**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| WASHINGTON UTILITIES ANDTRANSPORTATION 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**

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

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

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

**A.** Yes, I am.

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

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

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

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

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

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

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

**A.** At page 13 of his testimony, he states concern that PacifiCorp does not control its own capital structure. Rather, PacifiCorp capital structure is controlled by its ultimate parent company, MidAmerican Energy Holdings Company (“MEHC”). Mr. Elgin states the concern that MEHC has an economic incentive to increase PacifiCorp’s common equity ratio of total capital which will increase operating profits at PacifiCorp.

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

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

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

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

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

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

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

**A.** Generally, yes. Short-term debt (“STD”) is generally used to finance construction work in progress (“CWIP”), and at times can be used to finance permanent long-term assets after CWIP assets are placed in-service. It is odd and troubling that PacifiCorp does not appear to rely on short-term capital to finance its CWIP projects. It is a concern for at least two reasons. First, no STD results in an increased cost of CWIP, because the allowance for funds used during construction (“AFUDC”) rate is higher than it otherwise would be if the utility had used STD to acquire CWIP carrying charges. Second, PacifiCorp’s lack of STD is evidence that supports Mr. Elgin’s concern that MEHC is not managing PacifiCorp’s capital structure to support its financial integrity and credit rating at the lowest cost of capital possible. Third, PacifiCorp’s lack of STD also supports my concern that PacifiCorp is retaining too much cash, generally in the form of full earnings retention and large equity infusions from its parent company. This equity buildup is more than necessary in order to timely fund its utility plant investment. This excessive cash position contributes to an increase in common equity ratio because equity is increased ahead of utility debt and utility plant.

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

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

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

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

**A.** Yes, it does.