BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFICORP, d/b/a PACIFIC POWER & LIGHT COMPANY, Respondent.	DOCKET UE-230172 ***(Consolidated)***
In the Matter of ALLIANCE OF WESTERN ENERGY CONSUMERS' Petition for Order Approving Deferral of Increased Fly Ash Revenues	DOCKET UE-210852 ***(Consolidated)***

CROSS-EXAMINATION EXHIBIT
OF MATTHEW MCVEE

ON BEHALF OF
SIERRA CLUB

EXHIBIT MDM-__X
ORDER 04 & ORDER 03, UE-050684 & UE-050412 (APR. 17, 2006)

December 4, 2023

[Service Date April 17, 2006]

BEFORE THE WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	DOCKET UE-050684
	)	ORDER 04
Complainant,	)	
v.	)	ORDER REJECTING TARIFFS, AS FILED; REJECTING STIPULATION ON NET POWER COSTS; REJECTING, IN PART, AND ACCEPTING, IN PART, STIPULATION ON TEMPERATURE NORMALIZATION ADJUSTMENT; DETERMINING COST OF CAPITAL
PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY	)	
Respondent.	)	
. . . .	)	
In the Matter of the Petition of	)	DOCKET UE-050412
PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY	)	ORDER 03
For an Order Approving Deferral of Costs Related to Declining Hydro Generation	)	ORDER GRANTING PETITION, IN PART, DENYING PETITION, IN PART
. . . .	)	

1 ***Synopsis.*** *We reject the Company's proposed rates, because we find the Revised Protocol cost allocation methodology assigns resources to Washington which have not been proven to be "used and useful for service in this state," a statutory requirement. We also reject Staff's and ICNU's proposed modifications to the Revised Protocol, because they suffer from the same infirmity. While we find merit in power cost adjustment and decoupling mechanisms, we reject the proposals offered by the Company and NRDC, both because of the lack of an acceptable allocation method and because the proposals lack sufficient detail.*

2 *The existing rates are deemed to be fair, just, reasonable and sufficient, as the Company has not met its burden to provide an allocation methodology. Although we are not able to adjust rates or resolve contested adjustments to revenue requirement or rate base in the absence of an appropriate allocation method, we address those contested adjustments involving matters of policy, accounting rules or theory.*

3 *Determining an appropriate cost of capital does not depend on a method for allocating costs. We find that 10.2 percent is an appropriate return on common equity for PacifiCorp, establishing an overall cost of capital of 8.10 percent. We reject the proposals of Staff and Public Counsel to apply a double leverage adjustment in establishing the Company's cost of capital.*

4 *Finally, we grant, in part, the Company's petition to establish a deferral account for costs relating to declining hydroelectric generation. We reject that portion of the petition seeking recovery of these costs, finding the Company has not shown the costs were prudently incurred and because the costs are dependent on an unacceptable allocation method.*

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SUMMARY

5 **PROCEEDINGS.** In Docket UE-050684, PacifiCorp d/b/a Pacific Power & Light Company (PacifiCorp or the Company) filed with the Washington Utilities and Transportation Commission (Commission) revisions to its tariffs, proposing an increase in annual revenues from Washington operations of $39.2 million, resulting in a proposed uniform increase in rates of 17.9 percent. The Commission suspended the tariff filing to determine whether the proposed rate increase is fair, just and reasonable. In Docket UE-050412, the Company filed a petition seeking deferred treatment for excess power costs due to low hydroelectric generation. The Commission consolidated these two cases for hearing and decision.

6 **PARTIES.** Marcus Wood and Jason B. Keyes, Stoel Rives LLP, Seattle, Washington, and Portland, Oregon, and George M. Galloway, attorney, Cove, Oregon, represent PacifiCorp. Melinda J. Davison and Irion Sanger, Davison Van Cleve, P.C., Portland, Oregon, represent the Industrial Customers of Northwest Utilities (ICNU). Ralph Cavanagh, San Francisco, California, represents the Natural Resources Defense Council (NRDC). Brad M. Purdy, attorney, Boise, Idaho, represents The Energy Project. Simon J. ffitch, Assistant Attorney General, Seattle, Washington, represents the Public Counsel Section of the Washington Office of the Attorney General (Public Counsel). Donald T. Trotter, Senior Counsel, and Robert D. Cedarbaum, Senior Counsel, represent the Commission Staff (Staff).

7 **COMMISSION DECISION.** The Commission determines that PacifiCorp has not met its burden to show its proposed rates are fair, just and reasonable. The Company bases its request for increased rates on the Revised Protocol inter-jurisdictional cost allocation method, which the Commission rejects for failing to demonstrate that the resources included in the Revised Protocol are used and useful in this state. In the absence of an acceptable allocation methodology, the

Commission deems the Company's existing rates to be fair, just, reasonable and sufficient, as determined in a recent proceeding.

8 The Commission rejects the Company's proposed power cost adjustment and decoupling mechanisms, provides guidance on certain contested adjustments involving matters of policy, accounting rules or theory, and allows the Company to establish deferral accounts for costs relating to declining hydroelectric generation. The Commission also establishes an overall cost of capital for the Company of 8.10 percent (10.2 percent return on equity), rejecting proposals for a double leverage adjustment to the cost of capital.

MEMORANDUM

I. Background and Procedural History

9 PacifiCorp provides retail electric service in six states: Utah, Oregon, Idaho, Wyoming, California, and Washington. In 1988, the Commission approved the merger of Pacific Power & Light Company (Pacific Power) with Utah Power & Light Company (Utah Power), joining the operations of the two companies and two service territories, under one company – PacifiCorp. PacifiCorp's retail customers in Washington account for approximately 8 percent of the Company's total customers and 8.5 percent of the total Company load. Utah and Oregon are PacifiCorp's largest and second largest operations, respectively, followed by Wyoming. PacifiCorp's Idaho and California operations each are somewhat smaller than the Company's operations in Washington.

10 On March 18, 2005, PacifiCorp filed with the Commission its petition in Docket UE-050412 seeking approval for deferred accounting for excess power costs due to declining hydroelectric generation. On April 20, 2005, ICNU filed a petition to intervene in that docket. On May 3, 2005, Public Counsel filed a notice of intent to participate in the docket.

11 On May 5, 2005, PacifiCorp filed a general rate case with the Commission in Docket UE-050684, proposing revisions to its currently effective Tariff WN-U-74 and requesting an increase in annual revenues from Washington operations of $39.2 million, which would result in a proposed increase in rates of 17.9 percent.[1] The Commission suspended the tariff filing in Order 01 on May 24, 2005, to determine whether the proposed rates are fair, just, and reasonable. The stated effective date was April 4, 2006.[2]

12 On June 1, 2005, ICNU, the Energy Project, and NRDC filed petitions to intervene in the rate case proceeding, Docket UE-050684.

13 The Commission conducted a prehearing conference in Docket UE-050684 on June 6, 2005, before Administrative Law Judges Theodora M. Mace and Ann E. Rendahl. The Commission consolidated Dockets UE-050412 and UE-050684 for hearing and determination under WAC 480-07-320, and established a procedural schedule.

14 Staff, intervenors, and Public Counsel filed response testimony and exhibits on November 3, 2005. Staff proposed a decrease of $4.2 million from PacifiCorp's current annual revenues.[3] This equates to a $43.4 million reduction from the Company's initial revenue requirement request in this proceeding.[4] ICNU proposed adjustments to reduce PacifiCorp's requested increase in Washington revenues by $40.6 million, or a $1.4 million decrease to PacifiCorp's current

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[1] *See WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.*, Docket UE-050684, Complaint and Order 01 ¶ 1 (May 24, 2005).
[2] The Company agreed during hearing to waive the statutory deadline in Docket UE-050684 for two weeks, until April 18, 2006, to allow the Commission sufficient time to prepare an order.
[3] Exh. 631-T at 4 (Schooley); *see also* Exh. 531-T at 2 (Braden).
[4] On rebuttal and later in brief, the Company reduced its proposed revenue requirement to $32.6 million and $29.8 million, respectively.

revenue requirement.[5] Public Counsel's rebuttal calls for an $18.7 million reduction to the Company's revenue requirement request. This recommendation would allow PacifiCorp a $13.6 million increase in its revenue requirement.[6]

15 The Commission held a public comment hearing in Yakima, Washington, on December 1, 2006, before Chairman Mark H. Sidran, Commissioner Philip B. Jones, and Administrative Law Judge Ann E. Rendahl. Fourteen members of the public spoke at the hearing – all opposing the Company's proposed rate increase. Four of the fourteen speakers submitted written comments to supplement their oral comments opposing the rate increase. The Commission received 42 written comments about the proposed rate increase from Washington customers, with 38 comments opposing the increase, and four requesting a more gradual increase in rates.[7]

16 PacifiCorp filed rebuttal testimony on December 7, 2005, reducing its requested revenue requirement increase from $39.2 to $32.6 million. It also filed testimony jointly with NRDC proposing a decoupling mechanism. Public Counsel and Staff filed cross-answering testimony on December 7, 2005, addressing the proposed decoupling mechanism.

17 On January 9, 2006, the Commission convened a prehearing conference before Administrative Law Judges Theodora M. Mace and Ann E. Rendahl, who notified the parties the Commission would hear oral argument on January 11 concerning whether Commission approval of the proposed acquisition of PacifiCorp by the MidAmerican Energy Holdings Company (MEHC) would cause a material change

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[5] In brief, ICNU further reduced its recommendation to a $22.2 million decrease to PacifiCorp's currently approved revenue requirement.
[6] Public Counsel reduced its proposed revenue requirement on brief to a $4.5 million increase to PacifiCorp's currently approved revenue requirement. Exh. 291-T at 3:17–19 (Effron).
[7] *See* Exh. 721.

in PacifiCorp's capital structure and risk profile for purposes of the general rate case.[8]

18 Following oral argument, the Commission determined that the issues of ownership of the Company and the pending acquisition were material to determining a fair and just cost of capital for PacifiCorp in the rate case. The Commission found the existing record of pre-filed testimony and exhibits insufficient to determine the issues of cost of capital and capital structure. The Commission required the parties to supplement the record with respect to the impact of MEHC's possible acquisition of PacifiCorp on the cost of capital, either through live or filed testimony and exhibits.

19 The parties reached agreement on a revised procedural schedule, allowing parties to file supplemental testimony and exhibits, and modifying the hearing schedule. The Company filed testimony and exhibits with the Commission on January 19, 2006, and Staff and intervenors filed responsive testimony and exhibits on January 27, 2006.

20 The Commission conducted evidentiary hearings before Chairman Mark H. Sidran, Commissioner Patrick J. Oshie, Commissioner Philip B. Jones, and Administrative Law Judges Theodora M. Mace and Ann E. Rendahl on January 12, 13, 17, 18, 20, and 23, 2006, and February 2 and 3, 2006. The record in this proceeding, formally closed on February 21, 2006, includes testimony by 38 witnesses, more than 600 exhibits, and 13 transcript volumes including 1,735 pages of text.

[8] On May 23, 2005, in Docket UE-051090, ScottishPower and Pacific Holdings, Inc. (PHI), its wholly-owned subsidiary directly holding PacifiCorp's stock, reached agreement with MidAmerican Energy Holding Company (MEHC) allowing MECH to acquire PacifiCorp by purchasing all of its common stock. The Commission approved the acquisition on February 22, 2006, in the Final Order Approving and Adopting Settlement Stipulation, Order 07 in Docket UE-051090.

21 PacifiCorp, Staff, NRDC, ICNU, the Energy Project, and Public Counsel filed initial briefs on February 27, 2006. PacifiCorp, Staff, ICNU, and Public Counsel filed reply briefs on March 6, 2006.

II. Contested Issues

A. Inter-jurisdictional Cost Allocation Methodology

1. Overview

22 The primary issue in this proceeding is whether the Commission should approve PacifiCorp's proposed method for allocating costs across its six-state service territory. Allocating costs is a prerequisite to determining the revenue requirement to be borne by each state's ratepayers.

23 Since the merger of Pacific Power and Utah Power in 1988, representatives of the Company and the states have engaged in a series of discussions about the appropriate way to allocate the Company's costs and revenues across service territories. The most recent of these discussions is referred to as the Multi-State Process, or MSP,[9] which, like its earlier iterations, failed to bring the states and parties to an agreement on an appropriate allocation methodology. Over time, the Company has proposed a number of different cost allocation methodologies, but no agreement has been reached between all the states and parties.

24 The primary issue separating the states has been the proposed allocation of the Pacific Power states' lower cost resources to the higher cost Utah Power states, which would provide a disproportionate benefit to Utah Power ratepayers.[10] More

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[9] Exh. 1 at 26:8-9 (Furman).
[10] Pacific Power historically owned and relied on low-cost hydroelectric and other resources to provide power to states in its service territory: California, Oregon, Washington, and portions of Wyoming. The parties refer to this region as the Western control area. Conversely, Utah Power historically owned and relied primarily on higher-cost thermal resources to serve customers in its

recently, the allocation debate has included the related issue of how an allocation scheme would account for disparate growth in service territories. As states in the Eastern control area, particularly Utah, have experienced greater load growth than states in the Western control area, the Pacific Power states are concerned that some costs to serve the load growth in Utah would be shifted unfairly to the Western control area.

25 The Commission has not approved a methodology for allocating PacifiCorp's inter-jurisdictional costs and revenues to Washington since the merger with Utah Power and PacifiCorp. However, the Commission has approved settlements in Dockets UE-991832 and UE-032065, and allowed the Company to use a specific allocation method for the limited purpose of preparing reports or other filings that have not affected rates.[11]

2. The Revised Protocol

26 In this proceeding, PacifiCorp offers the PacifiCorp Inter-Jurisdictional Cost Allocation Protocol, or Revised Protocol, as the allocation methodology for use in Washington.[12] PacifiCorp asks that we adopt the Revised Protocol as developed through the consensus of a majority of states participating in the Multi-State Process.[13] Commissions in Idaho, Oregon, Utah, and Wyoming have approved the Revised Protocol, but only after applying a number of material conditions or modifications.[14]

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service territory: Idaho, Utah, and portions of Wyoming. The parties refer to this region as the Eastern control area.

[11] In those settlements, we note some or all parties agreed to apply an allocation method for the purpose of reaching settlement, and only for the purpose of the case. The parties have not agreed to any specific allocation method.

[12] Exh. 361-T at 2:10-13 (Taylor); *see also* Exh. 362, the Revised Protocol.

[13] Exh. 1-T at 26:7 – 27:9 (Furman).

[14] *Id.*, 27:9-13; Exh. 361-T at 3:11-14 (Taylor); Exh. 541-TC at 39:10-13, 41:10 – 43:10 (Buckley). Idaho and Utah both applied rate caps, and Oregon has required development of a fully functional Hybrid Method, with future rate filings made under both the Hybrid and Revised Protocol Methods.

27 The Revised Protocol is a method or plan for allocating "the costs and wholesale revenues associated with PacifiCorp's generation, transmission and distribution system" among the six states in PacifiCorp's jurisdiction for the purpose of setting retail rates.[15] It assumes an integrated six-state system in which customer loads are served from a common resource portfolio.[16] In fact, under the Revised Protocol, all states bear a rolled-in share of resources acquired to replace existing resources or to meet load growth.[17]

28 PacifiCorp commits in the Revised Protocol to plan and operate its generation and transmission system on an integrated systemwide basis to "achieve a least cost/least risk Resource portfolio for its customers."[18] If all the states follow the Revised Protocol, PacifiCorp asserts it will have a reasonable opportunity to recover all of its prudently incurred expenses and investments and earn its authorized rate of return.[19]

29 The Revised Protocol also includes several statements addressing state sovereignty:

- The assignment or allocation of costs "is not intended, and should not, prejudge the prudence of these costs";
- "Nothing in the Protocol shall abridge any State's right and/or obligation to establish fair, just, and reasonable rates based on the law of that State and the record established in rate proceedings conducted by that State," and;

[15] Exh. 362 at 2:11-13; *see also* Exh. 361-T at 2:13-16 (Taylor).
[16] Exh. 361-T at 15:15-17 (Taylor).
[17] Exh. 331-T at 23:14-16 (Duvall) A rolled-in method allocates systemwide all resources in the Company's service territory.
[18] Exh. 361-T at 2:16-18 (Taylor); Exh. 362 at 1:8-10.
[19] Exh. 361-T at 2:19-21 (Taylor); Exh. 362 at 1:11-14.

- While the Revised Protocol is intended to be enduring, a state will not be bound to the Revised Protocol if changed circumstances show that the results are no longer just, reasonable, and in the public interest.[20]

30 PacifiCorp represents that the Revised Protocol follows the conventional three-step process for allocating a utility's costs: functionalization, classification, and allocation.[21] PacifiCorp asserts this process "recognizes the way a utility provides electrical service and attempts to assign cost responsibility to the groups of customers for whom those costs were incurred."[22] In order to allocate system costs across the six states, the Revised Protocol first breaks down costs into three functional categories: generation, transmission and distribution. The Revised Protocol classifies costs as demand-related, energy-related (i.e., fuel costs), and customer-related. The allocation process then assigns demand, energy and customer-related costs among the states.[23] While there appears to have been no disagreement about the functional categories of costs, MSP participants disagreed about how to classify and allocate the costs.[24]

31 The Revised Protocol classifies 75 percent of fixed generation and transmission costs as demand-related and 25 percent of these costs as energy-related. The demand-related costs are allocated through the 12 coincident peak (12 CP) method, or demand factor.[25] The energy-related factor is simply Washington's share of annual system energy usage, i.e., based on Washington's percent of total system load.[26] PacifiCorp asserts the MSP chose this classification to "balance the

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[20] Exh. 362 at 1:14-2:5.
[21] Exh. 361-T at 14:13-19 (Taylor).
[22] *Id*., 14:16-19.
[23] *Id*., 14:20 – 15:13.
[24] *Id*., 14:20-22; 17:13-17.
[25] *Id*., 17:19 – 22:16. The 12 CP approach first identifies, for each month of the year, the hour of the greatest combined demand of all retail customers (i.e., the coincident peak). The proportion Washington contributed to the coincident peak for each of those 12 hours is determined. A simple average of Washington's proportional contribution to these 12 monthly system peaks establishes the state's demand factor. *Id*.
[26] *Id*., 22:18-22.

sharing of merger benefits among all the States," and "because it produced an overall cost allocation result that was acceptable to all the States."[27]

32 The Revised Protocol recognizes that distribution costs should be allocated solely to individual states, based on the location of distribution facilities.[28] The costs of transmission assets and firm wheeling expenses are classified as 75 percent demand-related and 25 percent energy-related and allocated similarly to costs of system generation resources.[29] Generation costs are allocated through five broad categories of costs: System Resources, Seasonal Resources, Regional Resources, State Resources, and Administration and General Costs. The Revised Protocol addresses these cost categories as follows:

- ***System resources*** are resources that are not seasonal, regional or state resources. The fixed costs of system resources are allocated 75 percent based on the demand factor and 25 percent based on the energy factor. Variable costs of system resources (fuel, non-firm contracts and other energy-related costs) are allocated using the energy factor.[30]
- ***Regional resources*** are owned Western control area hydro-electric facilities, mid-Columbia contracts, and contracts to replace the mid-Columbia contracts. Regional resource costs are allocated the same as system resource costs with one exception. After allocating costs on a system basis, the total normalized $/MWh (megawatt hour) costs of hydro-electric resources are compared to the normalized costs of the remaining generation. As hydro-electric resource costs are less expensive than other resources, the net difference is credited to the former Pacific Power jurisdictions and debited against other jurisdictions, using an embedded cost differential, or ECD.[31]

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[27] *Id.*, 17:4-12.
[28] *Id.*, 33:4-5. Special contracts are also allocated on a "situs" or location basis. *Id.*, 34:3-6.
[29] *Id.*, 32:20-23.
[30] *Id.*, 32:12-17.
[31] *Id.*, 26:6-21; 27:2-17.

- ***Seasonal resources*** are simple-cycle combustion turbines, seasonal contracts, Cholla Unit IV and the Arizona Public Service (APS) exchange. The costs associated with seasonal resources are also allocated 75 percent on a demand factor and 25 percent on an energy factor, except the demand factor is modified to account for the timing of the operation of seasonal resources relative to peak demand.[32] Variable costs are again allocated using each state's share of annual system energy usage.
- ***State resources*** are demand-side management programs, portfolio standards, and existing qualifying facilities (QF) contracts. To insulate states from policy decisions made by other states, the Revised Protocol provides for direct or "situs" assignment of the costs associated with demand-side management programs and portfolio standards.[33] Existing QF contracts are treated similarly to the Regional resources. After the initial allocation of costs is determined, the cost difference between each state's existing QF contracts and all other generation is calculated. An adjustment that reflects any cost difference is applied. New QF contracts are treated similarly to system resources.[34]
- ***Administrative and general costs***: Administrative and general expenses along with general plant, intangible plant, and other common costs are calculated using each state's proportional share of allocated and assigned plant investment, known as the system overhead factor.[35]

3. PacifiCorp on the Revised Protocol

33 PacifiCorp makes the following assertions in support of the Revised Protocol: (1) It is "a fully documented, exhaustively analyzed inter-jurisdictional allocation method that has already been approved as fair, just and reasonable by four other

[32] *Id.*, 23:19 – 26:1.
[33] *Id.*, 34:3 – 35:17. Situs means on site or where the plant is located.
[34] *Id.*, 27:19 – 28:14.
[35] *Id.*, 33:7-22.

jurisdictions";[36] (2) It represents a broad consensus among the states, is widely supported, is based on appropriate principles, and will provide substantial benefits to Washington ratepayers;[37] (3) Adopting the Revised Protocol is in the public interest, as the Company will be able to attract capital to make the necessary investments to minimize cost and risk to ratepayers,[38] and; (4) The Revised Protocol is consistent with the Commission's past decisions and industry standards.[39]

34 In support of the Revised Protocol, the Company provides its cost of service study, summaries of the cost of service for Washington, documents showing the classification and allocation of generation and transmission costs, as well as numerous reports comparing the revenue requirement impact of the Revised Protocol with prior allocation methods, such as the Hybrid Proposal and the Modified Accord.[40]

35 PacifiCorp asserts all states benefit from the integrated approach of the Revised Protocol through the physical flow of power from resource to load, as well as the economic management of generation and transmission assets and contracts to minimize cost to all customers.[41] The Company asserts that each resource provides benefits to the system through energy, reliability and economic value.[42]

36 The Company asserts that one benefit of an integrated system is the ability to transfer power "directly from resources in one control area to the other control area."[43] While the Company admits that its operations on a systemwide basis are limited by transmission constraints, it asserts it operates "on an integrated basis

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[36] Exh. 1-T at 16:22 – 17:1 (Furman).
[37] PacifiCorp Initial Brief, ¶¶ 15-20, 22.
[38] *Id.*, ¶ 11.
[39] *Id.*, ¶ 34; *see also* Exh. 371-T at 6:17 – 8:8 (Taylor).
[40] *See* Exhs. 333, 334, 336, 363, 364, 365, 367, 368, 369, 370.
[41] Exh. 371-T at 6:11-14 (Taylor).
[42] Exh. 341-T at 14:21-23 (Duvall).
[43] Exh. 331-T at 7:3-4, 19:16-20 (Duvall).

with two control areas," and dispatches power as a single system from a central location.[44] The Company also identifies, but does not quantify, other benefits of an integrated system: movement of power through the South Idaho Exchange contract, redispatching the system, the Bonneville peaking contract, and off-system or wholesale sales.[45]

37 PacifiCorp asserts that Washington benefits the most from the integrated systemwide approach of the Revised Protocol, as Washington receives 14 percent of "merger synergy" benefits under the Revised Protocol, while customers in the state represent only 8.5 percent of PacifiCorp's system.[46]

38 Relying on the Revised Protocol's integrated systemwide approach, its alleged benefits, prior Commission action and Staff's recommendations in a Joint Report, PacifiCorp asserts the prudence of a number of previously and recently acquired resources in the Eastern control area: Craig, Hayden, Cholla Unit 4, Foote Creek Wind Project, West Valley, Gadsby, Currant Creek, and several power purchase and generation agreements.[47] PacifiCorp requests the Commission find these resources prudently acquired, include them in rate base and allocate them through the Revised Protocol.[48]

39 Referring to the prudence "standard" prior to the Pacific Power/Utah Power merger and the Commission's decision in Cause U-86-02, PacifiCorp asserts the Commission "traditionally assessed prudence and cost allocation of new resources from a systemwide perspective."[49] PacifiCorp asserts the Staff recommended in a Joint Report on prudence of generating resources that Hayden, Craig, Cholla Unit 4 and Foote Creek were prudently acquired on a systemwide basis.[50] However,

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[44] *Id*., 3:20-22, 4:5-7.
[45] *Id*., 43:16 – 44:14; *see also* TR 664:13-665:3; 669:3-7; 685:3 – 686:14 (Duvall).
[46] Exh. 371-T at 28:16-22 (Taylor).
[47] Exh. 331-T at 30:9 – 33:3, 42:7-15 (Duvall); Exh. 338; Exh. 421-T (Tallman).
[48] Exh. 331-T at 36:23 – 37:8, 42:7 – 43:10 (Duvall); Exh. 421-T at 2:5-15 (Tallman).
[49] Exh. 331-T at 31:10-24 (Duvall).
[50] *Id*., 30:18-21.

