Exhibit No. KGS-1T
Docket UE-15____
Witness: Kurt G. Strunk

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of PACIFIC POWER & LIGHT COMPANY, Petition For a Rate Increase Based on a Modified Commission Basis Report, Two-Year Rate Plan, and Decoupling Mechanism.	Docket UE-15____

PACIFIC POWER & LIGHT COMPANY

DIRECT TESTIMONY OF KURT G. STRUNK

November 2015

TABLE OF CONTENTS

ATTACHED EXHIBITS

Q. Please state your name, business address, and present position.

A. My name is Kurt G. Strunk. I am Vice President at National Economic Research Associates, Inc. (NERA). NERA is a firm of consulting economists with its principal offices in a number of major U.S. and European cities. My business address is 1166 Avenue of the Americas, New York, New York 10036.

QUALIFICATIONS

Q. Please describe your education.

A. I hold an M.B.A. in Finance with Distinction from INSEAD (The European Institute of Business Administration) and an honors degree in Economics from Vassar College.

Q. Please describe your professional experience.

A. Since the mid-1990s, my work at NERA has focused on strategic and corporate financial issues facing public utilities in the natural gas, oil and electric power sectors. I have served as a testifying expert on public utility rate matters before federal, state and provincial regulatory commissions in the U.S. and Canada, and in U.S. court proceedings. I have also served as a consulting expert in dozens of administrative law proceedings before North American and European energy regulators. I have served as an expert in over 50 rate cases.

My assignments frequently require that I determine the appropriate return on equity capital for energy companies. I have calculated and supported required rates of return in traditional rate cases for regulated entities and in litigation and advisory work. I also speak on the topic at industry conferences.

My current curriculum vitae, which more fully details my educational, consulting, and testifying experience, is provided as Exhibit No. KGS-2.

PURPOSE OF TESTIMONY

Q. Please explain the purpose of your testimony.

A. Pacific Power & Light Company (Pacific Power or Company), a division of PacifiCorp, has asked me to provide an analysis of its cost of equity in today's capital markets. The purpose of my testimony is to explain the analysis I performed and to summarize the results for the Washington Utilities and Transportation Commission (Commission).

The Company is seeking approval of a two-year rate plan, including a decoupling mechanism, and offers my evidence as a gauge for whether capital markets have changed significantly since the Commission authorized a return on equity (ROE) of 9.5 percent only eight months ago in Order 08 in the Company's 2014 general rate case, Docket UE-140762 (2014 Rate Case).[1] While the Company's authorized return falls below the fair return level supported by my testimony and below the authorized returns available to similarly situated utilities, I understand the Company's petition does not seek change to the overall rate of return or any component thereof. Rather, the Company seeks approval of its Expedited Rate Filing (ERF), its decoupling mechanism and two-year rate plan. The Company proposes these measures as an attempt to address known and measurable cost increases associated with environmental initiatives, earnings attrition, and chronic under-

[1] *Wash. Utils. & Transp. Comm'n v. Pacific Power & Light Co.*, Dockets UE-140762 *et al.*, Order 08 at 77, ¶¶ 182 (Mar. 25, 2015).

recovery of costs, of which the cost of capital is a key component. The Company's proposal is an important step towards improving its financial strength.

Insofar as current capital market conditions and those projected to prevail over the rate-effective period remain consistent with those that were analyzed by the parties and the Commission in the 2014 Rate Case, sound policy grounds exist for avoiding a new adjudication of ROE. The Company, as part of its proposal, is attempting to limit controversial issues that are usually addressed in a general rate case. ROE is often one of the most hotly contested issues in any case.[2] In this context, the Company's proposal to retain the existing ROE and capital structure is appropriate.

Q. Please summarize your findings concerning the current and projected capital markets and their implications for a fair return level for the Company.

A. I presented the Company's ROE testimony in Pacific Power's most recent general rate case.[3] I recommended a 10.0 percent ROE based on my review of capital market conditions and the results of a number of financial models for estimating ROE. I examined return expectations for a proxy group of comparable utilities and for the electric industry more broadly. My updated analysis demonstrates that an ROE of 10.0 percent continues to be appropriate for Pacific Power and reflects an appropriate level of return commensurate with the risks faced by the Company's equity owners

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[2] *Wash. Utils. & Transp. Comm'n v. Pacific Power & Light Co.*, Dockets UE-140762 *et al.*, Order 08 at 75, ¶ 176, fn 260 (Mar. 25, 2015) ("The Commission devoted 21 pages to the analysis and discussion of cost of capital issues, more than 20 percent of the 97 pages of substantive discussion in Order 05.").

