Exhibit No.___(BNW-7T)
Docket No. UE-100749
Witness: Bruce N. Williams

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP dba Pacific Power Respondent.	)	Docket No. UE-100749

PACIFICORP

REBUTTAL TESTIMONY OF BRUCE N. WILLIAMS

November 2010

1 **Introduction and Summary of Rebuttal Testimony**

2 **Q. Are you the same Bruce N. Williams that previously provided testimony in**
3 **this docket?**

4 A. Yes, I am.

5 **Q. What is the purpose of your rebuttal testimony?**

6 A. The purpose of my rebuttal testimony is to respond to the capital structure
7 recommendations offered by Washington Utilities and Transportation
8 Commission Staff (Staff) witness Mr. Kenneth L. Elgin and Industrial Customers
9 of Northwest Utilities (ICNU) witness Mr. Michael P. Gorman. In my analysis, I
10 demonstrate that these recommendations unreasonably propose the use of a
11 hypothetical capital structure without a clear and compelling justification for
12 disregarding PacifiCorp's actual capital structure. PacifiCorp's proposed 52.1
13 percent equity component remains well supported by the updated cost of capital
14 summary presented in my testimony. Adoption of PacifiCorp's actual capital
15 structure will allow the Company a fair opportunity to maintain its credit rating
16 and attract capital on reasonable terms.

17 My rebuttal testimony also responds to Staff's and ICNU's overall rate of
18 return recommendations and shows how these recommendations, if adopted,
19 would negatively impact PacifiCorp's financial integrity.

20 **Review of Staff and ICNU Recommendations**

21 **Q. What are the parties' recommendations on capital structure?**

22 A. Messrs. Elgin and Gorman both recommend a hypothetical capital structure that

1 reduces the equity component from PacifiCorp's actual equity share of 52.1
2 percent to 46.5 percent and 49.1 percent, respectively.
3 **Q. Are there items concerning the cost of capital in your direct testimony with**
4 **which the parties agreed?**
5 A. Yes. Messrs. Elgin and Gorman both accept the Company's proposed cost of
6 long-term debt and preferred stock. No party in this docket has proposed
7 changes to either of those items.
8 **Company's Overall Cost of Capital**
9 **Q. Are you proposing a new overall cost of capital in this proceeding?**
10 A. No. PacifiCorp's rebuttal filing continues to support its original overall cost of
11 capital of 8.34 percent:
12 Overall Cost of Capital

Component	Percent of Total	% Cost	Weighted Average
Long-Term Debt	47.6%	5.89%	2.80%
Preferred Stock	0.3%	5.41%	0.02%
Common Stock Equity	52.1%	10.60%	5.52%
Total	100.0%		8.34%

19 Although the Company had a small amount ($34 million) of short-term debt
20 outstanding at September 30, 2010, the Company continues to expect no short-
21 term debt at December 31, 2010. The amount of short-term debt at September 30,
22 2010 is immaterial to the overall calculation of cost of capital.

1 **Reply to Staff's Capital Structure Adjustment**

2 **Imputation of Hypothetical Short-term Debt**

3 **Q. Please describe the adjustment that Mr. Elgin is proposing to the Company's**
4 **capital structure.**

5 A. Mr. Elgin proposes a hypothetical capital structure that includes less common
6 equity, more long-term debt and a component for short-term debt. To derive his
7 capital structure Mr. Elgin: (1) adds a hypothetical short-term debt component of
8 3 percent; (2) reduces the common equity to 46.5 percent; and (3) forces the long-
9 term debt component up to 50.2 percent to get his hypothetical capital structure
10 weights to sum to 100 percent. Mr. Elgin made no adjustment to the company's
11 proposed preferred stock component of the capital structure. (Elgin Direct at 2.)

12 **Q. What is the Commission's policy with respect to the use of hypothetical**
13 **capital structures in setting cost of capital?**

14 A. It is my understanding that the Commission has allowed the use of hypothetical
15 capital structures only when there is a "clear and compelling" reason to do so.
16 Mr. Elgin has not addressed this standard in his testimony, nor has he provided
17 evidence that satisfies it.