PacifiCorp acknowledges that Staff did not determine whether the resources were acquired prudently to serve ratepayers in Washington.[51] PacifiCorp argues that assessing prudence from a state-specific basis is a new and higher standard for prudence, would be inconsistent with the Company's least cost planning process, is not required under the Revised Protocol, and would increase costs to Washington.[52]

40 PacifiCorp asserts the Eastside resources provide the following additional benefits to Washington ratepayers: peaking diversity; the potential to defer resource acquisition for the Western control area; greater access to wholesale markets; enhanced system reliability, and; enhanced flexibility in dispatching power.[53] PacifiCorp asserts the Eastside resources are used and useful as they serve customers by generating power and providing other systemwide benefits, although the Company cannot determine whether power actually flows from these resources to Washington customers.[54]

41 PacifiCorp also argues that all jurisdictions in PacifiCorp's service territory, except Idaho, have included these Eastside resources in rates, and that Idaho has implicitly found them prudent by ratifying the Revised Protocol. PacifiCorp asserts that, while not binding on Washington, the findings of other states "should be an indication that these resources have been found to be reasonable in cost and necessary to service the Company's retail customers, including those in Washington."[55]

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[51] *Id*., 30:21 – 31:7; Exh. 338 at 62.
[52] Exh. 331-T at 36:12-21 (Duvall).
[53] *Id*., 38:22 – 41:18, 42:17 – 43:2; *see also* Exh. 421-T at 7:5 – 9:17 [West Valley]; 20:1-8 [Gadsby] (Tallman).
[54] Exh. 331-T at 42:16 – 43:2 (Duvall); TR 786:14-25 (Widmer).
[55] Exh. 331-T at 37:11-19 (Duvall).

4. Party Positions on the Revised Protocol

42 In response to the Company's case concerning the Revised Protocol, Staff, ICNU and Public Counsel sponsored extensive testimony and exhibits. They recommend the Commission reject the Revised Protocol and develop a new allocation method, or in the alternative, modify the Revised Protocol for use only in this proceeding.[56]

43 Staff, ICNU, and Public Counsel assert the Revised Protocol is based on a false assumption that all resources in PacifiCorp's system are used to serve all customers on a unified, systemwide basis.[57] They assert the transmission constraints between the Eastern and Western control areas effectively prevent PacifiCorp from moving power from its generation resources in the East to the Western control area.[58] Staff also asserts that PacifiCorp applies its least-cost planning on a control-area, rather than a systemwide basis, contrary to the systemwide approach of the Revised Protocol.[59]

44 Staff, ICNU, and Public Counsel assert the Revised Protocol is not based on proper cost causation principles. They fault the Revised Protocol for automatically allocating, or shifting the burden of, new Eastside resources to all customers throughout the system, although PacifiCorp's documents demonstrate the resources were built to address rapid load growth in Utah and the Eastern control area.[60] Staff objects to the results-based analysis PacifiCorp uses to

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[56] Exh. 541-TC at 146:18 – 147:15, 160:1 – 162:4 (Buckley); Exh. 491-TC at 39:15 – 40:15, 43:6 – 44:9 (Falkenberg); Exh. 461-T at 17:5 – 20:26 (Lott); Exh. 471-T at 43:16 – 45:22 (Black).
[57] Exh. 541-TC at 8:17 – 9:4 (Buckley); Exh. 491-TC at 35:13 – 39:21 (Falkenberg); Exh. 471-T at 31:12 – 32:5 (Black).
[58] Exh. 541-TC at 61:10 – 65:17 (Buckley); Exh. 491-TC at 35:13 – 39:21 (Falkenberg); Exh. 471-T at 35:16 – 41:2 (Black); Public Counsel Initial Brief, ¶ 105.
[59] Exh. 541-TC at 77:9 – 78:5 (Buckley).
[60] *Id.*, 46:14-16, 97:11 – 118:8; Exh. 461-T at 22:23 – 23:11 (Lott); Exh. 491-TC at 11:19 – 15:6, 28:1 – 30:6 (Falkenberg).

support the Revised Protocol, in particular results based on future revenue requirement assumptions that may not be correct.[61]

45 Staff, ICNU, and Public Counsel contest whether recently acquired Eastside resources are prudent for, or will be used by, Washington customers. Public Counsel asserts the manner in which PacifiCorp evaluated candidate resources, i.e., on a stand-alone basis, using commodity valuation measures, is inappropriate for making decisions about adding resources to a vertically-integrated utility.[62] Staff and ICNU suggest the Company must make an affirmative showing that these resources are used and useful in Washington before they may be included in Washington rate base.[63]

46 As an alternative to the Revised Protocol, Staff recommends adopting its "Amended Revised Protocol" only for the purpose of this proceeding. Staff proposes adjustments that would: Exclude the costs of certain new Eastside resources (Adj. 5.4); Reflect Washington's appropriate share of costs and benefits from the Mid-Columbia contracts (Adj. 5.5); Remove costs associated with certain seasonal contracts (Adj. 5.6); Modify how the Revised Protocol treats QF contracts (Adj. 5.7), and; Modify the allocation factor for administrative and general costs.[64] If we reject the Revised Protocol and Staff's Amended Revised Protocol, Staff recommends we reject the tariffs, as filed, in this proceeding.[65]

47 As its alternative, ICNU proposes two options for modifying the Revised Protocol: (1) Use the Multi-state or Pre-Merger ECD Credit to assign and allocate pre-merger resources to Western states, and; (2) Adjust the Revised Protocol by removing Currant Creek, treating new QF contracts like existing QF contracts, and reversing the production factor adjustment.[66] Public Counsel does not propose any

[61] Exh. 541-TC at 47:6 – 52:2 (Buckley).
[62] Exh. 471-T at 3:14-27:23 (Black).
[63] Exh. 541-TC at 198:9 – 201:19 (Buckley); Exh. 491-TC at 35:13 – 39:21 (Falkenberg).
[64] Exh. 541-TC at 159:18 – 162:4 (Buckley).
[65] *Id*., 184:3-10.
[66] Exh. 491-TC at 40:2 – 48:23 (Falkenberg).

specific adjustments to the Revised Protocol, but recommends we direct the parties to create a portfolio approach based on proper cost causation for former Pacific Power states, for the Western control area, or for Washington State.[67]

5. Discussion and Decision

48 In setting rates, we must follow certain statutory standards. In particular, we must regulate in the public interest, ensuring that rates or charges for services rendered by the public utility are just, fair, reasonable and sufficient.[68] When a company files a request to increase rates or charges, it bears the burden of proof to show the increase is fair, just and reasonable.[69] In determining the fair value of company property for rate making purposes, i.e., establishing the appropriate rate base, we must determine whether the property is "used and useful for service *in this state*."[70]

49 We find, based on the discussion below, that PacifiCorp has not met its burden of proof to show that resources allocated to Washington in the Revised Protocol are "used and useful for service in this state" or that the Revised Protocol meets statutory standards. We reject the Revised Protocol as an inter-jurisdictional cost allocation method for use in this state. Finally, we provide guidance to the parties for presenting an acceptable cost allocation method for approval.

50 Under our governing statutes, we must find a resource to be used and useful in this state before its costs[71] may be recovered in rates. We interpret the phrase "used and useful for service in this state" to mean benefits to ratepayers in Washington, either directly (e.g., flow of power from a resource to customers) and/or indirectly

[67] Exh. 461-T at 20:15-26 (Lott).
[68] RCW 80.01.040; RCW 80.28.010; RCW 80.28.020.
[69] RCW 80.04.130.
[70] RCW 80.04.250 (emphasis added).
[71] "Costs" include expenditures needed to operate the facility, depreciation and a return on the investment.

(e.g., reduction of cost to Washington customers through exchange contracts or other tangible or intangible benefits).

51 Under either circumstance, the Company must demonstrate a quantifiable benefit to Washington ratepayers. When a facility is actually used to provide service, its costs and benefits can be readily identified and allocated appropriately. The same cannot be said for resources that do not provide direct service or only have occasional or potential value to Washington ratepayers. While such resources may still be compensable under our statutory scheme, they require more complex analysis, which must consider and quantify any indirect benefit[72] sought to be recovered in rates.

52 We find the Company has not sufficiently demonstrated either the direct or indirect benefits to Washington of its integrated systemwide resources. Without such proof, we cannot conclude that PacifiCorp's integrated resources are "used and useful for service in this state."

53 The Company bases its "benefits" analysis and the Revised Protocol on the fundamental premise that the Company operates as an integrated six-state system. The evidence in the record demonstrates that resources recently acquired in Utah were purchased or built to serve the increasing load in Utah and the Eastern control area[73] and that there are significant transmission constraints impeding the exchange of power between the Western and Eastern control areas.[74] The Company responds to questions regarding the benefits of these investments for Washington, not with quantitative evidence of the benefits, but with unsubstantiated broad statements about the potential to move power through the South Idaho Exchange contract, the opportunity to redispatch power, the availability of the Bonneville peaking contract to serve the Western control area,

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[72] Indirect benefits include avoided costs, off-system sales revenues or other systemwide benefits.
[73] Exhs. 422, 423, 424C, 425C, 426C, 427, 428C, 429C, 430C, 431, 432, 433C, 434C, 435C, 436C, 437C, 438C, 439C, 545, 547, 548, 549, 550.
[74] PacifiCorp Reply Brief, ¶ 6; *see also* Exh. 331-T at 3:21 (Duvall).

the possibility of off-system or wholesale sales revenues, the potential to defer resource acquisition for the Western control area, and the enhancement of system reliability.[75]

54 While Staff concedes that some indirect benefits of integration exist[76] – the Company has simply failed to establish the value of any tangible benefits flowing to Washington ratepayers. The Company's position is most plainly stated in the testimony of Mr. Duvall: "The Revised Protocol does not require that we demonstrate a "State-specific" benefit for particular resources before they can be recovered in a particular State's retail rates."[77] The Revised Protocol may not require such a showing, but Washington law does.

55 In addition, PacifiCorp asserts that we can look to other states' determinations of prudence of Eastside resources as our basis for determining that the acquisitions were "reasonable in cost and necessary to serve retail customers across the system and in Washington."[78] We cannot delegate our statutory responsibilities for determining prudence and protecting the interests of Washington ratepayers to other states or to a cost allocation formula that does not comport with the requirements of our governing statutes.

56 The Company claims that it is entitled to full recovery of its prudently incurred costs systemwide and should not bear the risk that state decisions about cost recovery will not, in combination, ensure this entitlement.[79] The Company points to no provision of law in support of this proposition. In fact, the Company created and accepted the risk that divergent allocation decisions among the states might result in under-recovery when it chose to merge 20 years ago. Our order

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[75] Exh. 331-T at 38:22 – 41:18, 42:17 – 43:2, 43:16 – 44:14 (Duvall); Exh. 421-T at 7:5 – 9:17 [West Valley]; 20:1-8 [Gadsby] (Tallman); *see also* TR 664:13 – 665:3; 669:3-7; 685:3 – 686:14 (Duvall).
[76] TR 941:9-11, 946:15-21, 947:10 – 949:2 (Blackmon); TR 1011:16 – 1012:12 (Buckley).
[77] Exh. 331-T at 32:21-23 (Duvall).
[78] *Id.*, at 37:11-19.
[79] Exh. 1-T at 28:15-19 (Furman); PacifiCorp Initial Brief, ¶¶ 11-12.

approving that merger read together with the merger order of the Oregon Commission make clear that this risk existed, that the Company was aware of it, and that the Company accepted that it alone would bear the risk:[80]

> Pacific agrees, however, that its shareholders will assume all risks that may result from less than full system cost recovery if interdivisional allocation methods differ among the merged company's jurisdictions.

Further, the Company admits in the Revised Protocol that it bears the risk of inconsistent allocation methods adopted by the states.[81] In short, any claim of entitlement to a uniform allocation methodology among the states is inconsistent with the "deal" the Company agreed to in the merger.

57 The Company argues that the Commission has already determined an integrated systemwide cost allocation, citing to the Commission's 1986 order in the Company's last fully-litigated general rate case in Washington.[82] There, having found that the Company and representatives of the six states then in Pacific Power's service territory had reached a consensus on allocation, the Commission stated, "As the Company provides electric service to customers in six states

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[80] *In the Matter of the Application of PacifiCorp and PC/UP&L Merging Corp. for an Order Authorizing the Merger of PacifiCorp and Utah Power & Light Company into PC/UP&L Merging Corp. (to be Renamed PacifiCorp upon Completion of the Merger), and Authorizing the Issuance of Securities, Assumption of Obligations, Adoption of Tariffs, and Transfer of Certificates of Public Convenience and Necessity, Allocated Territory, and Authorizations in Connection Therewith*, Public Utility Commission of Oregon Docket UF 4000, Order 88-767 at 6 (July 15, 1988); s*ee also In the Matter of the Application of PacifiCorp (Maine) to Merge with PC/UP&L Merging Corp. (PacifiCorp Oregon), and to Issue such Securities and Assume such Obligations as May be Necessary to Effect a Merger with Utah Power & Light Company*, WUTC Docket U-87-1338-AT, Second Supplemental Order Approving Merger with Requirements at 14 (July 15, 1988).
[81] Exh. 362 at 15:6-7.
[82] Exh. 331-T at 31:17-24 (Duvall), quoting *WUTC v. Pacific Power & Light Co.*, Cause U-86-02, Second Supplemental Order at 33 (Sept. 19, 1986); *see also* PacifiCorp Initial Brief, ¶ 34.

including Washington, the Company's joint facilities must be allocated to each of the states."[83]

58 The Company's reliance on this citation is misplaced and overlooks the Commission's fundamental premise—facilities must serve and be found to provide quantifiable benefits before costs can be allocated to ratepayers. Recognizing the need for allocation is not the same as determining *how* the allocation should be made. Nothing in our prior orders suggests we have accepted an allocation method that does not meet the statutory used and useful "in this state" standard. As made clear above, the Company has not demonstrated in this proceeding that all of the resources used in its current six-state system are, in fact, "joint" facilities, used and useful for service in this state.

59 Finally, the Company represents the Revised Protocol as a "consensus" proposal, and requests Washington to join the other states and approve it. We value cooperation between, and comity with, our sister states, but on close examination we find the Company's claims of consensus curious.

60 Utah, Idaho and Oregon have all imposed conditions in "adopting" the Revised Protocol. Utah and Idaho have imposed rate caps, limiting the impact of the Revised Protocol on ratepayers.[84] While adopting the Revised Protocol, Oregon required the Company to file its next rate case under both the Revised Protocol and a Hybrid Model, which would allocate the costs and benefits of Western control area hydroelectric resources to the Western control area. Oregon reserved the right to adopt the Hybrid Model if the results of the Hybrid Model proved more favorable to Oregon ratepayers. This is no surprise—each Commission must fulfill its responsibilities to its citizens and its state laws. The reservations of the

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[83] *WUTC v. Pacific Power & Light Co.*, Cause U-86-02, Second Supplemental Order at 33 (Sept. 19, 1986).
[84] Exh. 1-T at 27:9-13 (Furman); Exh. 361-T at 3:11-14 (Taylor); Exh. 541-TC at 39:10-13, 41:10 – 43:10 (Buckley).

states adopting the Revised Protocol make clear that there is no lasting "consensus," but rather an accommodation to resolve the pending case.

61 We reject Staff's and ICNU's alternatives to the Revised Protocol for the same reasons we reject the Revised Protocol. Staff's and ICNU's proposals remove certain resources and revise certain calculations in the Revised Protocol as temporary "fixes", but there remains the fundamental question: Whether the resources allocated to Washington can be shown to be "used and useful for service in this state." Staff's and ICNU's good faith "guesstimates" fail to meet this test. The currently effective rates were established using an allocation method agreed to through settlement in Docket UE-032065. Without proof from the Company that the current rates are insufficient, and without an acceptable allocation methodology, we have no justifiable reason to replace one temporary fix with another.

62 In the final analysis, the Company has failed to carry the burden it alone bears to prove that resources in its Eastern service territories, remote from Washington, provide tangible and quantifiable benefits to customers "in this state" as required by RCW 80.04.250.[85]

63 In setting rates that are fair, just, reasonable and sufficient, we must balance the interests of the public, i.e., the ratepayers, and the utility.[86] Because we find the Company has not met its burden to show that the resources included in the Revised Protocol are used and useful for service in this state, we find the Company has not met its burden to show that the rates proposed in this proceeding would be fair, just and reasonable.

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[85] To the contrary, the unrebutted evidence shows that since the merger of Pacific Power and Utah Power, the rates for Utah customers have decreased while the rates for Washington customers have increased, despite a rapid increase in demand in Utah and substantial investments in Utah to serve that demand. *See* Exh. 764, Tables 1 and 2; Exh. 765. The Company has not explained how such evidence demonstrates the benefits to Washington of an integrated systemwide allocation of costs.

[86] *POWER v. Utilities & Transp. Comm'n,* 104 Wn.2d 798, 808, 711 P.2d 319 (1985).

64 The Company bases its entire general rate case in this proceeding on the Revised Protocol. Without a method to allocate costs (rate base and expenses) to Washington, we are not able to establish whether the proposed rates would be fair, just or reasonable, and reject the Company's tariffs, as filed.

65 Without further demonstration from the Company, the existing rates established in Docket UE-032065 are deemed fair, just, reasonable and sufficient for both the ratepayers and the Company.[87]

66 While we cannot determine new base rates for the Company in this proceeding, either by determining a new rate base or new levels of expense, we provide guidance to the parties on contested issues, where the issues involve matters of policy, accounting rules, or theory. We address these contested issues in Sections D and E, below, in the interest of providing guidance in the event PacifiCorp files a rate case in 2006, as it has stated on the record. Where contested issues are based solely on the Revised Protocol or matters of calculation, however, we cannot resolve the issues, and do not address them here.

67 Similarly, we also provide the parties guidance in developing an appropriate allocation method for Washington. First and foremost, any inter-jurisdictional cost allocation method we approve for Washington must meet our statutory requirement that all public utility property included in rates must be used and useful for service in this state.[88]

68 We reject Staff's argument that the Company must demonstrate each resource in the system provides a direct benefit, i.e., electron flow, to be considered used and useful for service in this state. We find, however, that the Company must demonstrate tangible and quantifiable benefits to Washington of resources in the system before we will include the resources in rates. The test for including a

[87] *See* RCW 80.04.150.

resource in rates is not whether it is "needed, deliverable and least cost" but rather whether it provides quantifiable direct or indirect benefits to Washington commensurate with its cost.[89]

69 The Company can demonstrate this through historical system operation or modeling of the system showing that Eastside plant costs added to Washington rates would be offset by reductions to other cost categories (e.g., power costs), such that overall costs to Washington ratepayers would be no more than without the Eastside resources.

70 We understand that developing a cost allocation methodology for Washington will require some work on the part of the Company. We believe the additional work we are requesting is similar to what the Company has committed to develop in the Hybrid Model for Oregon, and therefore not unduly burdensome. While there is not enough evidence in this record to allow us to base an allocation method on the Hybrid Model, we believe that model holds promise. Consistent with the Hybrid Model, we expect the Company to include the full value of hydroelectric resources in the Western control area in any inter-jurisdictional cost allocation model it develops for Washington.

B. Power Cost Adjustment Mechanism (PCAM) Proposal

71 PacifiCorp includes a proposed power cost adjustment mechanism, or PCAM, as a part of its general rate case. In arguing the need for a PCAM, PacifiCorp asserts: 1) It has not recovered from ratepayers $1.9 billion in net power costs systemwide, undermining its ability to earn its authorized rate of return;[90] 2) The PCAM would allow full recovery of net power costs;[91] 3) A PCAM would benefit customers by

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[88] *See* RCW 80.04.250.
[89] Once a decision is made to include the cost of a resource in rate base, the "need, deliverability and least cost" criteria come into play. They help determine whether a portion or all of the cost of a resource is included in rate base.
[90] PacifiCorp Initial Brief, ¶ 49; Exh. 1-T at 19-21 (Furman).
[91] Exh. 1-T at 19-21 (Furman).

improving the Company's credit quality and lowering the cost of borrowing money; 4) Major credit agencies impute debt on long-term purchased power agreements, and having a PCAM in place would reduce the risk of a credit downgrade,[92] and; 5) A PCAM would give customers better price signals to respond to higher power costs.[93]

72 PacifiCorp asserts that as the only investor-owned electric utility in Washington without a power cost adjustment mechanism, its shareholders shoulder more risks from net power costs than shareholders of other Washington utilities.[94] Net power costs may vary due to factors outside of the Company's control: volatile wholesale market prices, hydro conditions, the timing of forced outages, wheeling; purchased power expenses, and fuel costs. PacifiCorp asserts that all elements of net power costs are interrelated and should be recoverable in a PCAM.[95]

1. PacifiCorp's Proposal

73 PacifiCorp purports to have modeled its PCAM after Avista's proposed revised energy recovery mechanism, or ERM, in Docket UE-050482.[96] PacifiCorp's proposed PCAM would defer recovery of 90 percent of any difference between allowed and actual net power costs, with shareholders absorbing or benefiting from the remaining 10 percent difference.[97] PacifiCorp defines "net power costs" as all fuel, wheeling and purchase power expenses, offset by revenues from wholesale electricity and natural gas sales.[98]

[92] Exh. 381-T at 1-10 (Omohundro); Exh. 383-T at 1-8 (Omohundro); Exh. 5-T at 9-11 (MacRitchie); *see also* PacifiCorp Initial Brief, ¶ 51.
[93] Exh. 381-T at 8 (Omohundro).
[94] Exh. 391-T at 30 (Widmer). Avista has the energy recovery mechanism (ERM), and Puget Sound Energy has a power cost adjustment (PCA); *see also* PacifiCorp Initial Brief, ¶ 44.
[95] PacifiCorp Reply Brief, citing Exh. 398-T at 15-16 (Widmer).
[96] Exh. 383-T at 4:14-16 (Omohundro); TR 539:21 – 540:16; 542:10-19 (Omohundro).
[97] All (100 percent) of cost variations associated with qualifying facility (QF) contracts would be recovered from customers.
[98] Exh. 391-T at 34:17-34:2 (Widmer).

74 The proposed PCAM does not include a deadband, i.e., a range of power costs for which shareholders, not consumers, bear the risk or receive the benefits from power cost variation. It includes an adjustment similar to Avista's "retail revenue adjustment" for revenue changes due to load increases or decreases.[99] Power cost deferrals are calculated on a total company basis. After applying the Revised Protocol's allocation factors, Washington's share would be subject to deferral and potential future recovery in customer rates.[100]

75 On a monthly basis, PacifiCorp proposes to calculate Washington-allocated net power costs and post to a balancing account any positive or negative difference from baseline power costs. A positive balance represents money ratepayers owe to the Company, while a negative balance represents money the Company owes to ratepayers. The balance would accrue interest at the Company's authorized rate of return.[101]

76 When the balance reaches plus or minus $ 5 million, the Company proposes to return the negative balance to customers or recover the positive balance from customers over a one-year amortization period, restarting the balancing account.[102] Surcharges or surcredits would be spread to all customers on a uniform cents-per-kilowatt-hour basis.[103]

77 The PCAM also includes an earnings demonstration component. If the Company's actual rate of return during the deferral period is above authorized levels, the Company would not recover the deferred costs. If the Company's actual rate of return falls below authorized levels, the Company would not be required to return deferred balances to customers.[104]

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[99] *Id.*, 29-36.
[100] Exh. 331-T at 27-29 (Duvall).
[101] Exh. 391-T at 33:21 – 34:4 (Widmer).
[102] *Id.*, 34:7-15.
[103] *See* proposed Schedule 99 of the proposed tariff sheets for WN-U-74, filed with the Commission on May 5, 2005.
[104] Exh. 391-T at 36:9-12 (Widmer).

2. Positions of the Parties

78 Staff, Public Counsel and ICNU all oppose the Company's proposed PCAM, disputing both the need and the methodology.

79 Staff characterizes the PCAM proposal as extreme and premature. Staff commits to work with the Company to develop a workable PCAM after the Commission approves a cost-allocation method.[105] As a matter of policy, Staff asserts there is no need to ensure that utility power cost adjustment mechanisms "are equal, either in approach or implementation," noting that mechanisms should "recognize the specific characteristics of each utility's system."[106]

80 Public Counsel asserts the proposed PCAM is not in the public interest, as it does not follow the Commission's guidance on such mechanisms.[107] Public Counsel argues the proposed PCAM is not understandable to customers, as it is based on costs within PacifiCorp's control: There is no external event a customer can look to as a reason for price increases.[108]

81 ICNU, responding to PacifiCorp's claim that the PCAM is necessary to increase its opportunity to earn its allowed rate of return, asserts that an allowed rate of return is merely an opportunity for the Company to earn the return, not a guarantee.[109] ICNU asserts the proposed PCAM is so fatally flawed it will harm Washington ratepayers.[110]

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[105] Staff Initial Brief, ¶¶ 92-93, 100; Staff Reply Brief, ¶ 78.
[106] Staff Initial Brief, ¶ 100.
[107] Exh. 461-T at 44-50 (Lott).
[108] Public Counsel Initial Brief, ¶ 128.
[109] ICNU Initial Brief, ¶¶ 34, 41, ¶ 36, citing *WUTC v. Timberland Tel. Co., et al.*, Cause U-75-56, U-7569, and U-75-74, Third Supplemental Order at 11 (Aug. 16, 1976).
[110] ICNU Initial Brief, ¶¶ 34, 41.

