BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PACIFICORP d/b/a PACIFIC POWER AND LIGHT COMPANY, Respondent.	**DOCKET UE-061546**
In the Matter of the Petition of PACIFICORP d/b/a PACIFIC POWER AND LIGHT COMPANY, For an Accounting Order Approving Deferral Of Certain Costs Related to the MidAmerican Energy Holdings Company Transition	**DOCKET UE-060817** ***(Consolidated)*** **INITIAL POST-HEARING BRIEF OF PACIFICORP d/b/a PACIFIC POWER AND LIGHT COMPANY**

Dated April 23, 2007

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I. INTRODUCTION

1 PacifiCorp (or the "Company") has not received rate relief in Washington since November 2004, approximately two and one half years ago. Its previous filing in May 2005[1] to increase rates by $39.2 million (17.9 percent) resulted in no rate relief; the Commission in its April 2006 order at the conclusion of that proceeding rejected the cost allocation methodology upon which the filing was based (the Revised Protocol), finding that the method "fail[ed] to demonstrate that the resources included in the Revised Protocol are used and useful in this state."[2] In the absence of an acceptable cost allocation methodology, the Commission rejected the Company's proposed power cost adjustment and decoupling mechanisms.[3] Although declining to grant any rate relief, the Commission reached findings on a number of issues, including cost of capital.[4]

2 This filing was premised upon guidance provided by the Commission in its 2005 Rate Case Order. First, responding to clear direction regarding the necessary elements of an acceptable inter-jurisdictional cost allocation methodology, the Company (in consultation with Staff and other parties) developed an entirely new approach for determining costs allocable to Washington, based on the resources and characteristics of the Company's western control area. The West Control Area ("WCA") method was designed expressly to meet the requirements identified in the 2005 Rate Case Order, and is Washington-specific in its approach. Second, the Company streamlined this filing by declining to relitigate a number of the issues resolved in the 2005 Rate Case Order, including cost of capital, and by restricting the number of pro forma adjustments included in the case in the interests of minimizing contested issues. Third, the Company acted upon the guidance provided in the 2005 Rate Case Order and developed a proposed Power Cost Adjustment

[1] Dockets UE-050684 and UE-050412 ("2005 Rate Case").
[2] *Washington Utilities and Transportation Commission v. PacifiCorp d/b/a Pacific Power and Light Company*, Docket UE-050684 (Order 04); *In the Matter of the Petition of PacifiCorp d/b/a Pacific Power and Light Company for an Accounting Order For an Order Approving Deferral of Costs Related to Declining Hydro Generation*, Docket UE-050412 (Order 03) (consolidated) (Apr. 17, 2006) ("2005 Rate Case Order") at ¶ 7.
[3] *Id.* at ¶¶ 346-347.
[4] The Commission authorized an overall rate of return of 8.10 percent, comprising an equity ratio of 46 percent equity and a return on equity ("ROE") of 10.2 percent. *Id.* at ¶ 379.

Mechanism ("PCAM") that incorporates the elements of existing mechanisms in operation in Washington, as modified to reflect the Company's financial circumstances.

3 As a result of this narrowing of the issues, the requested rate relief was pared to $23.2 million (10.2 percent).[5] Following its rebuttal case, the Company reduced the request further, to $18.58 million (8.2 percent). Staff, for its part, supports adoption of the WCA method (subject to minor adjustments), supports implementation of a PCAM for the Company (although structured somewhat differently from the Company's proposal), and recommends rate relief of $12.8 million. (If a PCAM is not approved, certain downward adjustments recommended by Staff become moot and the recommended rate relief would increase to $16.5 million.) Public Counsel and the Industrial Customers of Northwest Utilities ("ICNU"), on the other hand, oppose adoption of the WCA method, oppose implementation of a PCAM for the Company, and propose adjustments which, in the aggregate, would reduce the Company's rates by nearly $25 million.[6]

4 In the face of the increasing pressures borne by the Company related to operating costs and capital investments necessary to maintain system reliability and integrity, Public Counsel and ICNU's recommended 10 percent rate reduction seems absurd, and even more so when considered in the context of the absence of any recent rate relief for the Company in Washington. Such cost pressures include increasing power supply costs necessary to serve growing retail load requirements, significant upward cost pressures related to employee labor, pension and health insurance costs, hydroelectric generation relicensing costs, and investments in new plants.[7] If the Commission accepts Public Counsel and ICNU's recommended rate decrease, it will have a dramatic, chilling effect on infrastructure investment in Washington and in the region at a time when investment is needed.[8] Even with the price increase proposed in this case, PacifiCorp's rates

