BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY Respondent. . . . . In the Matter of the Petition of PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY For an Order Approving Deferral of Costs Related to Declining Hydro Generation	DOCKET NOS. UE-050684/UE-050412

REPLY BRIEF

OF PUBLIC COUNSEL

MARCH 6, 2006

I. INTRODUCTION

1. Public Counsel's Initial Brief (hereinafter Public Counsel Brief) has already addressed the main issues addressed in PacifiCorp's Post-Hearing Brief (PacifiCorp Brief). This reply brief will focus primarily on the cost of capital, capital structure, and multi-state allocation issues, and to the extent possible avoid lengthy repetition of arguments already made. Where appropriate, the reply brief will provide citations to the more complete arguments and record references in the opening brief. Failure in this reply brief to address arguments contained in the PacifiCorp Brief does not indicate agreement with those arguments.

II. COST OF CAPITAL AND CAPITAL STRUCTURE

A. PacifiCorp Has Not Carried Its Burden of Proof To Show That A Return on Equity (ROE) Of 11.125 Percent Is Reasonable.

1. Other state commission ROE determinations are not persuasive in this case.

2. As its leading argument in the brief, PacifiCorp challenges the ROE recommendations of Public Counsel and other parties in part by pointing to the ROE set by other Commissions for other companies in other states. PacifiCorp Brief, ¶ 139. The underlying premise of this suggestion, that the Commission should give significant weight to other state orders, is fundamentally flawed. The Commission must set the ROE for this Company based on the record before it in this case. The ROE levels set for other companies in other jurisdictions are of no more than anecdotal significance for purposes of this case. The Commission does not have before it the record in those other cases and has no insight into the specific factual and policy reasons that led to those findings. The practice of state commissions simply following each other in setting ROE quickly can lead to a circularity in which the actual evidence before the individual Commission is devalued and ROE is set instead on what amounts to hearsay.

3. Additionally, it is difficult not to make the observation that the other states' findings, upon which the Company places so much weight, fall many basis points below PacifiCorp's own

recommendation in this case. Given the availability of many of these numbers during the pendency of the case, it is reasonable to question why Dr. Hadaway nevertheless recommended an ROE of 11.125 percent. PacifiCorp's emphasis on these findings represents an implicit admission that their own witness' position may not be defensible.

2. Bond rating metrics based on Public Counsel recommendations are more than adequate to support PacifiCorp's current bond rating.

4. PacifiCorp claims that Public Counsel's ROE recommendation does not support the Company's A- bond rating. PacifiCorp Brief, ¶ 142. In fact, analysis shows that the bond rating metrics based on Public Counsel recommendations are *higher* than those actually achieved by the Company over the last four years, a period during which it maintained this bond rating. Public Counsel Brief, ¶ 19. If PacifiCorp's bond rating falls it will be due to management's decision to be acquired by a parent (MEHC) capitalized with 20 percent equity, as compared with the current parent's (Scottish Power) level of 55 percent. Bond rating agencies have recognized that Scottish Power's financial strength supported PacifiCorp's bond rating.

3. Dr. Hadaway's outcome-oriented changes in methodology justify a finding that his testimony is not credible.

5. PacifiCorp's Brief places Dr. Hadaway's testimony in third and last place among the supporting reasons for its ROE recommendation, behind other state orders and bond metric arguments. Moreover, the Company argues that its ROE number is supported, even without his testimony, perhaps a tacit acknowledgement that significant doubts have been raised about his methodology as the case has progressed. PacifiCorp Brief, ¶ 143.

6. As Public Counsel noted in its opening brief, Dr. Hadaway has changed his methodology from the last PacifiCorp general rate case. Public Counsel Brief, ¶ 21. He now rejects use of the standard Discounted Cash Flow (DCF) approach and declines to use the standard input of analyst growth projections because he believes these growth rates are too low and too "pessimistic." PacifiCorp Brief, ¶144, Public Counsel Brief, ¶ 21 (and record citations therein). Apparently, he completely disregards the quite reasonable possibility that growth rates are lower because the

cost of capital is lower than it was in 2001. In so doing, Dr. Hadaway has substituted his subjective judgment for that of the market. PacifiCorp Brief, ¶144.

7. PacifiCorp claims that Dr. Hadaway's reliance on the long-term growth in gross domestic product (GDP) is "also employed by the FERC." PacifiCorp Brief, ¶145. This is an incorrect representation of the FERC decision, a copy of which is in the record as Exh. No. 51.[1] FERC does indeed use GDP, but it does so along with the analyst earnings growth projections which Dr. Hadaway discarded in his analysis. Exh. No. 51, p. 5 (page 4 of decision). Each is given weight in the FERC analysis. Dr. Hadaway conceded on cross-examination that this was the correct reading of the FERC opinion, acknowledging that "[t]hey blend gross domestic product growth rate estimates *with analysts' estimates*, and then they put that into the traditional DCF model." TR. 1233:14-16. (emphasis added). In light of his cited concession on the witness stand and the express language of the FERC order itself, it is troubling that the PacifiCorp Brief repeats the assertion that Dr. Hadaway uses the same approach as FERC.

