdened with the cost of these new resources under the Revised Protocol. Staff Initial Br. at 14-19; Public Counsel Initial Br. at 31-32.

8. Again, these conclusions are misplaced. PacifiCorp acquires new resources that will minimize costs and risks for all of the customers served by its integrated system. Public Counsel's own witness asserts that "individual resources are not planned, acquired or operated on a separate basis to serve specific retail electric customers." Exh. No. 471-T at 4:19-20 (Black). Therefore, it is inappropriate to conclude that any customer or group of customers is "causing" PacifiCorp to construct or acquire the output of new generation. Under Staff and Public Counsel's logic, a retired customer with stable consumption or a customer in Yakima, as opposed to faster-growing Walla Walla, could similarly claim that he or she is not "causing" new

plants to be acquired. Tr. 978-81 (Buckley). It is neither sensible nor fair to claim the benefits of being served by an integrated system, while trying to escape paying a share of its costs.

9. Furthermore, while Staff and Public Counsel accurately observed that under the Revised Protocol, Washington customers pay a share of the cost of all new resources, they neglected to acknowledge that under the Revised Protocol, as Utah loads grow, Utah customers pay a larger share of the costs of existing resources and system overheads.[2] Staff Initial Br. at 6; Public Counsel Initial Br. at 31-32. Company studies demonstrate that under the Revised Protocol, revenue requirement increases in faster-growing states arising from supporting a larger share of existing plant and overhead costs are sufficient to support the cost of new resource additions. Exh. No. 371-T at 18:11-16 (Duvall).

10. Staff and Public Counsel argued that a cost allocation process should reflect principles of cost causation. Staff Initial Br. at 7; Public Counsel Initial Br. at 29. The Company agrees with this proposition, although (along with Mr. Lott) it believes that other goals (such as economic efficiency) also need to be accounted for. Exh. No. 461-T at 18:22-24 (Lott). Mr. Buckley is alone among the witnesses in this case in refusing to acknowledge that "cost causation" is a subjective concept and that a cost allocation method for PacifiCorp could have been established 15 years ago if everyone was as certain as Mr. Buckley is about what the principles of cost causation require.[3] Because Mr. Buckley is in unique possession of this insight, Staff was able to argue in its Initial Brief that what the Company should have done is simply prepared a "cost causation study" and proposed an allocation method based on that study. Staff Initial Br. at 8.

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[2] For example, Public Counsel's Initial Brief states (at page 32): "Under the Revised Protocol, all states and divisions are allocated a share of new resources, new and old equally, without consideration of the growth which required the addition of the new resources."

[3] While it is true that Mr. Buckley has never left the cost causation bandwagon, he has also never presented a cost causation study, described how a cost causation study should be done, or proposed a specific allocation method.

11. Mr. Taylor testified that the Company does not know how to perform such a "cost causation study," because there is no agreement on what it should entail. Tr. 732:22-733:4 (Taylor). Instead, along with other Multi-State Process ("MSP") participants, the Company developed an allocation method that appeared to be reasonably consistent with a number of goals that the MSP participants had established for themselves. The Company then conducted numerous studies to determine the proposal's rate impact on customers in various states and whether the proposed method would reasonably protect customers from various risks such as changed wholesale market conditions and load loss. Staff's brief roundly criticized the Company for this analytical approach as being "results oriented." Staff Initial Br. at 9-10. However, it seems very naïve to suggest that an allocation method could or should be presented to the Commission for approval without an analysis of customer rate impact and customer risk.

12. Staff's brief accurately observed that at the time of the Pacific Power/Utah Power merger, the Commission was concerned about whether the merger of a relatively low-cost system with a relatively high-cost system would have adverse impacts on the low-cost states that would outweigh expected merger benefits arising from operating efficiencies. Staff Initial Br. at 2-3. Ultimately, the Commission approved the merger, believing that benefits would be derived from it and that allocation issues could be resolved on an equitable basis.[4] These conclusions have proven to be correct. PacifiCorp's Washington customers have substantially benefited from the Company's large and diverse system and have enjoyed excellent rate stability compared to customers served by other Washington utilities. Exh. Nos. 764, 765 (Staff and PacifiCorp

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[4] As observed by Public Counsel, the Commission was especially concerned that Washington customers continue to enjoy the benefits of Pacific Power's low-cost hydro-electric resources through some sort of permanent "entitlement" payment. Mr. Lott acknowledged that the Revised Protocol provides for such an entitlement that is not only permanent, but will also increase in value over time. Tr. 857:4 (Lott). While Public Counsel's Initial Brief avoided repeating some of Mr. Lott's wilder claims regarding the Commission's intentions, it incorporated his misquotation from the merger order, suggesting that new resource additions should be made consistent with Pacific Power's least-cost plan. *See* Public Counsel Initial Br. at 28; PacifiCorp Initial Br. at 12-13.

Responses to Bench Request 25). No party to these proceedings seems to deny that this has occurred. But now, 16 years later, Staff and Public Counsel wish to turn their backs on at least the costs of participating in an integrated system.[5]

13. No party has provided a viable alternative to the Revised Protocol. For purposes of this case, Staff's brief proposed its "Amended Revised Protocol." Staff Initial Br. at 25-27. In its Initial Brief, PacifiCorp described the analytical shortcomings of this proposal, which would afford Washington customers the benefits but not the costs of various new resources. *Id.* at 26. Staff's brief responded to these concerns by stating that its proposal (i) only excluded fixed costs of the resources and (ii) was presented merely as a "compromise position" anyway. Staff's brief suggested that on a longer-term basis, Staff favors a "Simplified Control Area Approach." *Id.* at 24-25. Staff's brief provided no explanation as to how this approach would resolve Mr. Buckley's "cost causation" issues, as faster load growth in Oregon or California would give rise to the same concerns presented in this case with respect to the Revised Protocol. It is also not clear how the Simplified Control Area Approach would further Mr. Buckley's wish that it be demonstrated that every new resource addition be cost-effective from a Washington-only perspective.[6] Finally, as observed in PacifiCorp's Initial Brief, after 16 years, a half-page description of a potential allocation method is a far cry from something that is either viable or acceptable to other states. Also, as indicated in the Company's Initial Brief, Public Counsel's proposed "two-portfolio" method does not account for any of the issues that caused the MSP

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[5] Staff and Public Counsel appear to be persuaded that because the economy in the Company's Washington service territory is "moribund" (*see* Staff Initial Br. at 4 n.11), the need for new PacifiCorp system resources does not concern them. However, the Company testified that because of load growth and existing contract expiration, Washington customers will require 300 megawatts of new resources. Exh. No. 331-T at 38:14 (Duvall). Additionally, this new found isolationism ignores the loss of system diversity and attendant heightened risks to Washington customers from a control area approach. Exh. No. 331-T at 14-16 (Duvall).

[6] Public Counsel has now apparently come to support Staff's view that least-cost planning for a multistate utility needs to be done on a state-by-state basis. Public Counsel Initial Br. at 37. This suggestion is unprecedented in Washington regulatory history and is hard to reconcile with even the name "Integrated Least-Cost Planning."

participants to reject a separate control area approach, and ICNU's proposal is both analytically flawed and certainly unacceptable to other states. PacifiCorp Initial Br. at 14.

14. Staff's, Public Counsel's, and ICNU's briefs all objected to the Revised Protocol's treatment of Mid-Columbia Contracts and Qualifying Facility ("QF") contracts. Staff Initial Br. at 19-21; Public Counsel Initial Br. at 30-31; ICNU Initial Br. at 13-16. None of these parties acknowledged that on both counts, Washington customers will be better off under the Revised Protocol than they are under the Modified Accord Method presently used by the Company in Washington. Tr. 682:22 (Duvall); Exh. No. 371-T at 19:1-2 (Taylor).

B. The Commission Should Approve PacifiCorp's Proposed Power Cost Adjustment Mechanism.

15. In its Initial Brief, PacifiCorp described how its proposed PCAM would work and why it is necessary to afford the Company a reasonable opportunity to earn its allowed rate of return. PacifiCorp Initial Br. at 15-19.

16. Staff's brief argued that the Company does not require a PCAM, because the variability in wholesale market prices has lessened since the Western energy crisis of 2000-01. Staff Initial Br. at 27-28. This position is contrary to evidence that there is still substantial market price variability and that in any event, short-term market prices account for a small portion of the Company's total net power costs. Exh. No. 398-T at 10:6-10 (Widmer). Notwithstanding the suggestion that the crisis has somehow passed, the Company incurred $197 million of unrecovered net power costs in the year ended September 30, 2005. Exh. No. 398-T at 8:18 (Widmer).

17. Staff's, Public Counsel's, and ICNU's briefs all suggested that only certain elements of total net power costs should be included in the PCAM. Staff's brief would exclude costs it associates with the Company's Eastern control area, Public Counsel's brief would exclude items it deems not "truly beyond the Company's control" and costs under long-term contracts, and ICNU's brief would exclude costs that are not "volatile, significant, or beyond the Company's

control."[7] Staff Initial Br. at 28-29; Public Counsel Initial Br. at 45-47; ICNU Initial Br. at 26. PacifiCorp continues to believe that all elements of net power costs are interrelated and that all should be reflected in a PCAM. Exh. No. 398-T at 15-16 (Widmer).

C. The Company Should Be Permitted to Recover the Full Amount of Its Hydro-Electric Cost Deferral.

18. In its Initial Brief the Company demonstrated that Staff's adjustments to its hydro-referral cost deferral were unreasonable. PacifiCorp Initial Br. at 19.

19. Staff's brief suggested that, "upon reflection," Mr. Buckley's acknowledgment that his adjustment reflected double-counting was erroneous. It then provided further explanation that is neither comprehensible nor based on anything in the record. Staff Initial Br. at 31-32. This portion of Staff's Initial Brief should therefore be disregarded.

D. The Commission Should Reject Unreasonable and Unsupported Adjustments to PacifiCorp's Revenues and Expenses, Unrelated to the Revised Protocol, That Are Proposed by Staff and Intervenors.

1. Proposed Adjustments to PacifiCorp's Wage and Benefit Expenses Should Be Rejected.

20. In its Initial Brief, PacifiCorp addressed various reductions proposed by Staff and Intervenors to the Company's pro forma adjustments to incentive pay, medical insurance, and pension and other post-retirement expenses. PacifiCorp explained why adoption of the proposed reductions would prevent the Company from recovering its prudently incurred costs of serving Washington retail customers. PacifiCorp Initial Br. at 19-22.

