

Exhibit \_\_\_ T (KLE-1T)  
Docket UE-061546  
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

Complainant,

vs.

PACIFICORP dba Pacific Power & Light  
Company,

Respondent.

DOCKET UE-061546

In the Matter of the Petition of

PACIFIC POWER & LIGHT COMPANY

For an Accounting Order Approving Deferral  
of Certain Costs Related to the MidAmerican  
Energy Holdings Company Transition.

DOCKET UE-060817

**TESTIMONY OF**

**Kenneth L. Elgin**

**STAFF OF  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION**

*PCAM Cost of Capital Offset and Rate of Return*

**February 16, 2007**

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1 I. INTRODUCTION

2  
3 **Q. Please state your name and business address.**

4 A. My name is Kenneth L. Elgin. My business address is Chandler Plaza Building,  
5 1300 South Evergreen Park Drive SW, Olympia, Washington, 98504-7250. My  
6 email address is: [kelgin@wutc.wa.gov](mailto:kelgin@wutc.wa.gov).

7  
8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Regulatory Services Division of the Washington Utilities and  
10 Transportation Commission as the Case Strategist.

11  
12 **Q. Please describe your education and relevant employment experience in public  
13 utility regulation.**

14 A. I have a Bachelor of Arts from the University of Puget Sound in 1974, and I obtained  
15 a Master of Business Administration from Washington State University in 1980. In  
16 January, 1985 I began my employment in public utility regulation with the  
17 Commission as a Utilities Rate Research Specialist for the Utilities Division. In that  
18 initial assignment I worked primarily on financial analysis and rate of return issues  
19 for all regulated utilities. I was also responsible for natural gas issues as the industry  
20 restructured in response to changes in Federal regulatory policy.

21 In December, 1989 I was promoted to the position of Assistant Director for  
22 Energy as part of the reorganization of the Regulatory Services Division. In that

1 capacity, I was responsible for the policy direction of the Utilities Division's electric  
2 and natural gas programs, which included the natural gas safety program.

3 In 1995, I assumed my present position as the Case Strategist for the  
4 Division. In this current assignment I consult with or represent Staff on all aspects  
5 of energy cases presented to the Commission in the context of litigation. I am also a  
6 resource for other sections in the Division in contested proceedings before the  
7 Commission, responsible for financial analysis of regulated operations under Titles  
8 80 and 81 RCW.

9 I have testified before the Commission on many occasions. Exhibit \_\_\_\_  
10 (KLE-2) is a table listing the contested cases in which I have presented testimony in  
11 litigation. I testified before the Federal Energy Regulatory Commission on issues  
12 related to rate design, capital structure and risk for interstate natural gas pipelines. I  
13 testified on several occasions in Superior Court as an expert in the regulation of  
14 investor-owned utilities, including issues of rate of return and valuation under the  
15 public service laws, as administered by the Commission pursuant to Title 80 & 81  
16 RCW. I have also testified as an expert witness for the Washington State  
17 Department of Revenue in arbitrations concerning valuation and on energy industry  
18 restructuring.

19 I have been the lead analyst for numerous tariff filings, and in that capacity I  
20 presented Staff recommendations to the Commission at its regular open public  
21 meetings. Finally, I have made numerous studies of the cost of capital for energy  
22 companies in contested rate proceedings leading to a settlement of this issue.

1                   During my twenty-two plus years of experience working on energy and  
2 financial issues, I have developed a thorough working knowledge of both the  
3 operational and financial profiles of jurisdictional energy utilities.  
4

5 **Q. Have you prepared any other exhibits in support of your testimony?**

6 A. Yes. I prepared Exhibit \_\_\_ (KLE-3), which I describe later in my testimony.  
7

8 **Q. What is the scope of your testimony?**

9 A. My testimony addresses the fundamental policy issue raised by any proposal for a  
10 power cost adjustment mechanism: the impact of a power cost adjustment  
11 mechanism on the utility's cost of capital.  
12

13 **Q. How is your testimony organized?**

14 A. After a summary, I provide a review of prior decisions regarding the Commission's  
15 policy on this issue. Next, I provide a framework for a financial analysis of the  
16 Company's and Staff's proposed Power Cost Adjustment Mechanisms ("PCAMs").  
17 In doing so, I develop a "benchmark" for comparing the shift in risk to the utility, if  
18 the Commission adopts a power cost adjustment mechanism.

19                   Then, I analyze the effect of PacifiCorp's PCAM on the risk of the Company.  
20 I also analyze Commission Staff's PCAM recommendation under the same financial  
21 criteria. Finally, I make a specific recommendation for a cost of capital adjustment  
22 under Staff's recommendation for PCAM.

1 My testimony also contains some general observations regarding the  
2 Commission's traditional practice for dealing with adverse power supply conditions  
3 in the context of the financial analysis I present for analyzing both PacifiCorp's and  
4 Staff's PCAM proposals. These traditional mechanisms are still valid and deserve  
5 consideration in the Commission's deliberations regarding the cost of capital  
6 impacts, risk and power cost mechanisms.

7  
8 **II. SUMMARY**

9  
10 **Q. Please summarize your financial analysis of the Company's proposed PCAM.**

11 **A.** My analysis shows that the operation of the Company's proposed PCAM shifts  
12 significant risk to ratepayers for variations in power supply costs that should be  
13 absorbed by the Company absent a PCAM.

14 The Company presented no analysis of the impact of its proposed PCAM on  
15 cost of capital, and the Company made no adjustment for this impact. The  
16 Company's proposed PCAM is therefore inconsistent with the Commission's policy  
17 that a cost of capital offset is necessary for the adoption of a power cost adjustment  
18 mechanism.

19 If the Commission adopts the Company's PCAM proposal, it must also adjust  
20 PacifiCorp's overall rate of return for the shift in risks to ratepayers from the  
21 operation of its proposed PCAM.

1 **Q. Please summarize your financial analysis of the Staff's proposed PCAM.**

2 A. My analysis shows that like the Company's proposed PCAM, the operation of the  
3 Staff's proposed PCAM also shifts significant risk to ratepayers for variations in  
4 power supply costs that should be absorbed by the Company absent a PCAM.  
5 However, the risk shift is less than under the Company's proposed PCAM.