82 ***Need.*** Staff, Public Counsel and ICNU assert the Company has not demonstrated the need for a PCAM. Staff asserts the market price volatility of the energy crises in 2000-2001 has lessened.[111] Like Staff, ICNU asserts the Company has not shown a need to address price volatility, or that actual power cost fluctuations continue to occur after the 2000-2001 energy crises.[112] Public Counsel and ICNU argue that PacifiCorp's regular requests for rate increases since 2000 and statements it will file another rate case during the summer of 2006 reduce the regulatory lag, weighing against the need for a PCAM.[113]

83 ***Revised Protocol.*** Staff and ICNU also fault the PCAM for relying on the Revised Protocol, asserting this inappropriately shifts costs of load growth in Utah to Washington ratepayers.[114] Staff and Public Counsel also argue the Commission cannot approve a PCAM without a cost allocation method in place sufficient to determine the actual costs attributable to Washington ratepayers or to design a reasonable power cost adjustment mechanism.[115]

84 ***Risk Sharing.*** Staff and ICNU claim the proposed 90/10 sharing band is insufficient compared to the sharing bands in a PCAM PacifiCorp recently agreed to in Wyoming.[116] Staff and ICNU also assert the lack of a deadband and the 90/10 sharing mechanism would not provide incentives to minimize power costs.[117] Staff asserts the PCAM does not appropriately share the risk of variation in power costs because normalized power supply costs in base rates reflect most, though not all, variation in water conditions, fuel prices and market prices.[118]

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[111] Staff Initial Brief, ¶ 93.
[112] *Id*., ¶¶ 37-38; ICNU Reply Brief, ¶¶ 20, 22.
[113] Public Counsel Initial Brief, ¶ 138; ICNU Initial Brief, ¶ 40.
[114] Exh. 541-TC at 190:16 – 191:6 (Buckley); Staff Initial Brief, ¶ 80; ICNU Initial Brief, ¶¶ 41-43.
[115] Staff Initial Brief, ¶¶ 86-87, citing TR 531:15-19 (Omohundro); Public Counsel Initial Brief, ¶ 124; Public Counsel Reply Brief, ¶ 54.
[116] Exh. 541-TC at 190-96 (Buckley); Staff Initial Brief, ¶ 100; Staff Reply Brief, ¶¶ 81-84; ICNU Initial Brief, ¶¶ 47-48.
[117] ICNU Initial Brief, ¶¶ 47-48.
[118] Staff Initial Brief, ¶ 93; Staff Reply Brief, ¶¶ 88-89.

Staff also asserts the PCAM should not be used to protect shareholders from volatile power costs due to load growth or participation in the wholesale market.[119]

85 Public Counsel asserts the PCAM does not compensate ratepayers for the shifting of risk. Like Staff and ICNU, Public Counsel criticizes the proposal for not including a deadband or including a reduction in the Company's rate of return.[120]

86 ***Power costs.*** Staff, Public Counsel and ICNU object to the PCAM including all net power costs, as well as variable costs for new generation, rather than including only those costs out of the Company's control.[121] Staff acknowledges that short-term day-to-day wholesale transactions are necessary to balance the system. However, Staff objects to PacifiCorp's reliance on long-term wholesale transactions, which increase exposure to net power costs.[122] Public Counsel claims that allowing the Company to recover such costs may create perverse incentives.[123] ICNU asserts the Company does not provide sufficient operational details to justify approving a PCAM, as the Company has not defined the costs eligible for the PCAM.[124] Public Counsel claims the proposed PCAM does not reflect the total cost of transmission required to provide service to customers. Under the proposal, costs may be deferred even if the total cost of service per unit did not increase.[125]

87 ***Incentives.*** Public Counsel objects to the PCAM including long-term contracts with embedded cost increases, asserting this creates an incentive to invest in contract resources, even if cost increases are likely.[126] Public Counsel also asserts

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[119] Exh. 541-TC at 187-190 (Buckley); *see also* Staff Initial Brief, ¶ 94.
[120] Public Counsel Initial Brief ¶ 133, citing Exh. 461 at 49-50 (Lott); Public Counsel Reply Brief, ¶ 53; ICNU Initial Brief, ¶ 49.
[121] Exh. 541-TC at 186:12-15; 191:8-17 (Buckley); Public Counsel Initial Brief, ¶ 132; ICNU Initial Brief, ¶¶ 49-51.
[122] Staff Initial Brief, ¶ 95.
[123] Public Counsel Initial Brief, ¶ 132.
[124] Exh. 491-T at 49 (Falkenberg); ICNU Initial Brief, ¶¶ 49-51; ICNU Reply Brief, ¶ 21.
[125] Public Counsel Initial Brief, ¶ 129.
[126] *Id.*, ¶ 135.

the Company should address employee incentives to lower power costs before implementing a PCAM, e.g., Integrated Resource Plans (IRPs), resource acquisitions and energy risk management.[127]

88 ***PacifiCorp's Response.*** PacifiCorp asserts Commission approval of the Revised Protocol would remove the primary objection of Staff and intervenors to the PCAM.[128] PacifiCorp rejects Staff's and Public Counsel's criticism of the Company's reliance on the wholesale market, asserting wholesale market purchases are necessary and account for only a small portion of the volatility of net power costs.[129] PacifiCorp rejects Staff's assertion that normalization methods will ensure the Company is made whole in the long run, claiming it is never made whole.[130]

89 Finally, in response to claims that the energy crises are over and there is no need for a PCAM, PacifiCorp asserts there continues to be substantial market price variability, citing $197 million in unrecovered net power costs in the year ending September 30, 2005.[131]

3. Discussion and Decision

90 Having established power cost adjustment mechanisms for Avista and PSE, we are prepared to consider one for PacifiCorp, but find the current proposal inadequate.

91 Previously, we have observed that a properly designed mechanism should address the following principles:

- The purpose is to recognize variability in the cost of operating *existing* power supply resources as a result of abnormal weather conditions that are

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[127] Exh. 471-T at 46-54 (Black); *see also* Public Counsel Initial Brief, ¶¶ 139-51.
[128] PacifiCorp Initial Brief, ¶ 52.
[129] *Id*., ¶ 53.
[130] *Id*., ¶ 55.
[131] *Id*., ¶ 54; PacifiCorp Reply Brief, ¶ 16, citing Exh. 398-T at 8:18, 10:6-10 (Widmer).

out of a utility's control. Ratepayers understand the connection between weather and rates;[132]

- Power cost adjustment mechanisms are *short-run* accounting procedures to address *short-run* cost changes resulting from unusual weather;[133]
- It is not appropriate to include new resources in a power cost adjustment mechanism. New resources must be considered in general rate cases or power cost only rate cases;[134]
- Ratepayers should receive the benefit of a reduction in cost of capital, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders,[135] and;
- Power cost adjustment mechanisms should not interfere with least cost planning, conservation or other regulatory goals.[136]

The application and appropriateness of these principles must take into account the specific circumstances facing the utility. We agree with Staff that all power cost adjustment mechanisms for Washington utilities need not be the same.

92 PacifiCorp asserts it needs the PCAM to address the volatility of power costs. However, the record does not show that current power cost volatility is due to extraordinary events. Unlike the PSE and Avista power cost adjustment mechanisms, which were designed, in part, to address changes in power costs due

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[132] *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); *WUTC v. Avista Corp.,* Dockets UE-991606 & UG-991607, Third Supplemental Order at 50, 52 (Sept. 2000).
[133] *Petition of Washington Water Power for PCA Mechanism*, Docket U-88-2363-P, First Supplemental Order Denying Petition at 8 (Sept. 1989); *WUTC v. Avista Corp.*, Dockets UE-991606 & UG-991607, Third Supplemental Order at 50, 52 (Sept. 2000).
[134] *WUTC v. Puget Sound Power & Light Co.*, Docket U-81-41, Sixth Supplemental Order at 22 (Dec. 1988) (PSE ECAC).
[135] *WUTC v. Puget Sound Power & Light Co.*, Docket U-81-41, Sixth Supplemental Order, (Dec. 1988) at 20 (PSE ECAC); *Petition of Washington Water Power for PCA Mechanism*, Docket U-88-2363-P, First Supplemental Order Denying Petition at 8 (Sept. 1989); *WUTC v. Avista Corp.*, Dockets UE-991606 & UG-991607, Third Supplemental Order at 50, 52 (Sept. 2000).
[136] *WUTC v. Puget Sound Power & Light Co.*, Docket U-81-41, Sixth Supplemental Order at 23 (Dec. 1988) (PSE ECAC).

to the unprecedented volatility in energy markets during 2000-2001, the proposed PCAM is not tailored to address short-run cost changes due to extraordinary or unusual events.

93 Other significant differences between PacifiCorp's proposed PCAM, and those in place for Avista and PSE include:[137]

- PacifiCorp does not include a deadband, while both Avista's ERM and PSE's PCA include deadbands and significant sharing bands;
- PacifiCorp appears to exclude only fixed power costs due to new generation from the PCAM, while Avista excludes transmission wheeling revenue and expenses, as well as the return on new owned generation. PSE excludes long-term contracts greater than two years and new owned generation, and;
- Only PacifiCorp's PCAM includes an earnings test, limiting Company recovery if the actual rate of return is greater than authorized, and limiting distribution to customers if the actual rate of return is less than authorized.

In considering these differences, we note that PacifiCorp is less reliant on hydroelectric power than Avista and PSE, which may suggest a differently structured PCAM.

94 We note that PacifiCorp has filed power cost adjustment mechanisms with varying risk sharing features in at least four other states in its service territory: California, Oregon, Utah, and Wyoming.[138] PacifiCorp's PCAM in Oregon does not include a deadband, but includes two sharing bands, such that customers bear 70 percent of costs up to $100 million, and 90 percent of costs over $100 million. PacifiCorp asserts these sharing bands are appropriate, as the Company has the option of

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[137] *See* Exhs. 759, 761, and 762 (PacifiCorp, Staff, and Public Counsel responses to Bench Request 23).
[138] Exh. 755, PacifiCorp's Response to Bench Request 22, Attachment 22-1; *see also* Exh. 381-T at 7:15 – 8:3 (Omohundro); TR 534:4-9 (Omohundro).

annually resetting its net power costs on a forecast basis through a Transition Adjustment Mechanism.[139]

95 PacifiCorp recently agreed to, and the Wyoming Commission recently approved, a revised PCAM for PacifiCorp as a part of a rate case settlement. PacifiCorp's Wyoming-revised PCAM includes a deadband of $40 million above and below the base, as well as three significant sharing bands.[140]

96 In addition to the principles we have stated previously, we observe that power cost recovery mechanisms should also apportion risk equitably between ratepayers and shareholders. In striking that balance, we consider risks already allocated through the normalization process, a utility's financial condition and other circumstances affecting a utility's ability to recover its prudent expenditures. Deadbands and sharing bands are useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs.

97 Generally, the design of a sharing mechanism is an important factor in our consideration of whether a reduction in the cost of capital should accompany approval of the mechanism. We will consider the need for a reduction in the cost of capital as a part of the overall analysis of how the mechanism shifts risks between investors and ratepayers.

98 Finally, because we reject the Revised Protocol, there is no allocation methodology to establish base line costs for a PCAM. PacifiCorp admits an allocation method is necessary before implementing a PCAM.

99 In sum, we reject the proposed PCAM for three reasons: 1) It should focus on short-term costs subject to market volatility or other extraordinary events that are beyond the Company's control, and should not include costs for new generation;

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[139] Exh. 755, PacifiCorp's Response to Bench Request 22, Attachment 22-1; *see also* TR 562:22-24 (Omohundro).
[140] *Id*., PacifiCorp's 1st Supplemental Response to Bench Request 22.

2) The 90/10 sharing band and the absence of a deadband do not adequately balance risks and benefits between shareholders and ratepayers, and; 3) An acceptable allocation methodology is a prerequisite to establishing a PCAM.

100 We encourage the Company to work with Staff and intervenors to develop a PCAM in line with the discussion above. Following discussions with Staff and intervenors, the Company may submit a revised PCAM proposal either as a stand-alone tariff filing or as a part of a general rate case.

C. PacifiCorp and NRDC's Joint Proposal for a Decoupling Mechanism

1. Overview

101 Under traditional rate regulation, a utility's rates are calculated by dividing the test year revenue requirement by the expected sales for the test year. The utility recovers its fixed and variable costs from the revenues derived from these rates. If sales fall below test year levels, revenues could decline which may compromise the utility's ability to recover its fixed costs.

102 The central goal of conservation is to encourage customers to reduce energy use. As a result, a utility engaging in conservation will likely see its sales and revenues fall, exposing it to the risk of being unable to recover its fixed costs. Because shareholders bear the burden of any shortfall in revenues, they may be reluctant to aggressively pursue energy efficiency measures.[141] Decoupling is a way to break the link between a utility's revenues and retail sales levels, and to reduce the utility's risk associated with recovering its fixed costs when retail sales decrease due to customer conservation.

2. Decoupling Proposal

103 In this proceeding, PacifiCorp and NRDC jointly propose a three-year pilot decoupling mechanism with the following features:[142]

- **Segregating the fixed cost revenue requirement from the variable cost requirement.** The Company's fixed cost revenue requirement for distribution, transmission and generation would be separated from its variable cost revenue requirement.[143]

- **True-up mechanism.** After determining the utility's fixed cost revenue requirement, the Commission would determine a fixed cost revenue requirement per customer to serve as a benchmark to determine the difference between actual and authorized revenue recovery.[144] Over-recoveries and under-recoveries would be posted to a balancing account and subject to an annual true-up. By customer class, over-recoveries would be refunded to ratepayers and under-recoveries would be charged to ratepayers. The pilot proposal permits only a 2 percent fluctuation in rates per year, with residual account balances carried forward to the next true-up filing.[145]

- **Weather risk excluded.** Retail sales would be adjusted for weather-driven fluctuations before calculating the true-up.[146]

- **Three-year pilot/independent assessment.** The true-up mechanism would operate for three years, after which an independent organization selected by Staff and the Company would assess the program.

- **Tariff filing.** The Company would make a tariff filing of the true-up mechanism.

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[141] NRDC witness Ralph Cavanagh testified that more than 60 percent of the Company's proposed revenue requirement in this case represents fixed costs of distribution, transmission and generation ($154.8 million out of $257.4 million). Exh. 671-T at 3-4 (Cavanagh).
[142] *See* Exh. 671-T (Cavanagh); *see also* Exh. 681-T (Omohundro / Cavanagh); TR 1066-1151 (Cavanagh/Omohundro).
[143] Exh. 672.
[144] The proposal pertains only to residential and small commercial customer classes.
[145] Exh. 671-T at 16 (Cavanagh).
[146] *Id*.; TR 1126-27 (Cavanagh).

- **Wholesale sales impact.** The independent assessment would include a review of the impact of the Company's wholesale sales on cost recovery.

3. Response to Decoupling Proposal

104 Staff and Public Counsel oppose the decoupling proposal.[147] ICNU and the Energy Project are silent on the issue.

105 Staff opposes the joint proposal because it fails to: 1) Provide detailed tariffs or accounting rules governing the operation of the true-up mechanism; 2) Quantify the effect the mechanism may have on risks associated with recovery of fixed costs,[148] and; 3) Identify or commit to any new demand-side management benefit for ratepayers to compensate for shifting the risk of conservation to them. Staff objects to including generation and transmission fixed costs that are subject to the Company's Revised Protocol allocation methodology. Staff also asserts the Company is currently capturing all cost-effective conservation measures in its Integrated Resource Plan and receiving adequate compensation for any reduction in retail sales through revenues derived from its wholesale sales.

106 Public Counsel faults the proposal for many of the same reasons identified by Staff, and further asserts the proposal: 1) Changes ratemaking from a cost-based approach to one tying revenues to the number of customers served; 2) Fails to recognize the windfall to the Company if the potential for profit from wholesale sales is not taken into account,[149] and; 3) May not be compatible with the PCAM proposed by the Company.[150]

107 NRDC responds that all fixed costs – distribution, generation and transmission – must be included in the mechanism or the Company risks excluding from

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[147] Staff Initial Brief at 32-34; Public Counsel Initial Brief at 51-59; *see also* Exh. 701-T (Steward) and Exh. 691-T (Lazar).
[148] Mr. Lazar echoes Staff's concern and recommends a 2 percent reduction in cost of equity if decoupling is permitted. *See* Exh. 691-T at 20-21.
[149] *Id*., 30; Exh. 694; Public Counsel Initial Brief at 56.
[150] Public Counsel Initial Brief at 59; Exh. 1-T at 24 (Furman).

protection half its fixed costs. NRDC asserts the mechanism is independent of the chosen method of allocating costs among jurisdictions. NRDC also asserts current favorable wholesale market conditions will not always provide a potential for profit, and the mechanism's 2 percent cap on rate fluctuation makes a reduction to the cost of equity unnecessary.[151]

4. Discussion and Decision

108 We favor utility efforts that accomplish cost-effective conservation through reducing utility costs and allowing consumers to manage their bills.[152] A well-designed decoupling mechanism may support the Company's increased investment in energy conservation and promote our state's goal of furthering energy conservation. We must reject the specific joint proposal offered by the Company and NRDC, however, for the following reasons: 1) We cannot calculate the mechanism's fixed cost revenue requirement without first having adopted an allocation methodology sufficient to make rates;[153] 2) The proposal lacks important analysis of implementation costs and its impact on the Company's overall revenues and cost of equity, and; 3) The Company has failed to identify and commit to incremental conservation measures as a counterbalance to its potential reduction in risk. We expect the Company to provide such evidence to allow us to fully consider a decoupling proposal.

109 If PacifiCorp seeks approval of a decoupling mechanism in a future filing the Company should include, at a minimum, the following detailed information:

- The scope of risk to be covered by the mechanism – conservation, weather, or both;
- The scope of fixed costs included;

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[151] NRDC Initial Brief at 1-4.
[152] *Natural Gas Decoupling Rulemaking*, Docket UG-050369, Summary, Analysis of Comments and Decision to Close Docket without Action at 10 (Oct. 17, 2005).
[153] See our discussion concerning the Revised Protocol, *infra*.

- The customer classes to be included and whether the baseline would be on an individual or class basis;
- Complete detail of the accounting for and calculation of any true-up;
- Rate of return implications;
- Method of cost recovery;
- Design of pilot test period and evaluation of the mechanism before determining whether to make it permanent;
- Timing and calculation of rate adjustments;
- Impact of new customers on revenue recovery under the mechanism;
- Impact of the mechanism on low-income customers;
- Identification of incremental conservation measures expected to be undertaken, and;
- Development of a target for energy conservation to be achieved through this mechanism relative to the baseline conservation programs currently in rates and the Company's Integrated Resource Plan.

110 We urge the Company to work cooperatively with Staff, Public Counsel and other intervenors to develop a more detailed, comprehensive proposal that meets these criteria. We also encourage the Company and other parties to consider whether one of the approaches identified by Public Counsel would achieve these objectives.[154]

D. Contested Adjustments to Net Operating Income/Revenue Requirement

111 PacifiCorp proposes a number of adjustments to its test year revenues, expenses and rate base.[155] Staff, Public Counsel and ICNU contest some of these and propose others. In addition, the Energy Project proposes changes to how the Company funds and implements its low-income assistance program. Given our rejection of the Revised Protocol allocation methodology, we cannot resolve these

[154] Exh. 691-T at 32 (Lazar).
[155] Exh. 193, Tabs 3-8.

contested issues.[156] Similarly, we reject the Net Power Cost Stipulation between PacifiCorp and ICNU as moot because the Company failed to justify use of the Revised Protocol as a means to make adjustments to Washington's share of the Company's power costs. However, in the interest of providing guidance for future PacifiCorp rate cases, we address certain contested issues below where the issues involve matters of policy, accounting rules, or theory.

1. Temperature Normalization Stipulation (Adj. 3.1)

112 Electric utilities in Washington have traditionally used a base temperature of 65°F to derive weather-related adjustments to customer energy use. PacifiCorp's initial filing proposed a weather normalization adjustment using base temperatures of 55°F, 65°F and 68°F, claiming that this approach better captures transitions in customer energy use.[157] While Staff initially recommended the Commission reject the Company's weather normalization proposal,[158] Staff and the Company reached a settlement on the issue. On January 30, 2006, the Company and Staff filed a Stipulation on Temperature Normalization Adjustment.[159]

113 The stipulation has two basic parts. The first part addresses the revenue requirement associated with this case. The parties agreed to a $1 million increase in the Company's revenue requirement deficiency and provided the calculations to incorporate this change in the Company's revenue requirement.[160]

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[156] We do not address the following adjustments, contested or agreed to, in this order: Out of Period Adjustment (Adj. 3.8), Scottish Power Cross Charge (Adj. 4.13), Remove Naches O & M (Adj. 4.20), West Valley Lease – MEHC Adjustment (Adj. 4.21), A&G Stretch – MEHC Adjustment (Adj. 4.23), Property Tax Expense (Adj. 7.2), Renewable Energy Tax Credit (Adj. 7.3), IRS Settlement (Adj. 7.4), and State Income Tax Calculation (Public Counsel Adj. C).

[157] *See* Exh. 261-T (Klein).

[158] *See* Exh. 581-T at 2-9 (Mariam).

[159] *See* Exh. 593.

[160] *Id.*, ¶ 6.

114 The second part of the stipulation addresses future temperature normalization filings by the Company. First, PacifiCorp agrees to a number of refinements to the temperature normalization methodology it plans to include in its next general rate case filing.[161] Second, the Company agrees to promptly begin collaborative discussions with interested parties to work towards an agreement on gathering hourly temperature data in Washington. The Company also agrees to begin collecting Washington-specific load data in 2006.[162]

115 No party, other than Staff and PacifiCorp, addresses the issue of temperature normalization or the proposed stipulation.[163]

116 ***Discussion and decision.*** The temperature normalization stipulation provides that "*for the purposes of this proceeding*, the revenue requirement impact of weather normalization shall be an increase of one million dollars ($1,000,000) in the Company's revenue requirement deficiency."[164] Given our decision concerning the Revised Protocol, and the effect of that decision on the overall revenue requirement determination for the Company, the stipulation's revenue adjustment is moot.

117 However, the stipulation demonstrates the parties are making progress towards developing a mutually-acceptable temperature normalization methodology. We are encouraged about refinements to PacifiCorp's methodology agreed to in the stipulation and the commitment to begin collaborative discussions with interested parties on this issue. Such an agreement is in the public interest. Therefore, we approve paragraph 7 of the stipulation, attached to this order as Appendix 1, in which the parties agree to an interim solution for the next rate case and agree to

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[161] *Id*.
[162] *Id*., ¶ 7 b, c.
[163] Neither ICNU nor Public Counsel directly address this issue in briefs. However, they appear to support the stipulation entered into between Staff and PacifiCorp. *See* ICNU Initial Brief at 4-5; Public Counsel Initial Brief, ¶ 166.
[164] Exh. 593, ¶ 6 (emphasis added).

work towards a longer term solution for a temperature normalization methodology.

2. Capital Stock Expense Amortization (Adj. 4.1)

118 Capital stock issuance expenses, or flotation costs, are "additional costs, such as legal, accounting, and underwriting fees" that are part of the cost of issuing common equity. These expenses may be included in rates so that "the actual proceeds of the issuer of the common stock will be whole with the price of the stock to the public."[165]

119 In this case, PacifiCorp proposes to amortize $4.1 million of stock issuance expenses accumulated up to 1998, or, alternatively, to increase the cost of equity by 13 basis points.[166] As none of the expenses were included in the test period for this case, Staff opposes including these expenses in rates because doing so would constitute retroactive ratemaking.[167] Staff also contends the expenses are non-recurring, the Company will not incur flotation costs in the future, and PacifiCorp has recovered the expenses, to some degree, in prior rate cases.[168]

120 Public Counsel opposes amortization, arguing that amortizing stock issuance expenses is prohibited under the Uniform System of Accounts and the proper way for the Company to recover the expenses is through an adjustment to its authorized return on equity.[169]

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[165] Exh. 195-T at 21-22 (Wrigley).
[166] *Id*.
[167] Staff Initial Brief at 57.
[168] *Id*.; Staff Reply Brief at 42.
[169] Public Counsel Initial Brief at 20-21.

121 The Company asserts that amortization is used to recover bond issuance expenses and that little, if any, stock issuance expense has already been recovered in rates.[170]

122 ***Discussion and decision.*** We reject the Company's proposal either to capitalize or to amortize capital stock issuance expenses. The Uniform System of Accounts requires such expenses to be capitalized, rather than amortized.[171] This required treatment constrains us from adopting the Company's amortization adjustment. While, in some circumstances, we have permitted adjustments to a Company's cost of equity to reflect issuance expenses or flotation costs,[172] we cannot do so in this case because PacifiCorp did not incur such expenses in the test year, nor does the Company expect to incur such expenses in the future. Moreover, the Company admits that portions of these expenses already have been recovered. Allowing an adjustment to the cost of equity in this case would lead to the Company recovering some portion of these expenses twice.

3. Wages and Benefits (Adj. 4.10)

123 This group of adjustments addresses issues of incentive pay, pension contributions, the discount rate to be applied to pension and post-retirement accounts, the level of co-pays for health benefits and the escalation rate for medical benefit costs. Because we reject the Revised Protocol, we have no basis for allocating the expenses associated with wages and benefits or for adjusting rates in this case. However, we provide guidance to the parties on two of the issues: 1) The principles we will use in considering recovery of incentive pay and

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[170] Exh. 195-T at 23 (Wrigley); PacifiCorp Initial Brief at 29.
[171] Bond issuance costs are amortized as an interest expense under the Uniform System of Accounts, not as an operating expense. Capital stock issuance costs are booked to Account 214, which does not provide for amortization. Staff Reply Brief at 41.
[172] We allowed the addition of 25 basis points to Avista's cost of equity to recover flotation costs. *WUTC v. Avista Corp.*, Docket UE-991606, Third Supplemental Order ¶ 358 (Sept. 29, 2000). However, as Staff notes, Avista issues common stock on a recurring basis. Staff Reply Brief at 42.