21. Staff's and Intervenors' briefs challenged PacifiCorp's wage and benefit expenses in five areas: (1) treatment of the Company's Annual Incentive Plan, (2) treatment of the Company's Performance Unit Plan, (3) the appropriate discount rate to be used to calculate pension and other retirement benefit expenses, (4) the amount of the IBEW Local 57 pension expense, and (5) the

[7] Curiously, while Public Counsel would exclude costs that are subject to the Company's control and costs under long-term contracts, it proposes to include transmission costs, including long-term transmission contracts and rate base items. Public Counsel Initial Br. at 45.

amount of the Company's medical insurance expenses. In each area, proposed adjustments reflected fundamental misunderstandings by Staff, Public Counsel, and ICNU; all of the Company's expenses in these areas are known and measurable, prudently incurred, and should be recoverable.

22. Annual Incentive Plan ("AIP"). PacifiCorp carefully designed the AIP to meet the Commission's requirement that, as worded in Staff's Initial Brief at 59, targets "must be tied to service-oriented goals, not just financial goals." *See Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket Nos. UE-040641 et al., Order No. 6 at 55 (Feb. 18, 2005). The Company believes that it correctly interprets this rule to mean that targets based on earnings are disfavored, but that cost-containment goals do not fall under this rubric because cost containment benefits ratepayers.

23. Staff's brief contended that 15 percent of the AIP should be disallowed because that amount is tied to financial goals. Staff Initial Br. at 58. This figure comes from Staff witness Thomas E. Schooley's interpretation that the "financial objectives" listed in the AIP scorecard refer to earnings targets. Exh. No. 631-T at 15:14 – 19:2 (Schooley); Exh. No. 273 (Wilson) (scorecard). In fact, the financial objectives are not tied to earnings, but rather are cost-containment targets. Exh. No. 271-T at 5:18-22 (Wilson); Exh. No. 273 at 5 (Wilson) ("financial objective"—10 percent of AIP tied to "optimize availability at best market point"). Note that the reference to earnings targets in the Company's Initial Brief was incorrect; there are no earnings-related targets. PacifiCorp Initial Br. at 20. In short, the AIP was crafted to meet the Commission's requirements and there should be no disallowance based on a misinterpretation of what the Commission interprets to be "financial objectives."

24. Public Counsel's brief asserted that the Company has not provided an analysis of the percentage of incentive compensation that is tied to financial targets, so one-half of all incentive pay should be disallowed. Public Counsel Initial Br. at 21. Public Counsel witness David J. Effron identifies "financial goals such as maximizing profitability and growth, increasing earnings per share, or increasing return on equity" as the type of targets that should be

disallowed. Exh. No. 291-T at 16:20-23 (Effron). The rebuttal testimony of PacifiCorp witness Erich D. Wilson and the summary provided in the previous paragraph demonstrate that none of the types of targets that concern Mr. Effron are included in the AIP.

25. Finally, ICNU has continued to claim that no incentive compensation should be allowed, because the Company says that it provides competitive salaries, so incentives are unnecessary. ICNU Initial Br. at 54. This argument was addressed by Mr. Wilson; the Company does provide competitive base salary, but it must also offer incentive compensation in order to offer a competitive total compensation package. Exh. No. 271-T at 4:11-17 (Wilson). ICNU has provided no response to this straightforward explanation.

26. Performance Unit Plan ("PUP"). The PUP is a separate incentive plan that utilizes exactly the same targets as the AIP does; the only difference is that AIP payments are made in cash, while PUP payments are made in ScottishPower shares. Exh. No. 271-T at 8:19-23 (Wilson). Therefore, the compensation expense of the PUP should be allowed for the same reasons that the AIP should be allowed.

27. Staff's brief referred to the PUP as the "Long Term Incentive Plan," which Mr. Schooley initially described as an executive compensation plan that should be completely disallowed. Exh. No. 631-T at 19:7-11 (Schooley). Mr. Wilson clarified that the PUP is distinct from the Company's executive long-term incentive plan, which the Company is not proposing to include in this case. Exh. No. 271-T at 9:12-17 (Wilson). Despite the clarification, Staff still contended that the PUP should be disallowed and still referred to it as the "Long Term Incentive Plan." Staff Initial Br. at 58-59. Staff contended that by awarding shares that are deferred over a three-year period, the PUP is an incentive plan based solely on the financial target of ScottishPower share price. *Id.*

28. Staff is missing the point. The PUP was designed, like the AIP, to meet the Commission's rules regarding incentive compensation targets. The targets are not tied to earnings, as discussed previously. The three-year share deferral is not even absolute; employees may vote their shares and may cash their shares on the same hardship basis used for early

withdrawal from the Company's 401k plan. Exh. No. 271-T at 9:5-10 (Wilson). The mere fact that employees hold shares rather than cash for the relatively short span of three years does not transform the PUP into an incentive plan based on financial targets. The PUP uses the same targets as the AIP does and should be allowed for the same reason that the AIP should be allowed.

29. Public Counsel's brief and ICNU's brief did not separately analyze the PUP. Their general positions on incentive compensation, discussed above, should be rejected with respect to the PUP for the same reasons that their arguments are invalid with respect to the AIP.

30. Finally, with respect to both the AIP and the PUP, it is critical to recall that the Company is only requesting one-half of the maximum incentive compensation, despite the fact that much more than half of the maximum has been awarded in the recent past. Exh. No. 272 (Wilson) (67 percent of maximum last year, 79 percent on average for the three prior years). In making this concession, the Company has already given up a great deal. Further reduction is unwarranted.

31. Pension and other retirement benefit expenses. ICNU's brief reiterated its argument that the Company should use a higher discount rate to calculate pension and other retirement benefit expenses. ICNU Initial Br. at 53. No other party proposes such an adjustment. The Company has adequately responded to ICNU's argument by noting that financial accounting standard ("FAS") rules require the use of a discount rate approved by the Company's accounting firm, based on current discount rates. PacifiCorp Initial Br. at 22; Exh. No. 231-T at 2:11-22 (Rosborough); Exh. No. 239 (Rosborough) (PriceWaterhouseCoopers memorandum setting the 6.25 percent discount rate that the Company used). Therefore, ICNU's adjustment would violate FAS requirements and should be rejected.

32. IBEW Local 57 pension expense. Staff's brief repeated its argument that the IBEW Local 57 pension expense is not known and measurable, so it should not be included in rates. Staff Initial Br. at 60-61. This contention ignored the Company's clear articulation of the basis for this estimated $3,000,000 expense—that the Company is obligated to contribute 7 percent of

participant pay for calendar year 2006 under the current collective bargaining agreement, and reasonably expects that obligation to continue. Exh. No. 237-T at 5:10-18 (Rosborough). Staff contended that because the Company made no contribution in FY 2005, the Commission should assume that there will be no contribution in the future. Exh. No. 631-T at 33:19 – 34:3 (Schooley). This argument ignored the explanation provided by the Company: Favorable pension returns in 2003 and 2004 led to the one-time event of no contribution in FY 2005, but the Company reasonably expects to make contributions in the future at historic levels. Exh. No. 231-T at 6:14-17 (Rosborough); Exh. No. 237-T at 5:7-18 (Rosborough).

33. Medical insurance. The Company has fully supported its estimate of a 12 percent increase in medical insurance expenses and its continued use of a 90/10 employer/employee sharing of those expenses. Exh. No. 237-T at 5:20 – 7:15 (Rosborough). Staff's brief and ICNU's brief argued that a lower escalation rate and greater employee contributions are appropriate. Staff Initial Br. at 61-62; ICNU Initial Br. at 49-52. The cited opinions are primarily based on general industry data, though they acknowledge the industry-specific information provided by the Company. *Id.*

34. Mr. Rosborough explained that the utility industry average medical expense escalation has been 11 percent, and that this figure should be adjusted upward by an additional percent to reflect the fact that PacifiCorp's workforce is three years older than the utility industry average. Exh. No. 237-T at 6. Staff countered that PacifiCorp has successfully managed to achieve lower-than-industry-average medical cost escalations in the past, so one can expect the trend to continue. Staff Initial Br. at 62. PacifiCorp's past success at cost containment is due to measures that essentially reduced the benefits provided. Exh. No. 231-T at 9:6 – 10:14 (Rosborough). It is unreasonable to expect the Company to continue to cut benefits. The expected utility industry average expense increase, with recognition of the age of PacifiCorp's work force, is the appropriate increase to use.

35. On another tack, both ICNU's brief and Staff's brief contended that the Company's plan to shift to an 85/15 employer/employee cost-sharing is known and measurable, as if the

Company has already taken this step. ICNU Initial Br. at 52; Staff Initial Br. at 61. Both briefs referenced the direct testimony of PacifiCorp witness Daniel J. Rosborough, but the citations were to Mr. Rosborough's statement that "the Company has bargained with its participating unions to move to [the 85/15 level] starting in January 2006." Exh. No. 237-T at 7:10-13 (Rosborough). The Company has taken the first step by moving to 90/10 sharing in 2005; the eventual shift to 85/15 sharing currently is not known and measurable, because the timing has not been determined. Exh. No. 231-T at 10:3-6 (Rosborough) (regarding shift from 91/9 sharing to 90/10 sharing in 2005); Exh. No. 237-T at 7:13-15 (Rosborough).[8] The Commission should base its medical expense escalation rate determination on the currently existing 90 percent employer contribution that currently exists, not a rate that the Company hopes to move toward at some time in the future.

2. PacifiCorp Should Be Allowed to Recover 75 Percent of Its Edison Electric Institute Dues.

36. In its Initial Brief, PacifiCorp defended the reasonableness of its requested recovery of 75 percent of its Edison Electric Institute ("EEI") dues expense. PacifiCorp Initial Br. at 22-23. Only Staff's brief contested this adjustment, and the revenue requirement difference between Staff's position and the Company's position is approximately $11,000, after correcting Staff's position by using actual bill payments. Staff Initial Br. at 62-63; Tr. 462:25 – 463:10 (Wrigley).