6 If the Commission adopts the Staff's PCAM proposal, the Commission  
7 should adjust the Company's ratemaking common equity ratio from 46 percent to 42  
8 percent. Staff's revenue deficiency calculation is based upon a rate of return  
9 developed using a 42 percent common equity ratio.

10

11

### III. DISCUSSION

12

13 **A. Commission Policy On PCAMs And Their Impact on Cost Of Capital**

14

15 **Q. What is the Commission's policy regarding the cost of capital impact of a**  
16 **PCAM or like mechanism?**

17 A. The Commission's policy is that adopting a PCAM or like mechanism requires a  
18 reduction in the utility's cost of capital. The Commission recently reiterated this  
19 policy in the last PacifiCorp rate case, Docket UE-050684 ("2005 Rate Case"):

20 Ratepayers should receive the benefit of a reduction in cost of capital, as a  
21 power cost adjustment introduces rate instability for ratepayers and earnings  
22 stability for stockholders.<sup>1</sup>  
23

---

<sup>1</sup> Order 04 at 35, ¶ 91 (April 17, 2006).

1 **Q. Has this been a consistent Commission policy?**

2 A. Yes. In the passage I just quoted, the Commission supported its statement of policy  
3 by citing three prior Commission orders ranging in dates from 1988 to 2000.<sup>2</sup>

4

5 **Q. Does the Commission policy make sense from a financial perspective?**

6 A. Yes. As I explain in more detail later in my testimony, a PCAM reduces the utility's  
7 exposure to excess power cost conditions. In doing so, it reduces the potential of the  
8 utility to suffer adverse financial consequences due to excess power costs. This  
9 lowers its cost of capital. A cost of capital offset is therefore appropriate.

10

11 **Q. In implementing that policy, has the Commission been consistent in requiring**  
12 **an explicit link to the cost of capital impacts as a condition of implementing a**  
13 **PCAM?**

14 A. Yes. In my review, I found: 1) examples where the Commission rejected a  
15 mechanism when the utility did not adjust for any related cost of capital impacts; 2)  
16 an example where the Commission approved a mechanism, and the cost of capital  
17 was adjusted to reflect the impact of it; but also 3) an example where the  
18 Commission approved a mechanism without an explicit adjustment to cost of capital-  
19 there was apparently no analysis that the utility's cost of capital reflected the  
20 mechanism.

21

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<sup>2</sup> In footnote 135 of Order 04 in the 2005 Rate Case, the Commission cited *WUTC v. Puget Sound Power & Light Co.*, Docket U-81-41, Sixth Supplemental Order at 21-22 (Dec. 1988) (PSE ECAC); *Petition of Washington Water Power for PCA Mechanism*, Docket U-88-2363-P, First Supplemental Order Denying Petition at 8 (Sept. 1989); and *WUTC v. Avista Corp.*, Dockets UE-991606 & UG-991607, Third Supplemental Order at 50, 52 (Sept. 2000).



1 **Q. Please describe the examples where the Commission rejected a mechanism**  
2 **because the utility did not adjust for related cost of capital impacts.**

3 A. In Docket U-88-2363-P, the Commission denied a petition by Washington Water  
4 Power Company (now Avista Corp., or "Avista") for a power cost adjustment  
5 mechanism. The utility testified that "eventually" it would need less equity in its  
6 capital structure if the mechanism were approved. However, the Commission ruled  
7 that while this was an "interesting" point, it was "not sufficiently specific." The  
8 Commission went on to reiterate "the requirement that a downward cost of capital  
9 adjustment must be demonstrated."<sup>3</sup>

10 Docket UE-991606 is another Avista rate case in which the utility asked for a  
11 power cost adjustment clause. The Commission denied that request, stating: "As we  
12 have already noted, such proposals must include an equitable balancing of risk  
13 between ratepayers and shareholders. Mechanisms that simply shift risk from  
14 shareholders to ratepayers without corresponding benefits do not meet this  
15 objective."<sup>4</sup>

16  
17 **Q. Please provide an example where the Commission approved a power cost**  
18 **adjustment mechanism, and the Commission adjusted the cost of capital to**  
19 **reflect the mechanism.**

20 A. The example is Docket U-901183-P, a petition by Puget Sound Power & Light  
21 Company ("Puget") to create a decoupling mechanism and power cost adjustment

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<sup>3</sup> *Petition of Washington Water Power for PCA Mechanism*, Docket U-88-2363-P, First Supplemental Order Denying Petition at 9-10 (September 19, 1989).

<sup>4</sup> *Utilities & Transp. Comm'n v. Avista Corp.*, Docket UE-991606, Third Supplemental Order (September 29, 2000) at 52, ¶ 185.

1 mechanism. In that case, the Commission explicitly ordered the utility to reduce the  
2 revenue it could recover in its next tariff filing by adjusting the equity ratio  
3 downward.<sup>5</sup>

4  
5 **Q. Please provide an example where the Commission approved a power cost**  
6 **adjustment mechanism, but the cost of capital did not reflect the impact of that**  
7 **mechanism.**

8 A. In Cause U-81-41, another Puget rate case, the Commission approved an Energy  
9 Cost Adjustment Clause (ECAC). In doing so, the Commission recognized that the  
10 rate stability the ECAC afforded Puget would provide “greater stability for the  
11 company, with resulting lower risks and financing costs,” but the Commission did  
12 not make an explicit adjustment to the utility’s rate of return at that time.<sup>6</sup>

13 The Commission later reopened Cause U-81-41 to review ECAC. The  
14 Commission order resulting from that review stated that the parties should address  
15 the “ECAC/Cost of capital link” in Puget’s next general rate case.<sup>7</sup> The Commission  
16 said the focus should be “on the actual size of the downward adjustment to Puget’s  
17 cost of capital to reflect this link.” (Emphasis added).<sup>8</sup>

18 In that next Puget general rate case, the Commission terminated the ECAC.  
19 Among other things, the Commission stated that on the record before it, ECAC’s

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<sup>5</sup> *Utilities & Transp. Comm’n v. Puget Sound Energy Co.*, Docket UE-901184-P, Third Supplemental Order at 29, Finding of Fact 9 (April 1, 1991).

<sup>6</sup> *Utilities & Transp. Comm’n v. Puget Sound Power & Light Co.*, Cause U-81-41, Second Supplemental Order at 17 (March 12, 1982).