[3] *Wash. Utils. & Transp. Comm'n v. Pacific Power & Light Co.*, Dockets UE-140762 *et al.*, Strunk Direct Testimony (May 1, 2014).

under the ERF, decoupling mechanism, and two-year rate plan. My conclusions reflect the following considerations:

1. The Company continues to face particularly challenging market and regulatory circumstances relative to other electric utilities in the U.S. Environmental initiatives locally and federally require that the Company make major capital investments, which in turn are putting upward pressure on rates. Energy efficiency investments and changes in economic activity have suppressed kilowatt-hour sales in the Company's service territory in Washington, which have limited the ability of the Company to recover costs since its rate structures provide for a significant portion of fixed-cost recovery through volumetric rates. Under the existing regulatory processes, the Company has faced consistent under-recovery of its costs, including the cost of capital, as reflected in persistent earnings shortfalls relative to authorized returns. Mr. R. Bryce Dalley documents this trend in his direct testimony. In the past, credit rating agencies have expressed concerns about the consequences of the challenging regulatory environment in Washington.[4] The Commission's invitation to address these challenges through ERFs and decoupling mechanisms is constructive. Adoption of the Company's proposal will be a step toward addressing these challenges, but it will take time for the effects of these innovative regulatory mechanisms to reflect themselves in the Company's financial health and for the efficacy of the new measures—which are not without ongoing risks—to be established.

[4] *See e.g*, the Rebuttal Testimony of Bruce N. Williams, Docket UE-140762, Exhibit No. BNW-16T at 8:1-12.

2. The data reviewed and financial modeling performed in connection with my ROE update indicate similar current and projected market conditions to those that prevailed at the time of my ROE analyses for the 2014 Rate Case. In my rebuttal testimony in that docket, I showed the 30-year Treasury yield as of November 6, 2014, to be 3.09 percent. The level one year later, as of November 12, 2015, is unchanged at 3.09 percent. Hence, the conditions in the long-term U.S. Treasury bond market are consistent today with the evidence presented to the Commission in the 2014 Rate Case. I note, however, that credit spreads for risky corporate debt have expanded since I prepared my rebuttal testimony in that docket. While the yield for Moody's Baa-rated long-term corporate bonds was 4.79 percent on November 6, 2014, it stood at 5.48 percent on November 18, 2015, indicating a higher-yield environment for risky corporate securities. My updated application of the ROE models to the data for the proxy group and the industry generally results in discounted cash flow (DCF) model results of 8.88 and 10.40 percent and risk premium model results of 9.29 and 10.14 percent. In the 2014 Rate Case, the corresponding DCF-based estimates were 9.23 and 9.90 percent in my direct testimony and 9.00 and 10.10 percent in rebuttal. For the risk premium models, the corresponding estimates were 9.67 and 10.22 percent in direct and 9.73 and 10.07 percent in rebuttal. Today, as it was one year ago, capital market analysts are projecting an increase in long-term bond yields over the coming years. For its part, the Federal Reserve has signaled that it will raise

short-term interest rates in December 2015.[5] While certain indicators of ROE have fallen slightly, others have increased. On balance, the data suggests that capital market conditions are similar to those analyzed in the Company's last general rate case.

3. Today's capital markets reflect anomalous conditions in at least two respects. First, the persistence of central bank intervention in capital markets has created an interest rate environment that has no precedent in recent history. Second, recent share price gyrations in stock markets have kept investors on edge and have led to bouts of decreased liquidity at times of market stress. In this context, it is appropriate to move cautiously when establishing fair returns as the prospects for equity investments are exhibiting considerable volatility and increased liquidity risks amidst the volatility.