2) The appropriate discount rate to apply to pension and post-employment benefits.

a) Incentive Pay

124 Companies provide incentive pay as an addition to base pay if the employee meets certain specified company goals. PacifiCorp includes approximately $33.3 million in incentive compensation in its pro-forma test year expenses.[173] PacifiCorp's Annual Incentive Plan applies to over 3,000 employees and its Performance Unit Plan applies to 186 higher level employees.[174] Each plan contains the same components and targets, but payment under the Performance Unit Plan is in stock.

125 PacifiCorp asserts the base pay it offers is competitive, but is only one element of compensation. The Company contends that over 90 percent of companies combine base pay and incentive pay in compensation packages to attract talented employees, and PacifiCorp must follow suit.[175]

126 Staff objects to PacifiCorp's incentive payments in either plan that relate to meeting financial targets, claiming that such payments should be borne by shareholders because they provide no benefit to ratepayers. Staff also opposes all stock incentive payments made under the Performance Unit Plan, on grounds that stock payments are inherently tied to meeting financial targets rather than to benefiting ratepayers.[176]

127 Public Counsel and ICNU support disallowing some or all costs for incentive plans, asserting the Company has not shown them to benefit ratepayers and that the Company currently provides competitive salaries.[177]

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[173] Exh. 193, Tab 4, 4.10.5; Exh. 301-T at 15-16 (Selecky).
[174] PacifiCorp Initial Brief at 21; Exh. 631-T at 19-23 (Schooley); Exh. 301-T at 15-16 (Selecky).
[175] PacifiCorp Initial Brief at 21-22.
[176] Staff Initial Brief at 58-60.
[177] Public Counsel Initial Brief at 21-22; Exh. 291-T at 16-17 (Effron); ICNU Initial Brief at 54.

128 ***Discussion and decision.*** Generally, we require that an incentive payment plan provide benefits to ratepayers. Under some circumstances, we have allowed in rates payments under plans that have a dual benefit – to shareholders and ratepayers.[178] We also will permit payments in stock, depending on the overall nature of the plan and whether there are benefits to ratepayers in terms of attracting good management for the company.[179] The ultimate issue is whether total compensation is reasonable and provides benefits to ratepayers, not whether incentive compensation is paid in stock or whether compensation, particularly for executives, is similar to that of other comparable companies.

b) Discount Rate for Pension (FAS 87) and Other Post-employment Benefits (FAS 106)

129 PacifiCorp's total actual pension expense for 2005 is $49,854,892 pursuant to Financial Accounting Standard (FAS) 87.[180] ICNU proposes a total system FAS 87 expense of $41.1 million. ICNU calculates its proposed expense level using a discount rate of 6.25 percent, while PacifiCorp uses a rate of 5.75 percent.[181] ICNU contends the higher discount rate correlates better with Dr. Hadaway's projection of significant interest rate increases.[182] Dr. Hadaway projects a 90-basis point increase in current Treasury security rates from 4.3 percent to 5.2 percent. ICNU asserts, in this light, a 50-basis point increase in the discount rate applied to pension expense is justified. ICNU proposes calculating other post-employment benefit expenses under FAS 106 using the same 6.25 percent discount rate.

[178] *WUTC v. Puget Sound Energy, Inc.*, Dockets UG-040640, UE-040641, UE-031471, UE-032043, Order 06 at 55, ¶ 144 (Feb. 15, 2005).
[179] *WUTC v. Avista Corp.*, Dockets UE-991606 & UG-991607, Third Supplemental Order ¶ 260 (Sept. 29, 2000).
[180] PacifiCorp initially proposed to use a rounded number of $49.9 million for this expense but agreed instead to use the slightly lower, actual number. *See* Exh. 237-T at 1 (Rosborough). Similarly, the Company accepts Staff's reduction of FAS 106 expenses to $24,026, 898.
[181] ICNU Initial Brief at 52-53.
[182] Dr. Hadaway is the Company's cost of capital witness.

130 The Company asserts the calculation of the discount rate that applies to these expenses is governed by Financial Accounting Standards Board (FASB) rules. These rules require "use of current interest rates in effect at the measurement date for the specific calculations being performed."[183] The test year for FAS 87 and FAS 106 expenses is calendar year 2005, and the Company uses December 31, 2004, as a measurement date.[184] The Company also points out that the FASB rules require the Company's accounting firm to approve the discount rate used and that its firm, PricewaterhouseCoopers, analyzed several interest rate indices and concluded that none of them supported a rate higher than 5.75 percent.[185]

131 ***Discussion and decision.*** We find the Company is correct in calculating FAS 87 and FAS 106 expenses. We expect that, barring a change in the accounting rules, the Company should continue to use the method employed in this case. The FASB rules constrain us from accepting ICNU's discount rate to calculate such expenses because it is a projected rate without support from the Company's accounting firm.

4. Remove RTO Expense (Adj. 4.19)

132 PacifiCorp included in its test year expenses amounts relating to its participation in efforts to form a Regional Transmission Organization (RTO), in the Pacific Northwest, including Grid West and RTO West. ICNU and Staff recommend removing these expenses from test year operating expenses.

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[183] Exh. 237-T at 1-4 (Rosborough). Mr. Rosborough states that a common proxy for discount rates used to calculate pension expense is the Moody's Corporate AA bond. As of December 31, 2004, that rate was 5.66 percent, lower than the 5.75 percent used by the Company. Also, other reporting companies used a rate between 5.75 percent and 6 percent. Only 10 percent of reporting companies were higher than 6.1 percent.

[184] *Id*.

[185] *Id.; see also* PacifiCorp Initial Brief at 22; Exh. 239.

133 Staff removes most, if not all, RTO development expenses from the Company's test year as unjustified, because: [186]

- No RTO is operating in Washington;
- An RTO is not necessary for PacifiCorp to fulfill its transmission obligations under FERC or state regulation;
- Expenses devoted to developing an RTO are therefore in excess of what is necessary and have not been proven by the Company to benefit customers or improve reliability, and;
- RTO expenses in the test year are unnecessary and should be disallowed.[187]

134 ICNU recommends removing certain amounts from test year expenses and moving them to a deferral account to be considered for inclusion in rates, if and when an RTO ever becomes operational and can be shown to provide benefits to Washington customers.[188] In support of its adjustment, ICNU argues:

- No RTO is currently operating and providing benefits to Washington;
- The Company has not shown that customers benefit from these expenses or that an RTO would be in customers' best interests;
- FERC is no longer requiring RTOs;
- RTO development is not necessary for the Company to fulfill its transmission and planning responsibilities, and;
- An RTO in the Pacific Northwest is less likely today than ever before because BPA is no longer participating in Grid West.[189]

135 PacifiCorp opposes both Staff's proposal to exclude RTO-related costs and ICNU's approach to defer the costs for future consideration. The Company asserts that as a major transmission provider in the Pacific Northwest, it must engage in on-going efforts to improve transmission planning and management to ensure reliable and cost-effective service to customers and to preserve the value of its

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[186] Exh. 621-T at 21:19 – 22:11 (Ward).
[187] Staff Initial Brief at 63-64.
[188] Exh. 301-T at 22:15 – 23:2 (Selecky).
[189] ICNU Initial Brief at 55-57.

transmission assets. The Company also asserts that no party has argued it is imprudent for the Company to participate in these efforts. PacifiCorp claims its expenses are ordinary, necessary and reasonable and should be recoverable in rates. The Company further claims that Federal Energy Regulatory Commission (FERC) rules require that the Company engage in these efforts. Even if the current Grid West efforts fail, the Company argues it will need to continue joint efforts with other transmission providers to plan and operate the region's transmission system.[190]

136 ***Discussion and decision.*** As a general rule, expenses for RTO-development are ordinary, necessary and reasonable so long as the expenses are incurred to fulfill the utility's obligation to operate and invest in facilities necessary to serve the public. No party has argued that it was, or is, imprudent for PacifiCorp to explore forming an RTO. Developing an RTO—or any transmission management entity—for the Pacific Northwest has been a long and contentious process, but that does not mean it is an unimportant or unnecessary effort. PacifiCorp correctly points out that its far-flung transmission system comes with important obligations and leadership responsibilities. It is generally acknowledged by regional utilities, customers and government leaders that the Pacific Northwest could benefit from improvements in transmission planning, expansion, reliability and management. PacifiCorp has an important role to play in those discussions, regardless of whether a new entity like Grid West results. Subject to an approved inter-jurisdictional cost allocation it would be appropriate for the Company to recover its RTO-related expenses in rates as ordinary, necessary and reasonable costs.

5. Malin Midpoint Adjustment (Adj. 7.5)

137 This issue concerns the regulatory treatment and ratemaking impact of a tax-basis sale and leaseback transaction on a transmission line between Malin, Oregon, and Midpoint, Idaho. In 1981, Pacific Power entered into a Safe Harbor Lease with Amoco under Section 168(f)(8) of the Internal Revenue Code, in which Pacific

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[190] PacifiCorp Initial Brief at 23-25.

Power "sold" the transmission line to Amoco for $44 million, representing the present value of tax benefits (accelerated depreciation and investment tax credits).

138 Since the 1981 transaction, the Commission has consistently ordered the $44 million be amortized above-the-line as an operating expense over 30 years (the life of the asset) and unamortized payments be deducted from rate base.[191] The Company has consistently challenged this treatment since 1982.[192]

139 In this case, Staff again recommends amortizing the $44 million payment, and reducing rate base by the unamortized amount. Staff's adjustment would increase operating expenses by $151,400, reduce rate base by $1.644 million and reduce the revenue requirement by $460,418.[193] The Company, on the other hand, imputes the income tax benefits from investment tax credits and accelerated depreciation associated with the transaction by decreasing operating expense by $156,972, increasing rate base by $582,789, and increasing the revenue requirement by $350, 703.[194]

140 The Company contends Staff's treatment violates the Internal Revenue Code and constitutes a double recovery because Staff amortizes the gain and reduces the rate base. The Company asserts it must normalize the underlying tax benefits in order to properly account for the transaction, citing an IRS private letter ruling which holds that proceeds of a sale/leaseback must be subject to tax normalization rules.[195]

141 Staff views the 1981 transaction as a "sale" of the asset for tax-law purposes only.[196] Staff claims that since the Company sold the asset for "tax-basis" purposes, PacifiCorp retains nothing, including depreciation, related to the asset's

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[191] Exh. 601-T at 21-32 (Kermode); *see also* Exhs. 607, 608 and 609.
[192] Exh. 281-T at 4-5 (Elliott).
[193] Exh. 601-T at 36-38 (Kermode).
[194] Exh. 191-T at 22 (Wrigley).
[195] Exh. 282.
[196] Staff Reply Brief at 48.

"tax-basis" to normalize.[197] Staff further asserts there is no double recovery because investors did not provide the gain on the sale. The rate base reduction is required to assure that investors do not earn a return on capital they did not provide.[198] Finally, Staff contends its approach was confirmed in a 1985 decision of the Ninth Circuit Court of Appeals and a FERC decision involving a similar PacifiCorp transaction.[199] In its decision, FERC rejected the Company's arguments that normalization was required and rejected the private letter ruling, noting that "private letter rulings do not qualify as generally applicable agency policy."[200]

142 ***Discussion and decision.*** We affirm our earlier decisions on this issue and direct the Company to adopt amortization, as proposed by Staff, as the proper regulatory treatment of the gain from the Malin Midpoint transaction**.** The Ninth Circuit Court of Appeals and FERC have confirmed that amortization is appropriate and that the private letter ruling on which the Company continues to rely is not controlling.

6. WAPA Contract (ICNU Adj. 1.4)

143 In 1962, Utah Power entered into an 80-year, fixed-rate contract with the U.S. Bureau of Reclamation (later the Western Area Power Administration (WAPA)), to wheel power over the Company's transmission system. In 1983, the Utah Commission found the contract was not compensatory due to the absence of price escalators and ordered an imputation of revenues. ICNU recommends this Commission now make the same adjustment.[201]

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[197] *Id.*, 49.
[198] *Id.*, 49-50.
[199] *Papago Tribal Utility Authority v. FERC*, 773 F 2d. 1056, 1062-1065 (9th Cir. 1985) cert. denied, 475 U.S. 1515 (1986); *see also In re PacifiCorp*, Docket No. AC91-110-001, Order Denying Rehearing, 81 FERC ¶ 61,225 at ¶¶ 61, 951-952 (Nov. 18, 1997).
[200] 81 FERC ¶ 61,225 n.6.
[201] *See* Exh. 491-T at 75-76 (Falkenberg).

144 PacifiCorp asserts WAPA has very limited flexibility under this contract. This results in short-term transmission marketing opportunities for PacifiCorp. The Company asserts it is not appropriate to impute revenue additions or deductions for any contract 43 years after it was signed.[202] PacifiCorp notes that Utah and Oregon no longer impose a revenue adjustment for the WAPA wheeling contract.[203]

145 ***Discussion and decision.*** We find it difficult to assess the prudence of a contract 43 years after it was signed. The circumstances facing utility decision-makers in 1962 were very different than those facing utility managers today. At a minimum, we would need substantial evidence that the utility acted imprudently at that time, based on what it knew or should have known. ICNU fails to provide such evidence. Nor do we find compelling the argument that simply because another Commission made an adjustment 22 years ago, albeit only temporarily, that we should do the same. The Company asserts it is not appropriate to impute revenue additions or deductions for any contract 43 years after it was signed.[204] We agree.

7. Federal Income Tax Interest Dividend (Public Counsel Adj. I)

146 In its initial filing, PacifiCorp removes from operating deductions an amount for "Interest and Dividends (AFUDC Equity)".[205] This adjustment increases taxable income and income tax expense. Public Counsel asserts the amount has been improperly used in the calculation of the state and federal income taxes.[206] The Company agrees it has included this cost in its tax calculation, but asserts the expense is offset by the same amount included in its "Schedule M" adjustment.[207]

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[202] Exh. 191-T at 26-28 (Wrigley).
[203] PacifiCorp Initial Brief, ¶ 78.
[204] Exh. 198-T at 26-28 (Wrigley).
[205] Exh. 193 at 2.22.
[206] Public Counsel Initial Brief at 24.

147 ***Discussion and decision.*** As this adjustment is not dependent on the Revised Protocol or any other allocation method, we decide this issue on the merits. We reject Public Counsel's adjustment as unnecessary. The Company's theory and practice of calculating federal income taxes on this issue is appropriate. The Company offsets the expenses in its tax calculation by including the same amount in its Schedule M adjustment.

8. Consolidated Tax Adjustment (ICNU Adj. 1.8)

148 ICNU proposes an adjustment to reduce by approximately $7.9 million the revenue PacifiCorp collects from ratepayers to cover state and federal income taxes. The adjustment is designed to protect customers from paying rates that include amounts for tax that ICNU asserts are never paid to the government because of an offsetting deduction associated with debt interest.

149 In support of its proposed adjustment, ICNU states PacifiCorp is a wholly-owned subsidiary of PacifiCorp Holdings, Inc. (PHI), a non-operating, direct, wholly-owned subsidiary of the British utility holding company ScottishPower. According to ICNU, ScottishPower designed the PHI corporate structure to minimize income taxes on the taxable income of PacifiCorp and other PHI affiliates. ICNU asserts ScottishPower capitalized PHI with an inter-company acquisition loan between ScottishPower and PHI, which PHI used to acquire ScottishPower's shares of PacifiCorp. ICNU asserts PHI pays interest on the acquisition loan and deducts the interest on its income tax filings, allowing PHI to avoid or significantly reduce the amount of state and federal income taxes paid on the profits generated from PacifiCorp's regulated utility operations.[208]

150 ICNU argues that if the income tax deduction associated with PHI's interest payments is not reflected in PacifiCorp's revenue requirement, customers will pay in rates an amount for taxes that is more than PacifiCorp's and PHI's actual tax

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[207] PacifiCorp Initial Brief at 55.
[208] Exh. 301-T at 17:3-13 (Selecky).

liabilities.[209] According to ICNU, such a result violates cost of service ratemaking principles and provides PHI with excessive compensation for its investment in PacifiCorp.[210] ICNU asserts its recommended adjustment need not consider any of the tax effects of losses incurred by any of PHI's non-regulated subsidiaries and that the tax deduction on which ICNU's recommended adjustment is based is permanent and does not give rise to deferred taxes.[211] ICNU acknowledges that PacifiCorp ratepayers do not pay the interest expense of PHI's loan in their cost of service.[212]

151 ICNU calculates the magnitude of its recommended adjustment based on the outstanding loan balance of $2.375 billion, an interest rate of 6.75 percent, and a composite state and federal tax rate of 37.95 percent. According to ICNU, these factors produce a deductible interest tax benefit of $60.8 million per year, 94.72 percent of which is associated with regulated utility operations. ICNU claims that 8.2 percent of this benefit should be allocated to Washington, reducing Washington's allocated tax expense by $4.726 million and Washington's revenue requirement by $7.967 million.[213]

152 The Company argues ICNU's position is unsupported by the facts, and the underlying philosophy—that customers should benefit from deductions arising from costs not borne by customers—represents a new policy for the Commission. Moreover, the Company asserts such a policy would change the risks associated with PacifiCorp's Washington operations and require an upward adjustment in the Company's return on equity.[214]

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[209] *Id.,* 18:10-14.
[210] *Id.,* 20:12-18, 21:4-7.
[211] *Id.,* 19:23 – 20:7.
[212] *Id.,* 20:19-22.
[213] *Id.,* 18:1 – 19:9. ICNU's adjustment accomplishes this by increasing net operating income (NOI) by $7.9 million to offset taxes that would otherwise be collected in rates.
[214] Exh. 5-T at 17:22 – 18:20 (MacRitchie).

153 PacifiCorp asserts ICNU's adjustment is inconsistent with tax accounting for businesses that file on a consolidated basis because the tax liabilities of each business are calculated separately and losses or deductions contributed by one business do not permanently reduce the tax liability of another.[215] According to Mr. Martin, the Company's witness on this issue, the interest tax deduction at PHI does not produce excess earnings for PHI because PHI, and not customers, pays the interest expense.[216] Mr. Martin asserts ICNU's adjustment violates principles of cost causation because customers have not borne the cost of the interest payments that give rise to the tax deduction. This, according to Mr. Martin, also violates the benefit/burden principle that customers are only entitled to benefits from an action if they have borne the cost or risks of that action.[217]

154 In addition, Mr. Martin claims that to reach tax benefits associated with consolidation, ICNU's adjustment "breaches" the ring fence designed to insulate customers from unregulated activities and puts customers at risk of exposure to liabilities from unregulated activities.[218] According to Mr. Martin, ICNU's adjustment to current expense is actually offset by an increase in deferred taxes and related reduction to rate base. Consequently, Mr. Martin argues that ICNU's adjustment constitutes double-counting: a reduction in current tax expense and a reduction in the ability to pay deferred taxes when they become due.[219] Finally, Mr. Martin offers an alternative calculation to correct errors he asserts exist in ICNU's calculations. He offers this calculation as the basis for an adjustment if the Commission disagrees with the Company's position that such an adjustment is not justified. Mr. Martin's alternative calculation yields a revenue requirement reduction of $3.145 million.

155 ICNU argues that the Company's objections to ICNU's adjustment are attempts to "obfuscate and distract the Commission." ICNU asserts extending the

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[215] Exh. 181-T at 4:19 – 7:5 (Martin)
[216] *Id.,* 7:11-20.
[217] *Id.*, 8:11 – 12:7.
[218] *Id.,* 14:4 – 15:4.

benefit/burdens test as proposed by the Company would grant its shareholders a windfall, and would be contrary to the principle that ratepayers should only be charged for reasonable and prudent costs incurred in providing service.[220]

156 In supplemental testimony focusing on the effects a change in PacifiCorp ownership might have for the parties' recommended adjustments, ICNU's witness, Mr. Selecky, argues that MEHC will file a consolidated tax return, but "because the acquisition has not been finalized, it is impossible at this point to indicate what corporate structure will exist after the acquisition occurs." He recommends the Commission adopt his originally proposed adjustment without changes.[221]

157 The Company argues that ICNU's adjustment is moot because it is based on the corporate structure and circumstances of ScottishPower's ownership of PacifiCorp, rather than MEHC's ownership.[222] ICNU counters that its adjustment is appropriate because MEHC will file a consolidated tax return and other aspects of parent ownership are included in this case despite the change in corporate ownership.[223]

158 Neither Public Counsel nor Staff adopt or mention this adjustment directly in their brief, but their double leverage adjustments cover the same issue indirectly.

159 ***Discussion and decision.*** We take official notice that MEHC's acquisition of PacifiCorp became effective on March 21, 2006. The basis of ICNU's calculation of an adjustment rests entirely on the facts and circumstances of PHI's ownership of PacifiCorp, PHI's loan from Scottish Power and PHI's consolidated tax returns. We agree with the Company that this change in corporate ownership means that the details of ICNU's calculations no longer apply and therefore the adjustment is moot.

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[219] *Id.*, 15:7-19.
[220] ICNU Initial Brief, ¶¶ 97, 101, 102, 103, 104.
[221] Exh. 821-T at 3:19 – 4:3 (Selecky).
[222] PacifiCorp Initial Brief, ¶ 49.

160 Were this not the case and we could reach the merits of ICNU's adjustment, we would be hard-pressed to consider the issues the Company raises as mere "obfuscation." While we agree with ICNU that rates should be cost-based, the Company raises important questions regarding the appropriate accounting for deferred taxes arising from the parent company's payment of taxes on a consolidated basis, as well as the principles of the benefit-burden test in this context. Should parties recommend similar adjustments in future proceedings, we would expect a full airing of these issues in the context of the pertinent corporate ownership and all other relevant facts.

9. Low-Income Issues

161 The Energy Project requests four changes to PacifiCorp's low-income energy assistance and energy efficiency programs:

- Increase funding of the low-income bill payment assistance (LIBA) program from 0.26 percent to 0.75 percent of gross operating revenues;
- Start tracking certain data on low-income customers (e.g., number of residential accounts, number of residential accounts in arrears, total value of residential arrears, and disconnections);
- Develop a program with Staff and community leaders to better manage arrearages for households unlikely to pay bills, and;
- End the Company's 50 percent funding condition for payment of low-income heat efficiency assistance program (LIHEAP) projects.[224]

162 The Company agrees to increase LIBA program funding to 0.34 percent of gross operating income—a 30 percent increase over current funding, and to increase the energy credit to 10 percent. The Company asserts this will fund an additional 900 customers. The Company also agrees to track certain low-income data if the

[223] ICNU Reply Brief, ¶ 37.
[224] Exh. 651-T at 9-17 (Eberdt).

Company can define and identify the data. The Company agrees to work with Staff and community leaders on an arrearage program, but will not implement such a program unless Staff agrees there is value to customers. Finally, the Company rejects the proposal to terminate its 50 percent funding condition for payment of LIHEAP projects.[225]

a) Funding of LIBA Program

163 The Energy Project asserts PacifiCorp underfunds its low-income bill assistance program relative to other Washington utilities: PacifiCorp funds the program at .26 percent of gross operating revenues, compared to .41 percent for PSE and .76 percent for Avista.[226] The Energy Project criticizes the Company's proposal to increase funding by 30 percent as simply bringing the program back to its initial level to compensate for rate increases. The Energy Project requests the Commission require PacifiCorp to go beyond its original goal of bill assistance.[227] The Energy Project also requests the Company increase the benefit level a household can receive, increase the discount level and apply the program year round, rather than in the winter.[228]

164 PacifiCorp asserts its proposed funding level is appropriate, noting that PacifiCorp's rates are lower than PSE's and Avista's, such that PacifiCorp's low-income customers face less of a utility bill burden than customers in other service areas.[229] PacifiCorp also asserts that PSE and Avista provide natural gas service, while PacifiCorp does not, so customers in PacifiCorp's Washington service area may also receive assistance from their gas provider.[230]

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[225] Exh. 5-T at 19-21 (MacRitchie).
[226] Energy Project Initial Brief at 4.
[227] *Id*., 4-5.
[228] *Id*., 5.
[229] PacifiCorp Initial Brief, ¶ 185.
[230] PacifiCorp Reply Brief, ¶ 113.