18 **Q. What are your specific concerns with Mr. Elgin's proposed capital**
19 **structure?**

20 A. As noted, Mr. Elgin's proposed capital structure does not match the Company's
21 actual capital structure. Mr. Elgin imputes a short-term debt component of 3
22 percent, even though the Company's actual short-term debt is now approximately
23 0.2 percent. The absence of any material amount of short-term debt in the

1 Company's capital structure is not an aberration; for the previous six quarters, the
2 Company has had no short-term debt in its capital structure.

3 **Q. What is the Company's actual capital structure?**

4 A. At September 30, 2010 the capital structure was:

Short-Term Debt	0.2%
Long-Term Debt	46.9%
Preferred Stock	0.3%
Common Stock Equity	52.6%

9 As the table above shows, the Company's actual equity component at the end of
10 September is in excess of the 52.1 percent in the proposed capital structure. In
11 addition, the common equity component will increase through the end of the year
12 as the Company continues to retain all earnings. Finally, it should be noted that
13 since acquisition by MidAmerican Energy Holdings Company in 2006,
14 PacifiCorp's common equity component has averaged 50.2 percent of total
15 capitalization (including short-term debt).

16 **Q. Why has the Company had little or no short-term debt?**

17 A. The Company has not needed short-term debt for various reasons, including
18 issuing a significant amount of new long-term debt during January 2009 and
19 capital contributions received from our indirect parent company. The Company's
20 capital structure takes advantage of short-term interest rates in its portfolio of
21 remarketed tax-exempt bond obligations. With long-term debt rates at such
22 favorable levels, the Company has been able to reduce short-term debt and limit

1 the exposure of PacifiCorp's financial structure to short-term interest rate
2 fluctuations and turbulence in the commercial paper markets.

3 **Q. Please explain the benefits of PacifiCorp's actual capital structure.**

4 A. The Company's actual capital structure is intended to maintain current credit
5 ratings. As I discussed in my direct testimony, maintenance of the Company's
6 credit ratings benefits customers by reducing immediate and future borrowing
7 costs. In addition, higher rated companies are more likely to have on-going,
8 uninterrupted access to capital and access at lower costs. Further, higher rated
9 companies have greater access to the long-term markets for power purchases and
10 sales which provides more alternatives to meet the current and future load
11 requirements of customers. Also, higher rated companies can often avoid or
12 reduce the amount of costly collateral requirements that are typically imposed on
13 lower-rated companies when transacting in the wholesale energy markets.

14 **Q. Is there a clear and compelling basis for imputing hypothetical short-term**
15 **debt into PacifiCorp's capital structure?**

16 A. No. There is no clear and compelling rationale to impute hypothetical short-term
17 debt into PacifiCorp's capital structure. Indeed, in my opinion, the only basis for
18 including actual short-term debt in a utility company's capital structure is if: (1)
19 the balance of short-term debt exceeded the company's balance of construction
20 work in progress (CWIP); and (2) there was a persistent balance of short-term
21 debt in excess of CWIP. Under those conditions, a commission could make a
22 finding that a utility was financing long-term assets with short-term sources of
23 funds and reasonably include the average of any persistent excess balance of

1 short-term debt above the balance of CWIP. Clearly, because PacifiCorp has not
2 maintained a material amount of short-term debt, these conditions would not be
3 met in PacifiCorp's case.

4 **Q. Historically, have the Company's CWIP balances exceeded its short-term**
5 **debt?**

6 A. Yes. PacifiCorp has historically had CWIP balances that, on average, were in
7 excess of short-term debt, especially during periods of large plant construction.
8 Exhibit No.___(BNW-8) compares PacifiCorp's short-term debt to CWIP
9 balances over the most recent 18-month period. During this period, the CWIP
10 balances have exceeded short-term debt by over $1.7 billion on average.