4. A fair return for Pacific Power must consider returns available to equity investors on comparable investments. The authorized ROE of 9.5 percent on a hypothetical 49.1 percent equity base is at the low end of returns available to equity owners of integrated electric utilities.[6] *See* Exhibit No. KGS-3. The average authorized return for all state-regulated electric utilities in the first three quarters of 2015 is 10.01 percent, a figure which has moved less than 10 basis points from the level observed for calendar year 2014. In addition, the Federal Energy Regulatory Commission (FERC) has authorized ROEs at levels that exceed these state-level returns for electric transmission and

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[5] *See* "Fed's Williams sees strong case for December interest-rate hike," *Reuters*, November 21, 2015. See also, "Fed Keeps December Rate Hike in Play," *Wall Street Journal*, October 28, 2015.

[6] In my testimony in the 2014 Rate Case, I explained why a lower equity ratio required an ROE leverage adjustment and performed a quantitative analysis of the appropriate level of the adjustment.

interstate pipeline investments. Comparisons to these other investment opportunities demonstrate that 10 percent reflects a fair equity return for Pacific Power.

5. The new regulatory mechanisms that the Company proposes are relatively common in the industry and do not warrant any change to ROE due to regulatory risk differences as between the Company and the Proxy Group. As shown in the direct testimony of Mr. Dalley, the Company's overall authorized rate of return is below other electric utilities regulated by this Commission. The Commission has approved overall rates of return for both Puget Sound Energy, Inc. (PSE) and Avista Corp. at levels higher than that previously approved for Pacific Power even while those firms incorporate decoupling and power cost adjustment mechanisms into their tariffs.

I will provide additional details on these points below.

Q. How is the remainder of your testimony organized?

A. First, I present the specific estimates of ROE resulting from my updated analysis. These estimates remain reasonably close to those that the Commission had on record when it approved a 9.5 percent ROE earlier this year. Second, I summarize current and projected capital market conditions and discuss the trends of central bank intervention, heightened volatility and liquidity constraints during periods of market stress. Third, I discuss the effects of the ERF, decoupling mechanism, and two-year rate plan on the business and financial risks faced by the Company as compared to those faced by proxy group companies, and conclude that these mechanisms do not warrant adjustment to the ROE. Fourth, I describe recent trends in the ROE levels authorized by regulators. I conclude by summarizing my findings.

UPDATED RETURN ON EQUITY ANALYSIS

Q. How did you arrive at your assessment of a fair return for Pacific Power?

A. I performed cost of capital studies using established financial models and reviewed general trends in capital market conditions. My familiarity with the Company's specific market and regulatory situation, gained from my involvement in its most recent general rate case, also helped to shape my conclusions on a reasonable ROE. I used several cost of capital methodologies, including the DCF model, the Capital Asset Pricing Model (CAPM), and a risk premium model, as well as an examination of comparable earnings and allowed returns. Exhibit Nos. KGS-3 through KGS-17 present the results of these financial models, together with graphical depictions of the evolution of key capital market parameters and a summary of recent allowed returns.

Q. To which proxy group did you apply these models?

A. I began with the proxy group that I found to be a reasonable set of comparable firms in my direct testimony in the 2014 Rate Case.[7] The twenty-four companies in that group, like Pacific Power, derive the majority of their revenues from regulated utility operations. I chose to start with this group because it was recognized to be a reasonable comparable group by me and by other cost of capital experts in that proceeding.

I then eliminated eight companies that have been involved in merger and acquisition activity. These are: Alliant Energy Corporation, Black Hills Corporation,

[7] Dockets UE-140762 *et al.*, Exh. No. KGS-1T (May 1, 2014).

Cleco Corp., Duke Energy Corp., NextEra Energy Group, Inc., Pepco Holdings, Inc., Southern Company, and Wisconsin Energy Corp. I removed Pepco Holdings and NextEra Energy Group, Inc. because each announced a combination with another utility (Exelon Corp and Hawaiian Electric Corporation respectively).[8] I omitted Cleco because it is being acquired by an investor group.[9] I excluded Wisconsin Energy Group because it is acquiring Integrys Energy Group, Duke Energy because of its purchase of Piedmont Natural Gas, Black Hills Corporation due to its acquisition of SourceGas, and Southern Company because of its acquisition of AGL Resources.[10] Finally, Alliant Energy Corporation was excluded because it sold utility assets.[11] As these merger activities led to a significant reduction in the size of my proxy group, I then included seven additional proxy companies that I had deemed to be comparable to Pacific Power in my rebuttal testimony in the 2014 Rate Case.