8. When Dr. Hadaway uses a traditional analysis, combining GDP and analyst projections, his DCF result is 9.3 percent. Exh. No. 35, pp. 1-2. In other words, if he had actually employed the same approach as FERC, his final recommendation would have been in the same range as the other analysts in the case. Instead, Dr. Hadaway, for the first time, discards use of analyst projections, departs even from the FERC approach, and generates a much higher final ROE recommendation. It would be hard to find a more stark illustration of an outcome- oriented methodology.

9. The PacifiCorp Brief describes Dr. Hadaway's GDP calculation as giving "greater weight to the years since 1980, which produced a lower GDP growth number." PacifiCorp Brief, ¶145**.** This argument masks and distorts what has really taken place in Dr. Hadaway's analysis. In the last PacifiCorp case, Dr. Hadaway averaged data only from the prior 20 year period, Exh. No. 46, p. 51 (description of col. 12), and calculated a GDP growth rate of 6.0 percent. Exh. No. 46,

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[1] *Williston Basin Interstate Pipeline Company*, 91 FERC ¶ 63,005 (2000).

p. 48 (column 12). In this case, he elected to average in data from earlier time periods, which had the effect of *raising* (not lowering) the GDP growth rate to 6.6 percent. In other words, if he had chosen to be consistent with his testimony in the last PacifiCorp case and actually relied on the years since 1980, as the brief suggests, instead of diluting the data with older numbers, his GDP number and ultimate ROE recommendation would have been lower. Dr. Hadaway acknowledged this on cross-examination. TR. 1206:19-24.

10. The "risk premium" analysis is used by the witnesses in the case, consistent with standard practice, as a corroborative measure for the DCF method. Public Counsel Brief, ¶ 20, p. 9. PacifiCorp's Brief recites Dr. Hadaway's risk premium analysis, but fails to address the fact that he has changed his method since the last PacifiCorp case, relying this time on projected rather than on current bond yields. If he had used the same method as he did in the last case his risk premium results would have been substantially lower, as was addressed during his cross-examination. TR. 1224-25. The post-hearing brief is silent on this issue of inconsistency. Recall also that one of Dr. Hadaway's justifications for discarding analyst growth projections from the traditional DCF analysis was that they appeared low when compared with his own new risk premium methodology. TR. 1199:5-6.

11. Finally, it should be noted that the PacifiCorp Brief does not address another of Dr. Hadaway's methodology changes since the 2003 case, the abandonment of the "market based" DCF analysis. Public Counsel Brief, ¶ 21. Public Counsel prepared an exhibit that shows that this methodology, if employed in this case, yields a DCF of 7.1 percent. Exh. No. 50 (revised)[2]

12. In its brief, PacifiCorp warns the Commission not to make a "radical break" with recent orders. PacifiCorp Brief, ¶ 148. Public Counsel would point out that PacifiCorp's ROE expert in this case has made a "radical break" with his own recent testimony in a number of ways that

[2] Public Counsel's initial version of the exhibit, which showed a DCF of 9.0 percent, contained an error, as Dr. Hadaway pointed out at the hearing. TR. 1215. Public Counsel offered PacifiCorp the opportunity to correct the exhibit but the Company declined. TR. 1220:2-1221:20. At the bench's request, Public Counsel made the correction and filed revised Exh. No. 50, which, as noted, reflects a significantly lower DCF result.

appear calculated to increase the final recommendation. This testimony is not credible and should be rejected.

B. Capital Structure.

1. PacifiCorp does not propose a common equity ratio based on actual levels.

13. PacifiCorp's recommendation for an equity ratio in this case does not represent its actual capital structure. It is based on projected data. PacifiCorp Brief, ¶ 126. The Company projected a 47 percent equity ratio in the last case, but the actual ratio rose no higher than 45 percent. Public Counsel Brief, ¶ 26.

14. Recent actual capital structure is more indicative of how the Company truly capitalizes its operations. By that measure equity has fallen to the 43 to 45 percent range. Public Counsel Brief, ¶ 25. PacifiCorp has not presented evidence of a need to raise the common equity ratio due to increased risk. The cost to ratepayers of setting the equity ratio at the Company's requested level is a very real one, approximately $4.6 million per year. Public Counsel Brief, ¶ 28.

15. PacifiCorp's assertion that a 49 percent ratio is similar to other companies' is true only if short-term debt is excluded. If short-term debt is included, the average electric utility equity ratio is around 41 percent. Exh. No. 97 (Hill).

16. If rates are set in this case allowing the Company to earn at a 49 percent equity ratio, then, following the rate case, the Company could finance more debt, drive down the equity ratio, and leverage the allowed return --- in effect, gaming the system. For this reason it is better to rely on actual capital structure for rate setting purposes.

17. PacifiCorp asserts that Public Counsel witness Stephen Hill's recommendation of 44 percent "ignores common equity ratios of the comparable companies he used in his equity return analysis." PacifiCorp Brief, ¶132. A review of Mr. Hill's evidence shows otherwise. Mr. Hill's testimony states that the average common equity ratio of the Companies in his similar-risk ample group is 46 percent. Exh. No. 91, p. 40. His testimony also notes that the average common

equity ratio for the electric industry overall is 41 percent (46 percent for electric companies and 40 percent for combination gas and electric companies.) *Id*., p. 39. Again, PacifiCorp has actually capitalized its operations in the most recent past at a level of 43-45 percent.