11 **Q. Could the imputation of short-term debt in the capital structure result in**
12 **double-counting of short-term debt?**

13 A. Yes. Mr. Elgin is essentially proposing that short-term debt be implied to fund
14 assets in service. The more appropriate view is that short-term debt funds CWIP
15 and thus it should not be a component of the capital structure that finances rate
16 base.

17 The inclusion of short-term debt in the capital structure creates a mismatch
18 inasmuch as rate base excludes CWIP, while the capital structure would include
19 the short-term debt financing. The result of including short-term debt in the
20 capital structure is to overstate the overall level of debt used to support rate base.
21 Even Mr. Elgin agrees that short-term debt is used to fund CWIP and that
22 completed construction projects financing will be "rolled-over" to more
23 permanent sources of funding (Elgin, page 19, lines 5-6).

1 Inclusion of short-term debt in the capital structure implies that CWIP
2 must be financed by long-term capital financing. This runs counter to the
3 allowance for funds used during construction (AFUDC) mechanism for recovery
4 of CWIP financing costs as prescribed by FERC, and followed by the Company,
5 which calls for short-term rates and balances to be incorporated into the
6 determination of the AFUDC rates. A key element underlying the FERC-
7 prescribed AFUDC rate is that short-term debt is the first source of capital used to
8 finance CWIP.
9 If short-term debt were to be included in the capital structure for
10 ratemaking purposes, it would be appropriate for PacifiCorp to adjust its AFUDC
11 to remove the impact of short-term debt in the determination of the AFUDC rate.
12 This adjustment would be necessary to avoid the double counting that would be
13 created by including short-term debt in the capital structure.
14 Under the FERC System of Accounts, PacifiCorp's utility customers
15 receive the benefits of lower-cost short-term debt financing at the time the CWIP
16 assets enter service, as their cost basis at that time will be lower. If the
17 determination of the AFUDC rates were adjusted as suggested above, then assets
18 would likely enter service at a higher cost.
19 **Q. What about Mr. Elgin's statement that a utility should use its short-term**
20 **borrowing capability to fund its construction budget?**
21 A. I find it wholly inconsistent for Mr. Elgin to promote the financing of construction
22 (which is not in rate base) with short-term debt while at the same time proposing
23 to use short-term debt as financing plant in service. The CWIP balance is already

1 charged a financing rate at the Company's AFUDC rate which includes a short-
2 term debt component. It would make sense and the Company would be receptive
3 to the inclusion of short-term debt in the capital structure if Staff correspondingly
4 proposed that CWIP be placed into rate base and included in the Company's
5 revenue requirements.

6 **Q. How did Mr. Elgin determine the amount of short-term debt he imputes into**
7 **PacifiCorp's capital structure?**

8 A. Mr. Elgin imputes short-term debt in the amount of $500 million or 3 percent of
9 the capital structure primarily by reference to the capital structures of Puget
10 Sound Energy and Avista. Exhibit No.___(BNW-9), page 1.

11 **Q. Should the Company's capital structure be set by reference to short-term**
12 **debt levels of two unrelated utilities?**

13 A. No. The Commission has made clear that a company's capital structure should be
14 based upon its own capital structure, absent a clear and compelling reason to
15 impute other data. Further, these two utilities have lower credit ratings than the
16 Company's, making them inappropriate comparators.

17 **Hypothetical Common Equity Component**

18 **Q. How did Mr. Elgin determine the 46.5 percent common equity component**
19 **for his hypothetical capital structure?**

20 A. Mr. Elgin's analysis included utilities that are either not rated or rated below
21 investment grade, neither of which should be used as the basis of determining the
22 Company's capital structure. Exhibit No.___(BNW-9), pages 2-3.

23 Further, the data from SNL that Mr. Elgin uses as the basis of his capital

1 structure analysis is not comparable to the Company's capital structure Exhibit
2 No.___(BNW-9), pages 4. SNL includes current maturities of long-term debt in
3 the definition of "short-term debt" [1]which results in a reduction of long-term debt
4 and a corresponding increase in short-term debt As such, any analysis that uses
5 SNL data to determine peer group short-term debt levels or long-term debt levels
6 should be disregarded.