The resulting proxy group consists of the following twenty-three companies: Ameren Corporation, American Electric Power Company, Inc., Avista Corporation, Centerpoint Energy Inc., Consolidated Edison, Inc., Dominion Resources, Inc., DTE Energy Company, Edison International, El Paso Electric Company, Eversource Energy, Great Plains Energy Incorporated, IDACORP, Inc., NorthWestern Corporation, OGE Energy Corp., Pinnacle West Capital Corporation, Portland General Electric Company, Public Service Enterprise Group Incorporated, SCANA

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[8] *See* http://www.pepcoholdings.com/about-us/exelon-acquisition/ and http://www.nexteraenergy.com/news/contents/2014/120314.shtml.

[9] Reuters, "Cleco Enters Agreement to be Acquired by North American Investor Group Led by Macquarie Infrastructure and Real Assets and British Columbia Investment Management Corporation," October 20, 2014.

[10] *See* Wisconsin Energy to acquire Integrys Energy Group for $9.1 billion in cash, stock and assumed debt - creating a leading Midwest electric and gas utility," June 23, 2014 http://www.integrysgroup.com/transaction/NewsRelease.pdf.

[11] *See* PR Newswire, "Alliant Energy Closes Sale of its Minnesota Electric Distribution Assets-to-Cooperatives" July 31, 2015.

Corporation, Sempra Energy, The Empire District Electric Company, Vectren Corporation, Westar Energy, Inc., and Xcel Energy Inc.

Q. What does your update to the models show?

A. Exhibit No. KGS-4 summarizes my update. The ROE estimates therein, taken together with the other considerations I describe in my testimony, continue to support a fair return for the Company of 10 percent.

Q. How do you interpret the DCF model result for the proxy group, which shows a return slightly below nine percent?

A. The proxy group DCF result is inconsistent with the other indicators of ROE. An ROE of under nine percent in these market conditions does not represent a fair return for Pacific Power.

Q. How has the FERC – which exclusively uses a proxy-group-based DCF to determine ROE – addressed the current anomalous market conditions and their effects on DCF results?

A. The anomalous capital market conditions led the FERC to question the reasonableness of the assumptions and inputs to its formulaic DCF approach. The FERC held: "all methods of estimating the cost of equity are susceptible to error when the assumptions underlying them are anomalous."[12] To address potential errors in the proxy group DCF under current conditions, the FERC developed an alternative

[12] *Martha Coakley et al v. Bangor Hydro-Electric Co. et al,* FERC Opinion No. 531-B, paragraph 50, 150 FERC ¶ 61,165 (March 3, 2015).

measure of central tendency that focuses on the upper half of the range of estimated ROEs and, in its judgment, resulted in a fair return.[13]

Q. Are your ROE determinations sufficiently forward-looking for the Commission to rely upon them when approving a rate plan that will be in effect for two years?

A. Yes. ROE analysis is a forward-looking exercise and my estimates reflect the Company's forward-looking cost of equity. In regulatory practice, ROE determinations based on these models and data are often in place beyond a two-year period and in some cases for many more years into the future. Further, I provide evidence of the forecasts made by capital market analysts with regard to the future interest rate environment. See Exhibit No. KGS-5.

CENTRAL BANK INTERVENTION AND HEIGHTENED VOLATILITY

Q. Has intervention by Central Banks led to anomalous market conditions?

A. Yes. The current capital market conditions are anomalous from a historical perspective. Yields on long-term treasury bonds have been suppressed by the Federal Reserve's bond-buying program and have been affected by its policy of holding short-term interest rates at levels close to zero. Although the Federal Reserve terminated its bond-buying program, which was designed to manage long-term interest rates, the agency has moved slowly to raise short-term rates. The fact is that long-term interest rates—those relied upon by financial analysts to model investor return expectations—remain near all-time lows. At the same time, as demand for

[13] *Martha Coakley et al v. Bangor Hydro-Electric Co. et al*, FERC Opinion No. 531, 149 FERC ¶ 61,032 (October 16, 2014).

stocks has pushed equity prices up, dividend yields have fallen significantly since 2009, both for industrial firms generally and for utilities.

Q. After the Fed stopped its bond-buying program (quantitative easing or QE), have there been other forces holding down long-term treasury yields?