37. PacifiCorp witness Paul M. Wrigley notes that Staff's adjustments include disallowance of EEI dues related to "strategic conservation, peak clipping, valley filling, load shifting, strategic load growth and flexible load shape, which are, I believe, all activities that this Commission would approve of us doing. Similar, the advertising which is being disallowed is for—some of the things are conservation, safety, customer education and is legally required by

[8] *See also* Commitment 29 of MEHC in Appendix A to the Stipulation in PacifiCorp acquisition Docket No. UE-051090: "After the closing of the transaction, MEHC and PacifiCorp will make no unilateral changes to employee benefit plans prior to May 23, 2007 that would result in the reduction of employee benefits." Exh. No. 228.

governmental requirements, and I think PacifiCorp should be participating in these activities." Tr. 465:10-20 (Wrigley).

38. Staff's brief contended that it is PacifiCorp's burden to segregate the costs that Mr. Wrigley identifies from other EEI expenses that Staff asserts are not allowable. Staff Initial Br. at 63. The segregation that Staff seeks did occur; Mr. Wrigley discussed the elements included in the disallowance item-by-item. Tr. 497:1 – 499:11 (Wrigley).

3. PacifiCorp Should Be Allowed to Recover Its Ongoing Costs of Participating in Grid West Development Activities.

39. In its Initial Brief, PacifiCorp noted its need to continue to incur Grid West-related costs as ordinary, necessary, and reasonable expenses. As the owner of the largest transmission system in the Pacific Northwest, apart from the Bonneville Power Administration, PacifiCorp has an ongoing obligation to engage in activities that protect the value of PacifiCorp's transmission assets to its retail customers, whether or not the participation leads to creation of a new transmission entity. No witness has been willing to recommend that PacifiCorp stop participating in such transmission planning efforts, and proposals to exclude rate recovery of the cost of such efforts, or to defer such costs for rate recovery only if Grid West becomes operational, thus are unreasonable. PacifiCorp Initial Br. at 23-26.

40. Staff's brief asserted that PacifiCorp's ongoing expenses of planning for potential transmission organizations should not be recoverable unless the specific organization has become operational. Staff Initial Br. at 63-64. As set out in PacifiCorp's Initial Brief, Staff's Grid West cost disallowance is advanced by Staff witness Christian J. Ward, who could not deny the value of PacifiCorp's continued participation in Grid West efforts and was not prepared to recommend that the participation be halted. Tr. 596:4-8, 597:2-15, 598:13-19 (Ward). Denial of recovery of ongoing costs that PacifiCorp as a prudent utility continues to incur is neither just nor reasonable.

41. The ICNU brief urged the proposed exclusion not only of outside contractor costs, but even of costs allocable to PacifiCorp's own employees in continuing to work on Grid West

development. Citing *Bonneville Power Admin. et al.*, Docket No. EL05-106-000, 112 FERC ¶ 61,012 (July 1, 2005), ICNU asserted that the Federal Energy Regulatory Commission ("FERC") is no longer actively promoting a Northwest regional transmission organization ("RTO"). ICNU Initial Br. at 56. To the contrary, the cited order addressed numerous issues that required resolution before Grid West could move forward and demonstrated FERC's continued active involvement in fostering Grid West, even if that organization cannot meet all of FERC's requirements for an RTO.

42. As the major investor-owned utility owner of transmission assets in the Pacific Northwest, PacifiCorp has a responsibility to participate in a variety of transmission planning efforts. Even if those efforts do not lead to new transmission organizations, they provide valuable transmission analysis and issue resolution. The Commission should not find that PacifiCorp's continued efforts in this area are inappropriate, and as a result should not deny or jeopardize PacifiCorp's recovery of the reasonable costs of its ongoing efforts.

4. Additional Revenues Should Not Be Imputed to PacifiCorp's Transmission Contract with the Western Area Power Administration.

43. In its Initial Brief, PacifiCorp addressed the issues related to ICNU's proposal to impute additional revenues to the Western Area Power Administration ("WAPA") contract. PacifiCorp Initial Br. at 26. Only ICNU's brief supports such an adjustment, and ICNU raised no new arguments that PacifiCorp needs to address in reply.

5. PacifiCorp Has Conservatively Stated Its Property Tax Expense, and the Amount Requested by PacifiCorp Should Be Allowed.

44. PacifiCorp's Initial Brief pointed out that its requested Company-wide $1,215,888 increase in property tax expense is below the range indicated by the $330,551,452 increase on PacifiCorp's net utility plant. The requested increase suffers only from being lower than the quantifiable range of reasonable projections, a fact confirmed by Staff witness Danny P. Kermode. Tr. 585:14-18. It would be arbitrary and capricious to reject a requested expense

increase on the ground that the Company's testimony supported an actual increase of greater magnitude. PacifiCorp Initial Br. at 27-28.

45. Staff's brief advanced a new factual argument for denial of any property tax adjustment in connection with an increase in taxable net plant of over $330 million. Staff claimed that even though PacifiCorp has made massive property additions, its total property tax bill might be the same or lower if property tax rates are sufficiently lowered. Staff Initial Br. at 64-65.

46. This new argument not only is unsupported in the record, but it also contradicts the judgment of Mr. Kermode. He candidly acknowledged that the more reasonable assumption was that PacifiCorp's property taxes would increase as a result of the large increase in net plant. Tr. 586:9-12 (Kermode). In fact, Mr. Kermode's opinion was that, based on the facts, he would expect an increase of $4 million, rather than the much smaller amount PacifiCorp has requested. Tr. 588:22 – 589:4, 588:19-23 (Kermode). PacifiCorp sees little basis in reality for the speculation in Staff's brief that property tax rates may substantially decline, and such a speculation advanced by Staff's attorney after the hearing should not override the evidence in the record, including the judgment of Staff's own witness on property taxes.

6. PacifiCorp Should Be Allowed to Amortize Its Capital Stock Issuance Expense.

47. In its Initial Brief, PacifiCorp explained that its proposal to amortize its capital stock issuance expense is comparable to the current practice of amortizing bond issuance expense. Such amortization is not retroactive ratemaking, just as the traditional comparable treatment of bond issuance expense is not retroactive ratemaking. Moreover, recovery through the amortization approach is less costly than using a 0.25 percent adder to ROE as proposed by Mr. Effron. PacifiCorp Initial Br. at 28-29.

48. Public Counsel's brief advanced a new argument that should be rejected. Public Counsel now contends that stock issuance costs should not be recoverable, because market prices of PacifiCorp shares at the times of issuance exceeded the book value of the shares, so "there is really nothing that has to be recovered." Public Counsel Initial Br. at 21. This argument

overlooked the fact that PacifiCorp only earns a return on the net book value of its investment, not on whether investors pay more or less than book value for newly issued stock. Investors have contributed and are entitled to a return on the equity component of the capital used to support rate base. The Company has been required to incur expense to obtain this equity capital. This expense is a cost of providing utility service, the same as bond issuance expense, and is a cost the Company should be allowed to recover.

7. The System Overhead A&G Allocation Factor Should Not Be Changed.

49. In its Initial Brief, PacifiCorp pointed out that Staff's proposed change to the system overhead ("SO") factor was based on mistaken analysis of historical data. PacifiCorp Initial Br. at 29-30. Staff's brief did not address this issue, but Staff still listed its system overhead A&G factor adjustments 8.16, 8.17, and 8.18 among its contested adjustments in Table 1 of its Initial Brief. Given Staff's failure to discuss these adjustments and PacifiCorp's testimony explaining why the adjustments lack merit, the Company urges the Commission to reject Staff Adjustments 8.16, 8.17, and 8.18.

8. Production Factor Adjustments Proposed by ICNU and Public Counsel Should Be Rejected in Favor of Staff's Corresponding Adjustment That PacifiCorp Has Accepted.

50. In its Initial Brief, PacifiCorp supported use of the same form of production factor methodology that the Commission has approved for Puget Sound Energy ("PSE"). To conform to that methodology, PacifiCorp has accepted a $3,413,288 downward adjustment proposed by Mr. Schooley as Staff Adjustment 8.10. PacifiCorp Initial Br. at 30-31.

51. ICNU's brief opposed the production factor methodology, even with the Staff adjustment. ICNU Initial Br. at 40-43. ICNU's arguments were fully addressed by PacifiCorp in its Initial Brief. PacifiCorp Initial Br. at 30-31. PacifiCorp simply seeks treatment comparable to that afforded PSE. The production factor methodology, incorporating Staff's downward adjustment, gives the Company a reasonable opportunity to recover the applicable portion of its rate period power costs; ICNU's proposed disallowance of rate period power costs, even with

Staff's adjustment to scale such costs back to match test period loads, patently would not allow cost recovery.

9. ICNU's Adjustment for ScottishPower Cross-Charges Should Be Rejected in Favor of Staff's Corresponding Adjustment That PacifiCorp Has Accepted.

52. In its Opening Brief, PacifiCorp noted that it had accepted Staff Adjustment 4.13, related to ScottishPower cross-charges, and that such acceptance mooted ICNU's somewhat smaller adjustment to the same charges. PacifiCorp Initial Br. at 31-32. ICNU's brief did not argue for any further adjustment.

10. Public Counsel's Proposed Out-of-Period Revenue Expense Adjustment Has Already Been Accepted by PacifiCorp and Is Included in Computing the Company's Revised Revenue Requirement Request.

53. Public Counsel's brief proposed a further $1.4 million reduction to PacifiCorp's revenue requirement for a proposed removal of an out-of-period revenue adjustment. Public Counsel Initial Br. at 20. In its rebuttal testimony, the Company not only accepted this adjustment, but applied a refined version of the adjustment that produced a larger reduction to the revenue requirement than that proposed by Mr. Effron. The adjustment already made for this item in the Company's rebuttal case totals $1,713,782. Exh. No. 195-T at 3:1, Adj. No. 3.8 (Wrigley); Exh. No. 257-T at 1:17 – 2:12 (Griffith).

11. Public Counsel's Proposed Updates to the Company's Rate Base for Depreciation Reserve and Accumulated Deferred Tax Balances Duplicate the Company's Acceptance of the Same Updates as Part of Staff's Production Factor Adjustment.

54. Public Counsel's brief raised an issue that PacifiCorp thought had been fully resolved. The brief claimed that the adjustment for major plant additions forecasted to occur after the end of the test period needed to be adjusted downward, for two reasons. According to the brief:

> "At a minimum, two modifications should be made to this adjustment. First, it should be modified to reflect more recent data. Second, if plant is adjusted through March 2006, it is reasonable to adjust the depreciation reserve to the same date."

Public Counsel Initial Br. at 19.