18. PacifiCorp also attempts to explain away the significance of its recent capital structure ratios as a result of a temporary decline during the energy crisis. PacifiCorp Brief, ¶ 132. PacifiCorp's average equity ratio between March 2004 and March 2005 was 43.85 percent. Exh. No. 97, p. 1. The Company has not established that the energy crisis of 2000-2001 continued up through the 2004-2005 time period.

19. The Company's brief asserts that Mr. Hill ignores the impact of equity infusions from Scottish Power. PacifiCorp Brief, ¶ 132**.** In fact, Mr. Hill discusses this issue in detail. Exh. No. 91, p. 35, l. 7-p. 37, l. 22.

2. Short term debt should be included in PacifiCorp's capital structure.

20. PacifiCorp argues that the inclusion of short-term debt in its capital structure would result in double counting. PacifiCorp Brief, ¶ 118. The Company, however, provides the rationale for disregarding this position in its own brief:

> Of course, the uses of short-term debt and the amount of short-term debt needed by PacifiCorp is not changed by whether such debt is counted as supporting CWIP or as supporting working capital requirements for day-to-day operations. The issue is not how PacifiCorp <u>uses</u> short-term debt, which is fungible with all other capital of the company. PacifiCorp Brief, ¶ 123 (emphasis in original).

Here the Company admits that its rate base is funded by all forms of capital (equity, preferred stock, long-term and short-term debt). Dollars provided by each type of capital are not distinguishable from each other (i.e. they are "fungible"). In selecting a ratemaking capital structure, the regulator determines the mix of capital used to finance rate base—that capital includes short-term debt. To exclude short-term debt would be to pretend that the Company does not use that form of capital and would overstate its actual capital costs.

21. The Company gets it wrong when it claims the point of its short-term debt position is "how many times ratepayers may be <u>allocated</u> credit for [short-term debt]." PacifiCorp Brief, ¶

123. CWIP is Construction Work In Progress not rate base. Allowing a return on unused and unuseful plant is not a benefit for ratepayers. Allowing a return on construction work in progress is a benefit only for the Company and its shareholders. It is a regulatory construct that does not exist in competitive industries. It was created during the late 1970s to allow companies to earn a return on huge nuclear construction projects. Although it since may have become a routine adjustment, it still must be considered a give-away from ratepayers to the utility. The balance instituted by the FERC formula is that the "profit" allowed on CWIP will be set at a level equal to that of the Company's lowest cost capital (short-term debt) as long as the amount of CWIP is less than the amount of short-term debt.[3]

22. The CWIP adjustment is a profit (a return) allowed on construction work in progress. It is allocated the lowest possible cost to balance the interests of ratepayers and stockholders. The allocation of the lowest possible cost rate to CWIP does not "use up" short-term debt dollars. Short-term debt is used to finance rate base and should be included in any ratemaking capital structure.

23. The PacifiCorp Brief misstates Mr. Hill's rationale for his estimated debt cost level. The Company asserts that after calculating an average debt use of 2.67 percent over the last 10 quarters, he used a 3 percent debt component. PacifiCorp Brief, ¶ 118. Mr. Hill actually stated: "Over the past three-year period, PacifiCorp's monthly short-term debt averaged $227 Million. The Exhibit [Exh. No. 97] also shows the Company's use of short-term debt has been increasing. Over the most recent twelve-month period, PacifiCorp's monthly short-term debt averaged $333 Million. Short-term debt of $227 to $333 Million represents approximately 2.7% to 3.4% of the Company's projected March 2006 capital base." Exh. No. 91, p. 39, ll. 16-21. As this testimony

[3] When the amount of CWIP is more than short-term debt, as it is for PacifiCorp, the FERC formula calls for attributing a return on CWIP balances based in part on the cost of short-term debt and in part on the cost of the overall cost of capital. On the other hand, if the amount of short-term debt were zero and the FERC formula for determining the return allowed on CWIP called for the use of the Company's overall cost of capital, it would obviously be unreasonable to claim that the overall capital had been "allocated" to CWIP and therefore could not be used to calculate the return on rate base.

indicates, Public Counsel's 3 percent figure for the short-term debt component is a conservative mid-point figure.

24. The Company claims that current short-term debt cost rates are 4.50%. PacifiCorp Brief, ¶ 118. Public Counsel has does not object to using the most recent short-term debt cost available but does not recommend using "forward" (projected) rates.

C. A Double Leverage Adjustment Is Required In This Case.

25. The Company's opening brief lays out several fundamental principles that it claims are violated by Public Counsel's double leverage testimony. PacifiCorp Brief, ¶¶ 176-177. The criticisms are wide of the mark and have already been addressed in Public Counsel's opening brief. In fact, PacifiCorp takes aim at a "straw man," attacking an analysis not made by Public Counsel. All of the concerns cited by Drs. Vander Weide and Morin regarding double leverage are critiques of an analysis that does not correctly attribute greater risk to the parent related to the additional leverage. Public Counsel's recommendations, however, in accordance with all the rules of corporate finance, have correctly attributed additional financial risk and additional capital cost to the parent Company operations. Public Counsel's double leverage adjustment recognizes the fact that greater leverage creates higher financial risk and the opportunity for higher returns. The Company wants the Commission to ignore that fact and, instead focus on theoretical issues not presented in this case.