A. Yes. As the Federal Reserve stopped its own asset purchases, other central banks, including the European Central Bank, the Bank of China, and the Bank of Japan acted to pursue similar policies. These actions of foreign central banks affect the increasingly global and interconnected capital markets and have put continued downward pressure on long-term government bond yields. As of November 2015, analysts reported over $15 trillion in aggregate central bank asset purchases, with the U.S. Federal Reserve's share representing just over $4 trillion.[14] The assets purchased by central banks include long-term U.S. treasuries, corporate bonds and equities. An examination of aggregate central bank asset purchases since 2008 shows no signs of a slowdown, even though the U.S. Federal Reserve has not engaged in any explicit new programs.[15] Currently, official foreign institutions hold close to 80 percent of ownership of long-term U.S. Treasury bonds by foreign. entities, a figure that has risen substantially since the financial crisis began.[16]

Q. Please explain the heightened volatility in equity markets.

A. Recent uncertainty over the domestic economy, the Fed's future course of action, and intervention of other central banks have led the stock market to exhibit wild swings in share prices. On August 24, 2015, for example, the Dow Jones Industrial Average

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[14] *See e.g.*, *Global Economic Briefing:Central Bank Balance Sheets*, Yardeni Research, Inc., November 15, 2015.
[15] *Id.*
[16] Jaime Caruana, General Manager, Bank for International Settlements, BIS Paper No. 66.

experienced the largest intraday price drop to date, falling 1,089 points upon market opening. Trading was halted 1,200 times that day. [17]

The so-called "flash crash" of May 6, 2010, offers another example of the swings in value that pose risks to equity investors. That day, the Dow Jones Industrial Average fell nearly 1,000 points (a 9 percent drop).[18] While the index did recover those losses, shares changed hands at prices that reflect the crash and investors faced a liquidity squeeze.

Consistent with this experience, the stock volatility index (VIX) has at times exhibited heightened readings. The VIX has risen from under 15 percent to over 25 percent on several occasions in recent years. The press has documented this trend of increased volatility. For example, an article in the Financial Times noted: "Investors are far from relaxed about the volatility spike, and understandably so."[19] This article considers several explanations for the increased volatility, including, for example, a reaction to reduced intervention by the Federal Reserve and a decreasing effectiveness of its policies to contain market volatility.

Q. Why does volatility matter?

A. Volatility is an important contributor to investment risk and to investor perceptions thereof. Heightened share price volatility implies higher risks and higher required returns for investors who bear those risks.

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[17] "Trading in Stocks, ETFs Was Halted More Than 1,200 Times Early Monday," *Wall Street Journal*, August 24, 2015.
[18] *Findings Regarding the Market Events of May 6, 2010*. Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, September 30, 2010.
[19] *See* "Three possible explanations have differing market implications," *Financial Times* (Nov. 3, 2014).

Q. Have there also been liquidity events identified in other capital markets?

A. Yes. Recent investigations into trading in U.S. Treasury bonds identified a similar liquidity event. For example, an investigative report on recent trading anomalies found:

> On October 15, 2014 ("October 15"), the market for U.S. Treasury securities, futures, and other closely related financial markets experienced an unusually high level of volatility and a very rapid round-trip in prices. Although trading volumes were high and the market continued to function, liquidity conditions became significantly strained.[20]

The report notes that the market movements on that day came without any news to explain them.

EXPEDITED RATE FILING, DECOUPLING MECHANISM, AND TWO-YEAR RATE PLAN

Q. Do you understand that the Company's proposal, as outlined in this filing, contains three primary elements?

A. Yes, I do. I understand that Pacific Power's proposal has three separate elements that work together to provide the Company an opportunity to recover its costs, including the cost of equity capital. These are: 1) an ERF; 2) a decoupling mechanism; and 3) a two-year rate plan. Although each separate element addresses a discrete issue, the overall purpose of the filing is to remedy the Company's inability to recover its costs over the next two years.

[20] *The U.S. Treasury Market on October 15, 2014*, Joint Staff Report, authored by staffs of the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission, July 13, 2015.

Q. How do you analyze these three proposals from an ROE perspective?

A. While these types of proposals typically bear little or no relation to ROE, I nevertheless consider them both individually and jointly to evaluate whether they warrant adjustments to the ROE. I also confirm that similar regulatory mechanisms are employed by the comparable utilities in the proxy group.