<sup>7</sup> *Id.*, Sixth Supplemental Order at 20 (December 19, 1988).

<sup>8</sup> *Id.*

1 impact on cost of capital “was too difficult to measure.”<sup>9</sup> Puget had calculated the  
2 impact of ECAC to be a 30 basis point reduction to the cost of equity, but the utility  
3 admitted this difference “could be due to measurement error rather than the effect of  
4 the ECAC.”<sup>10</sup>

5  
6 **Q. What conclusions should the Commission draw from these examples?**

7 A. While the Commission may not have implemented its policy perfectly by requiring  
8 an explicit reduction in the cost of capital each and every time it has been asked to  
9 approve a power cost adjustment mechanism, the Commission has been consistent in  
10 its pursuit of reductions to the utility’s cost of capital related to such mechanisms.

11  
12 **B. How Staff Analyzed The Financial Impact Of Each PCAM Proposal**

13  
14 *1. The financial parameters Staff used*

15  
16 **Q. What financial parameters should be used to analyze the link between a power  
17 cost adjustment mechanism and the utility’s cost of capital?**

18 A. The link between a power cost adjustment mechanism and the utility’s cost of capital  
19 should be evaluated by measuring the impact of the mechanism on the utility’s  
20 ability to service debt when variations in power supply costs adversely affect the  
21 company’s earnings.

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<sup>9</sup> *Utilities & Transp. Comm’n v. Puget Sound Power & Light Co.*, Docket U-89-2688-T, Third Supplemental Order at 14 (January 17, 1990).

<sup>10</sup> *Id.* at 12.

1 **Q. What financial metrics should be used to make this evaluation?**

2 A. The critical financial metric is pre-tax interest coverage, which is sometimes called  
3 times interest coverage, or coverage ratio. As I explain later, my analysis focuses on  
4 this important financial metric and how power supply cost variations affect this  
5 metric.

6  
7 **Q. What is a “pre-tax interest coverage,” “times interest coverage” or “coverage  
8 ratio,” and why is this metric useful?**

9 A. This metric measures the ability of a firm to make payments on its debt from pre-tax  
10 operating income. It is the simplest and most direct indication of a firm’s ability to  
11 not only service debt but also tells prospective lenders the firm’s ability to service  
12 new debt. It lends itself easily to calculating the impacts of adverse power supply  
13 conditions on the financial flexibility of the firm, and its cost of capital.

14  
15 **Q. Please explain the correlation between coverage ratio and the utility’s cost of  
16 capital.**

17 A. Higher coverage ratios for utilities are directly correlated to both the capital structure  
18 adopted for ratemaking purposes, and the return on that equity investment that  
19 ratepayers pay for in utility rates. A utility with a lower bond rating will typically  
20 have lower coverage than a utility with a higher bond rating, all else equal.

21 For example, if a firm has sufficient pre-tax operating income to pay its  
22 interest expense twice, it has a 2.0 times interest coverage, or a 2.0 times pre-tax  
23 coverage ratio. A firm with an interest coverage ratio of 3.0 times would be on even

1 firmer financial footing, because its pre-tax operating income covers its interest  
2 expense three times.

3 Moreover, most utility bonds contain covenants that prescribe specific ratios  
4 for interest coverage the utility must maintain before it can issue additional debt.  
5 This further confirms that the coverage ratio is a key indicator of financial health,  
6 and thus it is directly correlated to the cost of capital.

7  
8 **Q. How does the coverage ratio analysis lend itself easily to calculating the impacts  
9 of adverse power supply conditions on the utility's cost of capital?**

10 A. The interest coverage metric is very useful here because it is the one indicator that  
11 enables the analyst to focus on a single change in expense, *i.e.*, power supply, and  
12 then translate these power cost changes into changes in earned returns, and then  
13 translate these changes in earned returns to the utility's ability to service its debt as  
14 measured by the coverage ratio.

15 I should add at this juncture that the most critical aspect in reviewing a  
16 utility's performance is to evaluate the downside risk the company has when adverse  
17 power supply conditions occur, and how this impacts the utility's financial  
18 performance, *i.e.*, its ability to service its debt and thus continue to finance and  
19 satisfy its public service obligations.

20  
21 **Q. Why is this analysis appropriate to an analysis of a PCAM?**

22 A. This analysis is appropriate because a power cost adjustment mechanism protects the  
23 utility against the downside risk of increasing power supply costs. Therefore, a

1 PCAM reduces the risk of default to a prospective lender, which in turn enhances the  
2 utility's ability to access external sources of capital on reasonable terms during  
3 adverse power supply conditions.

4 Indeed, the definition of 'risk' involves the concept of the possibility of  
5 suffering loss, hazard and uncertainty. While it is true that a power cost adjustment  
6 mechanism also impacts "upside risk" (that is, it limits the utility's ability to keep all  
7 benefits of lower power costs), it reduces power cost variability to the utility. From a  
8 cost of capital perspective, this reduces the potential of the utility to suffer adverse,  
9 i.e. downside, financial consequences, and thus lowers its cost of capital.

10 This provides strong support for the Commission's policy requiring a cost of  
11 capital reduction when the Commission approves a PCAM.

12  
13 **Q. Do bond rating agencies agree a power cost adjustment mechanism protects**  
14 **against significant financial harm from power cost variability?**

15 A. Yes. Standard & Poor's (S&P) is a well-recognized bond rating agency. In a  
16 publication dated January 27, 2007, S&P states:

17 Because a significant component of a utility's operating expenses relate to  
18 fuel and purchased power, one of the keys to rating stability is the level of  
19 support that state regulators provide to utilities for fuel cost recovery,  
20 particularly as gas and coal prices have risen. Utilities...without access to  
21 fuel and purchase power adjustment clause...can face reduced operating  
22 margins, increased exposure to cash flow volatility, and greater demand for  
23 working capital.<sup>11</sup>

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<sup>11</sup> "Ratings Direct," found on page 7 of S&P's "Ratings Roundup: Pace of U.S. Utility Rating Activity Moderated in 2006" (January 23, 2007).

1 In my review of ratings reports, this is typical of the concerns expressed by bond  
2 rating services. It also reflects their focus on the downside protection afforded by  
3 power cost adjustment mechanisms.