55. Public Counsel apparently does not realize that its requested adjustments already have been made in Staff Adjustment 8.10, which PacifiCorp has accepted. In the testimony referenced in Public Counsel's brief, Mr. Effron seeks pro forma adjustments to bring forward both accumulated depreciation and accumulated deferred tax balances through March 2006. Exh. No. 291-T at 9:19 – 10:8 (Effron). As Mr. Wrigley explains in his rebuttal testimony, Staff Adjustment 8.10 does exactly that. Exh. No. 195-T at 15:22 – 16:5 (Wrigley). These adjustments can be confirmed by reviewing Staff's Exhibit 638 (Schooley), which details Staff's calculation of the impact of the production factor on rate base. Line 23 shows the pro forma and restated adjustment for accumulated depreciation and lines 28-31 show the pro forma and restated adjustments to deferred income tax.

E. The Commission Should Reject Unreasonable and Unsupported Adjustments to PacifiCorp's Rate Base, Unrelated to the Revised Protocol, That Are Proposed by Staff and Intervenors.

1. The Cash Working Capital Requirement That PacifiCorp Included in Its Rate Base, Based on a Lead-Lag Study, Is the Appropriate Amount and Should Be Allowed.

56. In its Initial Brief, PacifiCorp explained that it has determined its working capital needs using the state-of-the-art lead-lag study approach that is almost universally accepted by regulators throughout the nation. By contrast, Staff's balance sheet approach is not used elsewhere, and Staff has failed to keep current with the development of lead-lag analysis. In addition, PacifiCorp noted that the balance sheet approach is unusually sensitive to judgments by the person preparing the study; more important, by using an accrual accounting rather than cash flow analysis, the balance sheet approach fails to measure the actual cash needs that create a working capital requirement. PacifiCorp Initial Br. at 32-35.

57. Staff's Initial Brief attempted to cast doubt on PacifiCorp's lead-lag study. Staff Initial Br. at 72. However, Staff's record citations do not reveal any deficiency in the lead-lag study the Company has submitted.

58. First, Staff's brief stated that "[w]orking capital can be supplied by many entities, not just investors: *e.g.*, ratepayers, trade creditors, and the government." Staff Initial Br. at 68. All of the named entities, other than ratepayers, are entities to whom PacifiCorp must make payments, and Staff does not and cannot state that any are omitted in the lead-lag study. For example, the cross-examination of Mr. Wrigley brought out a discussion of how the lead-lag study accounts for the timing of payments to the government. Tr. 483:24 – 487:13 (Wrigley).

59. Staff's brief also questioned certain details of the lead-lag determination, despite the fact that no Staff witness was prepared to make such challenges in testimony and be subject to rebuttal or cross-examination thereon. For example, Staff's brief challenged PacifiCorp's calculation of an average 13.56-day lag in payroll payments with an assertion that some portions of payroll are in the form of incentive compensation paid once a year. Staff Initial Br. at 72. The cited transcript reference, however, provided no support for the proposition that any compensation item has been incorrectly accounted for in determining the average 13.56-day lag. *See* Tr. 487:14 – 488:15 (Wrigley). The Staff brief also failed to note that the cited incentive compensation is paid at mid-year (on June 2), negating in any event the implication that it is a year-end payment that should increase average annual lag in payroll distributions. Tr. 489:11-15 (Wrigley).

60. Finally, the Staff brief argued that some of PacifiCorp's expenses in the lead-lag study are actuarially determined, such as pension expense, and thus should not be included in a cash working capital study. Staff Initial Br. at 72. This newly-minted assertion is plainly incorrect, as pension obligations, while actuarially determined, must actually be paid as cash into funds for the benefit of employees. More telling, the Staff brief seemed to overlook the fact that every entry in Staff's balance sheet approach is an accrual entry, and there is not a single cash item reflected in Staff's approach. This glaring defect in the Staff approach is set out at pages 34-35 of PacifiCorp's Initial Brief and probably accounts for why the Commission appears to be alone in permitting such an approach.

2. Proposed Reductions in Miscellaneous Deferred Debits, Beyond the Levels Accepted by PacifiCorp in Its Rebuttal Testimony, Have Not Been Justified and Should Be Rejected.

61. In its Initial Brief, PacifiCorp pointed out that Staff had "scrubbed" its Miscellaneous Deferred Debits account, and PacifiCorp had removed from rate base in this proceeding various items found objectionable to Staff. In response to Mr. Effron's argument that all such Miscellaneous Deferred Debits should be removed because they have not been specifically authorized by the Commission, PacifiCorp pointed out that no such authorization is required. PacifiCorp Initial Br. at 35-36.

62. Staff's brief advanced one additional adjustment to this account. Staff proposed to reduce PacifiCorp's rate base by the amount of insurance proceeds received for PacifiCorp Environmental Remediation Company ("PERCO")-administered environmental cleanups. PacifiCorp has reversed this rate base reduction in Adjustment 8.5a in recognition of the Commission's rejection of PacifiCorp's proposal to defer PERCO-administered environmental clean-up expenses for later rate recovery. Staff's brief noted that the Commission in Docket No. UE-031658 excluded PacifiCorp's deferral of PERCO-administered environmental cleanups because the expenses will be recovered by the Company through an insurance settlement. The brief then argued that the same insurance settlement still should be treated as a rate base reduction. Staff Initial Br. at 73-74.

63. Staff's position constitutes a double-counting of the benefits of the proceeds of the insurance settlement related to the PERCO-administered environmental cleanups. Now that the Commission has denied recovery of the PERCO-administered environmental cleanups because of the availability to PacifiCorp of the related insurance settlement proceeds, the same insurance settlement proceeds cannot also be used to reduce the Company's rate base. Such treatment, as proposed by Staff, would credit ratepayers twice with the benefit of insurance proceeds for PERCO-administered environmental cleanups.

64. Public Counsel's brief proposed to exclude even the Miscellaneous Deferred Debits remaining after Staff has scrubbed the account, because PacifiCorp "does not offer any

explanation of why the Company should be authorized to include the deferred debits in rate base, even though their inclusion has been directly challenged in this case." Public Counsel Initial Br. at 18. However, Mr. Effron's only substantive challenge to the remaining items in this account was that they had not been specifically authorized by the Commission. Exh. No. 291-T at 4:19 – 5:12 (Effron). PacifiCorp correctly responded that no such authorization is required. Exh. No. 195-T at 16:23 – 17:10 (Wrigley). This response to Public Counsel's only specific objection should be sufficient. Public Counsel has advanced no cogent reason for rejection of the scrubbed Miscellaneous Deferred Debits account.

3. The Acquisition Premium Adjustments Included by PacifiCorp in This Proceeding Have Been Justified and Should Be Allowed.

65. In its Initial Brief, PacifiCorp justified three acquisition adjustments that have been challenged only by Public Counsel. PacifiCorp asks the Commission to find that these payments to third parties above book value were prudent, for the reasons presented by PacifiCorp, and to include the acquisition adjustments in rate base. PacifiCorp Initial Br. at 36-37.

66. Public Counsel's brief continued to urge disallowance of the acquisition adjustments. However, the brief makes no effort to respond to PacifiCorp's testimony as to why the adjustments were prudent and should be allowed. Public Counsel Initial Br. at 19.

F. The Commission Should Recognize in This Proceeding the Actual and Reasonable Capital Structure That Supports PacifiCorp's Utility Rate Base.

1. Inclusion of Short-Term Debt in PacifiCorp's Capital Structure Would Result in a Double-Counting of Short-Term Debt in PacifiCorp's Rates.

67. In its Initial Brief, PacifiCorp explained that the Company is not required by any other state commission to include short-term debt as part of capital supporting its plant in service. PacifiCorp explained why Staff's proposal to include short-term debt as part of the capital structure supporting plant in service constitutes an improper double-counting of the same low-cost capital already used to determine the financing costs of construction work in progress ("CWIP"). FERC requires that when the balance of short-term debt is less than the balance of CWIP, as is the case in this proceeding, that all short-term debt be used to determine the

allowance for funds used during construction ("AFUDC") rate, which in turn becomes the construction financing cost applied to new plant in service. As a result of this FERC-required allocation of short-term debt, PacifiCorp's customers receive the benefit of the lower cost of its short term debt financing at the time CWIP assets enter service, through a lower cost basis for such assets. Staff witness James A. Rothschild has admitted this double-counting if short-term debt then is applied a second time as part of the capital structure supporting plant in service. PacifiCorp also explained that Mr. Rothschild's fall-back argument—that additional nonexistent short-term debt should be imputed to PacifiCorp—is wholly unsupported. PacifiCorp Initial Br. at 37-40.

68. Staff's Initial Brief cited a snippet, out of context, from a 23-year-old Commission order, *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Docket Nos. U-82-12 and U-82-35, Fourth Supp. Order at 26 (Feb. 1, 1983), to argue that the Commission requires PacifiCorp to use the Commission-allowed rate of return as the cost of financing CWIP, rather than the FERC-required AFUDC rate. Staff argued that PacifiCorp should apply a higher Washington-only AFUDC rate to determine the cost at which CWIP enters Washington rate base, and therefore, application of short-term debt as financing plant in service would not constitute double-counting. Staff Initial Br. at 37.

69. Staff failed to note other facts relevant to its cited Commission order that demonstrate the order's inapplicability to Staff's recommendation for inclusion of short-term debt in this proceeding. Staff also failed to note the adverse consequences to Washington customers if Staff's proposal were adopted.

70. The cited order in Docket Nos. U-82-12 and U-82-35 addressed PacifiCorp's need to obtain additional rate relief to support a large construction burden, carried out at a time of high financing costs. As the Commission explained:

> "In recent years, electric utilities under the jurisdiction of the commission have been faced with the financing of generation projects on a scale hitherto unknown, to the point where the financing requirements of these projects have been so large that to

> meet the financing requirements under traditional approaches would endanger the financial integrity of the companies and would threaten their ability to provide service."

Order in Docket Nos. U-82-12 and U-82-35 at 25.

71. To assist the Company, the Commission in a previous PacifiCorp rate proceeding had authorized inclusion in rate base of a substantial portion of the Company's CWIP. *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Docket No. U-81-17, Second Supp. Order at 6 (Dec. 16, 1981). To further enhance the Company's current book earnings and future cash earnings, the Commission also concluded that both the Company and Staff should capitalize AFUDC at the Company's Washington rate of return, rather than at the lower FERC-specified rate. *Id.* The Commission did not, however, in either the 1981 or the 1983 decision, include any short-term debt in PacifiCorp's capital structure. *See id.* at 10; Order in Docket Nos. U-82-12 and U-82-35, at 30. The ordered adjustments thus were purely efforts to provide earning enhancements during a difficult period for the Company.