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[5] The current filing is based upon the twelve-month test period ending March 31, 2006. In addition, the rate case filing was consolidated with PacifiCorp's petition for an accounting order approving deferral of costs related to the MidAmerican Energy Holdings Company ("MEHC") transition in Docket UE-060817.
[6] Exh. No. 61 at 4:23–5:2 (Reiten Rebuttal).
[7] Exh. No. 11 at 3:3-4, 3:10-13 (Kelly Direct).
[8] Exh. No. 61 at 4:1-5 (Reiten Rebuttal).

will remain among the lowest investor-owned utility rates in the country and very competitive when measured against other utilities within the state.[9]

5 Public Counsel, ICNU, and, to a lesser extent, Staff take a number of positions that, if adopted, will ensure inadequate earnings on the Company's Washington operations. These positions include the following, each of which is addressed in this brief:

- **Cost Allocation Methodology.** Public Counsel and ICNU's recommendations with respect to the Company's proposed WCA method fail the Commission's "tangible and quantifiable benefits" test for a determination of the used and useful standard, as provided in the 2005 Rate Case Order, and are fraught with methodological errors or asymmetrical adjustments.

- **Power Cost Adjustment Mechanism.** Public Counsel and ICNU's opposition to the adoption of a PCAM does not adequately address the reality of power cost volatility faced by the Company. It is also essential that the Company have an expedited process for reflecting the inclusion of new resources, such as authorization to file for a power cost only rate case.

- **Cost of Capital.** The recommendation by Staff to adjust the Company's overall rate of return to compensate customers for alleged risk shift related to the proposed PCAM fails to recognize that risk is already reflected in the common equity returns of the comparable utilities used by all parties to derive the authorized return and that the Commission has adopted similar power cost recovery mechanisms for other utilities in Washington without a corresponding adjustment to rate of return. Furthermore, Staff's recommendation relies on the pre-tax interest coverage financial metric, a measure no longer utilized by major credit rating agencies. ICNU's recommendation to reduce the Company's authorized ROE by 30 basis points fails for similar reasons.

- **Net Power Costs.** ICNU/Public Counsel's recommendation to make certain adjustments to net power costs related to short-term firm transactions, long-term contracts, and modeling are flawed and should be rejected. In addition, Staff's proposed PCAM-related adjustment for extreme water years and WCA-related adjustment for Eastern market sales can be accommodated only if substantially modified.

- **Income Tax Adjustment.** ICNU's proposed consolidated tax adjustment for interest expense ignores the factual setting of the Company's parent Berkshire Hathaway Inc.'s consolidated federal tax return, dismisses principles of regulatory cost causation and the long-standing regulatory practice of matching "benefits and burdens," and breaks down the customer protection of ring fencing around the utility.

- **Adjustments to Revenue Requirement.** While the Company has agreed to a number of adjustments in its rebuttal testimony, the proposed adjustments to the MEHC transition savings recommended by Staff and ICNU result in a mismatch of costs and benefits. Staff's Investor Supplied Working Capital Methodology and ICNU's pension adjustment do not comply with the 2005 Rate Case Order. Public Counsel/ICNU's proposed line loss adjustment is inappropriate given the use of an historic test period in this proceeding.

[9] Exh. No. 11 at 3:13-15 (Kelly Direct).

- **Rate Design/Rate Spread:** The Commission should adopt the Company's uncontested proposed rate spread and rate design methodology.
- **Other Commission Determinations.** The Commission should make a finding that the Company has complied with certain MEHC acquisition commitments, should make a determination of prudence for the Company's acquisition of certain supply-side resources, and should make a determination with respect to the appropriate level of low-income assistance.