7 **Q. What capital structure does Mr. Elgin's ROE peer group have on average?**

8 A. If one were to use the projected capital structure of Mr. Elgin's peer group that he
9 uses for determining return on equity Exhibit No.___(BNW-9), pages 5-11, the
10 average common equity level would be 50.4 percent determined as follows:

	Common Equity
Alliant Energy	56.5%
Avista Corp	48.5%
DPL Inc.	50.0%
Idacorp, Inc.	51.0%
Portland General	50.0%
Wisonsin Energy	48.0%
Xcel Energy	48.5%
	50.4%

11 **Q. Mr. Elgin states that his proposed hypothetical capital structure balances**
12 **economy and safety. Do you agree?**

13 A. No, in fact the opposite is true. Mr. Elgin's own testimony is that his capital
14 structure would lead to a downgrade for PacifiCorp.

15 "A 46.5 percent equity ratio is sufficient to support a solid BBB
16 corporate credit rating and an A- secured rating for the

[1] SNL Table 10 – Definition of Short-Term Debt Exhibit 10, page 2.

1 Company."[2]

2 However, the Company's existing ratings are above that level and as such,
3 adoption of his proposed capital structure would indicate this Commission's
4 support for at least a one notch downgrade and possibly more for PacifiCorp.

5 Having a BBB rating imposes a tremendous risk for a utility, like
6 PacifiCorp, in the midst of a build cycle with a need to access the capital markets.
7 That rating level leaves little margin for unexpected events such as unsettled
8 financial markets, issues in the power markets, storms or other such
9 developments. For example, during the financial turmoil of 2008 Arizona Public
10 Service Company (rated Baa2/BBB- at that time) filed a letter with the Arizona
11 Corporation Commission stating that the commercial paper market was
12 completely closed to them and they could not likely issue long-term debt. See
13 Exhibit No.___(BNW–11). Another example is Avista Corporation which has
14 just recently achieved investment grade status from the three major rating
15 agencies. As stated in Avista's 2008 annual report:

16 "In late 2007 and early 2008, we restored an overall corporate
17 investment grade credit rating with the two major credit rating
18 agencies. Our credit ratings were downgraded during the fourth
19 quarter of 2001, which resulted in an overall corporate credit rating
20 that was below investment grade. The downgrades were due to
21 liquidity concerns primarily related to significant amounts of
22 purchase power and natural gas costs that we incurred in our utility
23 operations. These downgrades increased our debt service costs."

[2] Elgin Testimony October 5, 2010 page 16 lines 17 through 19.

1 Prior to downgrade, Avista was rated BBB- by S&P and Baa2 by Moody's, similar
2 to what Mr. Elgin is now recommending for PacifiCorp. Avista became a victim
3 of the Western energy crisis of 2000-2001 because of its weak investment grade
4 status. Its investment grade credit was not strong enough to survive the strain on
5 liquidity due to extreme purchased power costs. It was forced to non-investment
6 grade status causing debt costs to rise and capital market access to shrink.

7 **Q. Does Mr. Elgin propose a corresponding increase in the cost of debt due to**
8 **the new lower ratings of the Company resulting from his proposed capital**
9 **structure?**

10 A. No. Mr. Elgin accepts the Company's proposed cost of debt – which reflects the
11 interest rates resulting from the Company's actual credit ratings – while at the
12 same time proposing at least a one notch downgrade and ignoring the future
13 higher costs that would result.

14 It is at best inconsistent to propose a lower equity level while ignoring the
15 impact of the resulting downgrade on the Company's overall cost of debt. Mr.
16 Elgin seeks to diminish the Company's credit rating without reflecting any of the
17 costs of doing so.

18 **Q. Had PacifiCorp's credit ratings been lower, would the Company's cost of**
19 **debt be at the level is it today?**

20 A. Absolutely not. For comparison, the cost of long-term debt as filed by Puget
21 Sound Energy, which is rated at levels below the Company, in their most recent
22 rate case was 6.82 percent, nearly **100** basis points higher than PacifiCorp which
23 is at 5.89 percent.