26. Similarly, because Public Counsel's analysis accounts for the specific risks of Mid American Holding Company (MEHC), PacifiCorp's assertion that "[d]ouble leverage violates the principle that the required rate of return on an investment should depend only on the specific risks of that business" is not germane. PacifiCorp Brief, ¶ 179**.**

27. PacifiCorp is also mistaken that Public Counsel's "double leverage calculation incorrectly ascribes to a utility subsidiary the business and financial risks of the parent's other business operations." ***Id.*** Mr. Hill uses the parent-only capital structure in his analysis

28. Likewise, Mr. Hill's analysis does not violate the principle that the required return depends on the risks of that investment rather than the manner in which it is capitalized. PacifiCorp Brief, ¶ 180. Public Counsel's method recognizes and accounts for unique risks of MEHC and unique risks of PacifiCorp. Public Counsel Brief, ¶ 33**.** MEHC's capitalization is a matter of record in this case. It will hold 100 percent of PacifiCorp's stock. The individual investor rationale is a red herring.

29. PacifiCorp argues that "[Hill] failed, however, to justify how he could disprove the "single price" principle of finance using a beta risk measure." PacifiCorp Brief, ¶ 181 (e). Notably, the Company chose not to ask Mr. Hill this question directly on the stand. Mr. Hill does not have to disprove the "single price" theory. His analysis, in which he has attributed different risks to different corporate entities because of different levels of debt, does not violate financial theory. PacifiCorp may not agree with using betas to measure that risk differential, but it cannot correctly claim that Mr. Hill did not make an appropriate adjustment to the parent's cost of equity. Because this adjustment was made, the criticism based on the "single price" rationale fails.

30. The Company brief's assertion that ring-fencing obviates the need for a double leverage adjustment have been addressed in Public Counsel's Brief. Public Counsel, ¶ 36. As discussed there more fully, ring fencing is unrelated to and does not address the day-to-day over-recovery of allowed returns.

31. Additional debt imparts additional risk to the remaining common equity. As long as this additional risk is recognized, as Public Counsel has done in this case, all relevant financial theory is observed. It is undisputed that MEHC is purchasing PacifiCorp with both debt and equity. MEHC will, through that purchase, leverage the income stream it receives from PacifiCorp. In so doing, it will earn a return that exceeds its cost of capital. Ratepayers should not be required to provide a return that is excessive. A double leverage adjustment simply assures that both PacifiCorp and MEHC earn the return they require in the marketplace—not anything more.

III. MULTISTATE COST ALLOCATION

32. PacifiCorp begins its argument on this issue with a heading that states "A Uniform System of Inter-Jurisdictional Allocations for PacifiCorp Is in the Public Interest." In the abstract, a general statement like this sounds reasonable. However, given the circumstances of this general rate case, the statement is both inaccurate and insufficient to support adoption of the Revised Protocol. First, the record clearly shows that there is no uniform system of inter-jurisdictional allocation – each state that has adopted the Revised Protocol has done so with various conditions and reservations. Second, because the Revised Protocol rolls in the majority of PacifiCorp's power costs and then spreads them across its entire system, slower-growing states that are served from PacifiCorp's Western control area are disadvantaged by the "uniform" method of the Revised Protocol. Third, the objective of establishing consistency with other states, while not theoretically unworthy, is far less important than the objective of adopting a method that accurately and equitably allocates power costs to Washington State.

33. Public Counsel agrees with PacifiCorp that the allocation issue should be resolved for Washington. Our testimony proposes a means to achieve that resolution and we are committed to participating in that process. However, this should be accomplished through adoption of an accurate, equitable and sustainable methodology, not by establishing a false uniformity as the ultimate goal of the process.

34. The Company rewrites the history of this issue when it states that "this is the second consecutive PacifiCorp Washington rate case that has been nearly high-centered on allocation issues." PacifiCorp Brief, ¶ 13. In the five year rate plan PacifiCorp agreed to in 2000, the issue was not to have been taken up before its next permitted rate case in 2006 in any event. *WUTC v. PacifiCorp*, Docket No. UE-991832, Third Supplemental Order. When PacifiCorp abrogated that rate settlement and brought an earlier rate case in 2003 in Docket UE-032065, it agreed to settle the case with Staff without resolving multi-state allocation issues. Thus, PacifiCorp itself has agreed to the timing for consideration of this issue in the rate case context. Public Counsel

Brief, ¶ 138. PacifiCorp may not now seek to rush the Commission into a premature decision on this issue on the false premise that the Company has been prevented from addressing the issue by others.

35. By arguing that the absence of an agreed methodology, "distracts parties from far more important issues," such as PacifiCorp's "massive future investment requirements," PacifiCorp Brief, ¶ 13, the Company unintentionally highlights the very reasons why Public Counsel and other parties are concerned with the Revised Protocol. Adding new massive new resources in the Eastern control area to serve loads in the Eastern control area may indeed be "far more important issues" to PacifiCorp and the states that need those new resources. However, those circumstances do not justify adopting a flawed cost allocation method for Washington State. Further, to the extent that costs for new resources added in the Eastern control area are not properly allocable to Washington State, development of a cost allocation method that protects Washington consumers from subsidizing those costs is indeed an extremely important issue that should precede resolution of other issues.