II. ARGUMENT

A. The Commission Should Approve PacifiCorp's Proposed WCA Method For Inter-jurisdictional cost allocation.

6 In response to the 2005 Rate Case Order's rejection of the Revised Protocol, PacifiCorp, in consultation with key Washington stakeholders, created the WCA method, which includes the California, Oregon and Washington loads and resources.[10] Some of these generation resources, such as Colstrip and Jim Bridger, are located outside Washington, Oregon and California, but there is adequate transmission from those resources to provide delivery to Washington customers.[11] The WCA method isolates the costs associated with these assets, purchases and sales, and allocates to Washington a proportionate share of the costs based on Washington's relative contribution to the WCA's demand and energy requirements.[12] Under the Company's proposed WCA method, Washington's share of the WCA-related costs for the test period is approximately 22 percent.[13] The Company proposes a five-year evaluation period for the WCA method.

7 According to Staff witness Buckley, the WCA method satisfies the Commission's "used and useful" requirement from the 2005 Rate Case Order because it isolates the costs and benefits associated with WCA loads and resources for purposes of determining Washington rates in this proceeding.[14] In addition, Mr. Buckley explains that the WCA methodology is able to allocate the costs and benefits of resources which may provide "indirect" benefits to Washington upon a

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[10] Exh. No. 11 at 3:22-4:10 (Kelly Direct). The WCA also includes Company-owned generating resources such as the West hydroelectric resources, Hermiston, Colstrip, and Jim Bridger as well as wholesale contracts like the Bonneville Power Administration ("BPA") Peak Purchase contract and the Mid-Columbia hydro contracts. *Id.*
[11] *Id.* at 4:10-13.
[12] *Id.* at 4:13-16. In its rebuttal testimony, the Company agreed to utilize a 75 percent demand/25 percent energy allocation factor for fixed costs of generating resources. Exh. No. 136 at 3:13–4 (Wrigley Rebuttal).
[13] Exh. No. 11 at 4:16-17 (Kelly Direct).
[14] Exh. No. 261 at 12:1-3 (Buckley Direct).

showing by the Company that there are "tangible and quantifiable benefits" to Washington ratepayers.[15] Mr. Buckley concludes by remarking:

> In sum, the WCA methodology represents a balanced and workable solution to a long standing roadblock for determining an appropriate level of the costs PacifiCorp incurs to serve Washington [and] . . . . also provides an acceptable platform for use in implementing a power cost adjustment mechanism for the Company.[16]

8 Mr. Buckley agrees with the Company's proposal to continue to evaluate the WCA method and proposes the establishment of a monitoring committee.[17]

1. The Commission Should Condition Acceptance of Staff's Proposed Eastern Market Sales Bubble.

9 Staff proposes that a market "bubble" be established that provides for sales to the Eastern control area when and if those sales are determined to be economic.[18] In the Company's view, however, the benefits of the Eastern market bubble are not "tangible and quantifiable" as required under the Commission's used and useful standard. The Company nonetheless would be willing to accept Mr. Buckley's proposed adjustment under the condition that the monitoring committee recommended by Mr. Buckley is established to review this adjustment in the future.[19]

2. Public Counsel and ICNU's Recommendation that the WCA Method be Rejected in its Entirety is Not Supportable or Consistent with the 2005 Rate Case Order.

10 Public Counsel and ICNU, through the testimony of Mr. Falkenberg, recommend that the WCA method be rejected in its entirety. To make his case, Mr. Falkenberg asserts that the WCA method is flawed and points to his analysis demonstrating higher net power costs under the WCA method as compared with PacifiCorp's Area of Control East ("PACE") on a $/MWh basis.[20] Staff witness Buckley expressly disagreed explaining that "the net power cost, variable power cost is indeed higher, but when you consider the overall power cost and the overall rates, I think [the

[15] *Id.* at 12:23-27.
[16] *Id.* at 18:7-11.
[17] *Id.* at 13:27.
[18] *Id.* at 5:22–6:2.
[19] Exh. No. 88 at 4:6-13 (Widmer Rebuttal).
[20] Exh. No. 161 at 11:6-13 (Falkenberg Direct).