4  
5 2. *The financial information Staff used*

6  
7 **Q. In using interest coverage ratios to evaluate the impact on PacifiCorp's cost of**  
8 **capital by the power cost adjustment mechanisms proposed in this case, what**  
9 **financial information do you use?**

10 A. I use PacifiCorp's 8.060 percent overall rate of return for its Washington operations.  
11 This figure is based on the capital structure and corresponding cost rates the  
12 Commission found to be appropriate in the 2005 Rate Case, Order No. 04 at ¶ 287,  
13 adjusted for the changes to the cost of debt which PacifiCorp presents in its direct  
14 case. *See direct testimony of Mr. Williams, Exhibit \_\_\_ (BRW-1T) at 5, the Table*  
15 *after line 16.* This capital structure and overall rate of return produce a strong pre-  
16 tax coverage ratio of 3.22 times.

17 I also used the Washington rate base in the amount of \$535 million. This  
18 figure was developed by Staff witness Mr. Schooley. Applying the rate of return to  
19 the rate base produces net operating income of \$43,121,000.

20 In addition, I assumed a 35 percent federal income tax rate. Changes in  
21 power supply expense must be adjusted for federal income tax effects to produce a  
22 change in net operating income. Therefore, in my analysis, I adjust changes in  
23 power supply expense for federal tax impacts in calculating the impact of power cost

1 variances on PacifiCorp's net operating income, rate of return, and return on equity  
2 and coverage ratio.

3 Finally, I used the specific characteristics of both the Company and Staff  
4 proposed PCAMs, namely the dead bands and sharing bands, and the amounts of  
5 excess power costs, if any, the Company absorbs in each band under adverse power  
6 supply conditions. Once I have calculated a change in the overall rate of return due  
7 to a change in power supply expense reflected by these bands, I am then able to  
8 calculate the impact of expense changes on the Company's return on equity and pre-  
9 tax interest coverage.

10 These figures all appear in my analysis in my Exhibit \_\_\_ (KLE-3), page 1  
11 and are consistently used throughout the exhibit. (All figures are rounded.)  
12

13 3. *The "benchmark" Staff used to compare the proposed PCAMs to the existing,*  
14 *non-PCAM environment*  
15

16 **Q. Does your interest coverage analysis for each proposed PCAM provide you**  
17 **enough information to determine the extent to which PCAM shifts risk?**

18 A. No. The Commission cannot determine how a PCAM shifts risk unless it first  
19 understands how risk is allocated in the non-PCAM environment. Consequently, the  
20 Commission needs a "benchmark" measure of risk reflecting the non-PCAM  
21 environment, so that it can see how risk is re-allocated by a PCAM.  
22

23 **Q. How is risk allocated between ratepayers and the Company in the non-PCAM**  
24 **environment?**



1 A. In the absence of a PCAM, the Company absorbs excess power costs, but only up to  
2 a certain point. It is the Commission's policy to permit a utility to defer excess  
3 power costs or if necessary grant a temporary rate increase, when that utility's  
4 financial health is directly threatened by highly adverse power costs. Put another  
5 way, under the existing allocation of risks between ratepayers and the Company,  
6 ratepayers will be called upon to bear the risk of adverse power cost variability, and  
7 pay increased rates, to enable the Company to weather that financial storm.

8 Therefore, the level where a utility would in all probability be provided that  
9 sort of relief is the "benchmark" against which to compare a PCAM. This  
10 comparison would reveal the extent to which the PCAM shifts risk to ratepayers,  
11 over and above the status quo.

12  
13 **Q. Can you cite an example where the Commission applied its policy for granting**  
14 **relief in circumstances of highly adverse power costs?**

15 A. The most recent example of this policy involves Avista. Docket UE-000972 began  
16 on June 23, 2000. The Company requested Commission approval to defer excess  
17 power costs, and amortize them if the Commission did not approve a PCAM Avista  
18 was requesting in a pending rate case, Docket UE-991606. The Commission did not  
19 approve a PCAM in that rate case. On August 9, 2000 the Commission entered its  
20 order authorizing that accounting treatment.<sup>12</sup>

21 Later that year, on December 20, 2000, Avista requested further amendments  
22 to the original order to change the calculation of excess deferred power costs. On

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<sup>12</sup> *Utilities & Transp. Comm'n v. Avista Corp.*, Docket UE-000972, Order Approving Establishment of a Deferral Mechanism to Track Power Costs (August 9, 2000).

1 January 24, 2001 the Commission granted the amended accounting treatment for  
2 excess deferred power costs.<sup>13</sup>

3 These accounting mechanisms were in place as the “Western Energy Crisis”  
4 further unfolded. That crisis and the adverse power costs Avista incurred and  
5 deferred ultimately led the utility to seek interim rate relief in Docket UE-010395.  
6 The Commission ultimately approved an emergency or “interim” rate increase for  
7 Avista to recover its deferred power costs.<sup>14</sup>

8  
9 **Q. What should the Commission conclude from this example?**

10 A. The Commission should conclude that under the current risk allocation scheme  
11 between customers and utilities, ratepayers bear the risk of excess power costs when  
12 such costs begin to substantially impede a utility’s access to new sources of external  
13 capital.

14  
15 **Q. How did you use this risk allocation analysis to determine the appropriate  
16 benchmark to apply in this case?**

17 A. The benchmark relates to the point where the Company’s ability to access external  
18 sources of capital would begin to be threatened under adverse power supply  
19 conditions in a non-PCAM environment. I believe this point is when the Company’s  
20 coverage ratio falls to 2.50 times.

---

<sup>13</sup> *Utilities & Transp. Comm’n v. Avista Corp.*, Docket UE-000972, Order Granting Request to Modify Power Cost Deferral Mechanism (January 24, 2001).

<sup>14</sup> *Utilities & Transp. Comm’n v. Avista Corp.*, Docket UE-010395, Sixth Supplemental Order Rejecting Tariff Filing; Granting Temporary Rate Relief, Subject to Refund; and Authorizing and Requiring Compliance Filing (September 24, 2001).