72. In Docket Nos. U-82-12 and U-82-35, the Commission expressed irritation at the fact that PacifiCorp had not accrued AFUDC on its books at the higher level specified in the previous rate order. Docket No. U-81-17, Second Supp. Order at 26. Unfortunately, as well-meaning as the Commission was in addressing a means for PacifiCorp to boost its earnings, the Company was unable to comply with the booking requirement. PacifiCorp's books must comply with conflicting requirements of federal law, as set out in FERC's Uniform System of Accounts. As specified in FERC's regulations:

> "The Federal Power Commission acting pursuant to authority granted by the Federal Power Act, particularly sections 301(a), 304(a), and 309, and paragraph (13) of section 3, section 4(b) thereof, and finding such action necessary and appropriate for carrying out the provisions of said act, hereby adopts the accompanying system of accounts entitled "Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act," and the rules and regulations contained therein; and *it is hereby ordered*:

> (a) That said system of accounts and said rules and regulations contained therein be and the same are hereby prescribed and promulgated as the system of accounts and rules and regulations of the Commission to be kept and observed by public utilities subject to the jurisdiction of the Commission and by licensees holding licenses issued by the Commission, to the extent and in the manner set forth therein; . . .

18 C.F.R. pt. 101, *et seq.*; Order 141, 12 Fed. Reg. 8503 (Dec. 19, 1947) (emphasis in original).[9] As set forth in PacifiCorp's Initial Brief, the Uniform System of Accounts specifies how the AFUDC rate must be calculated. PacifiCorp's Initial Br. at 38-39.

73. The Commission's good intentions not only were incompatible with FERC requirements that the Company must follow, but the booking of a separate Washington AFUDC rate would have been impractical, even if allowed by FERC. PacifiCorp would have needed to book a "Washington-only" AFUDC rate applicable to jointly allocated utility plants located in a number of states. Moreover, because the precise allocation of such plants to Washington changes over time and is different in each rate proceeding, the amount to book for the allocated Washington-only AFUDC rate could only be estimated at the time the Company's accounts were closed for each period. Perhaps in recognition of these problems, after 1983 no Commission order for PacifiCorp has contemplated a separate Washington-only AFUDC rate.

74. PacifiCorp and the Commission do have one apparent option, if the Commission wants to follow Staff's recommendation without double-counting: While PacifiCorp cannot deviate in its books from FERC requirements, it could for ratemaking purposes restate its Washington plant in service by substituting, beginning with the date of the 1981 order cited above, the applicable Washington rate of return for the lower AFUDC rate it has accrued pursuant to FERC requirements. If this is what Staff proposes, Staff perhaps should be careful what it asks for. In the 1983 order cited by Staff, the Commission set an after-tax rate of return of <u>13.01 percent</u>, including a ROE of <u>18.5 percent</u>. If the Washington rate of return was substituted for the lower

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[9] FERC's statutory authority to prescribe the books and accounts for all public utilities over which FERC has jurisdiction is clearly specified in the Federal Power Act provisions cited in the above rule.

AFUDC rate, such higher rate would compound annually as the CWIP financing costs until the time the related plant actually went into service. The Commission might consider whether to preserve its unique status of counting short-term debt as supporting plant in service, it wants to follow Staff's recommendation and require PacifiCorp to restate its plant in service balances, for Washington rate case purposes only, at much higher levels than used to determine rate base in PacifiCorp's other regulatory jurisdictions.

2. PacifiCorp's Proposed 49.5 Percent Common Equity Ratio Is Consistent Both with the Company's Actual Common Equity Ratio and with the Common Equity Ratios of Electric Utility Companies Comparable to PacifiCorp.

75. In its Initial Brief, PacifiCorp demonstrated that its proposed 49.5 percent common equity ratio is the same as its actual common ratio as of March 31, 2006, is comparable to the common equity ratios of utilities found to be comparable to PacifiCorp, and is needed to maintain the ratings metrics for PacifiCorp's current credit ratings. The brief also demonstrated that a 49.5 percent common equity ratio merely restores PacifiCorp's common equity ratio to pre-energy-crisis levels. PacifiCorp Initial Br. at 41-44.

76. Staff's brief defended its proposed 43.5 percent common equity ratio by stating that its proposal "contains virtually the same 54.9 percent median debt ratio achieved by utilities that Standard and Poor's has rated 'A'." Staff Initial Br. at 35. Mr. Rothschild acknowledged on cross-examination, however, that if his double-counting of short-term debt is not allowed, his set of comparable companies actually have common equity ratios as a percent of their permanent capital ranging between 48.6 percent and 51.8 percent. Tr. 1350:18 – 1351:7 (Rothschild). These comparable numbers are in line with PacifiCorp's actual 49.5 percent common equity ratio and are far above Mr. Rothschild's recommendation of a 43.5 percent common equity ratio.

77. Staff's brief also made much of the fact that the Company's 49.5 percent common equity ratio is the result of a large capital infusion of $500 million made by ScottishPower in the fiscal year ending March 2006. Staff Initial Br. at 36. The brief failed to note that this equity contribution was needed to reverse the adverse impacts on PacifiCorp of the energy crisis and

merely restored the Company to its average common equity strength in the years preceding the energy crisis (when the Company's common equity ratio ranged from 48.6 percent to 51.1 percent). Tr. 1341:20 – 1342:3 (Rothschild).

78. Public Counsel's brief similarly sought to exploit the depressed equity ratios suffered by the Company because of the financial impacts of the energy crisis. Public Counsel Initial Br. at 13. However, restoring the Company to its pre-energy-crisis financial ratios has been a responsible action by ScottishPower, and the result has been to return PacifiCorp's common equity ratio to the level of those utilities that the cost-of-capital witnesses have found to be comparable to PacifiCorp. Tr. 1350:18 – 1351:7 (Rothschild).

79. ICNU's brief baldly asked that the last $375 million of equity invested in PacifiCorp be ignored in setting the Company's capital structure. ICNU claimed that these equity infusions be ignored because they are not known and measurable. ICNU Initial Br. at 30-31. This argument has been directly contradicted by ICNU's own cost-of-capital witness Michael P. Gorman. When asked by the bench, Mr. Gorman acknowledged that $250 million of the $375 million in equity infusions he ignored was by the time of the hearing known and measurable. Tr. 1670:23 – 1671:6 (Gorman). The remaining $125 million also is known and measurable, because ScottishPower is contractually required to make this additional infusion during this month of March, 2006. Exh. No. 66-T at 5:18 – 6:30 (Williams).

G. The Commission Should Reject the Abnormally Low Common Equity Return Allowances Proposed by Staff and Intervenors.

80. In this proceeding, PacifiCorp is seeking the opportunity to earn a reasonable ROE, which is an ROE comparable to what other utilities of similar risk are allowed to earn, an ROE that supports the Company's current credit rating, and an ROE that is consistent with the Company's investment requirements. PacifiCorp hopes the Commission will resist calls to become a national low-ball regulator in the ROE area.

1. The Common Equity Returns Recommended by Staff and Intervenors Are Out of Line with Returns Being Allowed Throughout the Nation.

81. In its Initial Brief, PacifiCorp demonstrated that the common equity returns recommended by Staff and by Intervenors are out of line with returns being allowed throughout the nation, including in Washington. PacifiCorp Initial Br. at 45-46.

82. Only ICNU touched this issue in brief, with the wholly unsupported statement that its recommended return on equity of 9.8 percent "is consistent with recent commission rulings in other jurisdictions." ICNU Initial Br. at 34. PacifiCorp assumes that this statement does not refer to the 10.84 percent average ROE allowed by other jurisdictions in the third quarter of 2005, or to the 10.75 percent average ROE allowed by other jurisdictions in the fourth quarter of 2005. Tr. 1235:8-14 (Hadaway). PacifiCorp also assumes that ICNU's assertion does not refer to the higher ROEs the Commission allowed in its 2005 electric utility decisions for PSE and for Avista Corp. ("Avista"). PacifiCorp agrees with ICNU that a comparison with actions in other jurisdictions "represents corroborative evidence and provides a useful check that demonstrates [whether] . . . ICNU's 9.8% ROE recommendation is reasonable." ICNU Initial Br. at 34. The comparisons speak for themselves.

2. The Common Equity Returns Recommended by Staff and Intervenors Are Insufficient to Maintain PacifiCorp's Credit Rating.

83. In its Initial Brief, PacifiCorp noted that the ROEs recommended by Staff and Intervenors are inconsistent with maintenance of PacifiCorp's current "A-" bond rating. With ScottishPower exhausted as a provider of capital and credit, and with PacifiCorp more tightly ring-fenced so that it must rely on its own financial health, PacifiCorp needs an ROE sufficient to maintain its credit ratings. PacifiCorp Initial Br. at 46.

84. Public Counsel's brief advanced the highly disturbing argument that the coverage provided by its proposed 9.125 percent equity return should be sufficient, because the coverage is better than PacifiCorp achieved in the post-energy-crisis years. Public Counsel Initial Br. at 7-8. Given PacifiCorp's truly miserable earned equity returns during this period, Public Counsel was correct that a 9.125 percent equity return would be better than actual results in recent years.

However, PacifiCorp's credit was maintained during this period through large infusions of replacement equity, which Public Counsel wants the Commission to ignore in setting the Company's capital structure, by ScottishPower's forgoing dividends during 2003, and by reliance of the rating agencies on the superior credit of ScottishPower. Exh. No. 66-T at 5:9-17 (Williams); Exh. No. 168 at 2 (Standard & Poors Report of May 5, 2005). The suggestion that results during this financially-stressed period is a proper measure of future ratings metrics is irresponsible.

85. ICNU's brief asserted that "a 9.8% ROE will produce financial ratios that support PacifiCorp's unsecured BBB+ bond rating and A- secured bond ratings." ICNU Initial Br. at 32. This unsupported assertion is contradicted by the record. PacifiCorp witness Bruce N. Williams set out the applicable metrics in detail and demonstrated that PacifiCorp can have a 9.8 percent ROE, or it can have metrics consistent with maintenance of its current credit rating, but it cannot have both. *See* Exh. No. 66-T at 8:21 – 16:9 (Williams).