WCA is] very competitive with Utah."[21] In his cross-answering testimony, Mr. Buckley summarized by stating that "Mr. Falkenberg's failure to include the revenue requirement associated with the fixed costs of facilities in any overall cost comparison is simply not appropriate."[22]

11 Mr. Falkenberg's analysis selectively includes information that supports his desired conclusions while ignoring the major reasons for a higher $/MWh for the WCA method. Specifically, Mr. Falkenberg ignores that the WCA must meet a significant amount of its retail load with wholesale market purchases whereas in PACE there is less need for market purchases.[23] In any event, the total average system cost for the WCA is only 1.2 percent higher than for PACE, hardly a significant difference.[24] Mr. Falkenberg's comparison is invalid and misleading, and provides no basis for challenging the WCA method.[25] In addition, Mr. Falkenberg's testimony mixes time periods and hydro normalization methodologies.[26]

12 Mr. Falkenberg calculates a WCA cost from the Company's actual net power cost reports and concludes that Generation and Regulation Initiatives Decision Tools ("GRID") consistently overstates power costs.[27] Mr. Falkenberg notes that there is a favorable load/resource balance in the WCA on a monthly basis then sells this surplus using the projected average price for short-term purchases.[28] Mr. Falkenberg's analysis, however, discards system balancing transactions and hourly dispatch decisions that are behind the monthly values. Thus, his average energy approach sells the surplus at unrealistically high prices and ignores the cost of covering hours when the system is short.[29] Mr. Falkenberg's analysis is asymmetric and selectively ignores the fact that, regardless of the favorable monthly average load/resource balance, in the individual hours there are unfavorable balances.[30]

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[21] Buckley, TR. 328:21-25.
[22] Exh. No. 265 at 7:18-20 (Buckley Cross-Answering).
[23] Exh. No. 88 at 10:8–11:2 (Widmer Rebuttal).
[24] *Id.* at 9:17-23.
[25] *Id.* at 10:1-2.
[26] *Id.* at 11:8.
[27] Exh. No. 161 at 13:10-12 (Falkenberg Direct).
[28] *Id.* at 12:20-23.
[29] Exh. No. 88 at 11:18–12:11 (Widmer Rebuttal).
[30] *Id.* at 12:2-11.

13 Mr. Falkenberg contends that the Company simply ignored the Commission's direction in the 2005 Rate Case on the "used and useful" requirement by failing to reflect all of the resources that Mr. Falkenberg feels are used and useful to Washington, while including other resources that are not used and useful to Washington.[31] This is a complete reversal from Mr. Falkenberg's position in the 2005 Rate Case, where he argued that because of limited transmission capability to move power from east to west, "the power from all of these eastern resources can hardly be considered to be directly connected to Washington."[32] Based on his analysis in that case of GRID reports showing the hourly, daily and monthly flows of power across each transmission link, Mr. Falkenberg concluded that, on average, only 47.1 MW flows from east to west.[33] In essence, Mr. Falkenberg prevailed on this issue in the 2005 Rate Case by convincing the Commission that eastern resources could not be shown to satisfy the "used and useful" standard for inclusion in Washington rates, and thus Revised Protocol should be rejected.[34] In this proceeding, however, he is arguing ***for*** the inclusion of certain eastern resources, in glaring disregard for his apparently convincing testimony from the 2005 Rate Case that the power simply cannot be transmitted from these eastern resources to Washington.[35]

14 In contrast, Staff witness Buckley concludes in his cross-answering testimony that the Company's WCA method satisfies the "used and useful" requirement from the 2005 Rate Case Order:

[31] Exh. No. 161 at 14:16-19 (Falkenberg Direct).
[32] Exh. 175 at 4:12-13.
[33] *Id.* at 6:2-14.
[34] As stated by Mr. Falkenberg in the 2005 Rate Case, this discussion of east-west transmission constraints "presents a factual basis for the Commission to reach the legal conclusion that PacifiCorp's eastern resources are not used and useful for Washington." *Id.* at 7:15-17.
[35] Mr. Falkenberg dodges this issue by throwing the eastern Wyoming loads into the equation. If the eastern resources are included, he reasons, "then so should the eastern Wyoming loads served by those plants." Exh. No. 161 at 25:4-9 (Falkenberg Direct). In other words, if these eastern loads are assumed to be served by these eastern resources, then it does not matter that there is insufficient transmission transfer capability for the eastern resources to benefit Washington customers. This approach disingenuously ignores the standard enunciated in the 2005 Rate Case Order regarding used and usefulness for ***Washington*** customers, for which Mr. Falkenberg so strongly advocated. That standard is not satisfied under his approach, where the eastern resources are simply assumed to be used exclusively to serve eastern loads and no tangible or quantifiable benefits to Washington customers are shown.