1           In other words, in an adverse power supply cost situation, if the Company's  
2 coverage ratio degrades to 2.5 times, the Company's financial flexibility begins to be  
3 impacted. At that point, and assuming the adverse power supply conditions were  
4 continuing and beyond the Company's control, it would be reasonable for the  
5 Commission to permit the Company to defer excess power costs for recovery from  
6 ratepayers, again, in a non-PCAM environment.

7           Indeed, my analysis of the Avista petition in Docket UE-991606 shows that  
8 Avista had around a 2.3 coverage ratio when it sought Commission permission to  
9 defer excess power costs.

10  
11 **Q. Why is a 2.50 coverage ratio an appropriate benchmark?**

12 **A.** A 2.50 coverage ratio still satisfies S&P's criteria for a "BBB" bond rating, which is  
13 an investment grade rating. However, if a utility's coverage ratio was degraded to  
14 that point, and if the excess power cost situation was continuing, the Commission  
15 would likely take action. If the Commission allowed substantial power cost deferrals  
16 at that point, it would send the signal to the market that the utility is recovering these  
17 short-term adverse power supply costs going forward. This protects bondholders  
18 from earnings attrition that impacts both the utility's ability to service debt, and to  
19 obtain additional financing.

20           Deferrals of excess power costs at this point would eliminate adverse power  
21 supply conditions as the contributing factor to the earnings attrition that was causing  
22 the Company's debt coverage to approach a below investment grade bond rating.

23

1 **Q. Without a PCAM, at what level of increased power supply costs for its**  
2 **Washington operations would PacifiCorp's coverage ratio be at risk of falling**  
3 **below 2.50 times?**

4 A. A \$13 million increase in power supply costs would place the Company at the risk of  
5 having its coverage ratio falling below 2.50 times. As I explained, in a non-PCAM  
6 environment, and at a \$13 million level of excess power supply costs (the term  
7 "excess power supply costs" means costs above the normalized level used for  
8 ratemaking purposes), the Commission would be likely to grant some form of relief,  
9 either by permitting deferrals, or interim rate relief, depending on the circumstances.

10

11 **Q. How can the Company absorb \$13 million in increased power costs, and yet still**  
12 **maintain a 2.50 times coverage ratio?**

13 A. The equity ratio and cost of equity the Commission found appropriate for PacifiCorp  
14 in the 2005 Rate Case provides the Company significant financial flexibility to  
15 weather such a significant event.

16 In the 2005 Rate Case, the Commission determined PacifiCorp was entitled  
17 to a ratemaking capital structure containing a 46 percent equity ratio, plus a 10.2  
18 percent cost of equity. This will provide PacifiCorp significant operating margins  
19 and a "cushion," that is, an ability to absorb significant cost variances, including  
20 power cost variances.

21

1 **Q. Why is this 2.50 coverage ratio a “benchmark?”**

2 A. In my opinion, under the existing allocation of risk between ratepayers and the  
3 Company, it is the point where Commission would likely authorize the Company to  
4 begin to defer excess power costs. Beyond that, ratepayers would be responsible for  
5 a substantial amount of excess power costs, e.g. 90 percent. This is a benchmark  
6 because if a PCAM does more to protect the Company than that, it is shifting risk to  
7 ratepayers.

8           Consequently, a 2.50 interest coverage at \$13 million in excess power costs  
9 for PacifiCorp constitutes the “benchmark” against which any proposed PCAM  
10 should be measured. This benchmark can be used both to determine the extent of  
11 risk shifting, and to measure the magnitude of the appropriate cost of capital offset.

12

13 **Q. Have you prepared an exhibit showing your calculation of the 2.5 coverage ratio**  
14 **at \$13 million in excess power costs?**

15 A. Yes. It is in my Exhibit \_\_\_ (KLE-3), at page 1.

16

17 **Q. Please explain page 1 of your exhibit.**

18 A. The calculation on page 1 is premised upon the PacifiCorp’s current capital structure  
19 and cost of capital. As line 1 and 5 indicate, this calculation assumes PacifiCorp  
20 does not have a PCAM and the Company absorbs all of the \$13 million in excess  
21 power supply costs. As lines 13 and 14 show, under this scenario, PacifiCorp’s  
22 return on equity would fall to 6.77 percent, and it would have a 2.48 times pre-tax  
23 interest coverage ratio, respectively.

1           This result is not surprising. A utility like PacifiCorp, that is authorized a 46  
2 percent equity ratio a 10.2 percent return on equity, should be expected to finance its  
3 ongoing operations in light of short-term power cost variations, including \$13  
4 million in excess power costs and no PCAM.

5  
6 **Q. Is this 2.5 times coverage benchmark consistent with the Commission's policy**  
7 **on PCAMs you described earlier?**

8 A. Yes. In effect, the Commission's policy requires that customers do not pay twice for  
9 risk: once for the cushion provided by the combined 46 percent equity ratio and a  
10 10.2 percent cost of equity, and then again for power costs variances which that  
11 cushion, in part, should cover.

12           Instead, consistent with the Commission's policy, ratepayers should only pay  
13 once for risk. If the Commission adopts a PCAM, it should reduce the equity  
14 component in PacifiCorp's capital structure. Rates should not support both the costs  
15 of a 46 percent equity ratio and a PCAM.

16  
17 **Q. Continuing on with your benchmark analysis, did you estimate at what point**  
18 **additional power costs would cause PacifiCorp to be at risk of losing its ability**  
19 **to finance?**

20 A. Yes. In my opinion, it is likely that the Company would be able to justify some form  
21 of rate relief, *e.g.* interim rate relief, if its coverage ratio went to 2.00 times due to  
22 adverse power cost events. My calculations show that if power costs increase  
23 \$20,000,000 over the normalized level used for setting rates, the Company's

1 coverage would fall to about two times. Page 2 of my Exhibit \_\_\_ (KLE-3) contains  
2 this calculation. Under these circumstances, the Company would likely experience  
3 difficulty in obtaining new financing on reasonable terms, and if adverse power  
4 supply conditions persist, the Company would be faced with the prospect of being  
5 unable to obtain external financing.