3. PacifiCorp's Requested Common Equity Return of 11.125 Percent Is Well-Supported.

86. In its Initial Brief, PacifiCorp summarized the testimony supporting its requested 11.125 percent common equity return. PacifiCorp witness Dr. Samuel C. Hadaway based his recommendation on a combination of discounted cash flow ("DCF") models and risk premium analysis. The risk premium analysis was derived from data that showed that equity risk premiums are lower when interest rates are high and are higher when interest rates are low. PacifiCorp Initial Br. at 46-48.

87. Staff's brief particularly focused on Dr. Hadaway's risk premium analysis. Citing testimony of Mr. Rothschild (Exh. No 151-T at 72:13 – 75:13 (Rothschild)), the brief asserted that Dr. Hadaway's findings of an inverse relationship between risk premiums and interest rates "applied only in the extreme markets from the late 1970's and early 1980's; not to any other periods." Staff Initial Br. at 43-44. Contrary to this assertion, Mr. Rothschild's cited testimony did not reference Dr. Hadaway's findings, but instead addressed the limited time period used in

one of the third-party studies cited by Dr. Hadaway. Dr. Hadaway's own risk premium regression analysis is set out in Exhibit 25, which reveals that the inverse risk premium relationship that he relies on has applied consistently over the full range of interest rates throughout the period 1980 through 2004. Exh. No. 25 at 1-2 (Hadaway).

88. Again citing Mr. Rothschild's testimony (Exh. No. 151-T at 6:17 – 7:5 (Rothschild)), Staff's brief purported to obtain an equity return applying what the brief asserts is "Dr. Hadaway's estimate of the current risk premium of 3.01 percent to Moody's current average utility bond yield of 5.79 percent." Staff Initial Br. at 39. Once again, the testimony cited does not support the claims made in Staff's brief. In the cited testimony, Mr. Rothschild identifies the 3.01 percent risk premium not as Dr. Hadaway's "current" risk premium, but as the average risk premium in the 1980-2004 period. The record does, however, provide the correct risk premium results. Using a projected bond interest rate of 6.6 percent, the risk premium regression produces a 10.9 percent ROE. Using a bond rate of 5.6 percent (which is <u>lower</u> than the current interest rate cited in Staff's brief), the risk premium regression produces a 10.4 percent ROE. Tr. 1229:7 – 1231:16 (Hadaway).

89. Public Counsel's brief challenged Dr. Hadaway's ROE analysis on the grounds that he has made changes to his approaches in recent years. Public Counsel Initial Br. at 10-11. Where any such changes were made, however, the reasons were clearly set out by Dr. Hadaway. Specifically, in response to the items cited by Public Counsel:

(a) Dr. Hadaway has concluded that the constant-growth DCF model currently produces unreliable results that are 1.7 percent to 2.3 percent below his risk premium results. Exh. No. 21-T at 24:5-10 (Hadaway). He explained that this model has become unreliable because current analyst-projected earnings-per-share growth rates have dropped from 5.3 percent in 2001 to 3.3 percent in 2005. While these much lower projections may be supportable for the three- to five-year forecast period, Dr. Hadaway notes there have been no changes in the underlying economy that suggest that <u>long-term</u> utility growth prospects, which a constant-growth DCF model requires, have similarly

dropped by almost one-half. Therefore, a simplifying assumption that Dr. Hadaway has made in the past, and that the other ROE witnesses continue to make—that the three- to five-year projected earnings growth rate may be used as a surrogate for long-term earnings growth—no longer is reasonable. Exh. No. 26-T at 11:1-15 (Hadaway).

The unreasonable reaction is to ignore the magnitude of the change in analysts' three- to five-year earnings growth projections and continue to assume that long-term earnings growth will be the same as analysts' near-term earnings growth projections. Consider, for example, if the analysts, instead of showing a dramatic drop in their three- to five-year forecasts, had been very bullish for the short-term, predicting 10 percent annual earnings growth in the three- to five-year period. If Dr. Hadaway in such case had "consistently" assumed that the 10 percent growth number should also be used for long-term utility earnings growth in his DCF analysis, he surely would have been justly criticized for projecting such a radical shift in long-term utility earnings growth. The same principle applies when the three- to five-year growth estimates show a near-term dramatic downturn. The assumptions of Mr. Rothschild, Mr. Gorman, and Public Counsel witness Stephen G. Hill that such near-term projections reflect a fundamental shift in expected long-term utility earnings growth have not been justified, are not plausible, and drive Staff's and Intervenors' DCF results to unreasonably low levels.

(b) Dr. Hadaway does not include a "market-based" (or "terminal price") DCF analysis in this proceeding, as he did in testimony two years ago. Public Counsel, however, ignores Dr. Hadaway's explanation that he has come to agree with the criticism that this "terminal price model" is too sensitive to the terminal stock price and thus is unreliable. Tr. 1200:11 – 1201:13 (Hadaway). Tellingly, no other witness recommends using this model.

(c) Dr. Hadaway does include the results of a new constant growth DCF equity cost estimate that uses long-term Gross Domestic Product ("GDP") growth as a single surrogate for growth. Dr. Hadaway also presents a two-stage DCF model that uses

GDP only as a surrogate for growth after the end of the Value Line earnings growth projection period. Exh. No. 21-T at 23:14 – 25:5 (Hadaway). The constant-growth DCF model produces an 11.2 percent ROE, while the two-stage DCF model produces a 10.7 percent to 10.8 percent ROE.

(d) Dr. Hadaway does use somewhat longer-term GDP data in this proceeding to project long-term growth in earnings. However, to recognize current lower inflation rates, he applies the data in a manner that gives much more weight to near-term GDP growth than to GDP growth from earlier periods. Tr. 1203:19 – 1204:9, 1205:20-25, 1206:13 – 1207:4 (Hadaway).

(e) Finally, in his risk premium analysis, Dr. Hadaway uses projected bond yields. The statement by Public Counsel that use of projected yields, rather than current yields, increases the risk premium results by almost 100 basis points (Public Counsel Initial Br. at 11), however, was contrary to the testimony. Because of the inverse relationship of risk premiums to interest rates, substitution of then-current interest rates as of the rate hearing would reduce the risk premium results from 10.9 percent to 10.4 percent. Tr. 1229:7 – 1231:16 (Hadaway). To make such substitution, Dr. Hadaway would have needed to ignore the substantially higher interest rates projected to be in effect during the rate period.

H. The Commission Should Reject Unsupported Adjustments to PacifiCorp's Washington-Allocated Income Tax Expense Proposed by Staff and Intervenors.

1. The Proposal to Allocate PHI's Interest Tax Deductions to PacifiCorp is Unreasonable and Is Unsupported in the Record.

90. In its Initial Brief, PacifiCorp challenged ICNU's proposal to appropriate during the rate period a tax deduction of PacifiCorp Holdings, Inc. ("PHI"), PacifiCorp's current parent. The Company pointed out that ICNU concurrently urges incorporation of expense reductions based on MidAmerican Energy Holdings Company's ("MEHC") acquisition of PacifiCorp, which will end PHI's ownership. The brief also explained how the proposed taking of PHI tax benefits

violates the long-standing regulatory principle of matching "benefits and burdens" in utility ratemaking and how such appropriation of non-PacifiCorp tax benefits would break down the ring-fencing around PacifiCorp. PacifiCorp Initial Br. at 49-51.

91. The inconsistency of ICNU—in seeking adjustments that assume the MEHC acquisition closes, while concurrently attempting an appropriation of PHI's future interest deductions on the assumption that the MEHC acquisition does not close—is clear in ICNU's Initial Brief. At page 7, ICNU asserted that MEHC's acquisition of PacifiCorp was known and measurable:

> "The Commission should adjust PacifiCorp's revenue requirement to reflect the MEHC acquisition, which has been approved by this Commission as well as the utility commissions in California, Oregon, Utah, Wyoming, and Idaho. The Commission should not wait to make these revenue requirement adjustments until the MEHC acquisition actually closes because the acquisition is a known and measurable event that is likely to occur during the time in which rates are expected to be in effect and during the test year for certain costs."

ICNU Initial Br. at 7.

92. If MEHC's acquisition of PacifiCorp is known and measurable, then the fact that PHI will not own PacifiCorp also is known and measurable. With the cessation of PHI's ownership of PacifiCorp, any basis for an allocation of PHI tax deductions also disappears.

2. The Proposal to Deny Tax Normalization with Respect to the Proceeds of the Malin-Midpoint Sale and Leaseback Transaction Is Contrary to the Tax Normalization Requirements of the Internal Revenue Code.

93. In its Initial Brief, PacifiCorp explained that a June 18, 1985 IRS Private Letter Ruling ("PLR") for another utility provides clarification regarding tax treatment of safe harbor lease transactions, such as the sale/leaseback of the Malin-Midpoint transmission line ("Malin Line"), under Internal Revenue Code ("IRC") section 168(f)(8). PacifiCorp Initial Br. at 52-53. PLR 8537063 clarifies that transactions under 168(f)(8) are sale/leaseback transactions for tax purposes only, and should be treated as a sale of tax benefits. Exh. No. 282 (Elliott). Most notably, the PLR establishes that the transactions have to be accounted for in a specific fashion that is at odds with prior orders of the Commission. PacifiCorp Initial Br. at 53.

94. Staff's brief contended that a PLR may not be used or cited as precedent and offered instead a judicial decision that supports the same treatment of a safe harbor lease transaction that the Commission used in the early 1980s. Staff Initial Br. at 66-68 (*citing Papago Tribal Utility Auth. v. FERC*, 773 F.2d 1056 (9th Cir. 1985)). Rather than supporting Staff's argument, *Papago* suffers from the same lack of IRS clarification that hindered the Commission in its orders related to the Malin Line in the early 1980s. The IRS's 1985 PLR was issued after *Papago* and after the two Commission orders referenced above. All three orders note that the decisions reached were subject to reconsideration based on any subsequent IRS clarification of the relevant tax laws. Exh. No. 608 (Kermode); *Papago*, 773 F.2d at 1064. The PLR is such a clarifying document.

95. As a preliminary matter, *Papago* reaches the same conclusion as the PLR regarding whether a safe harbor sale/leaseback transaction is anything more than a sale of tax benefits. Both agree that only tax benefits are sold in these transactions, not the underlying assets. *See, e.g., Papago*, 773 F.2d at 1063 ("ERTA [codified in part at IRC section 168(f)(8)] was enacted <u>and the tax benefits were sold</u> during the test year." (emphasis added)). Staff continued to contend that a safe harbor lease transaction such as the Malin transaction is not a sale of tax benefits, but rather is a tax basis sale of an asset. Staff Initial Br. at 67. Staff's own cited case contradicts this reasoning, as does the common-sense rationale of the statute that provided for the safe harbor sale/leaseback transactions. The crux of the statute is that these transactions would be treated as sales and leasebacks for tax purposes only.