> These resources are "used and useful" for Washington, because PacifiCorp operates the Western control area as a single service area. Moreover, the WCA GRID model runs show that Washington's load requirements and Western control area balancing needs can be met by this mix of resources and contracts.[36]

15 Indeed, the Company developed the WCA method for the ***sole purpose*** of meeting the Commission's express requirements in the 2005 Rate Case, a conclusion also reached by Staff witness Buckley.[37] When questioned by ICNU on cross-examination, Mr. Buckley reiterated that "the filed methodology that the Company used in this case was designed specifically to meet the requirements of the Commission order in the '05 case, which did not allow a system dispatch of the Company's cost in order to determine an integration benefit between the two divisions."[38]

16 The Company relies primarily on a control area approach because this term captures the responsibility for balancing loads and resources within area defined region, which in the case of Washington is the western control area.[39] This approach is consistent with the Commission's requirement that an allocated resource provide "tangible and quantifiable benefits" to Washington ratepayers. The Commission should reject Mr. Falkenberg's used and useful arguments and the related proposed adjustments for interconnection benefits, Johnston and Wyodak (Part 1) and Johnston and Wyodak (Part 2).[40]

17 In addition, Mr. Falkenberg proposes to allocate 100 percent of the Jim Bridger resource to the WCA because of its interconnections with *both* WCA and PACE.[41] In contrast, the Company's approach includes only the amount of energy that is being transferred to the WCA.[42] This approach is generous because it conservatively allocates 1,061 aMW of energy to the WCA, assuming that Bridger is supplying all of that generation when a very small portion could be delivered from higher-cost PACE resources.[43]

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[36] Exh. No. 265 at 8:18-22 (Buckley Cross-Answering).
[37] Exh. No. 88 at 13:2-7 (Widmer Rebuttal); Exh No. 261 at 12:1-5 (Buckley Direct).
[38] Buckley, TR. 210:14-19.
[39] Exh. No. 88 at 12:19-21 (Widmer Rebuttal).
[40] *Id.* at 15:1-4.
[41] Exh. No. 161 at 20:25– 21:5; 21:13-15 (Falkenberg Direct).
[42] Exh. No. 88 at 15:9-11 (Widmer Rebuttal).
[43] *Id.* at 15:19-23.

3. Public Counsel and ICNU's Recommendation that the WCA Be Substantially Modified to Include Proposed Adjustments is Flawed and Fails to Meet the Commission's "Tangible and Quantifiable Benefits" Standard.

18 In the event the Commission adopts the WCA method, Mr. Falkenberg offers a proposed interconnection benefit adjustment, which purports to calculate likely benefits WCA could capture if sales made at the Mid-Columbia ("Mid-C") market hub were instead made at PV, SP15 or Four Corners market hubs.[44] The proposed adjustment would reduce Washington net power costs by $8.6 million. The $8.6 million adjustment comprises $5.7 million for transfer capability and $2.9 million for dynamic overlay benefits.[45] Mr. Falkenberg attempts to justify his proposed interconnection benefit adjustment by claiming that the Company's WCA model includes only costs, while ignoring some of the most important benefits provided by PACE interconnections.[46]

19 As explained by Mr. Widmer, however, the primary interconnection between PacifiCorp's Area Control West ("PACW") and PACE is the ability to deliver Bridger generation to Utah under the terms of the Idaho Power Revised Transmission Service Agreement ("RTSA").[47] Mr. Falkenberg's observation is predicated on a perceived disconnect between costs and benefits and that with this correction, the potential disconnect does not exist.[48]

20 Mr. Falkenberg also claims that it does not make sense for the Company to include in the WCA model the California-Oregon-Border ("COB") interconnection, while ignoring PACE as a potential market for surplus PACW generation.[49] In the Company's view, however, it is reasonable to conclude that COB and Mid-C prices serve as a reasonable surrogate for Four Corners, the nearest liquid market hub in PACE, where any transactions with an independent PACE would have to take into account the transmission cost of reaching the Four Corners market.[50]