6  
7 **C. Financial Analysis Of PacifiCorp's Proposed PCAM**

8  
9 **Q. Please describe the Company's proposed PCAM.**

10 A. The Company's proposed PCAM has an initial \$3 million dead band. The Company  
11 would absorb all power cost variations between \$0 and \$3 million. The next band  
12 calls for sharing, with 60 percent ratepayer responsibility for all power cost variation  
13 between \$3 million and \$7.4 million. The Company's outer band also calls for  
14 sharing, with 90 percent ratepayer responsibility for any power cost variances above  
15 \$7.4 million. *See PacifiCorp witness Mr. Widmer's direct testimony, Exhibit \_\_\_*  
16 *(MTW-1T) at page 28, lines 12-21.*

17  
18 **Q. How do you use the bands and their related dollar amounts in your analysis of**  
19 **the Company's PCAM proposal?**

20 A. I assumed the Company would incur increased power costs at the limits of the bands.  
21 I then calculated how excess power costs at the band's limits would affect the  
22 Company's return on equity and its pre-tax coverage ratio.

1 **Q. What were the results of your analysis?**

2 A. The results are shown in my Exhibit \_\_\_\_ (KLE-3), beginning on page 3. Page 3,  
3 lines 1 and 5 show where I assumed the Company absorbed all \$3 million in power  
4 supply cost variance in the dead band. Line 6 shows the \$1.95 million impact on net  
5 operating income (NOI). In that scenario, the Company's return on equity would fall  
6 to 9.42 percent, and its coverage ratio would be 3.05 times. These figures are shown  
7 on page 3, lines 13 and 14, respectively.

8 I did the same calculation for the first sharing band. This is shown in my  
9 Exhibit \_\_\_\_ (KLE-3), at page 4. If the Company incurred excess power costs of \$7.4  
10 million, it would absorb \$4.76 million of these costs: \$3 million through the dead  
11 band, and an additional \$1.76 million through second band, *i.e.*, 40 percent of the  
12 next \$4.4 million. In this scenario, the Company's return on equity would fall to  
13 8.95 percent, and its coverage ratio would fall to 2.95 times. These figures are shown  
14 on page 4, lines 13 and 14, respectively.

15 Finally, for the outer band, the Company's PCAM would defer 90 percent of  
16 all power cost variances that exceed the \$7.4 million for customer responsibility. In  
17 this scenario, PacifiCorp's proposed PCAM provides the Company a return on  
18 equity floor of about 8.70 percent, and an interest coverage floor of a healthy 2.89  
19 times. Pages 5 and 6 of my Exhibit provide the basis for this conclusion.

20

21 **Q. Please explain your conclusion that the Company's PCAM provides a return on**  
22 **equity "floor" of about 8.70 percent, when PacifiCorp would continue to be**  
23 **responsible for 10 percent of the deferrals past \$7.4 million?**



1 A. The operation of the Company's PCAM in the outer band creates this effect. In the  
2 outer band, PacifiCorp is required to absorb a very small amount of incremental  
3 excess power costs: only 10 percent of the incremental power supply cost variance  
4 above \$7.4 million. This effectively sets a floor for the rate of return and coverage  
5 ratio.

6 Pages 5 and 6 of my Exhibit demonstrate this. First, I assume power costs  
7 increase by \$12,400,000 (page 5, line1); an increase of \$5 million over the  
8 \$7,400,000 threshold of the outer band. In that circumstance, the Company would  
9 absorb only an additional \$500,000 of that \$5 million increase in power supply  
10 expense. The Company's return on equity falls to 8.82 percent; only 13 basis points  
11 less than an 8.95 return on equity applicable at the \$7.4 million level. The change in  
12 interest coverage would also be small: it would go from 2.95 times to 2.92 times.  
13 This example is shown in my Exhibit \_\_\_ (KLE-3), at page 5. The comparison  
14 figures are from page 4.

15 Next, I assume PacifiCorp's excess power supply expense increases another  
16 \$5 million, to \$17,400,000, which is an extremely low probability event. The  
17 Company's return on equity would drop only to 8.69 percent, and a coverage of 2.89  
18 times, as shown in my Exhibit \_\_\_ (KLE-3), at page 6.

19 This is the basis for my conclusion that the Company's proposed PCAM  
20 provides a "floor" on the Company's return on equity of approximately 8.70 percent,  
21 and a floor on the interest coverage of about 2.89 times.  
22

1 Q. **What is the basis for your statement that a \$17.4 million power cost variation is**  
2 **an extremely low probability event?**

3 A. Within the Company's normalized GRID power supply study, PacifiCorp's  
4 Washington operations can be expected to have excess power cost variations of this  
5 magnitude only once every forty years.

6

7 Q. **What do these calculations show?**

8 A. These calculations show that PacifiCorp would still have reasonable access to  
9 external sources of capital and sufficient financing flexibility under these adverse  
10 power supply conditions. For example, a coverage ratio in range of 2.50 to 3.00  
11 times is considered within the "BBB" bond rating category, according to S&P. In a  
12 recent article, S&P shows that between 2003 and 2005, the average pre-tax coverage  
13 ratio for "A" rated utilities was 3.3 times and for "BBB" rated utilities, the average  
14 was 2.8 times.

15

16 Q. **Using the 2.5 times interest coverage benchmark you referred to earlier, what**  
17 **are the implications of these calculations on shifting risk under a PCAM?**

18 A. A power cost adjustment mechanism that protects a utility from falling below the  
19 2.50 times coverage "benchmark" would be consistent with the existing allocation of  
20 risk between ratepayers and the Company. However, as my analysis shows,  
21 PacifiCorp's proposed PCAM provides significantly more protection than that.

1           Therefore, in accordance with Commission policy, it is unreasonable to shift  
2 this much risk to customers by capping the downside risk from these adverse power  
3 supply cost variances, without any offsetting cost of capital reduction..  
4

5 **Q.   How does the benchmark help you measure the extent of the risk shifting that**  
6 **occurs under the Company's proposed PCAM?**

7 A.   The benchmark I calculate for a non-PCAM environment is a 2.50 interest coverage  
8 ratio, which occurs if PacifiCorp experiences \$13 million in excess power costs.  
9 PacifiCorp's proposed PCAM would require ratepayers to absorb an additional \$7.68  
10 million in cost responsibility than is reflected in the current, non-PCAM  
11 environment.

12           This is because the Company's first sharing band makes customers  
13 responsible for \$2.64 million (60 percent of costs in the first sharing band), and the  
14 outer band makes customers responsible for another \$5.04 million (90 percent of all  
15 power cost variations between \$7.4 million and \$13 million). The Company would  
16 absorb these costs in a non-PCAM environment, and it would still be able to service  
17 existing debt and finance on reasonable terms.