1 **Q. Have you attempted to quantify what the Company's cost of debt would be**
2 **had it been downgraded as Mr. Elgin is proposing?**
3 A. Yes. I have analyzed the Company's debt issuances since acquisition by MEHC
4 during 2006 and have correspondingly changed the issuance spread to match what
5 a BBB rated utility achieved at approximately the same point in time that the
6 Company issued debt. The result is that on those seven series of debt totaling
7 $3.4 billion the cost would increase by 88 basis points to 6.91 percent. That
8 increase in the cost of debt would result in PacifiCorp's customers paying
9 approximately $30 million more in annual interest expense. However, that may
10 not capture the extent of the increased capital costs as it assumes that PacifiCorp
11 would have been able to issue debt during the recent financial crisis, during which
12 certain BBB rated utilities found the long-term debt markets were closed to them.
13 It is also possible that the Company would have been forced to cut its capital
14 programs in response to the markets being inaccessible. Finally, it also ignores
15 the increase in investor required equity returns as described by Company witness
16 Dr. Samuel C. Hadaway. However, the Company was able to avoid this scenario
17 by being prudently capitalized and enjoying the benefits of its current ratings.
18 **Q. In addition to higher borrowing costs, would there be other adverse**
19 **consequences to a ratings downgrade?**
20 A. Yes, including potential loss of access to the capital markets, increased fees under
21 credit agreements, letters of credit and other banking arrangements, increased
22 collateral requirements to support wholesale energy activities and possible loss of
23 access to long-term wholesale energy markets.

1 **Q. Have you reviewed Mr. Elgin's analysis on the safety of his proposed capital**
2 **structure containing 46.5 percent common equity?**
3 A. Yes. Mr. Elgin appears to be confusing the issue with an attempt to analyze
4 whether a "typical bond indenture covenant" would allow additional debt
5 issuances. The relevant issue is whether investors and creditors would choose to
6 invest in and lend to such a company and if so, on what terms and conditions.
7 **Q. Are Mr. Elgin's attempts to justify his leveraging of the Company's balance**
8 **sheet persuasive?**
9 A. No. Mr. Elgin uses a pretax interest coverage ratio to determine the
10 appropriateness of his 46.5 percent common equity structure Exhibit
11 No.___(BNW-9), pages 12. However, there are several issues regarding his
12 analysis. First, pretax interest coverage is not a critical ratio followed by the
13 rating agencies. Instead, the agencies tend to rely on cash-flow driven ratios such
14 as funds from operations interest coverage and funds from operations debt
15 coverage in addition to capital structure. Please see Exhibit No.___(BNW-12)
16 which are copies of recent Moody's and S&P credit rating reports concerning
17 PacifiCorp. Their discussions concerning financial ratios highlights funds from
18 operations (also referred to as cash from operations before changes in working
19 capital) as the key interest coverage metric. One can safely conclude the rating
20 agencies do not consider pretax interest coverage a major credit rating
21 determinant.
22 Second, his ratio analysis is merely hypothetical, taking his recommended
23 pretax weighted cost of equity (both common equity and preferred) plus the

1 weighted cost of debt and dividing by the weighted cost of debt. This calculation
2 assumes that hypothetical authorized cost of capital will translate into actual
3 operating returns and debt costs, does not take into account adjustments that
4 rating agencies make to a utility's financial statements for off-balance sheet
5 financing and makes no allowances for future capital expenditures. As a result,
6 Mr. Elgin's pretax interest coverage ratio is not representative of the metrics used
7 by rating agencies in today's environment.
8 Third, Mr. Elgin's metric is further exposed as unrealistic because at one
9 point he states a 100 percent debt capital structure would be "very unsafe and
10 likely result in default".[3] However, his pretax interest coverage calculation of a
11 coverage ratio of 2x is in reality a 100 percent debt structure. This can be seen by
12 the fact that a 2x pretax coverage ratio with debt costs as the denominator
13 effectively requires the numerator to be twice the cost of debt or the pretax
14 weighted cost of capital. This is verified by the fact that the after tax cost of debt
15 3.83 percent (5.89 percent times (1-35 percent tax rates)) is almost identical to his
16 calculated ROE of 4.0 percent.[4] It also should be noted that he makes no
17 adjustment for removing the weighted preferred cost which slightly overstates the
18 result. More importantly, to say that by staying just above a 2x pretax interest
19 coverage ratio (a ratio not used by rating agencies and is hypothetically based),
20 the Company can maintain access to capital markets and maintain its loan
21 covenant requirements is unrealistic.