Q. Has the Commission acknowledged the lack of any direct or quantifiable relationship between risk mitigating regulatory tools and the cost of capital?

A. Yes. The Commission correctly concluded in the PSE ERF proceeding that:

> We believe it is correct that cost of capital analysis cannot be expected to produce results that support measurement of decrements to ROE ostensibly due to approval of one risk mitigation mechanism or another. Nor would cost of capital analysis be adequate to the task of identifying increments to ROE that might be considered due to some measure of additional risk a company takes on at some point in time. The Commission has never tried to account separately in its ROE determinations for specific risks or risk mitigating factors, nor should it. Circumstances in the industry today and modern regulatory practice that have led to a proliferation of risk reducing mechanisms being in place for utilities throughout the United States make it particularly inappropriate and unnecessary to consider such an undertaking. The effects of these risk mitigating factors was by 2013, and is today, built into the data experts draw from the samples of companies they select as proxies.[21]

The Commission's finding correctly characterizes the fact pattern for Pacific Power and the proxy group I rely upon. It also correctly highlights the analytical intractability of tying specific basis point adjustments to specific regulatory measures on a utility-specific basis. As shown in Exhibit No. KGS-18, twenty of the twenty-three proxy group holding companies employ decoupling for at least one

[21] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130137 and UG-130138 (consolidated) *et al.*, Order 15/14 at 69, ¶ 155 (June 29, 2015). Internal citations omitted.

utility operating company. In addition, several utility operating companies employ trackers related to capital expenditures. All electric utilities in the proxy group have power cost adjustment mechanisms (PCAM) of one form or another. A number have pursued multi-year rate plans. Hence, the regulatory mechanisms being proposed in this filing, and the already-approved PCAM, are not unique to Pacific Power; they are also reasonably reflected in the proxy group.

Q. Please describe the purpose of the ERF.

A. The ERF is a limited-issue rate proceeding that seeks smaller rate increases within a shorter timeframe than a general rate case. A primary motivation for initiating such a proceeding is to avoid the continuous stream of general rate cases that many utilities, like Pacific Power, have experienced over the last decade. The Company's ERF is intended to help it to manage regulatory lag and to recover a larger share of its prudently incurred costs.

Q. Did you factor in the costs, benefits, and risks of the ERF in your ROE analysis?

A. Yes, I did. The ERF has the potential to provide quicker changes in rates, but comes at a cost. On net, I do not find that the ERF warrants any adjustments to the ROE. This appears to be the view of the Commission as well, having in the past approved an ERF mechanism together with other innovative regulatory tools without requiring an ROE adjustment.[22]

Q. What about decoupling?

A. Decoupling mechanisms are now relatively common tools used by the industry. While not all utilities have a decoupling mechanism, many utilities do and many have

[22] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130137 and UG-130138 (consolidated) *et al.* (June 29, 2015).

other risk-mitigating mechanisms that Pacific Power does not have such as capital trackers. As noted, my proxy group of comparable utilities already reflects the impact of decoupling and other adjustment mechanisms on the applicable fair return.

Q. Did the Commission also state that it would be inclined to lower PSE's ROE if decoupling were the only factor it was considering?

A. Yes, but in the PSE ERF proceeding, like Pacific Power's filing, the Commission was not only considering decoupling, but was jointly considering an ERF, decoupling, and a rate plan.[23] In collectively considering the filings the Commission decided that the ROE should remain the same without adjustment for decoupling.[24]

Q. Should the ROE be adjusted because of the decoupling mechanism?

A. No, it should not be adjusted for the reasons I lay out above. In addition, I note that my empirical research shows that decoupling, even when considered in isolation, does not result in a lower cost of capital.

Q. Have you reviewed the Company's two-year rate plan?

A. Yes, I have. I understand that the Company, in addition to the May 2016 ERF rate increase, has also proposed a second increase effective May 2017. Both increases are under three percent.

Q. Did you factor in the two-year rate plan into your ROE analysis?

A. Yes. The two-year rate plan poses costs, risks, and benefits relative to the standard approach of annual general rate cases in an increasing cost environment. It is

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[23] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130137 and UG-130138 (consolidated) *et al.*, Order 15/14 at 69-70, ¶ 156 (June 29, 2015).