96. It is technically correct that a PLR may not be used or cited as precedent. However, a PLR does indicate how the IRS would rule on the tax treatment of a given transaction under similar facts. PacifiCorp's facts are similar to the facts in PLR 8537063. Exh. No. 282 (Elliott). The PLR states that IRC section 168(f)(8)(D) and section § 46(f)(2) apply to the property involved in a safe harbor sale/leaseback transaction. *Id.* The IRC requires normalization treatment of the tax benefits sold under the safe harbor lease transaction, or else the property will not qualify for the safe harbor treatment. *Id.* Through this PLR, the IRS clarified any ambiguity

as to how it would treat the components of the safe harbor lease transaction. No further ruling has been issued. Further rulings probably have not been given because the applicable law was repealed in 1984 by Congress, and the PLR was issued in 1985.

97. In *Papago*, the court upheld a FERC order finding that failure to normalize the proceeds from a sale/leaseback transaction did not violate the IRC. But the court stated that it so ruled because, at the time, it could find no authority to the contrary and therefore could not say the Commission's decision was based upon an irrational conclusion. However, with issuance of PLR 8537063, there is an authority that clarifies that the proceeds from a safe harbor lease transaction must be normalized.

98. Now that the IRS has clarified the statutory requirements, the Commission should acknowledge that the Company is required to follow the tax normalization rules related to IRC section 168(f)(8) safe harbor sale and leaseback transactions. It is understandable that the Commission issued contrary orders in the early 1980s, before PLR 8537063 was issued, but there is no reason to follow those orders now that there is superseding clarification by the IRS. The Company's adjustment will achieve the mandated accounting treatment of the Malin transaction.

3. PacifiCorp's Current Amortization of Tax Audit Settlement Amounts Is Appropriate and Should Continue.

99. In its Opening Brief, PacifiCorp provided the reasoning behind its request that ratepayers bear one-half of the Company's tax audit settlement costs. This approach continues the sharing set forth in the settlement of the Company's last rate case, Docket No. UE-032065. The Company noted that its proposal does not constitute retroactive ratemaking, because the tax deficiency it seeks to recover does not become known and measurable until the deficiency is actually accessed by the taxing authority. PacifiCorp's Initial Br. at 53-54.

100. Staff's brief characterized the Company's audit settlement adjustments as an attempt to "recover from current ratepayers the cost of mistakes the Company made on its tax returns six to 14 years ago." Staff Initial Br. at 65. Warming up in its advocacy, Staff's brief then implied fraud by the Company as a reason it needs to make tax settlement payments:

> "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.' The company is not simply providing a 'best estimate.'"

Id. at 65-66 (footnote omitted).

101. Staff's argument is both inaccurate and insulting. The Commission is unlikely to be shocked by the concept that the application of the tax code to a utility like PacifiCorp is not always cut-and-dried. For large corporations, ambiguities in the tax code can involve millions of dollars. There is nothing fraudulent about taking a tax deduction when the interpretation of the tax code is unsettled; indeed, it is in the interests of PacifiCorp's ratepayers that PacifiCorp not pay more taxes than the law requires and not resolve each ambiguity in favor of the highest possible tax payment. Such an approach would be a disservice to ratepayers, leading to millions of dollars in tax overpayments, just to avoid the possibility that some claimed deductions might be reversed on audit.

102. A Commission policy that denies the Company any rate recovery of tax settlements is a policy that encourages extremely conservative tax filings. Extremely conservative tax filings are simply not in the best interest of ratepayers. The Commission should allow the Company to recover one-half of its tax audit settlements through a five-year amortization, as the Company has requested, and as provided in the settlement of Docket No. UE-032065.

4. Proposed Reductions to PacifiCorp's State Income Tax Have Been Shown to Be Mistaken and Should Be Rejected.

103. In its Initial Brief, PacifiCorp explained that state and federal income tax adjustments proposed by Public Counsel were based on an apparent misunderstanding of two of the Company's accounting practices. PacifiCorp Initial Br. at 54-55. For some reason, Public Counsel's brief continued to advocate reductions to PacifiCorp's state income tax, despite the evidence demonstrating the simple mistakes underlying the adjustments. Public Counsel Initial Br. at 24-25.

104. Public Counsel's brief advanced a strange defense of the proposal to eliminate the $611,699 Washington-jurisdictional operating deduction for "Interests and Dividends (AFUDC-Equity)." The brief claimed that this deduction has increased PacifiCorp's taxable income by reducing income tax deductions. In response to Mr. Wrigley's explanation that this amount already has been completely offset in this proceeding by an identical and opposing Schedule M deduction, Public Counsel's brief states that the Schedule M deduction in this proceeding should be disregarded because it is only "temporary." Public Counsel Initial Br. at 24.

105. PacifiCorp is almost (but not quite) rendered speechless by this argument. The Schedule M deduction is hardly "temporary" as far as PacifiCorp's revenue requirement in this proceeding is concerned. As Mr. Wrigley explained, the Schedule M adjustment completely offsets the impact of the "Interests and Dividends (AFUDC-Equity)" item in the calculation of revenue requirement in PacifiCorp's filing. Public Counsel is only entitled to have this item removed once.

I. PacifiCorp's Supplemental Testimony Has Properly Stated the Impacts on Revenue Requirement of Any Acquisition of PacifiCorp by MidAmerican Energy Holdings Company.

1. Implementation of the Washington Stipulation in the MEHC Acquisition Docket Would Reduce PacifiCorp's Washington-Allocated Adjusted Test-Year Revenue Requirement by Approximately $940,000, with the Exact Impact Dependent on the Commission's Resolution of Other Rate Case Issues.

106. In its Initial Brief, PacifiCorp explained how and under what circumstances the implementation of the Washington Stipulation in the MEHC Acquisition Docket would impact PacifiCorp's Washington-allocated adjusted test-year revenue requirement. PacifiCorp Initial Br. at 56-57. The analyses of the Washington Stipulation contained in the other Initial Briefs appear to be consistent with PacifiCorp's explanation.

2. The Proposed MEHC-Related "Double-Leverage" Adjustments to PacifiCorp's Stand-Alone Cost of Common Equity Are Financially Unsound and Are Unsupported by the Facts in This Proceeding.

107. PacifiCorp's Initial Brief addressed numerous theoretical and factual defects in the attempts of Staff and Public Counsel to make a "double-leverage" reduction to PacifiCorp's ROE. PacifiCorp explained the various ways in which the double-leverage adjustments defy generally accepted principles of business finance. PacifiCorp also set out major factual errors in Staff's and Public Counsel's double-leverage testimony. Finally, PacifiCorp set out the adverse impacts the proposed double-leverage adjustments would have on PacifiCorp's post-MEHC-acquisition ring-fenced credit rating metrics. PacifiCorp Initial Br. at 57-62.

108. Staff's and Public Counsel's Initial Briefs advanced their double-leverage arguments by repeating a number of factual assertions that are demonstrably false. To be more specific:

(a) Staff's brief asserted that "Staff applied MEHC's incremental cost of debt to the equity in PacifiCorp's capital structure that is financed with new debt." Staff Initial Br. at 45 n.236. Public Counsel's brief made a similar assertion. Public Counsel Initial Br. at 15.

There is no support in the record for the statement that MEHC has financed any of PacifiCorp's equity. Instead, the record makes clear that any new MEHC debt related to the PacifiCorp acquisition will be used entirely for payments to ScottishPower to purchase its PacifiCorp stock and that no MEHC funds will have been used to provide equity to PacifiCorp. This matter was addressed on cross-examination of Staff witness Kenneth L. Elgin at Tr. 1528:13-18 (Elgin), and no witness has explained how any of PacifiCorp's equity could have been supplied by MEHC.

In a related inaccuracy, Staff's brief addressed the Iowa regulatory decisions Staff cites as the sole decisions supporting its proposed use of double leverage. Staff recognized that the Iowa decisions specify that double leverage will not apply when the parent's debt does not support the subsidiary's common equity. The brief then asserted "the Iowa exception does not apply here because Berkshire Hathaway will infuse equity

through MEHC to acquire PacifiCorp. Debt issued by MEHC to finance PacifiCorp will also be recorded on PacifiCorp's books as equity." Staff Initial Br. at 50 n.253 (citations omitted).

There is not a scintilla of truth in either of these assertions. As noted in the preceding paragraph, MEHC is using debt and equity capital to finance payments to ScottishPower for purchase of PacifiCorp stock, not to infuse equity into PacifiCorp. Moreover, the statement that MEHC debt will be recorded on PacifiCorp's books as equity is based on Mr. Elgin's characterization of what would happen if MEHC did debt-finance an equity infusion into PacifiCorp, which it has not done. The Iowa exception to double leverage clearly applies, which reduces from one to zero the number of states Staff can find where regulators would apply double leverage in the situation presented in this proceeding. *See* Tr. 1624:18 – 1625:4, 1636:9 – 1638:2 (Vander Weide).

(b) Staff's brief stated that "[d]ouble leverage allows MEHC to earn high returns on its equity investment in its subsidiary utilities." Staff Initial Br. at 46. In a frustratingly laborious cross-examination, this proposition as applied to PacifiCorp was shown to be incorrect. Staff's brief did not attempt to challenge the showing that if PacifiCorp were allowed <u>and earned</u> an 11 percent ROE, and also were allowed a capital structure that included its full $3.9 billion in actual common equity, the "leveraged" MEHC still would have difficulty earning an 11 percent ROE on its investment in PacifiCorp. The cross-examination showed that assuming, as Mr. Hill did, a 5.95 percent cost of long-term debt for MEHC, its ROE would be 10.88 percent when PacifiCorp's <u>earned</u> ROE was 11 percent. Exh. No. 810(a) (Elgin cross-examination); Tr. 1513:5 – 1523:13 (Elgin).

Staff's brief did challenge the conclusion that if Staff's cost-of-capital recommendations were adopted, without Staff's double-leverage adjustment, MEHC's "leveraged" ROE would be only 7.07 percent. This challenge revealed Staff's continued misunderstanding of the basic mathematics of its double-leverage proposals. Staff's brief

asserted that PacifiCorp's cross-examination Exhibit No. 810(a) contains errors in the calculation of MEHC's return under Staff's proposal. The brief stated:

> "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. 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."