[3] Elgin Responsive Testimony page 13 lines 6 through 1.
[4] Elgin Responsive Testimony page 18 line 2.

1 **Q. Mr. Elgin states that he performed an analysis of the cost of "additional**
2 **equity compared to the lower interest expense that would be achieved by the**
3 **higher equity level." Can you please comment on his analysis?**
4 A. Yes, in reviewing his work papers there appear to be several errors. Among other
5 things, he has not used the correct amount of debt outstanding in his analysis
6 Exhibit No.___(BNW-9, pages 13). The impact of this error is to underestimate
7 the amount of additional debt service cost which lowers the resulting all-in cost of
8 debt.
9 The next error is more significant and results from Mr. Elgin not
10 increasing the amount of debt to correspond to his proposed reduced equity
11 component. Clearly, the amount of assets being financed are not changed so as
12 equity is reduced, debt must correspondingly increase. However, Mr. Elgin failed
13 to increase the amount of debt and thus has significantly underestimated the
14 increased interest expense. As such, his analysis on this point should be ignored.
15 As I mentioned earlier, I have performed an analysis that shows the
16 Company's debt cost would be nearly 0.90 percent higher had Mr. Elgin's capital
17 structure been implemented. That increase in cost is just on the amount of
18 existing debt and does not capture the additional interest which accompanies the
19 additional debt Mr. Elgin proposes, the combined effect of which would be a very
20 substantial increase in the Company's costs.

1 **Q. Mr. Elgin also states that most electric utilities are rated BBB and that only**
2 **about 1 in 4 pay the extra cost to achieve the added safety of an "A" rating.**
3 **Can you comment on that?**
4 A. Certainly. While I cannot state why each of the other approximately 175 utilities
5 select their capital structure, I do believe that the industry as a whole is moving to
6 higher equity levels in their capital structure, just as the Company is. Following
7 the financial crisis of 2008, when many had difficulty accessing funding, the
8 utility industry is decreasing their debt component and correspondingly moving to
9 higher equity levels. As stated in S&P's recent report "*U.S. Investor-Owned*
10 *Electric Utilities Trended Positively In A Quiet Third Quarter" (dated October*
11 *15, 2010):*
12 "Based on a significant sampling of U.S. electric utilities, adjusted
13 total debt to total capital, including hybrid preferred securities (to
14 which most, if not all, were accorded intermediate equity
15 treatment) and adjusted for off-balance-sheet obligations such as
16 leases, purchased power contracts, accounts receivable financing,
17 and pension and retiree medical liabilities, declined to 57.78% at
18 June 30, 2010 from the 59% recorded at the end of 2009 and the
19 61% at the end of 2008. Notwithstanding the slight improvement
20 in capital structure balance, we generally consider a debt to capital
21 level of 50% or greater to be aggressive to highly leveraged for
22 utilities."

1 **Q. Please summarize your response to Mr. Elgin's testimony.**

2 A. Mr. Elgin proposes a hypothetical capital structure without providing a clear and
3 compelling justification for it. His hypothetical capital structure contributes to his
4 7.48 percent ROR recommendation, which is well below industry averages. Mr.
5 Elgin acknowledges that his capital structure recommendation will produce a
6 ratings downgrade, and his attempts to suggest that the Company's financial
7 integrity will remain intact if his capital structure is adopted are unpersuasive.