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[44] Exh. No. 161 at 21:18–22:14 (Falkenberg Direct).
[45] Exh. No. 88 at 16:9-11 (Widmer Rebuttal).
[46] Exh. No. 161 at 18:7-9 (Falkenberg Direct).
[47] Exh. No. 88 at 17:5-7 (Widmer Rebuttal). Mr. Widmer further explains that the Company previously acknowledged in response to ICNU data request 2.9 that it inadvertently left in that portion of the RTSA cost related to moving Bridger generation into Utah and moving Wyoming generation to WCA and that the Company corrected this oversight in its rebuttal case. *Id.* at 17:7-12.
[48] *Id.* at 17:12-14.
[49] Exh. No. 161 at 18:16-18 (Falkenberg Direct).
[50] Exh. No. 88 at 17:19–18:3 (Widmer Rebuttal). Mr. Falkenberg also includes Exhibit 166, calculating interconnection benefits. Mr. Widmer explains that the analysis contained therein must fail because it falsely assumes

21 Mr. Falkenberg's proposal to allocate to Washington a portion of dynamic overlay benefits (operating reserve benefits) is based on an unrelated and outdated study from 2004.[51] This adjustment comprises $2.9 million of the total $8.6 million interconnection adjustment proposed by Mr. Falkenberg.[52] Of the $2.9 million portion, $1.2 million is related to ready reserves and $1.7 million is related to spinning reserves.[53]

22 The proposed adjustment should be rejected, however, because it is based on stale information from a three-year-old data response from the Multi-State Process related to a different allocation method and because the adjustment does not consider the fact that the reserves may have little or no value if PACE carried its own reserves (as Utah Power did prior to the merger) or bought them from another entity.[54] The outdated study is also not representative of the current generating resources contained within PacifiCorp's system. The addition of new operating reserve contracts with PACE industrial customers has reduced the value of the spinning reserve dynamic overlay component and results from an updated semi-annual report show little value to the ready reserve dynamic overlay component.[55] Moreover, the addition of new wind projects in the WCA has increased spinning reserve and regulating margin requirements due to the variable and intermittent nature of wind resources.[56] These requirements can be expected to increase substantially in the future as a result of the renewable portfolio standards ("RPS") in Washington and California and the expectation that Oregon will soon adopt an RPS. Finally, Mr. Falkenberg's

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that transmission from Mid-C to PACW load pockets is available when PACW wishes to make a sale to PACE with an offsetting purchase at Mid C, which is not the case. *Id.* at 18:9-12. In fact, Mr. Widmer explains that transmission capability is heavily used at that interconnection. *Id.* at 18:12-13. Mr. Widmer notes that Mr. Falkenberg also falsely assumes that any sale made at Mid-C can be made in a Southern Market Hub by diverting Bridger generation. *Id.* at 18:13-15. In reality, some sales are made at Mid-C because it is the only outlet for a surplus in the Walla Walla area. *Id.* at 18:15-16. The third false assumption noted by Mr. Widmer includes that fact that Mr. Falkenberg's analysis assumes that whenever PACW wishes to make a sale, PACE has surplus transmission to a liquid market hub, whereas, in reality, it is likely that when PACW has a surplus to sell, PACE also has surplus to sell and is already using the transmission path to a liquid market. *Id.* at 18:16-20. Mr. Widmer's testimony also includes further discussion explaining Mr. Falkenberg's additional false assumption regarding access to the Southern liquid markets and additional issues with his margin calculation. *Id.* at 19:1–21:2.

[51] Exh. No. 88 at 21:5-6 (Widmer Rebuttal).

[52] *Id.* at 21:6-9.

[53] *Id.*

[54] *Id.* at 21:16-20.

[55] *Id.* at 22:1-8.

[56] *Id.* at 22:11–23:3.

suggestion that it is reasonable to assume that the full value of the dynamic overlay spinning reserve benefits will accrue to WCA is not reasonable; the more likely possibility is that the PACE system may provide its own reserve requirements or purchase them from another entity.[57]

B. The Commission Should Approve PacifiCorp's Proposed Power Cost Adjustment Mechanism.

23 The Company is seeking authorization in this proceeding to implement a PCAM, which is an incentive-based mechanism that shares variations in the sum of adjusted actual variable net power costs and actual fixed production costs from the sum of authorized variable net power costs and fixed production costs in rates.[58] Staff supports the implementation of a PCAM for the Company, subject to some modification. According to Staff witness Buckley, there are "many problems" with the use of normalized net power supply expense in setting rates, and "having a PCA mechanism . . . addresses many of those problems."[59] The table below shows the structure of the PCAM as originally proposed by the Company, and the Staff-proposed modifications to the PCAM:

Element	Company	Staff
Dead band	± $3.0 million	± $4.0 million
Range of First Sharing Band	$3.0 - $7.4 million	$4.0 - $10.0 million
Sharing % for First Band	60 / 40	50 / 50
Range of Outer Sharing Band	Above $7.4 million	Above $ 10 million
Sharing % for Outer Band	90 / 10	90 / 10

The Company proposed a monthly adjustment for the retail revenue impact of changes in Washington retail loads from the level included in rates.[60] Staff recommends that the Commission accept this adjustment, which is the same adjustment used in Avista's Energy Recovery Mechanism ("ERM").[61] Staff also supports the Company's proposal to limit the inclusion of variable costs associated with new long-term resources or wholesale transactions, to those

[57] *Id.* at 23:14-21.
[58] Exh. No. 81 at 28:11-14 (Widmer Direct).
[59] Buckley, TR. 336:11-15. *See also* Buckley, TR. 342:11 – 343:9.
[60] Exh. No. 81 at 30:14-15 (Widmer Direct).
[61] Exh. No. 261 at 38:21-22 (Buckley Direct).

instances in which the resource or transaction has a term less than two years and is under 50 aMW.[62]

1. The Company Accepts Several of the Changes to the PCAM Proposed by Staff.

24 The Company's position with respect to Staff's proposed modifications to the PCAM are as follows:

- The Company accepts (1) the September 1, 2007 effective date of the PCAM, (2) a 50/50 percent sharing percentage for the first sharing band, (3) monthly reporting, and (4) a $6.0 million threshold for returning balances to customers or collecting balances from customers.[63]
- With respect to Staff's recommendation to increase the upper range of the first sharing band to plus or minus $10 million, the Company's acceptance is conditioned on adoption of the Company's proposed changes to Staff's water year adjustment.[64]
- The Company is willing to accept for purposes of this proceeding Staff's recommended increase in the dead band to $4 million, as discussed below.
- If the Commission rejects the Company's proposed methodology for treating new long-term variable resource costs and wholesales transactions (including size and term restrictions), the Company requests authorization to make a filing to propose implementation of a power-cost only adjustment mechanism, as discussed below.[65]

a. Acceptance of Staff's proposal to remove the fixed production cost component of the PCAM should be conditioned on the Company being authorized to file a power-cost only adjustment mechanism.

25 Staff asserts that inclusion of the fixed production cost component of the PCAM violates the Commission's standard that the purpose of such mechanisms is to recognize variability in the cost of operating existing power supply resources as a result of abnormal weather conditions that are out of a utility's control.[66] Given the significant investment in renewable resources and related costs that will be required of the Company as a result of recently adopted RPS in Washington, however, it is important that the Company have an opportunity to file for a Power Cost Only Rate

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[62] *Id.* at 30:9-14.
[63] Exh. No. 88 at 41:10-15 (Widmer Rebuttal).
[64] *Id.* at 43:6-10.
[65] Exh. No. 88 at 41:18–21:2 (Widmer Rebuttal).
[66] Exh. No. 261 at 29:7-9 (Buckley Direct).

Case ("PCORC") type of mechanism so that both variable and fixed production costs can be trued up on an annual basis to provide a proper matching of costs and benefits.[67] Staff witness Mr. Buckley supports this type of combined approach: "[T]he PCAM, in conjunction with a general rate case or other power cost only proceeding, enhances the ability of the Company to address the timely treatment of costs and benefits available through least cost planning, conservation, or other regulatory actions."[68] If approval of an annual true up mechanism is received, the Company would adopt Staff's recommendation to remove the fixed production cost component of the PCAM.

b. Criticisms about the use of pseudo-actual net power costs are exaggerated.