Staff Initial Br. at 47 n.241 (citation omitted).

Contrary to the assertions in Staff's brief, the $3.4 billion in book equity corresponds to Staff's recommendation that PacifiCorp be denied an ROE based on the Company's actual 49.5 percent common equity ratio, representing $3.9 billion in equity, but that instead a hypothetical 43.5 percent common equity ratio (or $3.4 billion) should be imputed to PacifiCorp. The exhibit also correctly calculates MEHC's return if PacifiCorp were allowed and actually earned the Staff-recommended 8.95 percent ROE. Neither the 11 percent ROE for PacifiCorp that Staff cites nor the use of the actual $3.9 billion in PacifiCorp equity would apply if Staff's cost-of-capital recommendations were accepted, and MEHC's ROE under such assumptions would be 7.07 percent. *See* Exh. No. 116 (Hill); Tr. 1513:5 – 1523:13 (Elgin).

(c) Staff's brief asserted that double leverage is not similar to an individual investor's purchase of utility shares with debt, because "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." Staff Initial Br. at 51. The simple answer to this argument is that MEHC also cannot direct the utility to borrow funds and use the proceeds to pay a dividend to cover a margin call. In the first place, Washington law limits the purposes for which PacifiCorp may issue debt, and the Commission also has to approve the purposes of PacifiCorp's securities issuances. *See* RCW Ch. 80.08. The ability of PacifiCorp to make distributions to MEHC is further circumscribed by the Washington ring-fencing provisions that MEHC has offered and the Commission has ordered in connection with

Commission approval of MEHC's acquisition of PacifiCorp. *See* Exh. No. 809 at 5 (Elgin cross-examination).

(d) Public Counsel's brief stated, in an artfully worded sentence, that "Mid American Energy Holding Company (MEHC) has a consolidated capital structure of approximately 20 percent common equity and 80 percent fixed-income capital." Public Counsel Initial Br. at 14. This statement ignored the fact that Mr. Hill based his double-leverage adjustment on MEHC's parent capital structure, which he calculated to have a 51.76 percent common equity ratio. Exh. No. 116.[10] The careful wording of Public Counsel's statement also allowed him to ignore the fact that MEHC's capital structure contains subordinated debt with an 11 percent equity-like return, which the rating agencies treat as equity. With this equity-equivalent capital properly treated, MEHC's equity ratio is over 57 percent. Tr. 1549:12-23 (Elgin).

Finally, PacifiCorp believes it fully addressed in its Initial Brief the following erroneous claim by Staff:

> "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. 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."

Staff Initial Br. at 50.

109. As PacifiCorp pointed out in its Initial Brief, the fact that the cost of equity increases proportionally to the change in debt ratio follows from a fundamental principle of financial

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[10] Staff has used a "consolidated capital structure" for its double leverage adjustment. This approach includes all of the debt of MEHC's operating subsidiaries, employing the fantasy that such operating subsidiary debt would be useable by MEHC to make equity infusions into its subsidiaries. Thus, for example, by Staff's reasoning, PacifiCorp's own debt is a source of funding of PacifiCorp's equity. Exh. No. 796; Tr. 1539:20 – 1540:15.

economics—the "law of one price." If the situation were otherwise, every electric utility should be required to create a parent company to issue debt to fund equity contributions to its utility subsidiary. PacifiCorp Initial Br. at 57-58.

110. The formula Dr. Vander Weide used to calculate the cost of parent equity was taken from a distinguished financial textbook.[11] As PacifiCorp's Initial Brief also pointed out, the attempt by Mr. Elgin to provide an alternate formula for the calculation of the cost of parent equity relied on a citation to a nonexistent study by Mr. Rothschild. PacifiCorp Initial Br. at 60-61. Mr. Hill offered his own calculations, consisting of (a) as a "primary methodology," a home-grown capital-asset pricing-model ("CAPM") approach, based on the use a CAPM beta measure that Mr.Hill in his initial pre-filed testimony had described as "not a reliable primary indicator of equity capital costs," and (c) an admittedly misstated formula obtained from a book by Dr. Roger A. Morin.[12] Tr. 1694:8-18, 1723:2-9 (Hill); PacifiCorp Opening Br. at 61. Mr. Hill also acknowledged that Dr. Morin in the same book that was his source for his misstated formula, also concluded that double leverage theory has serious conceptual and practical limitations, violates basic notions of finance and economics, and should not be used in regulatory proceedings.[13] Tr. 1723:15-25 (Hill).

111. The double-leverage proposals in this proceeding are supported neither by finance theory nor by the facts presented. The only effect of adoption of a double leverage adjustment for a ring-fenced PacifiCorp would be to move it sharply toward the bottom of the utility financial heap, to join Avista.

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[11] Richard A. Brealey, Stewart C. Myers, and Franklin Allen, *Principles of Corporate Finance,* 8th ed. at 517. Exh. No. 811-T at 10 n.2.

[12] Roger A. Morin, "Regulatory Finance, Utilities' Cost of Capital," Public Utilities Reports, Inc., 1994, Chapter 20.

[13] *See also* Richard H. Pettway and Bradford D. Jordan, "Diversification, Double Leverage, and the Cost of Capital," cited by Dr. Vander Weide at Tr. 1650:17-19.

J. The Commission Should Approve PacifiCorp's Proposal to Increase Funding of PacifiCorp's Low-Income Energy Assistance to 0.34 Percent of Gross Operating Revenues.

112. In its Initial Brief, PacifiCorp defended its proposal to increase the Company's low-income energy assistance by 30 percent, to 0.34 percent of gross operating revenues. The Company explained that although its proposed increased funding level was lower than PSE's or Avista's funding levels, PacifiCorp also has lower residential rates than do PSE and Avista by a wide margin, so that PacifiCorp's low-income customers face less of a utility bill burden than their counterparts in those other service areas. PacifiCorp Initial Br. at 62.

113. The Energy Project's brief advocated a greater increase in funding levels for low-income energy assistance. Energy Project Initial Br. at 3-5. PacifiCorp believes, for the reasons set forth in its Initial Brief, that its response to the request for increased funding is appropriate. As an additional consideration, PacifiCorp observes that Avista and PSE offer both electric and natural gas service, while PacifiCorp offers electric service. Thus PacifiCorp's customers potentially also could receive low-income energy assistance from their natural gas provider.

114. PacifiCorp appreciates the Energy Project's concerns regarding the Company's commitment to track low-income customer data and to study arrearage management for low-income customers. The Company agrees that its data tracking should result in "meaningful data collection and analysis reported to the Commission to better understand how low-income households are affected." *Id.* at 7. This concurrence is consistent with the spirit of Washington-specific commitment Wa 15 from the Stipulation from the MEHC acquisition docket: The Company will work with Staff, the Energy Project, and others to collect "data pertinent to low-income customers in PacifiCorp's Washington service territory." Exh. No. 228 (Wrigley cross-examination). Regarding the arrearage study, the Company concurs with the Energy Project that the multi-state nature of the arrearage management study should not "impinge upon Washington's ability to implement programs that provide relief to low-income and other ratepayers." Energy Project Initial Br. at 8.

115. The Energy Project's final issue relates to "the 50 percent rule" followed by the Company with respect to its weatherization program. *Id.* at 9. The Company continues to believe that the best means to fund its low income weatherization program is by covering 50 percent of measure costs as long as the State of Washington Energy MatchMaker funds are available, and 100 percent of the costs once these state funds have been depleted. This approach assures that customers receive benefits from the MatchMaker program and their tax dollars. In the current two-year MatchMaker period (July 1, 2005 - June 30, 2007), PacifiCorp has committed to funding up to $2 million and the MatchMaker program to date has committed to match about 28% of this amount, $560,233. PacifiCorp personnel will work with the Company's local partnering agencies that provide the weatherization services (Blue Mountain Action Council in Walla Walla, Northwest Community Action Center in Toppenish and Opportunities Industrialization Center of Washington in Yakima) to ensure that the mix of PacifiCorp and MatchMaker program funds provides the greatest benefit to customers.

K. The Commission Should Approve the Joint Rate Decoupling Proposal of the Natural Resources Defense Counsel and PacifiCorp for a Three-Year Test Period.

116. In its Initial Brief, PacifiCorp set out the advantages of decoupling as a conservation-friendly pricing mechanism. The Company stated its willingness to work with Staff and Intervenors to establish details of the mechanism and agreed to a three-year trial period with reporting. PacifiCorp also explained that although decoupling removes a penalty for utility investment in conservation, it does not measurably reduce overall revenue risk, and should not be used as an excuse to reduce ROE. PacifiCorp Initial Br. at 63-64.

117. Public Counsel's brief denounced decoupling, asserting that the mechanism would be a profit center for PacifiCorp's shareholders. Public Counsel's theory is that at current power prices, and with decoupling, retail load reduction through conservation would net the Company high wholesale power sales revenues, plus decoupling adjustments. Public Counsel Initial Br. at 52-53. This "double-dipping" could be possible only if decoupling were implemented without a

PCAM. With a PCAM, any net power cost benefits from reduction in retail load, as shown in Public Counsel's example, would flow to ratepayers.

L. The Commission Should Adopt PacifiCorp's Proposed Rate Spread and Rate Design.

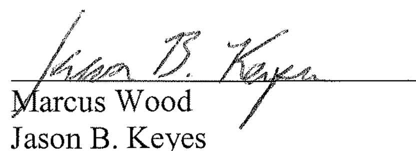
118. The Initial Briefs confirm that there are no rate spread or rate design issues in this proceeding.

III. CONCLUSION

119. For the reasons stated in PacifiCorp's testimony, at the hearings, and in PacifiCorp's Initial Brief and Reply Brief, the Company requests that the Commission grant PacifiCorp's rate increase as requested.

DATED: March 6, 2006.

STOEL RIVES LLP



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CERTIFICATE OF SERVICE

I hereby certify that I served a copy of the foregoing document upon the parties of record in this proceeding by first-class mail and electronic mail, addressed to said parties/attorneys' addresses as shown below:

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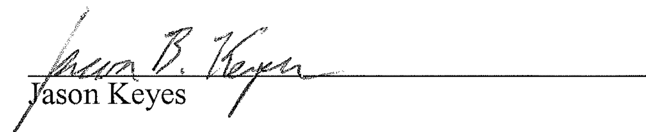

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