8 Mr. Elgin's proposed capital structure and overall cost of capital would
9 clearly miss the mark with rating agencies, investors and others who expect the
10 Company to receive "reasonable outcomes in pending and future rate
11 proceedings…."[5]

12 **Reply to ICNU Witness Mr. Gorman**

13 **Q. What is your general response to Mr. Gorman's capital structure**
14 **recommendations?**

15 A. Mr. Gorman proposes a series of adjustments to PacifiCorp's actual capital
16 structure to produce a hypothetical capital structure with a common equity
17 component of 49.1 percent. Like Mr. Elgin, Mr. Gorman has failed to provide a
18 clear and compelling justification for his hypothetical capital structure. Mr.
19 Gorman's adjustments for cash and acquisition adjustments are arbitrary and
20 without a financial basis. Further, he uses a time period for his common equity
21 analysis which is inconsistent with the rate case test period and his attempts to
22 prove the recommended equity structure is supportive of the Company's credit
23 rating are in error.

[5] Fitch Ratings, October 1, 2010

1 **Q. Does Mr. Gorman propose to impute short-term debt into his hypothetical**
2 **capital structure?**
3 A. No, unlike Mr. Elgin, Mr. Gorman does not attempt to include short-term debt in
4 the capital structure.
5 **Q. Please explain Mr. Gorman's adjustments to the Company's actual common**
6 **equity component.**
7 A. Mr. Gorman proposes to remove acquisition adjustments, special deposits, short-
8 term investments, and the difference in affiliate notes receivable and payable.
9 The most significant of these are the approximate $360 million adjustment for
10 short-term investments of $196 million and acquisition adjustments of $158
11 million for a total of $354 million. Mr. Gorman believes his capital structure "is
12 more reasonable in setting rates because it reflects the actual common equity
13 capital PacifiCorp relied on to invest in utility plant."[6]
14 **Q. Please identify the fundamental problems in Mr. Gorman's analysis**
15 **regarding the removal of acquisition adjustments.**
16 A. The acquisition adjustments Mr. Gorman proposes to remove from the common
17 equity component of the capital structure relate to the Craig and Wyodak
18 generating plants, both of which are recoverable investments in all other state
19 jurisdictions. Due to the Washington allocation methodology, Mr. Gorman
20 excluded the adjustments since they relate to plants outside the western control
21 area. However, this makes no sense for several reasons. First, the Company
22 finances its operations for all states with one capital structure. The Company does
23 not finance a specific unique capital structure for each state jurisdiction or finance

[6] Gorman Responsive Testimony page 13 lines 22 and 23.

1 assets differently depending on state allocations. For example, the majority of
2 pollution control bonds are related to plants out of the west control area and have
3 a rate of 2.69 percent. Mr. Gorman does not exclude these favorable financings
4 from the capital structure.
5 Second, Mr. Gorman mistakenly excludes the gross amount of acquisition
6 adjustments and ignores the accumulated amortization related to the two plants
7 totaling nearly $100 million. Had he correctly determined his proposed exclusion
8 for the acquisition adjustments, it would be $58 million. Even at this reduced
9 level, however, the adjustment remains inappropriate and violates the matching
10 principle.
11 **Q. Please respond to Mr. Gorman's adjustment related to short-term**
12 **investments.**
13 A. First, as of September 30. 2010, the Company had exhausted its temporary cash
14 investments, effectively eliminating this aspect of Mr. Gorman's adjustment.
15 Additionally, in general financial treatment, short-term investments are often
16 netted against long-term debt to determine what is known as "net debt". Net debt
17 is used as a financial metric to reflect the company's net obligation to its
18 bondholders. Nowhere in general finance is there support for Mr. Gorman's
19 novel proposal to net common equity with cash to derive net common equity.
20 **Q. Did Mr. Gorman use the same period of time as the Company to determine**
21 **his hypothetical capital structure?**
22 A. No, based on his workpapers (Exhibit No.__(MPG-3)) Mr. Gorman is using a
23 period of time from June 30, 2009 through June 30, 2010. However, the

1 Company's capital structure was determined as the average during the twelve
2 months ending December 31, 2010. Therefore, as the Company expects to retain
3 all earnings during 2010 to finance necessary capital expenditures to serve its
4 customers, Mr. Gorman would naturally have a lower common equity percentage
5 than what the Company calculated.