36. The Company's brief insists upon repeating the theme appearing in its testimony that the Revised Protocol "benefits Washington customers." PacifiCorp Brief, ¶ 22. This purported advantage dissolves upon closer examination. Revised Protocol is only an improvement when compared to Modified Accord or to a fully "rolled in" approach. This is a false comparison. The Washington Commission has never adopted either of these other approaches, and they are not before the Commission now. The correct comparison should be between Revised Protocol and the requirement of the merger order -- that ratepayers should not be worse off than they would have been absent the merger (i.e. "stand alone" analysis). Exh. No. 469.

37. The PacifiCorp Brief's attempt to challenge Public Counsel witness Merton Lott's review of the history of allocation is unfounded and disingenuous. PacifiCorp Brief, ¶ 35. The brief alleges that his memory of the history is "imperfect." It is curious then that PacifiCorp, itself a participant in every step of the process has never seriously challenged Mr. Lott's careful review

of the history of allocation, Exh. No. 461, pp. 6-17 (Lott), by providing alternative information that contradicts his. Instead, PacifiCorp contents itself with asserting that he "was not able to provide any credible support" for his statements. PacifiCorp Brief, ¶¶ 35-36. As is apparent from his testimony, his statements are based on his extensive personal involvement as a senior member of Commission Staff and as a Commission accounting advisor. *See e.g.* TR. 838:4-15. All Mr. Lott's records and memos regarding this history, forming the documentary basis of his testimony, were produced to PacifiCorp by Public Counsel in discovery. TR. 838:23-24. Thus, while PacifiCorp counsel on cross and in brief tries to unfairly create the impression that Mr. Lott's testimony was somehow based on faulty memory and lacked written support, the Company had in its possession all of the documentary support for his statements. TR. 867:13-868:10. Had the Company differed with his summary of the history or found discrepancies in the documents they could have offered these documents in testimony or used them on cross-examination, as well as offering their own records. The fact that they did none of this adds further credibility to Mr. Lott's testimony and allows the Commission to draw the inference that his testimony is consistent with the documents he produced and any records held by PacifiCorp. The only document the Company produced at hearing, Exh. No. 469, as discussed below, supports Mr. Lott's reconstruction of events.

38. The PacifiCorp Brief suggests that Exh. No. 469, the Washington Commission's letter to the Utah Commission, somehow undermines Mr. Lott's testimony regarding the merger and the Commission's early views on allocation issues. The merger order and the letter speak for themselves. These issues were discussed in Public Counsel's opening brief. Public Counsel Brief, ¶¶ 66-70**.** Public Counsel stands by its reading of these documents, particularly the key paragraph in Exh. No. 469, p. 1:

> When we approved the merger, we approved it for the benefit of our ratepayers. Most importantly, we approved the merger so that our ratepayers would benefit by receiving lower rates over the stand-alone costs that would exist if the merger had not been approved. Further, we held that our ratepayers should not in any circumstance be required to pay more than they would have without the merger.

The merger order, contrary to the brief's assertion, states that cost allocation should be consistent with a Pacific division focused least cost plan:

> Staff witness Folsom correctly points out the discrepancy in average system cost between Pacific Power and Utah Power. The Commission continues to concerned about the effects on Pacific's ratepayers of merging with a higher cost system, and believe that any integration of the power supply function for the two companies should be done in a manner consistent with Pacific's least cost planning process, now getting under way.[4]

From this express language and the context, it is clear that the Commission meant to protect Pacific division ratepayers from the costs of the higher cost system by using the Pacific (not the Utah) least cost planning process as a buffer. *See also*, TR. 842:21-843:12.

39. As discussed in Mr. Lott's review of the history of multi-state allocation, the PITA group agreed that the sharing of benefits above "stand alone" should be done a 50/50 basis. Exh. No. 461, p. 11, l. 11 (Lott). Studies performed by PacifiCorp itself indicated that PacifiCorp "stand alone" costs would not cross-over (i.e. the PacifiCorp cost curve would not cross above) post-merger system-wide costs unless the Pacific division grew faster than the Eastern division. *Id.*, p. 12, ll. 10-14. Yet, based on review of PacifiCorp witness David Taylor's Exh. No. 365, p. 1, it appears that even with huge growth in Utah, the cross-over between Revised Protocol and "rolled in" occurs in the next eight years. The bottom lines are that "rolled in" allocation methods are unfair to Pacific division states, including Washington, and should not be used in any fashion to demonstrate fairness of an allocation plan.

40. In Section III.A.5, PacifiCorp attempts to address the growth issue raised by Public Counsel and others. The Company acknowledges that recent resource additions have been located in Utah and that Utah loads have been growing faster than those in other states. PacifiCorp Brief, ¶ 25. The Company argues that it operates its system on an integrated basis

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[4] *In the Matter of the Application o f PacifiCorp to Merge*, Docket No. U-87-1388-AT, Second Supplemental Order, p. 14. It is PacifiCorp, not Mr. Lott, which is "misreading" the merger order. PacifiCorp Brief, ¶ 35. At the hearing, PacifiCorp counsel attempted to challenge Mr. Lott's testimony by finding significance in the supposed distinction between a least cost plan and a least cost planning process. TR. 842:9-20.

and that Public Counsel and others' concerns amount to cherry-picking or electron tracing. PacifiCorp Brief, ¶¶ 26-28.