165 Staff supports the Company's funding proposal. Staff notes the money for these programs comes from ratepayers and that the Energy Project's proposal would increase funding by 136 percent.[231] Staff echoes the Company's arguments, asserting the Company's proposal "strikes a reasonable balance between providing meaningful benefit levels, and reaching as many eligible customers as possible."[232]

166 ***Discussion and decision.*** As utility companies participate voluntarily in programs to assist low-income ratepayers, we may encourage, but not require, PacifiCorp to spend a particular amount for these programs.[233] For the reasons the Company and Staff identify, we welcome the Company's proposed funding level of .34 percent of gross operating revenues, and proposal to increase the energy credit by 10 percent.[234] We encourage the Company to file tariff revisions consistent with these proposals.

b) Tracking Low-income Data & Arrearage Management

167 The Energy Project applauds the Company's willingness to work with Staff and appropriate agencies to better track low-income data and evaluate its arrearage policies and efforts. The Energy Project remains concerned, however, that the Company will simply study the issues and not apply the data to better understand how low-income households are affected or to develop a better arrearage program.[235]

168 The Company is committed to pursuing the Energy Project's proposals.[236] The Company agrees to report this information to the Commission, consistent with the commitment in Item Wa 15 of the Stipulation in Docket UE-051090.[237] Staff

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[231] Staff Reply Brief, ¶¶ 215-216.
[232] *Id*., ¶¶ 220-22.
[233] *See* RCW 80.28.068.
[234] *See* Exh. 9; TR 318:10 – 319:4 (MacRitchie).
[235] Energy Project Initial Brief at 6-8.
[236] PacifiCorp Initial Brief, ¶ 186.
[237] PacifiCorp Reply Brief, ¶ 114, citing Exh. 228.

notes that data gathered as a result of the Company's commitments can be used to evaluate whether to increase funding or benefit levels, or to expand the program beyond the winter heating season.[238]

169 ***Discussion and decision.*** We commend PacifiCorp for agreeing to work with Staff and low-income assistance agencies on better tracking low-income data and evaluating its arrearage policies and efforts. To provide further structure to PacifiCorp's agreement and any collaborative discussions about these issues, we require PacifiCorp to report on its efforts in these areas within one year of the effective date of this order.

c) PacifiCorp's 50 Percent Rule

170 The Energy Project objects to PacifiCorp's policy of funding only 50 percent of weatherization projects until the matching funds from the state-funded Energy MatchMaker (EMM) program funds have been spent.[239] The Energy Project asserts this policy limits, rather than leverages, the use of other funding sources for weatherization.[240]

171 PacifiCorp insists the best way to fund its low-income weatherization program is to cover 50 percent of costs as long as EMM funds are available, and then fund 100 percent of the costs once the state funds have been depleted. The Company asserts this approach ensures benefit from the state program and tax dollars.[241]

172 Staff supports retaining the Company's current policy, asserting the Company's goal of maximizing the use of other funding sources is in the ratepayers' interest.[242] Staff discounts the Energy Project's arguments, asserting the 50

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[238] Staff Reply Brief, ¶ 223.
[239] Energy Project Initial Brief at 9.
[240] *Id*., 9-10.
[241] PacifiCorp Reply Brief, ¶ 115.
[242] Staff Reply Brief, ¶ 226.

percent rule gives low-income assistance agencies incentive to maximize the use of other funds besides utility funds.[243]

173 ***Discussion and decision.*** For the reasons the Company and Staff identify, we reject the Energy Project's proposal to end PacifiCorp's 50 percent rule for weatherization program assistance. The Company's program encourages agencies to use all sources of funds, and ensures ratepayers have the benefit of tax dollars as well as ratepayer-contributed funds.

E. Contested Adjustments to Rate Base

174 Similar to the contested adjustments to net operating income or revenue requirements discussed above, where contested adjustments to rate base are supported solely by the Revised Protocol or matters of calculation, we do not address them in this order.[244] However, in the interest of providing guidance for the future, we address those contested issues involving matters of policy, accounting rules, or theory.

1. Cash Working Capital (Staff Adjs. 8.1, 8.1a, 8.2, 8.3, and 8.7)

175 PacifiCorp's initial filing includes an increase to rate base of $1.03 million to reflect its calculation of cash working capital balance, and $16.9 million for certain "prepayments," "fuel stock," "working capital" and "materials and supplies."[245] Staff recommends five interrelated adjustments to rate base

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[243] *Id*., ¶¶ 227-30.
[244] We do not address the following adjustments, contested or agreed to, in this order: Mid-Columbia Contract Allocation (Adj. 5.5), Seasonal Contract Allocation (Adj. 5.6), QF Contract Allocation (Adj. 5.7), Production Factor on Rate Base (Adj. 8.10), Remove Naches and Skookumchuck (Adj. 8.11), Remove Trail Mountain (Adj. 8.12), Remove Deferred Environmental Remediation (Adj. 8.13), Remove Transition Regulatory Asset (Adj. 8.14), Multi-State Adjustment (ICNU Adj. 1.1), Eastside Resource Allocation (Adj. 8.15), A&G Allocator Per Books (Adj. 8.16), A&G Allocator Uncontested Adjustment (Adj. 8.16), A&G Allocator Staff Adjustment (Adj. 8.17) and Updated Factors Adjustment (PacifiCorp Initial Brief Tables).
[245] Exh. 193, Tab 2, at 2.2, lines 42-44.

associated with current assets and cash working capital. In Adjustment 8.1a, Staff accepts the Company's increase to the working capital balance, but then recommends removing all of the current assets, including working capital, for a total reduction to rate base of $17.9 million.[246] Staff asserts these assets are not appropriate to include in rate base because they are not supported with capital supplied by investors and, therefore, investors are not entitled to earn a rate base return.[247]

176 In addition, Staff removes $47,494 for inventories and prepayments included in the rate base adjustment for the Trapper mine (Adjustment 8.2), $534,735 for like items included in the rate base adjustment for the Bridger mine (Adjustment 8.3), and $270,089 for like items associated with the rate base adjustment for the Dave Johnson mine (Adjustment 8.7).[248]

177 Staff supports these reductions with an Investor-Supplied Working Capital (ISWC) analysis derived from the Company's balance sheet.[249] Staff asserts the ISWC demonstrates that investor-supplied work capital is negative by at least $16 million and therefore investors have not supplied the funds supporting the current asset line items or the working capital balance. Consequently, Staff asserts investors are not entitled to a rate base return on these amounts.[250]

178 Staff argues the Company's reliance on a so-called "lead-lag" study is not adequate to demonstrate that investors have supplied the amounts Staff recommends removing from the rate base.[251] Staff challenges the Company's lead-lag study asserting that it contains errors of both fact and method.[252]

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[246] Exh. 631-T at 50:7-10 (Schooley).
[247] *Id.*, 50:2 – 51:6.
[248] *Id.*, 50:14 – 51:6.
[249] Exh. 637.
[250] Exh. 631-T at 48:1-19 (Schooley).
[251] Staff Reply Brief, ¶ 204.
[252] Staff Initial Brief, ¶ 228.

179 Moreover, Staff asserts the ISWC method is superior to the lead-lag approach because it actually measures the working capital supplied by investors, rather than simply measuring the utility's cash-flow needs regardless of the source of funds.[253] According to Staff, the Commission has consistently preferred the use of the balance-sheet method for calculating cash working capital.[254]

180 PacifiCorp argues its proposed $1.03 million increase to Washington's allocated share of cash working capital is supported by a calculation[255] based on figures taken from its "2003 Lead Lag Study."[256] The Company asserts the ISWC approach is inferior to lead-lag studies,[257] and Staff's rate base adjustments related to the Trapper, Bridger and Johnston mines are unjustified because Staff erred in its ISWC calculations.[258] According to the Company, when errors in the Staff ISWC are corrected, investor-supplied working capital is a net positive $92.8 million.[259]

181 Staff refers to our prior cases, arguing that we have consistently "preferred" the ISWC method.[260] In addition, Staff asserts the Company's corrections to Staff's ISWC analysis are themselves in need of correction. According to Staff, when these corrections are made, investor-supplied working capital is shown to remain negative by $3.7 million.[261] In summary, Staff argues we should, "follow [our] precedent, appropriately calculate investor supplied working capital, and find that no investor supplied working capital should be added to rate base."[262]

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[253] Staff Reply Brief, ¶ 203.
[254] Staff Initial Brief, ¶ 217.
[255] Exh. 193 at Tab 8, 8.1. The discrepancy between the $1,044,155 that appears on this exhibit and the $1,029,079 adjustment the Company makes to the cash working capital balance allocated to Washington is not explained.
[256] Exh. 195-T at 12:5-7 (Wrigley). We note, however, the "2003 Lead Lag Study" is not a part of the record in this proceeding.
[257] *Id.,* 12:8-20.
[258] *Id.,* 12:23 – 15:14.
[259] *Id.,* 14:10-12.
[260] Staff Initial Brief, ¶ 217.
[261] *Id.,* ¶¶ 223-24.
[262] *Id.,* ¶ 229.

182 With regard to the Company's lead-lag study method, Staff asserts the Commission has rejected a lead-lag approach in favor of the ISWC approach and that, in any event, the Company's lead-lag study is flawed.[263] Staff asserts there is nothing in this record to support the Company's claim that its lead-lag study is "state-of-the-art" nor is there any evidence in the record to support the Company's claim that Staff's ISWC approach is "outmoded, less accurate and unreliable."[264] The Company responds that the lead-lag method is nearly universally accepted by utility regulators, including FERC, and that the Company is aware of none that rely on the balance sheet approach Staff uses.[265] The Company argues that no party, including Staff, has identified any errors or deficiencies "in the lead-lag study the Company has submitted."[266]

183 ***Discussion and decision.*** It is evident from the record that the actual amounts of current assets and cash working capital in dispute are derived by applying the Revised Protocol allocation formula that we have rejected.[267] Consequently, without an acceptable inter-jurisdictional allocation formula, we are not able to resolve the specific adjustments Staff proposes for Washington jurisdictional rate base.

184 The core of this dispute, however, is at least as much about methodology as it is about numbers. Staff asserts the superiority of its ISWC method largely by claiming that this method complies with Commission "precedent." The Company argues the ISWC method is used nowhere outside of Washington and that federal and state regulators have chosen the lead-lag method it advocates as superior.

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[263] *Id.*, ¶¶ 226-28.
[264] Staff Reply Brief, ¶¶ 199-202.
[265] PacifiCorp Initial Brief, ¶¶ 102-105.
[266] PacifiCorp Initial Brief, ¶ 100; PacifiCorp Reply Brief, ¶ 57.
[267] Exh. 193 at Tab B-13, B-14 and B-15.

185 After careful review of the record and the materials cited by Staff and the Company, we observe that both parties have failed to capture an accurate or balanced presentation of this issue.

186 The Company argues that regulators commonly prefer lead-lag over the balance sheet approach. However, the FERC precedents cited by the Company involve a choice between the lead-lag method and short-cut "45-day" method, not a choice between lead-lag and a balance sheet calculation. Moreover, the 2003 lead-lag study upon which the Company relies in its testimony and argument, does not appear in the record in this proceeding. Even if we were to accept the lead-lag method, we have no way to determine whether the Company's study is valid and sufficiently current.[268]

187 Turning to Staff's arguments, we observe that it is overstatement to claim that we have established a firm "precedent" for the ISWC method over lead-lag. In addition to the 1995 proceeding Staff cites,[269] we have reviewed sixteen Commission decisions entered in proceedings over the past thirty years in which this topic has been in dispute. In the 1995 U S West proceeding, we note that Staff accepted lead-lag studies in concept, but opposed the Company's proposal. The Commission accepted Staff's approach as appropriate "in th[at] proceeding." Over the longer period, the Commission has not had occasion to address working capital methodology intensively since the 1980s. The Commission has generally accepted ISWC analyses. But the Commission has also accepted lead-lag studies (some offered by Staff), indicated openness to methods other than ISWC, and declined to "endorse" either method.[270]

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[268] We are puzzled by Staff's and the Company's arguments on brief about alleged errors in the 2003 study. Neither party cites to this record for evidence of the "study" or facts and methods used in the "study."

[269] WUTC v. *US WEST Communications, Inc.,* Docket UT-950200, Fifteenth Supplemental Order at 68 (April 11, 1996).

[270] "There has been no need demonstrated on this record for abandoning the lead lag study approach to working capital." *WUTC v. Pacific Northwest Bell,* Cause 75-40. Third Supplemental Order at 8 (April 23, 1976); "We do not rule out use of other calculation methods in other proceedings; where shown warranted by the record in a given case we have used other

188 In short, Staff's reliance on precedent to defeat the Company's use of lead-lag studies or any other method to prove its working capital requirements is misplaced. Further, as we have observed, "[T]he fact that the Company bears the burden of proof on an issue does not relieve Staff of its responsibility to provide full evidentiary support in the record for a proposition it advances."[271] We expect Staff to support its reliance on the ISWC approach, particularly if it is true that the ISWC method is used by no other regulators, as the Company asserts.

189 We agree with Staff that the objective is to quantify the amount of working capital and current assets supported by capital on which investors are entitled to a return. We do not state a preference for the method of analysis to achieve that objective. We do expect that a company using a lead-lag study, or any other method, will submit the study for the record so that Staff, intervenors, and ultimately the Commission, can determine whether the study is valid, current, accurate and appropriate. We also expect Staff and other parties to provide full evidentiary support of any proposals and methods they may submit to substantiate adjustments to a company's figures.

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methods." *WUTC v. Puget Sound Power and Light Co.,* Cause U-81-41, Second Supplemental Order at 9 (March 12, 1982); "In this rate case both the respondent and Staff have relied on a lead-lag study to measure working capital. The Commission will accept the working capital as presented." *WUTC v. Puget Sound Power and Light Co.,* Cause 82-38, Third Supplemental Order at 14 (July 28, 1983); "Therefore, without endorsing either methodology [balance sheet or lead-lag], the Commission is constrained to accept the rate base adjustment for working capital submitted by Commission Staff." *WUTC v. Puget Sound Power and Light Co.,* Cause U-83-54, Fourth Supplemental Order at 17 (Sept. 28, 1984); "The Commission remains open to suggestions regarding application of this method [balance sheet], and expects that future cases will provide opportunity to examine modifications to the balance sheet method, or other suggestions to accurately calculate the working capital need of the Company." *WUTC v. Puget Sound Power and Light Co.,* Cause U-85-53, Second Supplemental Order at 29 (May 16, 1986).

[271] *WUTC v. Pacific Power and Light Co.,* Cause U-83-33, Second Supplemental Order at 19 (Feb. 9, 1984).

2. Major Plant Additions (Adj. 8.4)

190 PacifiCorp used a historic test period of the calendar year ending September 2004 to calculate rate base, yet has used a projected test year to calculate net power costs. To match up the resources used to calculate net power costs with the resources it included in rate base, the Company made an adjustment to the historic test period including all major plant additions over $5 million placed into service prior to March 31, 2006.[272]

191 Public Counsel asserts the proposed adjustment is "selective and one-sided in that it does not recognize other changes that will be taking pace after the end of the test year that will tend to offset the revenue requirement."[273] Public Counsel particularly identifies three events it asserts will mitigate the revenue requirement of the plant additions: 1) growth in accumulated depreciation on embedded production plant in service taking place as new plant additions go into service; 2) growth in the balance of accumulated deferred income taxes on embedded plant; and 3) growth in sales.[274]

192 PacifiCorp claims that Public Counsel's adjustment is not necessary and is inconsistent with Staff's Production Factor methodology, which the Company has accepted.[275] PacifiCorp also asserts it proposed to reflect utility plant additions that are used and useful as of the start of the rate period using the same method as Puget Sound Energy.

193 ***Discussion and decision.*** The issue in dispute is one of implementation more than a matter of fundamental policy. Public Counsel does not claim it was inappropriate for PacifiCorp to include in rate base additions to production plant

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[272] Exh. 191-T at 2, 24 (Wrigley).
[273] Exh. 291-T at 9 (Effron).
[274] *Id*., 9:22 – 10:8.
[275] Exh. 195-T at 15 (Wrigley).

after the close of the historic test year.[276] Rather, Public Counsel calls for two changes to the adjustment. First, Public Counsel seeks to update the forecasts of major plant additions used to calculate the adjustment. Second, Public Counsel proposes to include the effect of growth in the balance of the accumulated reserve for depreciation.[277] PacifiCorp, for its part, does not dispute a need to update depreciation schedules. Rather, PacifiCorp asserts the change Public Counsel requests was addressed in Staff adjustment 8.10, which PacifiCorp has accepted.

194 Given our decision to reject the Revised Protocol, we address only the ratemaking principles at issue. The Company refers to our decision in Dockets UE-050482 and UG-050483 as precedent on this issue.[278] While we allowed Avista in that proceeding to include in rate base major plant additions that were used and useful at the start of the rate period, we also reduced revenue requirement to reflect Avista's failure to follow the matching principle.[279] Under the matching principle, "all cost of service components–revenue, investment, expenses, and cost of capital–must be considered and evaluated at a similar point in time.[280]

195 Our guidance is: A company advocating the inclusion of plant additions used and useful at the start of the rate period must clearly demonstrate it has made a properly matching depreciation adjustment. Similarly, parties advocating a different methodology must develop a record sufficient to demonstrate the company's proposal was not proper.

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[276] Exh. 291-T at 12 (Effron).
[277] *Id*., 11.
[278] Exh. 195-T at 29 (Wrigley), citing *WUTC v. Avista Corp*., Dockets UE-050482 and UG-050483, Order 05 at 113 (Dec. 21, 2005). *See also* PacifiCorp Initial Brief, ¶ 95.
[279] *WUTC v. Avista Corp*., Dockets UE-050482 and UG-050483, Order 05 at 113 (Dec. 21, 2005).
[280] *Id*., ¶ 111.

3. Environmental Settlement (Adj. 8.5)

196 PERCO is a PacifiCorp subsidiary involved in cleaning up toxic waste sites. It manages an insurance settlement for PacifiCorp relating to specific sites covered by that settlement. PacifiCorp's original filing included Adjustment 8.5, which proposed a method for dealing with environmental expenses.

197 Staff asserts the Commission, in Docket UE-031658, simply forbade including the costs of PERCO-administered projects for regulatory accounting, "because those expenses are already recovered through an insurance settlement."[281] Staff recommends the Commission reject PacifiCorp's proposed adjustment and adopt Staff's Adjustment 8.13.

198 In response, PacifiCorp reversed the original Adjustment 8.5 with Adjustment 8.5a, stating that the original adjustment was based on a procedure "rejected by the Commission in Docket UE-031658."[282] PacifiCorp also notes the effect of Adjustment 8.5 on revenue requirement was substantially offset by its acceptance of Staff's recommended Adjustment 8.13, which removed deferred environmental remediation from the miscellaneous deferred debits account.[283]

199 ***Discussion and decision.*** While we cannot decide the rate base effect of this issue, we provide guidance on the intent of our order in Docket UE-031658. There, we allowed the Company "to defer current remediation expenses not covered by the insurance settlement, or recover them as a current period expense."[284] Consistent with that decision, the Company may either defer current

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[281] Staff Initial Brief, ¶ 230.
[282] *Id*.
[283] PacifiCorp Initial Brief, ¶ 112.
[284] The environmental remediation costs covered by the insurance settlement PERCO now administers are only a portion of the total environmental remediation costs the Company incurred. The Commission's order in Docket UE-031658 addressed both PERCO-related and non-PERCO-related environmental remediation expenses. *See Petition of PacifiCorp d/b/a Pacific Power &*

remediation expenses not covered by the PERCO insurance settlement, or recover them as a current period expense. Under either method, the Company must demonstrate it has not already recovered the expenses through the insurance settlement.

4. Acquisition Premium (Public Counsel Adjustment B; ICNU Adjustment 1.12)

200 When a utility purchases plant, it may seek an acquisition premium adjustment to reflect that the price paid for the plant may be higher than its book value.[285] However, the cost of the premium is not included in rate base unless the Commission allows such treatment after finding the underlying plant purchase was prudent.[286]

201 In this case, PacifiCorp proposes to include in rate base its acquisition premiums for three utility assets: Yampa (Craig and Hayden generating plants); the Wyodak Steam Plant (Wyodak); and a transmission line. Of these, Yampa is the largest.[287] The Company contends the Commission authorized the Company to record the Yampa acquisition on its books in Docket UE-981116 and that Staff agreed the acquisition was prudent in a Joint Report filed in compliance with the Commission's order in Docket UE-991832.

202 Neither Wyodak nor the transmission line have been addressed in any prior Commission proceeding. For the first time in this case, the Company seeks approval of the premiums for the Wyodak and transmission acquisitions "on the

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Light Co., for an Accounting Order Regarding Treatment of Environmental Remediation Costs, Docket UE-031658, Order 01 at 4, ¶ 12 (April 27, 2005).

[285] Book value is the original cost of the plant less accumulated depreciation.

[286] *WUTC v. Puget Sound Power & Light*, Dockets UE 920433, UE-920499, and UE-921262, Nineteenth Supplemental Order at 5 (Sept. 27, 1994).

[287] The total PacifiCorp adjustment is $7,969,300, of which Yampa constitutes 92 percent. PacifiCorp Initial Brief at 36-37.

basis that it was prudent to acquire the assets at a small premium over cost less depreciation, rather than construct duplicate facilities."[288]

203 Staff supports including the Yampa acquisition premium in rate base on the strength of Mr. Schooley's testimony that the Joint Report in Docket UE-991832 concurred in the prudence of the Yampa acquisition.[289] Staff included the Yampa Acquisition premium in rate base in its Amended Revised Protocol proposal in this case. Staff points out, however, that if we adopt a control area model for inter-jurisdictional cost allocation, the acquisition would be part of the Eastern control area and would not be included in Western control area rates.[290]

204 Public Counsel recommends we disallow the total adjustment because we have not explicitly approved the Yampa, Wyodak and transmission line acquisitions, and because the Company has failed to show the asset acquisitions were in the interests of ratepayers.[291]

205 ***Discussion and decision.*** For the same reasons we reject the Revised Protocol, we reject the Company's acquisition premium adjustments for Yampa, Wyodak and the transmission line. Staff's recommendation about the Joint Report's conclusion that Yampa was prudently acquired is not controlling. Staff's recommendation was based on considering prudence on a systemwide basis, rather than whether the acquisitions were prudent for Washington ratepayers.[292] Moreover, we have never made an explicit finding that the acquisition was prudent. We also conclude that, consistent with our determination on the Revised Protocol, the Company has not sufficiently demonstrated on this record that the acquisitions of Wyodak and the transmission line were prudent or of benefit to ratepayers in Washington.

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[288] *Id*., at 37.
[289] Staff Reply Brief at 55.
[290] Exh. 631-T at 60-62 (Schooley).
[291] Exh. 291-T at 7:21 – 8:22 (Effron).

5. Deferred Debits (Public Counsel Adj. 1.11)

206 The deferred debits at issue represent costs the Company deferred on its books at the time the costs were incurred, without Commission authorization to establish the deferral accounts. The Company includes in rate base deferred expenses in two accounts, regulatory assets and miscellaneous deferred debits.

207 Public Counsel asserts the Company has provided no substantive reason why it should be able to include these deferred debits in rate base.[293] Public Counsel objects to the Company's position that its own election to defer certain expenditures on its books binds the Commission's future ratemaking treatment of the deferrals.[294] Public Counsel asserts that accepting the Company's position would establish a bad precedent.

208 Staff supports Public Counsel's position, asserting that costs deferred without Commission authorization, and without substantive reason for including the costs in rate base, should not be accepted for ratemaking. Staff asserts it adhered to this principle in its Adjustments 8.12, 8.13 and 8.14, which address the appropriate treatment of certain deferred costs, with and without Commission authorization.[295]

209 PacifiCorp asserts that no explicit authorization by the Commission is necessary to defer costs for future recovery. The Company points to the Uniform System of Accounts (FERC Account 186) that pertains to book accounting for the deferred debits, not to the ratemaking treatment.[296] The Company concurs that Staff's adjustments zero out the miscellaneous deferred debits account.[297]

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[292] *See* Exh. 338 (Joint Report) at 62.
[293] Exh. 291-T at 5:14-21 (Effron); Public Counsel Initial Brief, ¶ 39.
[294] Public Counsel Initial Brief, ¶ 41.
[295] Staff Reply Brief, ¶ 210.
[296] Exh. 195-T at 16-17 (Wrigley); *see also* Exh. 210.
[297] PacifiCorp Reply Brief, ¶ 64.

210 ***Discussion and decision.*** Utility companies may not defer costs for later recovery without prior approval. Compliance with FERC's Uniform System of Accounts does not set aside this principle. The Company does not offer any explanation for why it should *not* obtain prior approval before maintaining a deferred debits account. We note the Company is aware of this requirement: The Company properly sought approval, before the fact, to establish a deferral account for excess costs due to hydroelectric conditions.[298] The Company must seek approval before establishing any deferral account, or risk the Commission disallowing future recovery of the deferred expenses.

F. Cost of Capital/Rate of Return

211 The Commission set PacifiCorp's currently authorized rate of return 18 months ago at 8.39 percent as part of a multi-party settlement approved in Docket UE-032065.[299] Consistent with the settlement, the Commission's order included only the overall rate of return and did not define the capital structure or determine the cost rates for debt and equity capital.

212 In this proceeding, the Company seeks approval to increase its overall authorized rate of return to 8.75 percent and establish a detailed capital structure and cost rates for debt and equity capital.[300]

213 Staff, Public Counsel, and ICNU recommend rates of return of 7.058 percent, 7.451 percent and 8.01 percent, respectively. Each party supports its

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[298] *In the Matter of the Petition of PacifiCorp for an Order Approving Deferral of Costs Related to Declining Hydro Generation*, Docket UE 050412, Petition for Accounting Order (filed March 18, 2005) [Hereinafter Hydro Deferral Petition].
[299] *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.,* Docket UE-032065, Order 06 Approving And Adopting Settlement Agreement Subject To Conditions; Rejecting Tariff Sheets; Authorizing And Requiring Compliance Filing (Oct. 27, 2004).
[300] Exh. 61-T at 20:20-23 (Williams); PacifiCorp Initial Brief at 37-48.

recommendation with a detailed capital structure and cost rates for each of the capital components.[301]

214 Determining the appropriate cost of capital for PacifiCorp does not depend fundamentally on the form of an inter-jurisdictional allocation method. The Company's authorized cost of capital is used for a number of purposes, including as the carrying charge applied to balances in deferred accounts and the cost rate the Company uses for any single-issue filings it might make between general rate cases. We have a well-developed record on cost of capital in this proceeding and, therefore, we determine an updated rate of return for the Company.

1. Capital Structure

215 The parties disagree on two features of a capital structure appropriate to set rates for PacifiCorp: 1) Whether short-term debt should be included as a component of general capitalization, and if so, at what level, and; 2) What should be the appropriate equity share.

