

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND)
TRANSPORTATION COMMISSION,)

Complainant,)

v.)

PACIFICORP d/b/a PACIFIC POWER &)
LIGHT COMPANY,)

Respondent.)

Docket No. UE-100749

CROSS ANSWERING TESTIMONY OF MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

November 5, 2010

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 **A.** Michael Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q. ARE YOU THE SAME MICHAEL P. GORMAN WHO PRESENTED**
5 **RESPONSIVE TESTIMONY IN THIS PROCEEDING ON OCTOBER 5, 2010?**

6 **A.** Yes, I am.

7 **Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

8 **A.** I am appearing on behalf of the Industrial Customers of Northwest Utilities (“ICNU”).

9 **Q. WHAT IS THE PURPOSE OF YOUR CROSS ANSWERING TESTIMONY?**

10 **A.** I will comment on certain aspects of Washington Utilities and Transportation
11 Commission Staff witness Kenneth L. Elgin’s rate of return recommendations for
12 PacifiCorp d/b/a Pacific Power & Light Company (“PacifiCorp” or the “Company”).

13 **Q. PLEASE SUMMARIZE MR. ELGIN’S POSITION CONCERNING RATE OF**
14 **RETURN.**

15 **A.** Mr. Elgin is proposing a return on common equity of 9.5%, and he also proposes an
16 adjustment to PacifiCorp’s proposed capital structure. Mr. Elgin is proposing to adjust
17 PacifiCorp’s capital structure to include a balance of short-term debt components set
18 at 3.0% of total capital. As a result, Mr. Elgin’s proposed capital structure then
19 includes a common equity ratio of 46.5%, compared to PacifiCorp’s proposed 52.1%
20 common equity ratio.

21 **Q. WHY DID MR. ELGIN TAKE ISSUE WITH PACIFICORP’S PROPOSED**
22 **CAPITAL STRUCTURE?**

23 **A.** At page 13 of his testimony, he states concern that PacifiCorp does not control its own
24 capital structure. Rather, PacifiCorp capital structure is controlled by its ultimate
25 parent company, MidAmerican Energy Holdings Company (“MEHC”). Mr. Elgin

1 states the concern that MEHC has an economic incentive to increase PacifiCorp's
2 common equity ratio of total capital which will increase operating profits at
3 PacifiCorp.

4 **Q. IS MR. ELGIN'S CONCERN THAT MEHC HAS AN INCENTIVE TO**
5 **MAXIMIZE ITS PROFITS IN PACIFICORP BY INCREASING ITS**
6 **COMMON EQUITY COMPONENT OF TOTAL CAPITAL A REASONABLE**
7 **CONCERN?**

8 **A.** Yes. I agree with Mr. Elgin that MEHC does have an incentive to maximize its
9 earnings (or profit) at PacifiCorp. One method of accomplishing this profit
10 maximization would be to unnecessarily increase its common equity ratio of total
11 capital, thereby increasing PacifiCorp's operating income and net income. Both of
12 these will have the result of increasing the cash flow of PacifiCorp, and creating
13 unnecessary pressure to increase its tariff rate charges.

14 **Q. SHOULD A UTILITY'S CAPITAL STRUCTURE REPRESENT AN**
15 **APPROPRIATE BALANCE BETWEEN CUSTOMERS AND THE UTILITY**
16 **IN DEVELOPING A UTILITY'S COST STRUCTURE IN RETAIL RATES?**

17 **A.** Yes. A utility's capital structure should be composed of a reasonable balance of debt
18 and equity that will maintain the utility's financial integrity and access to capital.
19 However, the common equity component of this balanced capital structure should not
20 be excessive, because that will increase the cost of capital to retail ratepayers, above
21 that necessary to maintain the utility's financial integrity. As such, the capital
22 structure objective should be to minimize the utility's cost of capital, while preserving
23 its financial integrity and investment grade credit rating.

1 **Q. IS STAFF WITNESS ELGIN CONCERNED THAT PACIFICORP'S**
2 **PROPOSED CAPITAL STRUCTURE DOES NOT REFLECT THIS**
3 **BALANCED OBJECTIVE?**

4 **A.** Yes. Mr. Elgin's critique of PacifiCorp's capital structure is similar to mine.
5 PacifiCorp's capital structure is too heavily weighted with common equity. Indeed,
6 the capital structure exceeds Mr. Williams' previous testimony that PacifiCorp's
7 capital structure mix should contain roughly 50% debt and 50% equity. It is to
8 PacifiCorp's parent company's advantage to unnecessarily inflate the common equity
9 component because it will increase PacifiCorp's profitability and cash flows. The
10 Commission should set rates based on capital structures that represent a reasonable
11 balance.

12 **Q. MR. ELGIN IS PROPOSING TO INCLUDE A BALANCE OF SHORT-TERM**
13 **DEBT IN ITS CAPITAL STRUCTURE. IS IT COMMON FOR UTILITIES TO**
14 **HAVE SHORT-TERM DEBT IN THEIR CAPITAL STRUCTURE MIX?**

15 **A.** Generally, yes. Short-term debt ("STD") is generally used to finance construction
16 work in progress ("CWIP"), and at times can be used to finance permanent long-term
17 assets after CWIP assets are placed in-service. It is odd and troubling that PacifiCorp
18 does not appear to rely on short-term capital to finance its CWIP projects. It is a
19 concern for at least two reasons. First, no STD results in an increased cost of CWIP,
20 because the allowance for funds used during construction ("AFUDC") rate is higher
21 than it otherwise would be if the utility had used STD to acquire CWIP carrying
22 charges. Second, PacifiCorp's lack of STD is evidence that supports Mr. Elgin's
23 concern that MEHC is not managing PacifiCorp's capital structure to support its
24 financial integrity and credit rating at the lowest cost of capital possible. Third,
25 PacifiCorp's lack of STD also supports my concern that PacifiCorp is retaining too
26 much cash, generally in the form of full earnings retention and large equity infusions

1 from its parent company. This equity buildup is more than necessary in order to
2 timely fund its utility plant investment. This excessive cash position contributes to an
3 increase in common equity ratio because equity is increased ahead of utility debt and
4 utility plant.

5 **Q. BASED ON YOUR AND MR. ELGIN'S CONCERN THAT MEHC MAY NOT**
6 **BE MINIMIZING PACIFICORP'S COST OF CAPITAL, WHILE**
7 **SIMULTANEOUSLY MANAGING ITS CAPITAL STRUCTURE TO**
8 **MAINTAIN ITS FINANCIAL INTEGRITY AND ACCESS TO CAPITAL**
9 **MARKETS, DO YOU HAVE SPECIFIC RECOMMENDATIONS TO THE**
10 **COMMISSION?**

11 **A.** Yes. I think it would be appropriate for the Commission to outline appropriate capital
12 structure target weights for setting rates. PacifiCorp should be required to explain and
13 justify any deviation from the Commission capital structure components targets.

14 To the extent MEHC has an economic incentive to maximize PacifiCorp's cost
15 of capital, then the Commission should ensure that customers are protected from such
16 a monopolistic management action by establishing capital structure targets that are
17 designed to support PacifiCorp's financial integrity and credit rating, but at the lowest
18 cost of capital possible.

19 **Q. DOES THIS CONCLUDE YOUR CROSS ANSWERING TESTIMONY?**

20 **A.** Yes, it does.