41. PacifiCorp's arguments in this section miss the point. Whether or not they operate as a single system, the issue is at what point it is advantageous for the Pacific division to share in the higher costs of the Utah or Eastern division, if ever. The fact that the system is operated on a single basis does not mean that a new cost incurred in the system is incurred to serve every part of the system. PacifiCorp itself defends Revised Protocol by pointing out that it can allocate various types of costs to specific states. The Company's seasonal allocator recognizes the existence of different costs in different regions.

42. It is not "cherry picking" or opportunistic to identify costs incurred by a system which was built and designed to serve specific characteristics of specific portions of the system. For example, if the system has put more peaking resources in a region with substantial peak requirements and put large base load plants in a region where load is flat, those costs can be identified and associated with those regions. By contrast, it would be cherry picking if resources built to serve a region were accepted by a party only if low cost, but others built to serve the same region were rejected because they were high cost. Public Counsel makes no such proposal here.

43. PacifiCorp quotes the testimony of Public Counsel witness Charles Black in support of its integrated system argument. PacifiCorp Brief, ¶ 25. PacifiCorp's Brief attempts to use this quote to show that Mr. Black somehow agrees with PacifiCorp's broad, unsubstantiated claims that its entire generation and transmission system benefits all of its customers and, therefore, that new resources being added in the Eastern control area are needed and used to serve customers in Washington State. This is a misrepresentation of Mr. Black's testimony.

44. Mr. Black does not state that new resources added in the Eastern control area are needed to serve Washington. Indeed, Mr. Black's testimony has identified significant constraints in PacifiCorp's ability to move power between its Eastern and Western control areas, particularly in

the East-to-West direction. Public Counsel Brief, ¶ 94. Further, new evidence has emerged in this case indicating that recent actual net flows of power (both energy and capacity) on PacifiCorp's system have been dramatically larger from West-to-East than from East-to-West. Public Counsel Brief, ¶¶101-105. This has raised additional concerns that the net flow of benefits from the merger is strongly from West to East, thereby elevating the importance of evaluating PacifiCorp's system on a control area basis. Public Counsel has become particularly concerned that what PacifiCorp has long characterized as efficiency gains from the merger are in actuality largely a transfer of economic value from the Western control area to the Eastern control area.

45. It is noteworthy that in the entire discussion in Section III.A.5, the Company never directly rebuts the fundamental critique of Revised Protocol, i.e., that it improperly allocates Utah costs to Washington, or to the Pacific division generally, instead it only makes a subsidy argument. PacifiCorp Brief, ¶ 33. According to PacifiCorp, Company witness Gregory Duvall has refuted this assertion in his testimony with the aid of certain studies conducted during the MSP process. What the Company does not address (or acknowledge) in its brief is that Mr. Lott's testimony contains a detailed discussion and rebuttal of the Duvall testimony. Exh. No. 461, pp. 34-43 (Lott). Mr. Lott points out, *inter alia*, that Mr. Duvall's focus on revenue requirement is misleading. *Id.*. p. 35. Indeed, when one looks at rates and unit costs, one sees that the state with the highest growth, Utah, is the only state in the system to see rate decreases, while all others have increases. *Id.*, p. 37, ll. 8-13.[5]

46. Throughout this case, PacifiCorp has argued that its power costs can be allocated on only two bases: 1) assignment of costs to a specific state, and 2) allocation of costs across its entire system. However, Public Counsel and others have identified a third basis – allocating costs to two portfolios, one for each of its two control areas. Public Counsel Brief, ¶ 92 *et seq*. A control

[5] The brief refers to "numerous studies." PacifiCorp Brief, ¶ 33. Public Counsel requested copies of additional studies relied on by Mr. Duvall but they were not provided. Exh. No. 461, p. 40, ll. 5-11 (referring to Public Counsel Data Request No. 69.) *See also*, TR. 863:4-864:6.

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area approach reflects the physical and operational characteristics (e.g., transmission constraints, resource needs, and cost differentials) of PacifiCorp's two control areas. As a result, it makes sense in terms of cost causation. It would also help to ensure that consumers in Washington State do not bear increased costs as a result of the merger. Further, while PacifiCorp claims that unless Washington State adopts the Revised Protocol "the efficient operation of PacifiCorp's integrated system will suffer," PacifiCorp Brief, ¶12, it has provided no evidence that a control area approach to allocating costs would interfere in any way with the economically efficient and reliable operation of its system.

47. PacifiCorp has posed a number of objections to dissuade the Commission from even considering a control area portfolio approach to inter-jurisdictional cost allocation. The litany of supposed shortcomings that PacifiCorp has identified include color-coding electrons, cherry-picking resources, impossibility of untangling complexities in PacifiCorp's system, inability to price inter-control area power transfers, and loss of efficiency benefits from operating its overall system on an integrated basis. None of the supposed shortcomings that PacifiCorp offers are convincing or substantiated. Indeed, Public Counsel notes that the Revised Protocol (in both its general form and its various state-by-state versions) itself allocates various types of costs to specific states. Some of the same justifications that PacifiCorp offers for Revised Protocol actually support the feasibility of using a control area portfolio method to allocate specific costs.