216 PacifiCorp proposes a capital structure based on its forecasted actual capitalization on March 31, 2006, the end of its fiscal year 2006.[302] This structure includes 49.5 percent equity, 49.4 percent long-term debt, and 1.1 percent preferred stock. It does not include short-term debt. The equity share includes a cash infusion of $500 million to be received from its parent ScottishPower in quarterly payments of $125 million each between June 2005, and March 2006.[303]

217 Staff proposes a capital structure including 43.5 percent equity, 51.3 percent long-term debt, 4.0 percent short-term debt, and 1.2 percent preferred stock.[304] Staff

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[301] Staff Initial Brief at Appendix Table 3; Public Counsel Initial Brief at Appendix Table 3; ICNU Initial Brief at Appendix Table 3.
[302] Exh. 61-T at 2:16-19 (Williams).
[303] *Id*., 5:4-10.
[304] Exh. 151-T at 4:3-6 (Rothschild).

recommends this structure based on the actual capitalization used by PacifiCorp as of December 31, 2004.[305]

218 Public Counsel proposes capitalization that includes 44 percent common equity, 52 percent long-term debt, 3 percent short-term debt, and 1 percent preferred stock.[306] Public Counsel recommends this structure based on the average capital structure used by the Company over the most recent five quarters.[307]

219 ICNU proposes a capital structure consisting of 47.1 percent common equity, 51.8 percent long-term debt, and 1.2 percent short-term debt.[308] ICNU bases its recommended structure on the Company's fiscal year 2006 capital structure excluding the three $125 million cash infusions from ScottishPower that were scheduled but not yet made by early November 2005. ICNU excludes these three cash infusions asserting they are not yet known and measurable.[309]

a) Short-term Debt

220 Both Public Counsel and Staff recommend including a component of short-term debt in the capital structure because it is the lowest cost source of capital available to the Company and because the Company's capitalization has historically included short-term debt.[310]

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[305] To implement its recommendation to adjust the Company's rate of return for double leverage associated with the pending acquisition of PacifiCorp by MEHC, Staff subsequently modifies the capital structure it recommends to replace a portion of the equity share with parent company debt. We address the issue of double leverage below in Section F.3.
[306] Exh. 91-T at 40:1-7 (Hill).
[307] Public Counsel also recommends modifying its proposed capital structure to account for double leverage in the MEHC acquisition.
[308] Exh. 121-T at 16:1-14 (Gorman).
[309] *Id*.
[310] Staff Initial Brief, ¶ 122; Public Counsel Initial Brief, ¶¶ 24-25.

i) PacifiCorp on Short-term Debt

221 The Company counters that it is inappropriate to include short-term debt in ratemaking capital structure because it uses short-term debt to fund construction work-in-progress (CWIP), not general rate base. PacifiCorp points to FERC regulations it asserts require it to use short-term debt solely to finance CWIP.[311] The Company contends that including short-term debt as a component of the general capital structure would constitute double-counting because CWIP balances over the last 18 months have exceeded its balances of short-term debt and CWIP is not included in rate base.[312]

ii) Other Parties on Short-term Debt

222 Staff responds that utility management should finance operations based on all available sources of capital and that individual financing instruments like short-term debt are not tied to particular purposes such as CWIP. Staff notes further that Commission rules require the Allowance for Funds Used During Construction (AFUDC) rate applied to CWIP to be the weighted cost of all forms of capital, not just short-term debt. Finally, Staff notes that the materials cited by the Company to support its claim that the five other states served by PacifiCorp exclude short-term debt from the capital structure do not in fact address that issue.[313] Staff asserts its recommended 4 percent share of short-term debt is within the range the Company has used over the past 10 years.[314]

223 Public Counsel also responds that the Company's rate base is funded by all forms of capital. Public Counsel asserts FERC's requirement to calculate the AFUDC rate using short-term debt first is intended to reduce the carrying charge on CWIP, not to require all short-term debt be allocated to CWIP.[315] Public Counsel

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[311] PacifiCorp Initial Brief, ¶ 120.
[312] *Id*., ¶¶ 121-24.
[313] Staff Reply Brief, ¶¶ 104-12.
[314] Exh. 155 at 3:4 (Rothschild).
[315] Public Counsel Reply Brief, ¶¶ 20-22.

contends its recommended 3 percent share of short-term debt is consistent with the Company's recent short-term debt balances, which range from 2.7 percent to 3.4 percent as a share of the projected 2006 capital base.[316]

iii) Discussion and Decision

224 The appropriate capital structure for ratemaking purposes is one that balances economy with safety in view of all of the sources of capital available to a company. The Commission has traditionally included a component for short-term debt, based on a company's actual capital structure. This case should be no different. We agree with Staff and Public Counsel that the appropriate capital structure should include a component of short-term debt. Using the cost for short-term debt in the FERC formula for CWIP carrying charge neither "ear-marks" all short-term debt for that sole purpose, nor precludes the use of short-term debt in the Company's general capitalization. Contrary to what the Company alleges, including short-term debt in the capital structure does not amount to double-counting. Public Counsel's recommended 3 percent share for short-term debt is consistent with the Company's recent capitalization. We find the capital structure should include 3 percent short-term debt.

b) Equity Share

i) PacifiCorp on Equity Share

225 The Company proposes an equity share of 49.5 percent to reflect its projected actual capitalization in March 2006, including the $500 million of scheduled cash infusions from ScottishPower. PacifiCorp contends these cash infusions are certain to occur.[317] It requests the Commission reject the historical capital structures proposed by Staff, Public Counsel and ICNU because they do not reflect the "measures the Company is undertaking to maintain its financial health in order

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[316] *Id.*, ¶ 23.
[317] Exh. 66-T at 5:9 – 6:30 (Williams).

to efficiently finance the significant investments in new resources and infrastructure…," and are insufficient to maintain the Company's credit rating given new credit rating agency guidelines.[318] The Company asserts relying on historical capital structures is not consistent with recent Commission practice of focusing on forward-looking capital structures.[319]

226 The Company argues its proposed 49.5 percent equity share is in line with the average equity shares of the comparable utility groups used by Mr. Rothschild and Mr. Hill, when short-term debt is excluded.[320] The Company asserts its proposed equity share of 49.5 percent is necessary to maintain its single-A credit rating given new Standard and Poor's metrics concerning equity ratios and debt-imputation for long-term purchase power contracts.[321] It argues that maintaining its current credit rating is important to keep debt costs low, maintain access to borrowed capital and avoid onerous collateral requirements related to long-term purchase and sales of power.[322] Finally, the Company asserts, based on Value Line reports, that equity shares of the comparable utility group are projected to increase from 48.6 percent to 51.8 percent between 2004 and 2010.[323]

ii) Other Parties on Equity Share

227 Staff argues that, over the past decade, the Company has maintained a capital structure including an equity share similar to the 43.5 percent Staff proposed, and this structure has supported an investment grade credit rating.[324] According to Staff, an increase in the Company's equity share beyond what is sufficient to support an investment grade rating is not economical and not justified. Staff points to Standard and Poor's data for 2005 that shows the median debt to equity

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[318] *Id*., 9-11.
[319] *Id*., 7:19-23.
[320] PacifiCorp Initial Brief, ¶¶ 129, 132.
[321] Exh. 66-T at 8-9 (Williams).
[322] *Id*., 12:14-22.
[323] *Id*., 12:4-9.
[324] Exh. 151-T at 10:15-17 (Rothschild).

ratio for single-A rated companies is 54.9 percent.[325] Staff asserts the Company has demonstrated its proposed capital structure is safe, but has not proven it is economical.

228 Public Counsel argues the Company has maintained a capital structure containing an average of 43.85 percent equity over the past five quarters and 43.98 percent over the past 10 quarters.[326] Public Counsel acknowledges PacifiCorp will receive the scheduled $500 million in cash infusions from ScottishPower, but argues this fact does not justify increasing its equity share above historical levels. First, according to Public Counsel, the Company is increasing its debt capitalization at a rate greater than these equity infusions. Second, Public Counsel argues the Company has demonstrated no need to increase its equity share beyond the historical averages that have permitted it to maintain an investment grade credit rating and to capitalize its operations.[327] Using the Company's proposed cost rates for equity and debt, Public Counsel asserts increasing the equity share from an historical average of 44 percent to the Company's requested 49.5 percent would cost Washington ratepayers $4.7 million.[328] Finally, Public Counsel points to the 46 percent average equity share of Mr. Hill's set of comparable risk companies and the 46 percent average equity share of 23 electric companies across the country as further evidence the Company's proposal is too high.[329]

229 ICNU argues PacifiCorp's fiscal year 2006 capital structure, before including $375 million of projected ScottishPower cash infusions, is adequate to support its credit rating. ICNU asserts its proposed equity share of 47.1 percent is appropriate because it is adequate to maintain the Company's credit rating and falls within the 46 percent to 49 percent range of equity shares among Mr. Gorman's comparable risk utility group.[330] Mr. Gorman notes the equity components in both

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[325] *Id*., 11:8-11.
[326] Exh. 91-T at 35:1-6 (Hill).
[327] *Id*., 36:1-25.
[328] *Id*., 38:4-17.
[329] *Id*., 39:1-3.
[330] Exh. 121-T at 15:1-25 (Gorman).

PacifiCorp's and ScottishPower's capital structures have been increasing recently.[331]

iii) Discussion and Decision.

230 Our task in determining a capital structure is to set the framework for calculating an overall rate of return. That framework must balance safety (the preservation of investment quality credit ratings and access to capital) against economy (the lowest overall cost to attract and maintain capital). We are not constrained to a single method to strike this balance. We may look to the Company's historical capital structure, as Staff and Public Counsel urge, or we may look to the Company's projected rate year capitalization, as the Company urges. Alternatively, we may consider both points of view and set a structure that considers all the evidence in the record. We have determined so-called hypothetical capital structures in the past when our fundamental objective to balance safety and economy required that we do so. We are presented with that situation here.

231 The Company's historical equity capitalization in recent years falls in the range of 43 to 45 percent. Considering the equity infusions from ScottishPower, the Company's rate year equity capitalization may achieve the Company's proposed 49.5 percent (not including the effect of the short-term debt component we require). It is fair for Public Counsel to question whether the Company may also issue additional debt offsetting the effect of the equity infusions. It is also fair for Staff to question whether the cost of such a large increase in equity capitalization is economical. The Company has not addressed either question squarely. It argues that maintaining a single-A credit rating permits it to avoid higher debt costs and onerous collateral requirements, but it provides no estimate of the magnitude of these benefits. Nonetheless, we do understand that credit rating agencies have tightened their rating criteria, utility equity capitalization ratios have

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[331] *Id*., 14:11-23.

recently increased and ScottishPower has added substantial equity to the Company's balance sheet.

232 In view of these factors, we determine that an appropriate equity share should be higher than the historical equity share to reflect infusion of capital from ScottishPower and the general trend of increasing equity capitalization in the industry. We do not approve an equity share as high as the Company proposes, however, because the Company has failed to prove why such a significant increase in equity – from an historical range of 43 percent to 45 percent to the proposed 49.5 percent – is necessary and economical.

233 When short-term debt is included, the average equity capitalization of Mr. Hill's comparable utility group is 46 percent and the average equity capitalization of 23 electric utilities in 2005 was also 46 percent.[332] We think this is a reasonable benchmark for comparable utilities based on the most recent data. We determine that 46 percent is a reasonable equity share to include in a capital structure for PacifiCorp that appropriately balances safety and economy.

2. Cost of Debt and Equity Components

a) Cost of Debt

234 The parties agree that the cost of long term debt is 6.427 percent and the cost of preferred stock is 6.59 percent.[333] In addition, Staff and Public Counsel agree with the Company's current estimate of 4.50 percent for the cost of short-term debt.[334] The parties disagree on the appropriate cost rate for common equity.

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[332] Exh. 91-T at 39:1-3 (Hill); Exh. 97 at 3.
[333] Exh. 66-T at 16:10-12 (Williams).

b) Cost of Equity

235 We have evidence in this record presented by four financial experts who recommend four widely divergent values for the cost of equity. The experts rely on a variety of analyses including discounted cash flow methods based on stock prices as well as methods based on bond yields and risk premiums. The witnesses use many of the same tools, but disagree sharply about the inputs and assumptions. Our task is to consider all of this information and determine a rate of return that meets the well established standards set out by the U.S. Supreme Court in the *Hope* and *Bluefield* decisions.[335] These standards entitle a utility to a rate of return that is no less and no more than:

> [C]ommensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[336]

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.[337]

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[334] Public Counsel Reply Brief, ¶ 24; Staff Brief at Appendix Table 3; TR 1309:24 – 1310:5 (Williams).
[335] *FPC v. Hope Natural Gas Co.,* 320 U.S. 591, 88 L. Ed. 3333, 64 S. Ct. 281 (1944); *Bluefield Water Works & Imp. Co. v. Pub. Serv. Comm'n,* 262 U.S. 679, 67 L. Ed. 1176, 43 S. Ct. 675 (1923).
[336] *Hope*, 320 U.S. at 603.
[337] *Bluefield*, 262 U.S. at 692-93.

i) PacifiCorp on Cost of Equity

236 The Company's witness, Dr. Hadaway, recommends a cost of equity of 11.125 percent.[338] He supports his recommendation with alternative versions of the constant growth and multi-stage discounted cash flow (DCF) model, confirming his recommendation though risk premium analysis and ambient economic conditions.[339]

237 Dr. Hadaway describes the DCF method as grounded in the theory that a stock's price represents the present value of all future cash flows, including dividends and earnings, expected from the stock. He notes that while current dividend yields are readily available, long-term growth in cash flows is more difficult to measure. In its basic form, the DCF method assumes that the growth rate is constant and that it continues in perpetuity. Alternatives to the constant growth DCF method attempt to more explicitly estimate growth rates that change over time. These methods are generally described as multi-stage or non-constant growth rate methods.[340]

238 Dr. Hadaway presents both single-stage (constant growth rate) and multi-stage (non-constant growth rate) DCF analyses. He applies the analyses to a sample of 17 utilities he finds comparable to PacifiCorp.[341] Dr. Hadaway asserts it is necessary to examine multiple DCF analyses because current, short-term growth projections made by analysts are not representative of the long-term growth rates required by the DCF method.[342] Dr. Hadaway asserts that forecasts of nominal growth in the nation's Gross Domestic Product (GDP) are a reasonable estimate for the long-term growth rate required by the DCF method. He estimates the long-

[338] Exh. 21-T at 4:16 (Hadaway).
[339] *Id*., 3-4.
[340] *Id*., 12-15.
[341] Dr. Hadaway adjusts this group on rebuttal to remove three utilities for which conditions have changed sufficiently for them to no longer qualify as comparable to PacifiCorp. Removing these utilities from the comparable group did not change Dr. Hadaway's 11.125 percent recommendation for equity return. Exh. 26-T at 31:1-9 (Hadaway).

term growth in nominal GDP at 6.6 percent based on the historical average of 10-year, 20-year, and 40-year average growth in GDP.[343]

239 Dr. Hadaway's traditional constant growth rate DCF produces an estimate of 9.3 to 9.5 percent for the cost of equity. His constant growth rate method using historical GDP growth as a proxy for long-term growth produces an estimate of 11.2 percent. His multi-stage estimate, which relies on analysts' estimates of near-term growth rates for five years and historical GDP growth rate for the long-term, yields estimates ranging from 10.7 to 10.8 percent.[344] Dr. Hadaway asserts the results of the traditional constant growth rate analyses should be excluded, with a resulting range produced by the DCF method of 10.7 to 11.2 percent.[345]

240 Dr. Hadaway also presents analyses and equity cost estimates based on the risk premium method. Using the comparable utility group, he compares authorized utility returns on equity with contemporaneous yields on the long-term bonds of those utilities to estimate the risk premium associated with equity. Dr. Hadaway asserts there is an inverse relationship between risk premiums and interest rates and adjusts the risk premium he calculates to reflect this relationship.[346] His resulting estimate of risk premium is 4.25 percent. Adding this risk premium to forecasted utility bond yields, Dr. Hadaway produces an estimate of 10.95 percent.

241 Dr. Hadaway compares his estimated risk premium to estimates published by Ibbotson, and Harris and Marston for the risk premium of stocks over corporate bonds. Dr. Hadaway asserts the results depend on whether arithmetic or geometric averaging is used. Under the more conservative assumption of geometric averaging, Dr. Hadaway presents these published risk premiums as 4.5 percent and

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[342] *Id*., 24:1-10.
[343] Exh. 24 at 5, Column 12.
[344] *Id*., 1-4.
[345] Exh. 21-T at 22:10-15 (Hadaway).
[346] *Id*., 25-26.

5.13 percent which yield equity return estimates of 11.2 percent and 11.8 percent, respectively.[347]

242 Finally, Dr. Hadaway acknowledges that inflation and interest rates in the recent past have declined to very low levels. He asserts, however, that forecasts for the GDP, treasury notes and bonds, and corporate bonds all show an increasing trend.[348]

ii) Staff on Cost of Equity

243 Staff's witness, Dr. Rothschild, recommends an 8.95 percent return on equity based on both constant-growth and multi-stage DCF analyses and a capital asset pricing model (CAPM) risk premium analysis. Dr. Rothschild applied his analyses to the same set of comparable utilities Dr. Hadaway used.[349] He observes that the median equity share for the comparable group is 48.1 percent. Because this is higher than his recommended equity share of 43.5 percent, he adds .20 percent to his analytic result of 8.75 percent to reach his recommendation of 8.95 percent.[350]

244 Dr. Rothschild's DCF analyses yield estimates ranging from 7.8 percent (constant growth) to 8.7 percent (multi-stage) for return on equity.[351] He estimates the growth rate used in his DCF analysis based on the "BxR+SV" formula where "R" is the expected return on book equity forecast by market analysts, "B" is the earnings retention rate and "SV" is the growth due to sales of stock at a price in excess of book value.[352] Based on this formula, Dr. Rothschild estimates a growth rate of 3.44 percent to 3.65 percent which he argues is sustainable over the long-

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[347] *Id*., 26:20 – 27:27.
[348] *Id*., 18-19.
[349] Exh 151-T at 24:1-5 (Rothschild).
[350] *Id*., 25:10-19.
[351] *Id*., 24:9-13.
[352] *Id*., 39-42.

term. Contrasting these growth rates to the 6.6 percent Dr. Hadaway uses highlights the major reason for the sharp difference in their results.

245 Dr. Rothschild's risk premium analyses yield estimates of 7.7 percent to 9.5 percent for required return on equity. He asserts equity risk premiums have been declining over the last 78 years and offers two reasons, the reduced tax rate on capital gains, and less volatile stock prices.[353] The high-end of Dr. Rothschild's risk premium analysis is based on adding his estimated long-term inflation rate of 2.55 percent to an estimated long-term inflation-adjusted return on stocks of 7.0 percent.[354] Using a "debt risk premium" method, Dr. Rothschild computed an estimate of 7.2 percent to 8.3 percent for equity return. According to Dr. Rothschild, the range in these risk premium results brackets and confirms his recommended 8.95 percent return on equity.[355]

246 Dr. Rothschild criticizes Dr. Hadaway's reliance on GDP growth rates as an error. He argues that there is no relationship between nominal GDP and investor growth expectations.[356] According to Dr. Rothschild, Dr. Hadaway also erred in estimating the "BxR+SV" formula by using inconsistent inputs and using growth rates from Zacks and Value Line inappropriately. Dr. Rothschild also claims that Dr. Hadaway's risk premium estimates are flawed because they are based on forecasted bond yields that are too high and unreliable, assume an inverse relationship between equity premiums and interest rates that is unproven and inconsistent with financial theory, and mismatch allowed rates of return to bond yields in calculating equity premiums.[357] Dr. Rothschild observes that if Dr. Hadaway had used Ibbotson's geometric risk premium of 3.84 percent, his risk premium result would have been 10.54 percent.[358]

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[353] *Id.*, 45-46.
[354] *Id.*, 49-52.
[355] *Id.*, 53-54.
[356] *Id.*, 57-59.
[357] *Id.*, 67-83.
[358] *Id.*, 83:1-2.

iii) Public Counsel on Cost of Equity

247 Public Counsel presents its cost of capital case through Mr. Hill who recommends a return on equity of 9.125 percent.[359] Like Drs. Hadaway and Rothschild, Mr. Hill uses the DCF method along with risk premium analyses to arrive at his recommendation.

248 Mr. Hill notes that the DCF method is based on sound theory, but that it "does not exactly 'track' reality" because its theoretical assumption that earnings, dividends, retention rates, book value and stock price all grow at the same rate, forever, is never met in reality.[360] He cautions that the DCF method must be used carefully, especially with regard to the growth rate assumed. Mr. Hill uses a sample group of thirteen utilities similar to, but not exactly the same, as Dr. Hadaway's. Using the "BxR+SV" formula, Mr. Hill estimates a sustainable growth rate for his sample utility group averaging 5.09 percent. He confirms this rate against five-year historical and projected growth rates from a number of published sources.[361] Combining this estimated growth rate with an average dividend yield of 4.13 percent, Mr. Hill estimates a constant growth DCF estimate of 9.23 percent for equity return.[362]

249 Mr. Hill also presents results from the CAPM method, the modified earnings-price-ratio method (MEPR), and the market-to-book (MTB) ratio method. Mr. Hill's CAPM analysis estimates an equity return range of 8.21 percent to 10.02 percent. His MEPR and MTB methods yield a range of 8.45 percent to 9.30 percent for the cost of equity. Based on these analyses and his DCF result, Mr. Hill constructs a range of 8.75 percent to 9.50 percent and concludes that 9.125 percent, the mid-point of the range, is the appropriate cost of capital to use in this case.[363] Considering this cost of equity along with his recommended capital

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[359] Exh. 91-T at 3:24 – 4:1 (Hill).
[360] *Id*., 41:3-12.
[361] *Id*., 48:10-24.
[362] *Id*., 50:1-5.
[363] *Id*., 51:4-20.

structure and costs for debt, Mr. Hill calculates a pre-tax interest coverage ratio of 2.83 which he asserts is higher than the 2.2x ratio the Company used in 2005.[364]

250 Mr. Hill asserts that Dr. Hadaway should not have rejected the results of his traditional constant growth DCF analysis without proof that current investment community expectations are "too low." He demonstrates that Dr. Hadaway's 9.3 percent DCF result is actually consistent with Dr. Hadaway's evidence regarding risk premiums.[365] He also criticizes Dr. Hadaway's use of nominal GDP growth rate as a proxy for long-term growth in his three DCF analyses. Mr. Hill argues it is inappropriate to use such a growth rate instead of individual data for each of the utilities in the comparable sample group.[366] With regard to Dr. Hadaway's use of multi-stage DCF, Mr. Hill asserts the method is less reliable than single-stage DCF because it requires many more difficult assumptions.[367] With regard to risk-premium methods, Mr. Hill contends Dr. Hadaway's results are unreliable because they depend on an estimation of equity risk premium that is prone to error, ignore more recent studies that indicate lower risk premiums, and assume an inverse relationship between interest rates and risk premiums that may be statistically unreliable.[368]

iv) ICNU on Cost of Equity

251 ICNU's witness, Mr. Gorman, recommends a return on equity for PacifiCorp of 9.8 percent. He supports his recommendation by applying the DCF method as well as risk premium and CAPM analyses.[369] Mr. Gorman uses the same comparable utility group as Drs. Hadaway and Rothschild.

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[364] *Id*., 55:5-20.
[365] *Id*., 56-57.
[366] *Id*., 57-59.
[367] *Id*., 59-60.
[368] *Id*., 67:13-21.
[369] Exh. 121-T at 1:16-22 (Gorman).

252 Mr. Gorman uses the constant growth (i.e., single-stage) DCF method to produce 8.9 percent as an estimate of the required return on equity. With regard to the growth rate component of the DCF formula, Mr. Gorman contends that security analysts' estimates of future returns have been shown to be more accurate than historical data. He bases his growth rate estimate of 4.58 percent on the average of the growth rates projected by securities analysts and published by three sources: Zacks, Reuters, and Thomson.[370]

253 Mr. Gorman also offers results derived from applying the risk premium and CAPM methods. For the risk premium estimate, Mr. Gorman calculates two estimates of equity risk by comparing regulatory authorized returns to either Treasury bond yields or contemporary A-rated utility bond yields. The former comparison produces a range in equity risk premium from 4.4 percent to 5.7 percent. When added to the projected yield on 20-year Treasury bonds of 5.2 percent, the midpoint of these risk premium estimates falls at 10.3 percent.[371] Applying the same method to utility bonds, Mr. Gorman produces a range of results from 8.6 percent to 10.1 percent with a mid-point at 9.4 percent.[372]

254 Mr. Gorman's CAPM analysis is based on the projected yield of 5.2 percent on 20-year Treasury bonds as the risk-free rate, 6.6 percent as the market premium, and .77 as the average beta for the comparable utility group. Mr. Gorman's CAPM analysis produces 10.3 percent as a measurement of the required return on equity.[373]

255 Mr. Gorman contends that Dr. Hadaway's results are flawed because they rely on forecasted yields on utility bonds of 6.7 percent rather than actual observable utility bond yields of 5.6 percent, and historical GDP growth rather than available

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[370] Exh. 127.
[371] Exh. 121-T at 24:1-20 (Gorman).
[372] *Id.*, 25:1-4.
[373] *Id.*, 26:7 – 2:17.

forecasted GDP growth.[374] With regard to using GDP growth rates in the DCF, Mr. Gorman contends Dr. Hadaway's constant growth DCF would produce an estimate of 10.1 percent if forecasted GDP growth of 5.5 percent were used rather than historical data.[375] Concerning Dr. Hadaway's use of risk premiums published by Ibbotson, and Harris and Marston, Mr. Gorman contends that these are only applicable to the overall market for equities, not to less risky utility stocks.[376]

v) PacifiCorp Rebuttal on Cost of Equity

256 On rebuttal, Dr. Hadaway responds that Staff's, Public Counsel's and ICNU's recommendations are inconsistent with the average returns on equity ranging from 10.41 percent to 10.84 percent granted by state regulatory agencies across the country during 2004 and 2005.[377] He asserts the major difference between his DCF analyses and those presented by Mr. Hill, Mr. Gorman and Dr. Rothschild is his estimate of long-term growth compared to the competing analyses which rely only on near-term growth projections.[378] According to Dr. Hadaway, these short-term estimates have been volatile over the past few years and this volatility makes the estimates inappropriate to estimate long-term growth assumption required by the DCF method. He asserts the DCF estimates of Dr. Rothschild and Mr. Hill would increase to 10.7 percent and Mr. Gorman's DCF estimate would increase to 11.2 percent if the historical growth in GDP is used as a proxy for long-term growth.[379] With regard to use of GDP to estimate long-term growth rates, Dr. Hadaway asserts that using GDP to estimate long-term growth rates in DCF analyses is accepted in proceedings before FERC.[380]

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[374] *Id.*, 37:15 – 38:17, 34:9 – 36:11.
[375] *Id.*, 36:9.
[376] *Id.*, 39:12-15.
[377] Exh. 27.
[378] Exh. 26-T at 4:15-23 (Hadaway).
[379] *Id.*, 12:15, 22:5, 30:5.
[380] *Id.*, 24:5-7.