6 **Q. Do you agree with Mr. Gorman's statement that PacifiCorp's capital**
7 **structure at June 30, 2010 is 52.2 percent and is very close to that projected**
8 **by PacifiCorp for year-end 2010 of 52.1 percent?**[7]

9 A. Yes. Mr. Gorman has correctly stated the Company's actual common equity level
10 of 52.2 percent at June 30, 2010. However, the 52.1 percent he cites is the
11 expected average during the test period in this case and the common equity
12 component will be higher at year end 2010. This higher ratio will permit
13 maintenance of the Company's credit rating and allow the Company to attract
14 additional capital to meet construction needs.

15 **Q. Mr. Gorman states that it is reasonable to believe that these short-term cash**
16 **investments simply represent a placeholder for all the retained earnings**
17 **PacifiCorp is retaining to build up its common equity ratio.**[8] **Do you agree**
18 **with him?**

19 A. No, all of the Company's net cash from operations since acquisition by MEHC
20 has been re-invested in the business. The fact is that PacifiCorp is investing more
21 into its business than the amount of cash flow generated by operations. For
22 example, during the first six months of 2010, the Company has invested $876

[7] Gorman Responsive Testimony page 13 lines 14 through 15.
[8] Gorman Responsive Testimony page 14 lines 24 through 26.

1 million into capital expenditures while generating only $779 million of net cash
2 flow from operations. These facts show that Mr. Gorman's position is unfounded.

3 **Credit Metric Analysis**

4 **Q. Please comment on Mr. Gorman's discussion concerning financial integrity**
5 **and his credit metric analysis.**

6 A. I disagree with Mr. Gorman's analysis and conclusions for four reasons. First,
7 Mr. Gorman's calculations did not properly reflect the adjustments that rating
8 agencies make when calculating their credit metrics. For instance, my direct
9 testimony stated that S&P adds nearly $1 billion of additional debt and $73
10 million of interest to PacifiCorp's reported results.[9] While Mr. Gorman did
11 attempt to include the adjustments, he unfortunately only included a portion of the
12 total adjustments and not the entire amounts. He includes less than half of the
13 total debt adjustments ($432 million vs. $998.2 million) and only $28.1 million of
14 the $73 million of additional interest.[10]

15 Second, even the portion of the adjustments he included is incorrectly
16 stated as Mr. Gorman further reduces the amount by mis-matching a Washington
17 allocation percentage to a total company capital structure. This further reduces
18 the impact of the already too low adjustments.

19 Third, Mr. Gorman's model also excludes a significant amount of interest
20 expense that the Company reports on its financial statements such as interest
21 expense on customer deposits, interest on capital leases, regulatory liabilities and

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[9] Beginning with their April 30, 2010 report, S&P now imputes $78.2 million of interest while the debt amount is approximately the same. This increase, while not material to the discussion above, would further weaken Mr. Gorman's credit metrics had he included the updated adjustments.

[10] Gorman Exhibit No.__(MPG-19), lines 5 and 9.

1 others.

2 Fourth, Mr. Gorman ignores the rating agencies' published expectations

3 for PacifiCorp and instead measures the flawed results of his model against the

4 general utility industry. Had Mr. Gorman used the Company specific targets from

5 the rating agencies, his already over-stated results still would not have supported

6 the Company's current ratings.

7 **Q. Was Mr. Gorman aware of these rating agency published expectations for**

8 **PacifiCorp?**

9 A. Yes, Mr. Gorman cites them in his testimony on page 9 for Standard & Poor's and

10 page 11 for Moody's. It is not clear why he ignored them for purposes of his

11 credit metrics. For all these reasons the Commission should disregard Mr.

12 Gorman's statements that his recommended return on equity and proposed capital

13 structure are supportive of the Company's current bond rating.

14 **Q. Does that conclude your rebuttal testimony?**

15 A. Yes.