18           Therefore, I conclude that the Company's proposed PCAM shifts an  
19 additional \$7,680,000 million to customers, compared to how excess power costs  
20 would be recovered in a non-PCAM environment.  
21

22 **Q.   Does PacifiCorp offer any offset to the cost of capital for this shift in risk?**

23 A.   No.

1 **Q. Based upon your analysis of PacifiCorp's proposed PCAM, what is your**  
2 **conclusion and recommendation?**

3 A. The Commission should reject the Company's PCAM proposal. It shifts significant  
4 risk to customers, and it does not compensate its customers for accepting this  
5 increased risk.

6

7 **D. Financial Analysis Of Staff's Proposed PCAM**

8

9 **Q. Did you perform the same sort of financial analysis of Staff's proposed PCAM**  
10 **as your analysis of the Company's proposed mechanism?**

11 A. Yes.

12

13 **Q. Please summarize the results of your financial analysis.**

14 A. The Staff's proposed PCAM also shifts significant risk from the Company to the  
15 customers, although less than the Company's proposed mechanism. If the  
16 Commission adopts Staff's proposed PCAM, the Commission should also adjust the  
17 cost of capital.

18

19 **Q. Please describe the PCAM proposed by Staff.**

20 A. Staff proposes a \$4 million dead band, a 50/50 sharing band between \$4 million and  
21 \$10 million, and an outer band with 90/10 sharing above \$10 million.

22

1 Q. Please summarize your financial analysis of Staff's proposed PCAM.

2 A. My analysis uses the same method as before, in that I calculate the maximum  
3 downside exposure to the Company when it incurs excess power costs at the limits of  
4 each band proposed by Staff.

5 First, I calculate the Company's return on equity and coverage assuming the  
6 Company absorbs all \$4 million in power supply cost variances in Staff's dead band.  
7 In that scenario, the Company's return on equity would fall from 10.20 to 9.15  
8 percent, and its coverage ratio would fall from 3.22 to 2.99 times. The 9.15 percent  
9 return and the 2.99 coverage ratio are shown in my Exhibit \_\_\_ (KLE-3), at page 7,  
10 lines 13 and 14 respectively. The 10.20 return on equity figure is from the  
11 Company's direct case for cost of capital. *See direct testimony of Mr. Williams,*  
12 *Exhibit \_\_\_ (BRW-1T) at 5, the Table after line 16.* This capital structure and cost  
13 of capital generates a coverage ratio of 3.22 times.

14 For Staff's proposed first sharing band, if the Company incurred excess  
15 power costs of \$10 million, the Company would absorb \$7 million of these costs: \$4  
16 million through the dead band, and an additional \$3 million through the first sharing  
17 band, *i.e.*, 50 percent of \$6 million. In this scenario, the Company's return on equity  
18 would fall to 8.36 percent, and its coverage ratio would fall to 2.82 times. This is  
19 shown in my Exhibit \_\_\_ (KLE-3), at page 8, lines 13 and 14 respectively

20 For Staff's outer band, I assumed the Company incurred \$15 million in  
21 excess power supply costs. In this scenario, the Company would absorb \$7 million  
22 from the first two bands, and 90 percent of power cost variances above \$10 million  
23 to \$15 million. The Company's return on equity under these adverse power cost

1 conditions would be 8.23 percent, with a coverage ratio of 2.79 times. This  
2 calculation is in my Exhibit \_\_\_ (KLE-3), at page 9, and these figures are shown on  
3 lines 13 and 14, respectively.

4 Finally, I calculated the “floors” for return on equity and coverage for Staff’s  
5 proposed PCAM, as I did for PacifiCorp’s proposed mechanism. The results show  
6 that Staff’s proposed PCAM provides PacifiCorp a return on equity floor of 8.16%,  
7 and a coverage ratio floor of 2.78 times. This is shown in my Exhibit \_\_\_ (KLE-3),  
8 at page 10, lines 13 and 14 respectively.

9  
10 **Q. Based upon this analysis, what conclusions should the Commission draw about**  
11 **risk shifting under Staff’s proposed PCAM?**

12 A. Like PacifiCorp’s proposal, Staff’s proposed PCAM also shifts significant risk from  
13 the Company to customers, though less than the Company’s proposed PCAM. My  
14 analysis shows that under Staff’s proposed PCAM, the Company would still be able  
15 to meet coverage ratios well above 2.50 times, and thus finance on reasonable terms,  
16 even when excess power supply costs reach \$10 million, the start of Staff’s outer  
17 sharing band. A cost of capital offset is required in these circumstances.

18  
19 **Q. How should the Commission address this shifting of risk?**

20 A. Consistent with its policy, the Commission should reduce the cost of capital to  
21 PacifiCorp, if it accepts Staff’s proposed PCAM. I calculate the appropriate  
22 adjustment in the next section of my testimony.

1 **E. Cost of Capital Adjustment For Staff's Proposed PCAM**

2

3 **Q. If the Commission accepts Staff's proposed PCAM, how should the Commission**  
4 **adjust PacifiCorp's cost of capital?**

5 A. The Commission should reduce the Company's approved 46 percent equity ratio to  
6 42 percent.

7

8 **Q. How did you calculate that cost of capital offset?**

9 A. Staff's proposed PCAM provides for 90/10 sharing of excess power supply costs  
10 exceeding \$10 million, and it allows PacifiCorp to automatically defer 90 percent of  
11 these costs. I begin with the 2.50 coverage benchmark I previously calculated in my  
12 Exhibit \_\_\_ (KLE-3), at page 1. Then, I calculate what changes to PacifiCorp's  
13 ratemaking capital structure would produce a 2.50 times interest coverage when  
14 power costs in excess of \$10 million are automatically deferred for 90/10 sharing.

15

16 **Q. Have you prepared an exhibit that shows your calculation of the cost of capital**  
17 **offset related to Staff's proposed PCAM?**

18 A. Yes. The calculation is provided in my Exhibit \_\_\_ (KLE-3), at page 12.

19

20 **Q. Please explain the basis for Staff's cost of capital offset calculation.**

21 A. The calculation adjusts the Company's capital structure to achieve the benchmark at  
22 the Staff's outer band: a 2.50 times interest coverage once excess power costs reach

1 \$10 million. This is the point where Staff's PCAM automatically begins deferring  
2 90 percent of excess power costs.