257 Dr. Hadaway also contends the recommendations made by the other experts yield returns that fail the standard of *Hope* to "ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." He argues the returns on equity recommended by Staff, Public Counsel and ICNU would weaken, rather than support, PacifiCorp's financial condition and its current credit rating.[381] According to Dr. Hadaway, credit rating agencies do not currently use the "pre-tax interest coverage" calculation offered by Mr. Hill.[382]

258 Summarizing its position on the return on equity, PacifiCorp states, "PacifiCorp seeks an ROE result more consistent with the national mainstream of regulatory decisions."[383]

vi) Discussion and Decision

259 We are presented with an extensive record of financial analyses and opinion provided by four experts in the field. As has been our experience in prior cases, the experts disagree on matters of opinion, method, application and assumptions. We must exercise our judgment, informed by this rich record, to determine an equity return that meets the standards set out in *Hope*.

260 At the outset, we note that the financial analyses produce results that range from Dr. Rothschild's 7.2 percent "debt risk premium" to Dr. Hadaway's 11.8 percent "risk premium." Within that range we have no fewer than 50 separate analytically derived estimates of the required return on equity. We are confident that a fair and sufficient return lies somewhere within that range, but at neither of its extremes.[384]

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[381] *Id*., 6-8.
[382] *Id*., 14:22 – 15:1.
[383] PacifiCorp Initial Brief, ¶ 148.
[384] We note that the divergence in the extremes of analytical results presented by cost of capital witnesses has been growing in our recent proceedings. We find these extreme values to be of little practical use.

261 The principal disagreement between the Company and its expert critics centers on Dr. Hadaway's use of nominal historical GDP growth rates in the DCF formula. We do not take issue with Dr. Hadaway's opinion that the DCF formula requires a long-term growth rate or that growth in GDP may serve as a better measure of long-term growth than analysts' forecasts in the short-term. However, in this case, we find persuasive Mr. Gorman's argument, that if growth in GDP is used for this critical input to the DCF formula, it should be a forward-looking, not an historical average. We also find persuasive Mr. Hill's point that use of the simple constant-growth DCF method is generally preferable to the more complex and assumption-intensive multi-stage method. Finally, we find credible the arguments offered by Dr. Rothschild and Mr. Gorman that risk premium analyses that rely on utility bond yields are better calibrated to currently-known yields rather than forecasts of future yields because currently-known yields capture much of the market's current expectation of future inflation.

262 The record shows that if Dr. Hadaway's GDP-based, constant-growth DCF is adjusted for forward-looking rather than historical GDP growth rates, the result is a 10.1 percent return on equity.[385] Similarly, the record shows that if Dr. Hadaway's risk premium analysis is adjusted to include current rather than forecasted utility bond yields, the result is 10.4 percent.[386] And for corroboration, two estimates based on the capital asset pricing method in the record are 10.02 percent (Mr. Hill)[387] and 10.3 percent (Mr. Gorman).[388] Considering these estimates, we conclude that a fair return lies in the range of 10.0 to 10.4 percent.

263 While the financial analyses constitute a significant body of evidence informing our judgment, it is also important to consider the broader context in which we make our decision. We are mindful of the direction in *Bluefield* that:

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[385] Exh. 121-T at 36:9 (Gorman).
[386] PacifiCorp Initial Brief, ¶ 147.
[387] Exh. 103.
[388] Exh. 121-T at 28:16-17 (Gorman).

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties …[389]

The record shows that our recent decisions have set equity returns for electric utilities at 10.5, 10.3 and 10.4 percent.[390] Decisions of other Commissions that regulate PacifiCorp have set the Company's cost of equity at 10, 10.5 and 10.75 percent in recent proceedings.[391] These rates of return were granted close in time, are taken from the same general part of the country, and are associated with utilities facing the same or similar business risks. Consequently, such comparative data serve as a useful reference on the reasonableness of results from financial analyses applied to a particular company.

264 Considering all of this, we conclude that 10.2 percent is the appropriate return on common equity for PacifiCorp. This rate of return is consistent with the body of financial analyses in the record and is corroborated by the contextual data. Under sound management, this rate of return should permit PacifiCorp to maintain an investment grade credit rating and attract the capital necessary to meet its public service obligations.

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[389] *Bluefield*, 262 U.S. at 692.

[390] The return on equity implicit in the overall rate of return approved as a settlement in the last PacifiCorp rate case was 10.5 percent. *See WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.,* Docket UE-032065, Order 06, Approving And Adopting Settlement Agreement Subject To Conditions; Rejecting Tariff Sheets; Authorizing And Requiring Compliance Filing (Oct. 27 2004); *see also WUTC v. Puget Sound Energy, Inc.,* Docket 040641, Order 06, Final Order Rejecting Tariff Sheets; Authorizing And Requiring Compliance Filing; Requiring Subsequent Filing (Feb. 18, 2005) [10.3 percent]; *WUTC v. Avista Corp*., Docket UE-050482, Order 05, Approving and Adopting Settlement Agreement with Conditions (Dec. 21, 2005) [10.4 percent].

[391] PacifiCorp Initial Brief, ¶¶ 140-141.

3. Double Leverage

265 In consideration of the impending acquisition of PacifiCorp by MEHC, the parties submitted supplemental testimony in this proceeding regarding the possible implications of the acquisition.[392] Staff and Public Counsel recommend that "double leverage" adjustments be applied to PacifiCorp's capital structure and cost rates to reflect debt in the capital structure of MEHC. The Company and ICNU oppose the recommended adjustments.

a) PacifiCorp on Double Leverage

266 PacifiCorp addresses the issue of double leverage through the testimony of Dr. Vander Weide. Dr. Vander Weide asserts the theory of double leverage lacks merit because the means an investor uses to finance an investment cannot change the underlying risk or equity return requirement of a business.[393] According to Dr. Vander Weide, an investor's use of leverage affects the risk the investor faces, but not the business risk of the firm in which the investment is made. Specifically, Dr. Vander Weide faults the double leverage approach to ratemaking because it violates three fundamental principles of financial economics: 1) The required return on an investment is the same as the required return on investments of the same risk; 2) The required return on an investment depends only on the risk of that investment, not on the risk of the owner's other investments, and; 3) The required rate of return for a business depends only on the risks of that business, not on how the owner finances his investment.[394] According to Dr. Vander Weide, financial theory demonstrates that when the added risk associated with greater leverage is properly reflected in the parent company's cost of equity, the double leverage

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[392] We approved the sale of PacifiCorp by ScottishPower to MEHC with 79 conditions established in Order 7 in Docket UE-051090 on February 22, 2006. We were recently informed that the transaction closed on March 21, 2006.
[393] Exh. 811-T at 3:11-14 (Vander Weide).
[394] *Id*., 15:5 – 17:17.

approach produces the same cost of equity for the subsidiary as would a stand-alone calculation.[395]

267 With regard to income taxes, Dr. Vander Weide contends that any tax savings associated with parent debt or other activities should go to the parent's shareholders because they have borne the cost of the debt and accepted the additional risk of greater financial leverage.[396] Finally, Dr. Vander Weide argues that the double leverage approach is inconsistent with the ring fencing proposed and implemented as a condition of the MEHC acquisition of PacifiCorp.[397]

268 Dr. Vander Weide concludes that the Commission should not adopt a double leverage adjustment because it violates three basic principles of finance, is significantly more complex than a stand-alone approach, and produces the same result as a non-double leveraged approach when properly applied.[398]

b) Staff on Double Leverage

269 Staff presents its case for a double leverage adjustment through Mr. Elgin.[399] Mr. Elgin recommends adjustments to Staff's proposed cost of capital, yielding an overall rate of return of 7.01 percent.[400] In particular, he recommends an equity ratio of 28 percent, an equity cost of 9.6 percent, and an added debt component of 15.5 percent at a cost rate of 5.25 percent.[401] Staff also adjusts PacifiCorp's

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[395] *Id*., 10:6-13.
[396] *Id*., 17:20 – 18:10.
[397] *Id*., 14:13 – 15:4.
[398] *Id*., 19:7-12.
[399] Dr. Rothschild, Staff's primary cost-of-capital witness, does not sponsor a double leverage adjustment and did not describe any specific need for such an adjustment when asked if MEHC ownership would have an effect on the analysis in his testimony. TR 1390:8-22; 1394:14 – 1396:25 (Rothschild).
[400] Exh. 791-T at 4:8-10 (Elgin).
[401] Staff Initial Brief, ¶ 172. Staff imputes a cost for the incremental debt MEHC may issue. Public Counsel also imputes a debt cost, but uses MEHC's 7.759 percent overall weighted cost of debt.

interest and tax expenses to capture for ratepayers the tax advantages of debt issued by MEHC to finance its equity investment in PacifiCorp.[402]

270 Mr. Elgin contends these adjustments are necessary to preclude "high returns on book equity to the significant benefit of MEHC shareholders at the expense of PacifiCorp ratepayers." He argues the high returns generated by double leverage will permit MEHC to recover in rates the acquisition premium it paid for PacifiCorp and that if his proposed adjustments are not made, PacifiCorp's rates will not be just, fair, reasonable and sufficient.[403]

271 Mr. Elgin presents an analysis of MEHC's balance sheet to demonstrate that MEHC uses debt to finance its equity investments in its subsidiary companies.[404] He asserts the mismatch between MEHC's debt ratio and the debt ratios of its subsidiary companies allows MEHC shareholders to benefit from both higher realized equity returns and the income tax revenues allowed by regulators on the higher equity ratios of the subsidiaries.[405] He asserts that, under the proposed plan for financing its acquisition of PacifiCorp, MEHC will continue to benefit from double leverage because its equity ratio will be 28 percent, significantly below PacifiCorp's equity ratio.[406] According to Mr. Elgin, MEHC's shareholders will earn a 14 percent return on equity if the transaction closes with financing as planned.[407] Referring again to MEHC's balance sheet, he contends that the significant share of MEHC assets that consists of "goodwill" constitutes a significant financial risk because MEHC's debt ratio would grow to 93 percent if those intangible assets are impaired or written-off.[408]

[402] Staff Initial Brief at 45 n.236.
[403] Exh. 791-T at 3:4-6, 3:12-14, 3:18-20 (Elgin).
[404] *Id*., 9:17 – 10:18.
[405] *Id*., 14:11 – 15:5.
[406] *Id*., 16:1-20.
[407] *Id*., 18:10-18.
[408] *Id*., 21:8 – 22:3.

272 Based on his balance sheet analysis, Mr. Elgin concludes that, absent his double leverage adjustment, ratepayers will be harmed because MEHC will be able to recover through rates the $1.2 billion acquisition premium it will pay to acquire PacifiCorp.[409]

273 Staff asserts the testimony of Dr. Vander Weide is not persuasive because Staff's adjustment reflects the risk of higher leverage at MEHC by adjusting upward its recommendation on return on equity.[410] In addition, Mr. Elgin faults Dr. Vander Weide's examples as tautologies because they inappropriately assume that the cost of equity increases linearly with increasing leverage.[411] Finally, Staff argues "ring fencing" is inadequate to address the problem of double leverage because MEHC will control the capital structure, and particularly, the equity ratio, of PacifiCorp.[412]

274 In its Initial and Reply Briefs, Staff argues its double leverage adjustment serves the principle that ratepayers should benefit from reductions in the cost of capital that come from "diversification," but should be held harmless if diversification increases the cost of capital.[413] It argues that ring fencing and double leverage address fundamentally different problems. The former protects ratepayers against risk in times of financial distress at the parent and the latter prevents the parent from earning a return in excess of its cost of capital.[414] Based on Mr. Elgin's analysis, Staff concludes the Commission can and should approve a double leverage adjustment in this proceeding.[415]

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[409] *Id*., 25:1-18.
[410] *Id*., 34:2-9.
[411] *Id*., 34:11-20.
[412] Staff Initial Brief, ¶¶ 163-64.
[413] Staff Initial Brief, ¶ 162.
[414] Staff Reply Brief, ¶ 151.
[415] Staff Initial Brief, ¶¶ 173-75.

c) Public Counsel on Double Leverage

275 Public Counsel witness Mr. Hill also recommends a double leverage adjustment to PacifiCorp's capital structure and cost rates. Mr. Hill's adjustments produce an overall rate of return of 7.45 percent based on an assumed MEHC capital structure of 52 percent equity and 42 percent debt to calculate the cost of the equity component of PacifiCorp's capital structure.[416]

276 Mr. Hill argues that if a double leverage adjustment is not made, ratepayers will be providing a return in excess of the cost of equity capital for MEHC.[417] He contends double leverage is an issue in the case of the MEHC acquisition, but not under ScottishPower ownership because ScottishPower's consolidated capital structure contains more equity than does PacifiCorp's.[418] Responding to Dr. Vander Weide, Mr. Hill argues the cost-savings associated with increasing leverage is not directly offset by the increased cost of equity caused by the increased risk attendant with increased leverage.[419] He further argues that ring fencing is not an adequate solution because it "does nothing to abate the problem of over-earning at the parent Company level."[420]

d) ICNU on Double Leverage

277 Mr. Gorman, representing ICNU, also contributes testimony regarding the potential consequences of the MEHC acquisition. He observes that the "exact impacts on PacifiCorp's cost of capital from being acquired by MEHC are not yet

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[416] Exh. 114-T at 17:13 – 18:14 (Hill). Mr. Hill proposes an adjusted capital structure containing 22.78 percent common equity at a cost of 10.125 percent and an additional 21.22 percent component of "MEHC debt" at a cost of 7.759 percent. Close examination of Mr. Hill's Exhibit 116 reveals that he actually based these figures on a 51.78 percent equity and 48.253 percent debt for the MEHC capital structure.
[417] Exh. 114-T at 2:15-16 (Hill).
[418] *Id*., 5:3-20.
[419] *Id*., 8:7 – 15:8.
[420] *Id*., 15:13-22.

known."[421] According to Mr. Gorman, those capital costs cannot be higher than would have been the case for a stand-alone PacifiCorp by the terms of the settlement agreements in the MEHC acquisition.[422] He speculates that merger conditions regarding the flow of dividends from PacifiCorp to MEHC could cause PacifiCorp to rely more heavily on short-term debt. He also speculates that some consequences of the merger could reduce PacifiCorp's off-balance-sheet debt and improve its credit ratios. According to Mr. Gorman, both of these factors might cause PacifiCorp's cost of capital to be lower than it would otherwise have been.[423]

278 Mr. Gorman agrees with Dr. Vander Weide that the standards for determining a fair and reasonable rate of return for PacifiCorp relate to the investment risk of the utility and the utility's ability to attract capital.[424] However, Mr. Gorman asserts it is also necessary to adjust customer rates to reflect actual taxes paid at the level of the consolidated parent. Mr. Gorman argues that this adjustment is necessary to ensure that customers do not pay more in provision for taxes than the taxes actually paid to governmental entities.[425]

279 Mr. Gorman does not describe any need for a double leverage adjustment. ICNU recommends in its Initial Brief that the Commission decline to adjust PacifiCorp's capital structure or cost of capital based on the proposed MEHC acquisition. While ICNU asserts the acquisition in the future may have significant affects on PacifiCorp's cost of capital, it asserts the record is not adequately developed to determine them.[426]

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[421] Exh. 141-T at 1:16-17, 3:11, 6:12-14 (Gorman).
[422] *Id*., 2:12-15.
[423] *Id*., 3:6-7.
[424] *Id*., 7:18-20.
[425] *Id*., 7:18 – 9:2.
[426] ICNU Initial Brief, ¶ 60

e) PacifiCorp Rebuttal on Double Leverage

280 In response to Staff's and Public Counsel's proposals, the Company argues that the double leverage adjustments are not viewed favorably in the academic literature, are not consistent with the ring fencing conditions attendant to the MEHC acquisition, are not consistent with fundamental principles of finance, and are not consistent with facts in this record.[427] The Company asserts that the actual capital structure of MEHC contains 57 percent equity when the debt issued by MEHC subsidiaries and the subordinated debt held by Berkshire Hathaway (considered equity by rating agencies) are appropriately excluded.[428] With regard to the formulas Staff and Public Counsel use to measure the relationship between leverage and equity cost, the Company argues that both are unreliable because they are either not supported in the record or shown to be in error.[429]

f) Discussion and Decision

281 With the recent repeal of the Public Utilities Holding Company Act[430] and other trends, nationally, toward consolidation, we may see an increase in merger and acquisition activity affecting utilities. We remain vigilant to ensure that Washington's utility customers are not harmed by the consequences—intended or unintended—of any merger or acquisition. However, in this case, and on this record, we reject the double leverage adjustments proposed by both Staff and Public Counsel for several reasons.

282 First, the record is insufficient to support the adjustments Staff and Public Counsel recommend. Both adjustments are based on critical assumptions regarding the final terms of MEHC's acquisition of PacifiCorp and of MEHC's consequent capital structure and balance sheet. Both adjustments make assumptions about the cost of any debt MEHC may issue as part of the acquisition. We understand that

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[427] PacifiCorp Initial Brief at 57-62.
[428] *Id*., 60.
[429] *Id*., 60-61.

the transaction has now been closed, but our record closed well beforehand. We do not know the final terms and consequences of the transaction.

283 Second, we question the merits and theory of double leverage as it applies to these circumstances. Both Staff and Public Counsel assert the cost of capital for PacifiCorp to provide service in Washington is made lower by the ownership and debt financing of MEHC than it would have been if PacifiCorp were a stand-alone utility. Assuming that this makes financial sense, which the Company's expert witness and other respected academicians apparently dispute, it could only be true if MEHC employs a more leveraged and therefore more risky capitalization. Both Staff and Public Counsel acknowledge this point. In fact, to protect Washington customers from such risks, both parties advocated for and secured strong ring fencing provisions in our acquisition docket.

284 The ring fencing provisions required by our final order in Docket UE-051090 insulate PacifiCorp and its customers from risks and financial distress at the MEHC level. In addition, conditions affecting the flow of dividends from PacifiCorp to MEHC serve to constrain the ability of MEHC to manipulate the capital structure of PacifiCorp. Staff describes the ring fencing provisions as "state of the art."[431]

285 Nonetheless, after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for customers the cost and tax benefits of that financing.[432] The Company's expert witness argues this may violate the familiar principle in utility law that financial benefits should follow burden of risks. We agree.[433] If the risks and costs of

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[430] Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).
[431] TR 1576:10-13 (Elgin).
[432] ICNU seeks to secure tax related benefits through its consolidated tax adjustment which we discuss in Section D.8. of this order.
[433] The Commission relied on this principle in a recent decision when allocating the gain on sale equitably between the ratepayers and the shareholders of the utilities selling the Centralia power plant. *In re the Matter of the Application of Avista Corporation for Authority to Sell Its Interest*

activities at the parent-level are born exclusively by shareholders—because customers are insulated from them by the ring fence—then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities. In circumstances that do not include adequate ring fence protections, the analysis could well be different.[434] But in circumstances that do include a "state-of-the-art" ring fence, as here, we are not persuaded it would be equitable to insulate customers from the burden of risks and costs borne at the parent-level while allowing customers to capture the benefits of those same

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in the Coal-Fired Centralia Power Plant, Docket UE-991255; *In re the Matter of the Application of PacifiCorp for an Order Approving the Sale of its Interest in (1) the Centralia Steam Electric Generating Plant, (2) the Rate Based Portion of the Centralia Coal Mine, and (3) Related Facilities; for a Determination of the Amount of and the Proper Rate Making Treatment of the Gain Associated with the Sale, and for an EWG Determination*, Docket UE-991262; *In re the Matter of the Application of Puget Sound Energy, Inc. for (1) Approval of the Proposed Sale of PSE's Share of the Centralia Power Plant and Associated Transmission Facilities, and (2) Authorization to Amortize Gain over a Five-Year Period*, Docket UE-991409, Second Supplemental Order (Mar. 6, 2000).

[434] Staff relies on a substantial body of case law to demonstrate that double leverage adjustments to capital structure and rate of return have been used in other jurisdictions and that those adjustments have been upheld by the courts. Staff Initial Brief, ¶¶ *153-155*. We have examined these cases carefully. We have also examined other relevant decisions. The case law Staff cites, however, is dated—the most recent case being in the mid-to late 1980's. There is more recent case law and policy, of which Staff is presumably aware. *See, e.g., Williams Natural Gas Co.*, FERC 80 ¶ 61,158 (1997); *Transcontinental Gas Pipeline Corp.*, 84 FERC ¶ 61,084 (1998); *Northwest Pipeline Corp.*, FERC 87 ¶ 61,266 (1999).

The FERC does not embrace the concept of double leverage. For purposes of calculating rate of return for wholly owned subsidiaries, FERC uses the stand-alone capital structure and return on equity of the subsidiary so long as the subsidiary issues its own debt, maintains its own credit ratings and meets other standards related to equity ratio. The courts have upheld this policy. *See Missouri Pub. Serv. Comm'n v. Federal Energy Reg. Comm'n*, 215 F.3d 1, 342 U. S. App. D.C. 1 (D.C. Cir. June 27, 2000).

While the FERC's policy touches on some of the features included in the ring fence surrounding PacifiCorp, we have yet to find an example in case law pertinent to double leverage that is fully comparable with the circumstances here. That is, where a ring fence has been comprehensively and specifically designed and implemented to insulate customers from risks of financing and other activity undertaken by a parent company. Without such ring fence protections, the utility customers in the cases Staff cites were presumably exposed to the costs and risks of activity at the parent-level and consequently it may have been appropriate for those customers to share in any tax or financing-related benefits that flowed from those activities. This significant difference in circumstances distinguishes the cases Staff cites from the circumstances in this proceeding.

parent company activities. Without the proposed double leverage adjustments, customers are held harmless from the consequences of the acquisition—they pay a return on capital that is no higher than they would have paid if PacifiCorp were a stand-alone utility. Reducing potential harm to customers by activities at the parent-level is the objective of the ring fence and also an appropriate objective for our determination of a reasonable and sufficient cost of capital for PacifiCorp.

286 We will revisit the issue if the "state-of-the-art" ring fence does not succeed in its purpose.

4. Cost of Capital Summary

287 Table 1 summarizes the capital structure and the cost rates for capital components we determine in this case.

Table 1. Overall Rate of Return Approved for PacifiCorp

Component	Share (%)	Cost (%)	Weighted Cost (%)
Equity	46	10.2	4.69
Long-term Debt	50	6.427	3.21
Preferred	1	6.59	.0659
Short-term Debt	3	4.5	.135
TOTAL	100		8.10

G. PacifiCorp's Petition to Defer Hydroelectric Costs

288 On March 18, 2005, PacifiCorp filed a petition in Docket UE-050412 seeking approval to establish a deferral account for costs relating to declining hydroelectric generation. The Company "seeks deferral of these costs to track and preserve them for later incorporation in rates, to be considered as part of the Company's next Washington general rate case. . ."