48. PacifiCorp's Brief attempts to dismiss the alternative recommendations in this case as insubstantial, including those of Public Counsel witness Charles Black. PacifiCorp Brief, ¶¶ 39-40. The Company also mischaracterizes the testimony of Mr. Black regarding a control area approach to inter-jurisdictional cost allocation and then uses the mischaracterization to belittle his testimony in an apparent effort to divert attention from the central point. *Id.* Mr. Black's testimony presents several straightforward principles for developing a sound conceptual approach to allocating costs by control area. Rather than attack this method on its merits, PacifiCorp can only point out that the details of it have not been fully fleshed out. The fact that

Mr. Black does not present, and was not retained to present, a specific technical proposal, does not mean that the concepts presented are not worthy of consideration. Mr. Black's testimony provides the Commission with a thoughtful and credible alternative framework for considering the cost allocation issues based on his broad experience in energy resource and power cost issues.[6]

49. PacifiCorp apparently hopes that its sarcastic criticism somehow demonstrates that the basic approach of allocating costs by control area is flawed and should be rejected. Public Counsel recognizes that development of a cost allocation method for PacifiCorp's system will require addressing a number of specific issues, such as pricing of transfers between control areas. As noted above, Public Counsel is aware that this process would take some additional work by the parties. That does not mean that the approach is to be rejected out of hand.

IV. REVENUE REQUIREMENT ISSUES

A. Incentive Compensation.

50. PacifiCorp states that "Mr. Effron makes no effort to analyze the components of the incentive pay plan or to justify the level of disallowance he recommends." PacifiCorp Brief, ¶ 60. This is incorrect. Mr. Effron explains why incentive compensation in general must be tied to customer benefit goals to be recoverable. Exh. No. 271, p. 16, l. 18 – p. 17, l. 8. Mr. Effron does not dispute that the 50 percent disallowance is an estimate. Public Counsel attempted through discovery to obtain information about how much of the incentive compensation was tied to

[6] PacifiCorp also again tries to challenge Mr. Black's credentials, as it did at the hearing. Mr. Black brings significant relevant utility industry experience to bear on the power cost and resource acquisition issues in this case. As his testimony reflects, prior to becoming a consultant, Mr. Black worked for investor and publicly owned utilities for 19 years (Pacific Gas & Electric, Tacoma Power, and Puget Sound Energy), focusing on energy resource matters including planning, forecasting, analysis, acquisition, risk management, contracts, marketing and regulatory issues. Exh No. 471, p. 1 (Black). At Pacific Gas & Electric he was the coordinator of the fuel management working group with responsibility for monthly operational planning for generating resources. TR. 924: 10-23. At Tacoma Power he became the assistant power manager, TR. 924:25. At Puget Sound Energy he was the company's first director of energy risk management, TR. 927:14, and also participated in Puget's 2003 least cost planning process. Exh. No. 471, p. 2, ll. 7-9 (Black).

consumer, as opposed to financial goals, but did not receive answers that made it possible to make that analysis. *Id.*, p. 17, l. 11-21.

B. Pro Forma Plant Additions.

51. PacifiCorp states that "Mr. Effron contends that the production plant factor should not be used [.]" PacifiCorp Brief, ¶ 96. This misunderstands his recommendation. Mr. Effron's testimony is that, as a matter of simple consistency, if the test year plant in service is projected beyond the end of the test year, so should the balance of the accumulated depreciation.

C. Electric Plant Acquisition Adjustments.

52. PacifiCorp acknowledges that Commission approval is required to include the acquisition premiums in rate base and that no approval has yet been received. PacifiCorp Brief, ¶ 115. The Commission should not authorize recovery of the premiums based on the cursory and belated assertions by the Company that the acquisitions were prudent and beneficial to customers.

V. POWER COST ADJUSTMENT (PCA) MECHANISM

53. The Company continues to justify its PCA proposal as "similar to the Energy Recovery Mechanism (ERM) that has been approved by the Commission for Avista." PacifiCorp Brief, ¶ 45. In reality of course, there is a critical difference on the face of the two proposals – the absence of a deadband in the PacifiCorp proposal. Given that fact, it is unclear why the Company sees them as functionally similar. Since the Avista ERM and the manner by which it shares risk is currently in the process of a full review in a docketed proceeding, PacifiCorp seems to be building its house on shifting sands. PacifiCorp has also not explained how it will improve its risk management and resource acquisition practices in order protect the interests of the retail customers who would bear 90 percent of the variability in its net power costs. Public Counsel Brief, ¶ 139 *et seq.*

54. PacifiCorp argues on brief that a PCA could be adopted without an approved inter-jurisdictional cost allocation method. PacifiCorp Brief, ¶ 52. The brief does not explain how

variances in net power costs would be determined under a PCA if it has not been determined which costs are allocable to Washington State. Public Counsel Brief, ¶ 124.