3 In other words, the cost of capital "offset" is the degree to which PacifiCorp  
4 could have less equity in its capital structure and still achieve the benchmark 2.50  
5 times interest coverage, when Staff's proposed 90/10 sharing of excess power costs  
6 "kicks in" at \$10 million.

7 By comparison, Exhibit \_\_\_ (KLE-3), at page 11 is a calculation of the  
8 amount of excess power supply costs PacifiCorp would need to incur under Staff's  
9 proposed PCAM before its coverage degraded to 2.50 times. As page 11 shows, if  
10 no cost of capital adjustment were proposed, it would take \$25 million in excess  
11 power costs before PacifiCorp's coverage would reach 2.50 times, and the  
12 Company's return on equity would fall to only 8.12 percent.

13  
14 **Q. Please explain the details of the Staff's cost of capital offset calculation.**

15 **A.** The calculation involves an iterative process. First, I make incremental reductions to  
16 the common equity ratio and complementary increases to the long-term debt ratio.  
17 These changes to the capital structure cause the weighted cost of equity to decrease  
18 and the weighted cost of debt to increase.

19 As the weighted cost of equity decreases, PacifiCorp's operating margin  
20 decreases, reducing pre-tax operating income. As the weighted cost of debt  
21 increases, interest expense increases. The effect of these two simultaneous  
22 adjustments causes PacifiCorp's coverage ratio to fall.



1           Page 12 of my Exhibit \_\_\_ (KLE-3) shows that by reducing the common  
2 equity ratio to 42 percent and increasing the long-term debt ratio to 54 percent, the  
3 Company's coverage ratio falls to 2.58 times under an adverse power scenario of \$10  
4 million. This is slightly above the benchmark coverage ratio of 2.50 times.

5           Therefore, under Staff's proposed PCAM, a ratemaking capital structure  
6 containing 42% common equity and a 10.2 percent return on equity will enable  
7 PacifiCorp to still be at the benchmark coverage of 2.50 times when excess power  
8 costs reach \$10 million, when 90/10 sharing takes effect.

9  
10 **Q. Please summarize the logic of your calculations in Exhibit \_\_\_ (KLE-3).**

11 **A.** Exhibit \_\_\_ (KLE-3) reflects the following logic: 1) In a non-PCAM environment,  
12 and under PacifiCorp's currently-authorized capital structure, the Company reaches a  
13 2.50 times interest coverage when excess power supply costs reach \$13 million; 2) If  
14 Staff's PCAM is implemented, and the capital structure is not adjusted, excess power  
15 supply costs must increase to \$25 million; before PacifiCorp is at risk of reaching the  
16 2.50 benchmark interest coverage ratio. This shows substantial risk shifting to  
17 ratepayers is occurring and the effect of the PCAM by creating a floor on the  
18 Company's return on equity ; 3) Reducing the ratemaking equity ratio from 46  
19 percent to 42 percent, and increasing the debt ratio by a corresponding amount,  
20 enables PacifiCorp to achieve the benchmark 2.50 times coverage ratio under Staff's  
21 proposed PCAM.

1 **Q. Does your analysis produce sensible results?**

2 A. Yes. These results are intuitive because reducing PacifiCorp's equity ratio reduces  
3 its operating margins from equity, and simultaneously increases its interest expense  
4 due to more debt. This reduces the coverage ratio, as my calculation shows. Indeed,  
5 this is the expected impact as the Company moves to a more leveraged capital  
6 structure.

7 It is also worthwhile to acknowledge that this increased operating leverage is  
8 beneficial to the Company on the "upside." Under conditions where power costs are  
9 favorable, the Company's earned returns on equity are magnified. Earnings are  
10 applied to less equity and provide greater upside potential to shareholders.

11

12 **Q. Please summarize your conclusions regarding the cost of capital offset the**  
13 **Commission should adopt in this proceeding.**

14 A. If the Commission accepts Staff's proposed PCAM, the Commission should adjust  
15 the authorized equity ratio from 46 percent to 42 percent. This reflects the shifting  
16 of risk from the Company to customers that is inherent in the Staff's proposed  
17 PCAM. This adjustment will compensate customers for accepting a portion of the  
18 risk of power supply cost variations inherent in Staff's PCAM.

19

20 **IV. CALCULATION OF PACIFICORP'S COST OF CAPITAL**

21

22 **Q. If the Commission implements Staff's proposed PCAM, what rate of return**  
23 **should the Commission use for setting rates in this case?**

1 A. The rate of return should be 7.902 percent. The weighted cost of debt for purposes  
2 of the *pro forma* debt adjustment is 3.553 percent.

3  
4 **Q. How did you calculate those figures?**

5 A. I used the same cost rates of capital approved by the Commission in the 2005 Rate  
6 Case, adjusted for the changes to the cost of debt which PacifiCorp presents in its  
7 direct case. *See direct testimony of Mr. Williams, Exhibit \_\_\_ (BRW-1T) at 5, the*  
8 *Table after line 16.* Staff has reviewed these adjustments and they are acceptable.

9 The only change from the Company's cost of capital calculation is the change  
10 in equity ratio from 46 percent to 42 percent, and the corresponding increase to the  
11 debt ratio, from 50 percent to 54 percent. This is the adjustment to compensate for  
12 the risk shifting under Staff's proposed PCAM, as I explained earlier. If the  
13 Commission does not implement a PCAM, the Company's proposed 8.057 percent  
14 rate of return is acceptable. *Id.*

15 The following table summarizes my calculation of the 7.90 percent rate of  
16 return:

<u>Component</u>	<u>Ratio (%)</u>	<u>Cost (%)</u>	<u>Wtd cost (%)</u>
18 LT Debt	54.0	6.33	3.421
19 ST Debt	3.0	4.50	0.135
20 Preferred	1.0	6.46	0.065
21 Common	<u>42.0</u>	10.2	<u>4.284</u>
22 Rate Return			<u>7.90</u>

23  
24 **Q. Does this complete your direct testimony?**

25 A. Yes.