289 We later consolidated the Company's petition for deferred accounting with the Company's general rate case.

290 The Company asserts its hydroelectric generation has declined systematically over the last six years, primarily due to low water availability.[435] The Company notes hydroelectric generation has declined despite fluctuations in actual water conditions.[436] The Company asserts it has purchased energy on the wholesale market and relied on more expensive thermal generation during this period to make up the shortfall in generation from hydroelectric resources, resulting in losses or excess power costs.[437] The Company also forecasts losses for 2005 due to drought conditions resulting from the low mountain snow pack and record-low river flows across the state.[438]

291 PacifiCorp asserts the financial impact of the low water trend since 2000 has amounted to losses in excess of $500 million on a systemwide basis.[439] According to the Company, these circumstances warrant the use of deferred accounting to recover the excess power costs. PacifiCorp relies on our prior decisions approving the use of deferred accounting for variations in power costs due to extraordinary events, including power cost adjustment mechanisms we have approved.[440] PacifiCorp requests approval to defer from the date of the petition through the end of the general rate case its increased power costs caused by the continued trend of

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[435] Hydro Deferral Petition, ¶ 7.
[436] *Id*.
[437] *Id*., ¶¶ 7, 10.
[438] *Id*., ¶ 2; *see also* Exhibit A to the Hydro Deferral Petition.
[439] *Id.*, ¶ 10
[440] *Id*., ¶¶ 15, 16, citing *WUTC v. Puget Sound Power & Light Co.*, Cause U-81-41, Second Supplemental Order at 17-18, Appendix A (Mar. 12, 1982); *WUTC v. Puget Sound Power & Light Co.*, Docket UE-901183-T, Third Supplemental Order at 11-17 (April 1, 1991) (addressing PSE's proposed decoupling mechanism); *WUTC v. Avista Corp.*, Docket UE-000972, Order Granting Deferral of Power Cost Expenses Pending Demonstration of Prudence (Aug. 9, 2000).

low water availability.[441] PacifiCorp also intends the PCAM it proposes in the rate case to address future losses due to poor water conditions.[442]

292 PacifiCorp proposes to calculate its excess power costs using the Revised Protocol consistent with the terms of the settlement approved in Docket UE-032065.[443] In the settlement, the parties agreed the Company would use the Revised Protocol as the basis for its routine filings with the Commission.[444] The Company proposes to reconcile any amounts deferred under the Revised Protocol with the allocation method the Commission ultimately adopts in the rate case.[445] Finally, PacifiCorp requests it be allowed to accrue interest on the unamortized balance of deferred costs at its weighted average cost of capital, 8.39 percent, as authorized in Docket UE-032065.[446]

293 Based on the accounting proposed in the petition, which relies on the Revised Protocol for assignment of power costs to Washington, the Company requests approval to include $7.5 million in rates for recovery of costs anticipated to be deferred through December 2005.[447]

294 After reviewing the effect of the recent drought on water conditions and the Company's hydroelectric generation, Staff agrees that "some form of deferred accounting may be appropriate."[448] After considering the snow pack's water content for the winter of 2004/2005, and the differences between actual hydroelectric generation and normalized amounts, Staff concludes that

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[441] Hydro Deferral Petition, ¶ 3.
[442] *Id*., ¶ 14; *see also* Exh. 398-T at 4:2-7, 18-22 (Widmer).
[443] Hydro Deferral Petition, ¶ 19.
[444] *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.*, Docket UE-032065, Order 06 Approving and Adopting Settlement Agreement Subject to Conditions; Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing, Appendix A (Settlement) ¶ 8 b (Oct. 27, 2004).
[445] Hydro Deferral Petition, ¶ 21.
[446] *Id.*, ¶ 22
[447] Exh. 398-T at 3:1, 4:1-13, 20-22 (Widmer); *see also* PacifiCorp Initial Brief, ¶ 56 and TR-750:14-16 (Widmer), where the magnitude is revised to $8.3 million.
[448] Exh. 541-T at 208:5-20 (Buckley).

PacifiCorp's hydroelectric resources were affected by the 2005 Northwest drought "to an extraordinary degree."[449]

295 However, Staff contests the Company's calculation of the magnitude of the deferred cost appropriate to recover in rates. Staff objects to the Company including the cost of any Eastside hydro generation in its calculation, and its failure to consider variances in water conditions, which are already included in rates through normalizing power costs. Staff also objects to the use of the Revised Protocol for allocating costs and benefits, insisting that any allocation be consistent with the method Staff proposes.[450]

296 Staff recommends that the Company's calculation be adjusted and that recovery in rates be limited to a one-time deferral of $2.1 million in excess power costs for Washington, amortized over a three-year period.[451] Staff proposes to limit recovery of excess power costs to those incurred between March 2005 through December 2005. Staff's adjustment:

- Removes Eastside hydroelectric resources;
- Applies a 15 percent band to Company-owned and mid-Columbia hydroelectric resources as an estimate of variation in hydroelectric generation included in determining rates under a normalization process;
- Derives the excess costs for deferral by subtracting the band from the difference between actual and normalized generation, then multiplying the result by a weighted average replacement energy price, and;
- Allocates deferred costs to Washington based on Staff's recommended Amended Revised Protocol allocation factors.

297 Consistent with Staff's methodology in the prior rate case, Staff asserts the 15 percent band is necessary to limit recovery of excess costs to those incurred in extreme circumstances, and not those ordinary variations normalized during the

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[449] *Id*., 208:17-19.
[450] *Id*., 210:4-14.
[451] *Id*., 210:17 – 211:8; 214:8-10; *see also* Exh. 557.

ratemaking process.[452] Staff claims existing rates already account for variation in water conditions. Staff recommends the Commission apply the proposed 15 percent band and reject 100 percent recovery of excess costs due to hydro conditions.[453] Staff claims the Company accepted the 15 percent band in a settlement in the last rate case. Finally, Staff argues that the Company's request for 100 percent recovery of costs due to poor water conditions is inappropriate, as "ratemaking is a balancing of ratepayer and investor interests."[454]

298 The Company opposes Staff's adjustments to reduce recovery in rates to less than the full amount of the costs the Company has deferred. PacifiCorp discounts Staff's adjustment to remove Eastside hydroelectric resources as relating chiefly to Staff's "unwillingness to accept the Revised Protocol."[455] As to the proposed 15 percent band, the Company asserts that adjustments included in settlement agreements do not set a precedent for future ratemaking.[456] PacifiCorp also asserts Mr. Buckley conceded in cross-examination that the 15 percent band to remove the variance in water conditions was already included in base rates. According to the Company, this means that Staff is adjusting the same thing twice.[457] PacifiCorp requests the Commission disregard Staff's assertion in its Initial Brief that its adjustments to the deferred costs do not amount to double counting.[458]

299 In brief, Staff denies its proposed 15 percent band results in double counting of weather normalization.[459] Staff asserts both the Company and Staff's proposals remove some of the extreme wet and dry water years. According to Staff, the band is intended to limit the Company's recovery of retroactive power costs to

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[452] *Id*., 211:16-20.
[453] Staff Initial Brief, ¶ 104.
[454] Staff Initial Brief, ¶ 103, citing *POWER*, 104 Wn.2d at 808; Staff Reply Brief, ¶ 91.
[455] PacifiCorp Initial Brief, ¶ 56.
[456] Exh. 398-T at 3:12-21 (Widmer).
[457] *Id*., citing TR 966:1-8 (Buckley).
[458] PacifiCorp Reply Brief, ¶ 19.
[459] Staff Initial Brief, ¶¶ 105-6; Staff Reply Brief, ¶¶ 94-95.

extraordinary conditions and maintain an appropriate level of risk-sharing between investors and ratepayers.[460]

300 ICNU requests the Commission reject PacifiCorp's proposed hydroelectric cost deferral as well as Staff's adjustment, asserting the Company has not presented any evidence to support that the costs are extraordinary or not otherwise included in rates.[461] ICNU also asserts that the record contains no evidence showing these costs were prudently incurred or would produce just and reasonable rates. ICNU asserts there is no baseline against which to consider whether costs are above and beyond those included in rates, as the last several rate cases resulted in settlements.[462]

301 ICNU also opposes Staff's proposal, criticizing Staff's acceptance of the costs without determining prudence, finding fault with Staff's mix of actual and projected hydropower costs. Finally, ICNU argues that the record lacks any evidence regarding the portion of any deferred costs that should be allocated to Washington. ICNU observes that Staff's proposed amortization of a portion of the deferred account is based on Staff's Amended Revised Protocol method.[463]

302 ***Discussion and decision.*** The petition for an accounting order and the proposals of the Company and Staff for recovery of some level of deferred costs in rates present us with two related, but distinct questions:

1. Should we approve the deferral of costs as requested in the accounting petition?

2. Should any deferred costs be included for recovery in rates based on the evidence in this record?

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[460] Staff Initial Brief, ¶¶ 105-6; Staff Reply Brief, ¶ 94.
[461] ICNU Initial Brief, ¶ 52; ICNU Reply Brief, ¶ 23.
[462] ICNU Initial Brief, ¶ 54.
[463] *Id*., ¶¶ 56-58; ICNU Reply Brief, ¶ 23.

303 We start by reiterating what we said in a recent order approving deferred accounting for Puget Sound Energy:

> We emphasize that the question of accounting treatment and the question of recovery in rates are separate and distinct questions. The first question–accounting treatment–can be answered without the necessity for a detailed record because there is no inherent risk to ratepayers in doing so. That risk is not present precisely because the second question–rate treatment–will be answered only after the development of a detailed record. If PSE seeks to recover these costs in future rates, the Company will bear the burden to prove that such recovery is proper. Other parties will have the opportunity to contest whatever proof the Company offers, and to offer their own evidence and argument concerning how we should treat these costs for ratemaking purposes.[464]

304 As set forth *infra*, the current case presents us with a record sufficient to answer the first question in the affirmative, but insufficient to determine an answer to the second.

305 Focusing on the first question, the Company has pointed out that we have approved deferred accounting when such accounting is warranted by extraordinary circumstances. Unlike PacifiCorp's petition in Docket UE-020417, PacifiCorp limits this request for deferral specifically to excess costs due to low water conditions. Staff provides us with persuasive evidence and analysis that hydroelectric conditions affecting the Company's power costs through most of 2005 were indeed extraordinary.

306 Based on the evidence that hydroelectric conditions during 2005 were extraordinary, we will approve the Company's request to defer costs as described in its petition. PacifiCorp is authorized to create a deferral account and defer costs according to the accounting described in the petition beginning March 18, 2005, and ending with the effective date of this order. We extend this period beyond December 2005 in order to reflect that conditions in 2006 may have affected conditions during the winter of 2005/2006. The Company bears the burden to demonstrate that it continued to face extraordinary circumstances from January through the date of this order at such time as it seeks to recover any deferred cost balance in rates.

307 While we reject the Revised Protocol for purposes of allocating costs in this proceeding, PacifiCorp may use the Revised Protocol for purposes of calculating deferred costs consistent with this order. The settlement agreement in Docket UE-032065, which allows use of the Revised Protocol for filings with the Commission, remains in effect. Any deferred costs calculated using the Revised Protocol is subject to true-up under any allocation method approved in a future proceeding.

308 The Company is authorized to accrue interest on any unamortized balance in the deferral account at a rate equal to its 8.10 percent weighted average cost of capital authorized in this order.

309 Turning to the second question, we have previously identified the following considerations for the recovery of deferred power costs in rates:

- A company must demonstrate that any increase in costs above normalized levels are prudent, that the use of a deferral mechanism is appropriate, and that company-owned resources were used to benefit retail ratepayers.[465]

- A company must demonstrate prudence of power costs for which it seeks recovery, separate ordinary factors driving increases in costs from

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[464] *In re Petition of Puget Sound Energy, Inc., for an Order Authorizing Temporary Deferred Accounting*, Docket UE-011600, Order Granting Accounting Petition ¶ 9 (Dec. 28, 2001).
[465] *Petition of Avista Corporation for an Order Regarding the Accounting Treatment of Certain Wholesale Power Costs to Serve Firm Load Obligations*, Docket UE-000972, Order Granting Deferral of Power Cost Expenses Pending Demonstration of Prudence (Aug. 9, 2000).

> extraordinary factors, offset increased costs with increased revenues, and establish a well-supported baseline for measuring excess power costs.[466]

310 Both the Company and Staff recommend that some amount of deferred cost is appropriate for recovery in customer rates, although they disagree on the amount. However, as ICNU points out, the Company provides no evidence proving that it incurred the deferred costs prudently. Neither does the Company provide evidence with which we can judge compliance with the other elements included in the above-noted principles. For its part, Staff fails to state specifically whether it has reached a conclusion about whether the deferred costs were prudently incurred.

311 As to interstate cost allocation, the Company bases its request for $8.3 million in rate recovery on use of the Revised Protocol. The Staff bases its recommendation of $2.1 million on its Amended Revised Protocol. We have rejected both allocation methods. Consequently, we reject both amounts because both depend upon a flawed allocation formula.

312 Accordingly, we determine that the record does not support recovering deferred hydroelectric costs in rates at this time. In a future proceeding, the Company may request recovery of any balance in the deferred account we authorize in this order. However, any amounts deferred using the Revised Protocol must be adjusted to be consistent with the interstate cost allocation method we ultimately approve. In addition, the Company must demonstrate that any amounts it requests be recovered in rates were incurred prudently and meet the criteria stated above in paragraph 309.

313 As to Staff's recommended 15 percent band for limiting recovery of deferral balances, we observe that Staff conceded in hearing that the 15 percent band

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[466] *In re Petition of PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-020417, Sixth Supplemental Order, Denying Petition for Accounting Order; Rejecting Tariff Filing; Authorizing Subsequent Filing ¶¶ 25-33 (July 15, 2003).

would, in these circumstances, amount to double counting when considered with the adjustment the Company agreed to in the last settled rate case. Therefore, it would not be appropriate to apply the 15 percent band to any costs deferred pursuant to the accounting petition we have granted. While Staff asserts the general need for a sharing mechanism to avoid guaranteed recovery of costs, that issue can be more appropriately addressed separately in the design of a power cost adjustment mechanism.

FINDINGS OF FACT

314 Having discussed above in detail the evidence received in this proceeding concerning all material matters, and having stated findings and conclusions upon issues in dispute among the parties and the reasons therefore, the Commission now makes and enters the following summary findings of fact, incorporating by reference pertinent portions of the preceding detailed findings:

315 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices and accounts of public service companies, including electric companies.

316 (2) PacifiCorp is a “public service company” and an “electrical company” as those terms are defined in RCW 80.04.010, and as those terms otherwise may be used in Title 80 RCW. PacifiCorp is engaged in Washington State in the business of supplying utility services and commodities to the public for compensation.

317 (3) PacifiCorp provides retail electric service in six states: Utah, Oregon, Idaho, Wyoming, California and Washington.

318 (4) PacifiCorp's service territory is divided between two control areas – the Eastern control area comprised of Utah, Idaho and Wyoming, and the Western control area comprised of Oregon, Washington and California.

319 (5) Allocating costs is a prerequisite to determining the revenue requirement to be borne by each state's ratepayers.

320 (6) The Revised Protocol is PacifiCorp's proposed method or plan for allocating costs and wholesale revenues associated with the Company's generation, transmission and distribution system across its six-state service territory for the purpose of setting retail rates.

321 (7) The Revised Protocol is based on the premise that the Company operates as integrated six-state system in which customer loads are served from a common resource portfolio, and all states bear a rolled-in share of resources acquired to replace existing resources or to meet load growth.

322 (8) The Revised Protocol includes resources PacifiCorp recently acquired in Utah that were purchased or built to serve the increasing load in Utah and the Company's Eastern control area.

323 (9) There are significant transmission constraints impeding the exchange of power between PacifiCorp's Eastern and Western control areas.

324 (10) PacifiCorp does not provide quantitative evidence of the benefits of an integrated system, but offers only unsubstantiated broad statements about such benefits, including the potential to move power through the South Idaho Exchange contract, the opportunity to redispatch power, the availability of the Bonneville peaking contract to serve the Western control area, the possibility of off-system or wholesale sales revenues, the potential to defer resource acquisition for the Western control area and the enhancement of system reliability.

325 (11) When it chose to merge with Utah Power 20 years ago, PacifiCorp assumed the risk that divergent allocation decisions among the states in its service territory might result in under-recovery of costs.

326 (12) An approved cost allocation methodology is necessary before the Commission will approve, and PacifiCorp can implement, a power cost adjustment mechanism or a decoupling mechanism.

327 (13) PacifiCorp's proposed power cost adjustment mechanism is not tailored to address short-term changes in power costs due to extraordinary or unusual events.

328 (14) The decoupling mechanism proposed by PacifiCorp and NRDC lacks necessary operational details, such as impacts on the Company's overall revenues and cost of equity, implementation costs, and a commitment to incremental conservation measures as a counterbalance to the potential reduction in risk.

329 (15) The portion of the Stipulation on Temperature Normalization Adjustment reflecting a revenue requirement adjustment for temperature normalization is moot due to the lack of an acceptable allocation method.

330 (16) PacifiCorp did not incur capital stock issuance expenses in the test year for this rate proceeding, does not expect to incur such expenses in the future and has already recovered in rates some of the capital stock expenses it seeks to recover in this proceeding.

331 (17) The facts and circumstances underlying ICNU's consolidated tax adjustment, i.e., ScottishPower's and PHI's ownership of PacifiCorp, no longer apply, given that Mid-American Energy Holdings Company, Inc. (MEHC) acquired PacifiCorp on March 21, 2006.

332 (18) PacifiCorp has historically included short-term debt in its capital structure.

333 (19) PacifiCorp received $500 million in capital infusions from ScottishPower through March 2006.

334 (20) Extraordinary low water and hydroelectric conditions affected PacifiCorp's power costs during 2005.

335 (21) The Commission is unable to determine the appropriate share of excess power costs due to low water conditions in 2005 to be recovered from Washington ratepayers until PacifiCorp develops an acceptable cost allocation formula.

CONCLUSIONS OF LAW

336 Having discussed above all matters material to this decision, and having stated detailed findings, conclusions, and the reasons therefore, the Commission now makes the following summary conclusions of law incorporating by reference pertinent portions of the preceding detailed conclusions:

337 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to, these proceedings.

338 (2) The Commission regulates in the public interest, ensuring that rates or charges for services rendered by a public utility are fair, just, reasonable, and sufficient.

339 (3) In determining the fair value of public utility property for ratemaking purposes, i.e., establishing the appropriate rate base, the Commission must

determine whether the property is "used and useful for service in this state." *See RCW 80.04.250*.

340 (4) In determining whether public utility property is "used and useful for service in this state," the Commission considers whether a resource provides benefits to ratepayers in Washington either directly (e.g., the flow of power from a resource to customers) and/or indirectly (e.g., reduction of costs to Washington customers through exchange contracts or other quantifiable tangible or intangible benefits), commensurate with its cost.

341 (5) A public utility company bears the burden of proof to show that any requested increase in rates or charges is fair, just and reasonable.

342 (6) PacifiCorp has failed to meet its burden of proof to show that the resources included in the Revised Protocol inter-jurisdictional cost allocation methodology provide tangible direct or indirect benefits to Washington ratepayers and are "used and useful for service in this state." *See RCW 80.04.250*.

343 (7) The alternative cost allocation methods proposed by Staff and ICNU in this proceeding simply remove certain resources from and revise certain calculations in the Revised Protocol, and therefore fail to meet the statutory standard of "used and useful for service in this state" for the same reasons as the Company's Revised Protocol method.

344 (8) The rates proposed by tariff revisions filed by PacifiCorp, on May 5, 2005, and suspended by prior Commission order, are not fair, just, or reasonable and should be rejected.

345 (9) PacifiCorp's existing rates, established in Docket UE-032065 approving and adopting the settlement agreement, are deemed to be fair, just, reasonable and sufficient for both the Company and Washington ratepayers.

346 (10) PacifiCorp's proposed power cost adjustment mechanism does not adequately balance the risks and benefits between shareholders and ratepayers.

347 (11) The decoupling mechanism proposed by PacifiCorp and NRDC lacks necessary operational details and is insufficient.

348 (12) Paragraph 7 of the Stipulation on Temperature Normalization Adjustment, in which Staff and the Company agree to work toward a solution to a temperature normalization method for future proceedings, is in the public interest.

349 (13) The Uniform System of Accounts requires capital stock issuance expenses to be capitalized, rather than amortized, or reflected as a reduction of a company's cost of equity where the expenses have not already been recovered in rates.

350 (14) In determining the reasonableness of executive compensation, the Commission will consider compensation as a whole, not limited to whether executive incentive compensation is paid in stock or whether compensation is similar in level or benefits to that of other comparable companies.

351 (15) Rules established by the Financial Accounting Standards Board, in particular FAS 87 and FAS 106, require the use of current interest rates in effect on the measurement date for calculating the discount rate for pension and other post-employment benefits.

352 (16) Expenses for developing a regional transmission organization are ordinary, necessary and reasonable so long as the expenses are incurred to fulfill a utility's obligation to operate and invest in facilities necessary to serve the public.

353 (17) The $44 million payment PacifiCorp received in the Malin Midpoint transaction must be amortized, above-the-line, as an operating expense over the life of the asset (30 years), and unamortized payments deducted from rate base, consistent with the Commission's treatment of the transaction since 1982 and decisions by the Ninth Circuit Court of Appeals and the FERC.

354 (18) To impute revenue additions or deductions for any contract 43 years after it was signed requires substantial evidence that the utility acted imprudently at the time. It is not sufficient to show that another state Commission previously made a similar adjustment.

355 (19) PacifiCorp properly calculates state and federal income taxes by including interest and dividends in calculating taxable income and income tax expense, and then offsetting the expense by including the same amount in its Schedule M Adjustment.

356 (20) The Commission may encourage, but not require, utility companies to spend particular amounts on programs to assist low-income ratepayers, as utility companies participate voluntarily in such programs.

357 (21) PacifiCorp's policy of funding 50 percent of weatherization projects until taxpayer-supplied matching funds have been spent is appropriate.

358 (22) The Commission does not state a preference for a method to determine the amount of working capital and current assets supported by capital on which investors are entitled to a return. The proponent of a particular method for determining a company's working capital must include the study or method in the record, and parties proposing adjustments to the method must provide full evidentiary support of their proposals.

359 (23) A company advocating the inclusion of plant additions used and useful at the start of the rate period must clearly demonstrate it has made a properly matching depreciation adjustment.

360 (24) Consistent with the decision in Docket UE-031658, PacifiCorp may either defer current remediation expenses not covered by the PERCO insurance settlement, or recover them as a current period expense, but must demonstrate the expenses have not already been recovered through the insurance settlement.

361 (25) PacifiCorp has not met its burden of proof to show that the acquisitions of Yampa, Wyodak and a transmission line were prudent or of benefit to Washington ratepayers.

362 (26) Utility companies must seek approval before establishing deferral accounts or risk the disallowance of future recovery of the deferred expenses.

363 (27) The appropriate capital structure for ratemaking purposes is one that balances economy (the lowest overall cost to attract and maintain capital) with safety (preserving investment quality ratings and access to capital) in view of all the sources of capital available to a company.

364 (28) Consistent with PacifiCorp's recent capitalization, its capital structure should include short-term debt.

365 (29) PacifiCorp's share of equity capital should be higher than its historical equity share to reflect the infusion of capital from ScottishPower and the general trend of increasing equity capitalization in the industry, while considering the equity capitalization of comparable utilities and balancing safety and economy.

366 (30) The Commission must establish an overall cost of capital that would "ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital" (*Hope*, *320 U.S. at 692-93*), and would be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." *Bluefield, 262 U.S. at 692.*

367 (31) The Commission finds a capital structure of 46 percent equity, 50 percent long-term debt, 1 percent preferred stock and 3 percent short-term debt, with a cost of equity at 10.2 percent, cost of long-term debt at 6.427 percent, preferred stock at 6.59 percent and cost of short-term debt at 4.5 percent, meets the *Hope* and *Bluefield* standards.

368 (32) The record is insufficient to support the double leverage adjustments Staff and Public Counsel recommend to reflect assumptions of debt in the capital structure of MEHC, as the final terms and consequences of MEHC's acquisition of PacifiCorp are not a part of the record.

369 (33) It would be inequitable to insulate customers from the burden of risks and costs borne at the parent-level through the ring fencing approved in Docket UE-051090 and then capture the benefits of those parent company activities through a double leverage adjustment to PacifiCorp's cost of capital.

370 (34) Where a company faces extraordinary circumstances affecting its power costs, deferred accounting for those costs is generally appropriate.

371 (35) We find the low water conditions in 2005 were extraordinary circumstances that warrant allowing PacifiCorp to establish deferral accounts to track resulting excess power costs.

372 (36) To recover deferred power costs in retail rates, a company must demonstrate the excess power costs were prudent, after separating ordinary from extraordinary costs, offsetting increased costs with any increased revenues and establishing a well supported basis for measuring the excess costs.

373 (37) PacifiCorp has failed to bear its burden to demonstrate that excess costs due to low water conditions were prudently incurred and otherwise appropriate for recovery in rates.

374 (38) The Commission should retain jurisdiction over the subject matters and the parties to this proceeding to effectuate the terms of this Order.

ORDER

THE COMMISSION ORDERS:

375 (1) The proposed tariff revisions PacifiCorp d/b/a Pacific Power & Light Co. filed on May 5, 2005, and suspended by prior Commission order, are rejected.

376 (2) The Stipulation on Power Cost Issues filed by PacifiCorp d/b/a Pacific Power & Light Co. and the Industrial Customers of Northwest Utilities on November 3, 2005, is rejected.

377 (3) The Stipulation on Temperature Normalization Adjustment filed by PacifiCorp d/b/a Pacific Power & Light Co. and Commission Staff on January 30, 2006, is rejected, in part, and accepted, in part, consistent with this order identified in Appendix 1.

378 (4) PacifiCorp d/b/a Pacific Power & Light Co. must report to the Commission on its collaborative discussions concerning tracking data regarding low-income ratepayers and evaluating the Company's policies and efforts regarding arrearages within one year of the effective date of this order.

379 (5) PacifiCorp d/b/a Pacific Power & Light Co. is authorized to use an overall rate of return of 8.10 percent, based on a capital structure of 46 percent equity, 50 percent long-term debt, 1 percent preferred stock, and 3 percent short-term debt, with the cost of equity set at 10.2 percent, cost of long-term debt at 6.427 percent, preferred stock at 6.59 percent and the cost of short-term debt at 4.5 percent.

380 (6) PacifiCorp d/b/a Pacific Power & Light Co.'s Petition for Accounting Order in Docket UE-050412 is granted, in part, and denied, in part, consistent with this order, allowing PacifiCorp to establish deferral accounts for costs due to declining hydroelectric generation.

381 (7) The Commission retains jurisdiction to effectuate the terms of this order.

Dated at Olympia, Washington, and effective April 17, 2006.

WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

MARK H. SIDRAN, Chairman

PATRICK J. OSHIE, Commissioner

PHILIP B. JONES, Commissioner

NOTICE TO PARTIES: This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-07-870.

APPENDIX 1