[24] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130137 and UG-130138 (consolidated) *et al.*, Order 15/14 at 73-74, ¶ 163 (June 29, 2015).

important to note that the two-year plan includes a “stay-out provision,” which poses new risks for the Company.

Q. Should the ROE be adjusted because of the rate plan?

A. No. It is not appropriate to adjust the ROE due to the effects of the rate plan. As noted, the beneficial effects are balanced by costs and risks.

Q. Please turn now to your review of the joint effects of the three elements of the proposal on ROE. Why did you consider the elements jointly?

A. At the most basic level, the Company is requesting these three relief mechanisms in the same filing. This makes it reasonable to look at the requested relief in aggregate.

Q. And what do you conclude from your assessment of the three elements of the proposal jointly?

A. I conclude that the Company’s proposal, taken as a whole, does not warrant an ROE adjustment. While the proposal is constructive and responsive to the Commission’s invitation to employ innovative regulatory tools, it comes at a cost to the Company and creates new risks. The Company proposes locking in rate increases of less than 3 percent per year even though it may have been entitled to higher increases under a series of general rate cases. The provisions designed to protect customers in turn create risks for Pacific Power. For example, the Company’s commitment to not file for a rate change effective before April 1, 2018, or approximately two years after the ERF rates go into effect is noteworthy. This “stay-out” provision means the Company will need to continue to engage in active cost control if it is to recover its costs—including the cost of equity capital—during the stay-out period. On balance, the proposal, while constructive, should not be viewed as a panacea that eliminates all risks for the Company.

Q. What about the PCAM approved by the Commission in the 2014 Rate Case? Does that warrant an adjustment to the ROE?

A. No. Virtually every electric utility in the U.S. has a power cost adjustment mechanism in place. This attribute of the regulatory framework is, like decoupling, already reflected in the ROE analyses I perform.

AUTHORIZED RETURN BENCHMARKS

Q. Are returns granted to public utilities in other jurisdictions relevant to the assessment of the fair return for Pacific Power?

A. Yes. The returns allowed by other regulators can influence investor expectations for investments in public utilities in the U.S. An examination of the average rate of return granted to investors in public utilities is therefore useful to provide context to my analysis of the fair return and to establish the relative stability in rates of return since the Commission issued its order in the Company's 2014 Rate Case.

Q. What levels of returns have state regulators awarded to public utilities recently?

A. As shown in Exhibit No. KGS-17, return on equity awards in the first nine months of 2015 for electric utilities averaged 10.01 percent, nine basis points higher than the comparable figure for calendar year 2014.

Q. Is your assessment of a 10.0 percent fair return consistent with the ROEs approved in other states?

A. Yes, it is. The average authorized ROE of 10.01 percent for electric utilities is derived from a diverse group of utilities that reflect the risk of the industry. The recommended ROE of 10.0 percent for the Company is consistent with the specifics of the investment climate context faced by Pacific Power and falls squarely at the average level authorized by other state regulators.

CONCLUSION AND SUMMARY

Q. Based on your analysis, is it necessary to reduce the ROE in this proceeding based on the most current information available?

A. No. My analysis shows that the ROE that was approved in Pacific Power's 2014 Rate Case is low relative to the benchmark evidence from the capital markets, low relative to the risks borne by the Company's equity owners, and low relative to the returns available to similarly-situated electric utilities. If the Company were requesting to change its ROE in this proceeding, my recommendation would be to raise the ROE to 10.0 percent, but that is not the purpose of my testimony. Instead the purpose of my testimony is to provide information to the Commission to facilitate its assessment of whether there have been material changes in the underlying factors that led it to find a 9.5 percent ROE to be reasonable for the Company.

To that end, I updated the comprehensive cost of equity analysis I undertook in Pacific Power's 2014 Rate Case. My updated financial analysis demonstrates that the fair return for Pacific Power is unchanged. I also confirmed that the capital market conditions today are substantially similar to those analyzed by the parties and the Commission in the 2014 Rate Case. Finally, I reviewed the effects of the ERF, two-year rate plan, and decoupling mechanism on the business and financial risks faced by the Company. I conclude that these new regulatory tools, individually and jointly, do not warrant adjustment to the cost of capital.

Q. Does this conclude your direct testimony?

A. Yes.