VI. DECOUPLING

55. PacifiCorp devotes little attention in its brief to the issue of decoupling. Public Counsel will focus here on responding to the Natural Resources Defense Council (NRDC) Brief. As a justification for adopting its decoupling proposal, NRDC states "…the Company is not in fact now close to achieving the conservation performance benchmark proposed in the NRDC testimony." NRDC Brief at 4. There are two problems with this assertion. First, it does not address the fact the PacifiCorp has been achieving its share of the regional conservation targets set by the Northwest Power Planning Council. Public Counsel Brief, ¶ 162. The second is that the Company has not committed to any changes whatsoever in its conservation program if this proposed "pilot" is approved. Public Counsel Brief, ¶164. In other words, there is no evidence in this record of how the proposal would in any way move PacifiCorp toward (or away from) any conservation performance benchmark set by anyone.

56. NRDC criticizes Public Counsel's analysis of the proposal by saying:

> Public Counsel's principal contention is that the Joint Proposal is unnecessary because PacifiCorp can count on recouping all losses from reduced retail consumption by reselling into wholesale markets. Exh. No. 691-T, pp. 22-31. This is implausible on its face[.] NRDC Brief at 4

In fact, it is the PacifiCorp forecast of wholesale market prices that drives this conclusion, not any "contention" by Public Counsel. The graph of PacifiCorp's estimate of future wholesale market prices, compared to PacifiCorp's rates, shows that for the next five years the Company expects its wholesale sales to bring greater revenues than it currently receives from retail sales. Exh. No. 691, p. 23, Table 2 (provided by PacifiCorp in response to Public Counsel Data Request No. 163.).

57. On the issue of changed level of risk, NRDC argues that "Public Counsel is unconvincing and at best premature in its additional claim that the Joint Proposal would justify or compel a change in the Company's capital structure." NRDC Brief at 4. These are not simply claims by Public Counsel. In fact, it is the bond rating agencies – Moody's and Standard and Poor's -- which have opined that decoupling and other risk-reduction mechanisms justify a reduction in the equity ratio. S&P has specifically reduced the "Business Risk Profile" for Northwest Natural Gas to a "1," is the lowest risk rating, following the approval of the WARM program by the Oregon Commission. Northwest Natural believes it was these decoupling mechanisms that led to its improved bond rating. Exh. No. 691, p. 18, l. 20-p. 19, l. 24. (Lazar).

58. The key issue, above all others, is that NRDC has proposed a concept, but has not set forth a concrete proposal. As the Staff brief noted, "[t]he result is a record that lacks not only the tariffs and accounting rules that would implement the proposed mechanism, it also lacks a thorough evaluation of the potential consequences." Staff Opening Brief, ¶ 110, [footnote omitted].

59. Nowhere in the NRDC/PacifiCorp proposal are there any of the elements that would be necessary to implement the proposal. These include:

- The methodology or any example of how to calculate the "fixed cost revenue requirement" that the proposal is dependent upon;
- How that calculation would change with changes in the allowed rate of return;
- How that calculation would change with changes in the approved capital structure;
- How that calculation would change with changes in the approved interstate allocation formula;
- How the exclusion of the industrial class is performed, given the stipulation among the parties to a different rate spread than proposed by the Company;
- How the exclusion of the industrial class can be calculated, given that the parties have NOT agreed on any particular inter-class cost allocation method ;

- The specific accounts to be deferred;
- The method to be used to amortize any deferrals;
- Any level of interest or return to be applied to deferrals;
- The definition of "customer" to be applied;
- The identification of how changes in customer counts for the various classes would affect the allowed fixed-cost revenue requirement;
- Definitions of what costs are considered "fixed" and what costs are considered "variable" in this calculation;
- The treatment of revenues from sales for resale that would result from changed sales volumes;
- The treatment of expense variations from changes in fuel use that would result from changed sales volumes;
- The method to be used for weather normalization, since NRDC has proposed that weather-normalized sales volumes should be used;
- The means by which the "revenue per customer" would be computed; and
- The form and substance of the Company's increased commitment to increased conservation investment as a condition of the proposed mechanism.

60. Staff witness Steward termed the proposal "rather vague." TR. 1154. This is, if anything, an understatement. This proposal is not ready for real-world implementation. Decoupling may be an important concept, but regulation must be tied to more than concepts. Regulation must be tied to facts, to analysis, to costs and to calculations. The NRDC proposal does not provide any of these.

61. If the Company wants to propose a fully-developed decoupling mechanism, that addresses the above issues, it is free to do so in the general rate case it has indicated it will file in the next few months. There is no reason or justification for adopting the half-formed generic proposal advanced by NRDC in this proceeding.

VII. LOW INCOME ISSUES

62. While Public Counsel has not filed any testimony regarding the low-income issues in the case, Public Counsel supports the recommendations of the Energy Project. We share the Energy Project's concern that the PacifiCorp Low-Income Bill Assistance Program does not compare favorably to the funding levels of other investor-owned utilities. Public Counsel also strongly supports the recommendation for the tracking of data regarding arrearages, disconnections, reconnections, and other related data. This has historically been a problematic gap in the information available to the Commission and other interested parties for the evaluation not only of low-income programs, but also of arrearages and uncollectibles in general and their impact on the rates of all customers.

VIII. CONCLUSION

63. For the foregoing reasons, Public Counsel respectfully requests that the Commission adopt the recommendations contained in the Public Counsel testimony and briefs in this proceeding.

DATED this 6th day of March, 2006.

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