26 Staff's proposal to increase the size of the dead band in the PCAM to plus or minus $4 million is based primarily on the Company's use of "pseudo" actual net power costs for purposes of the PCAM.[69] Pseudo-actual results are used as representative numbers because actual numbers are not available and because the Company's accounting system does not generally distinguish between day-to-day system transactions on a control area basis.[70] Staff's concern is related to the use of the GRID model to determine actual power costs. Mr. Falkenberg also raises various concerns relating to the proposed PCAM, including his criticism that the process for developing pseudo-actual net power costs is too "vague."[71]

27 In fact, however, most of the costs would be actual or calculated from actual information.[72] Retail loads, hydro generation, thermal outages, market prices, coal fuel prices, gas fuel prices and executed short-term firm purchases and sales are based on actual results.[73] In addition, thermal generation is calculated by GRID based on actual forced outages and planned maintenance, fuel

[67] Exh. No. 88 at 41:18–21:2 (Widmer Rebuttal). As Mr. Widmer stated during the hearings in response to a question from Chairman Sidran, "[a]ll we're really asking for is for the Commission to provide the Company approval to file for a mechanism in this proceeding. Whether or not it actually gets adopted would be up to the Commission, but we would like to have approval to be able to file for a mechanism." Widmer, TR. 226:2-7.
[68] Exh. No. 261 at 31:12-15 (Buckley Direct).
[69] Exh. No. 261 at 40:15-17 (Buckley Direct).
[70] *Id.* at 14:23–15:2.
[71] Exh. No. 161 at 58:3-10 (Falkenberg Direct).
[72] Exh. No. 88 at 42:6-8 (Widmer Rebuttal).
[73] *Id.* at 42:8-16.

prices, and loads.[74] System balancing transactions are calculated by GRID based on actual informa-tion plus thermal generation.[75] Long-term purchases and sales are held constant at the level included in rates except for those contracts that are impacted by the variability of wholesale market prices.[76]

28 The use of pseudo-actual results is required because the system is, in fact, operated and accounted for on an integrated basis, even though the 2005 Rate Case Order does not recognize such an integrated approach for purposes of setting rates.[77] Mr. Buckley acknowledges that "the use of the GRID model to determine 'adjusted' actual expenses is a necessary tool at the present time in order to implement a PCAM for the Company"[78] and that the "problem is pretty minimal in the context of the whole proposal."[79] For purposes of this case, the Company would accept a Commission-authorized PCAM that incorporates Staff's dead band recommendation. The Company would reserve the right to revisit the issue in the future after the Company has gained some experience with the mechanism.

c. The Company respectfully reserves the right to decline to implement a PCAM in the event the Commission adopts the various PCAM-related adjustments proposed by Staff, the cumulative effect of which is to make PCAM implementation unattractive to the Company.

29 As described above, the Company is agreeable to most of the modifications proposed by Staff with respect to the structure and design of the PCAM. At the same time, Staff is proposing a number of adjustments that would accompany the implementation of a PCAM, including Mr. Buckley's water year adjustment (discussed in the net power costs section of this brief) and Mr. Elgin's 16-basis point reduction to the Company's overall rate of return (discussed in the cost of capital section of this brief). The combined impact of these adjustments is a $4 million reduction in the Company's revenue requirement[80] which, in the Company's view, is punitive and

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[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.* at 42:17-20.
[78] Exh. No. 265 at 20:18-21 (Buckley Cross-Answering).
[79] Buckley, TR. 339:16-17.
[80] Kelly, TR. 162:20-22.

unprecedented. The Company therefore respectfully reserves the right to decline to implement a PCAM if the Commission adopts, in connection with PCAM implementation, (1) Staff's cost of capital adjustment, and (2) Mr. Buckley's water year adjustment (without the modification proposed by the Company). In addition, PacifiCorp requests that it be permitted to file for recovery of resource costs through a power-cost-only type mechanism.

2. Public Counsel and ICNU's Recommendation to Reject the PCAM Fails to Recognize that the PCAM Addresses the Commission's Concerns Expressed in the 2005 Rate Case and the Reality of Power Cost Volatility.

30 Mr. Falkenberg's testimony on behalf of ICNU is difficult to reconcile with the various positions he has taken with respect to power cost recovery mechanisms in other proceedings. For example, Mr. Falkenberg advocated a power cost recovery mechanism as the ICNU consultant when ICNU supported adoption of Avista's ERM.[81] However, in this proceeding, Mr. Falkenberg recommends that the PCAM be rejected and claims that the Company failed to address the Commission's concerns expressed in the 2005 Rate Case.[82] Staff witness Mr. Buckley disagrees with Mr. Falkenberg's assessment and states that the PCAMs proposed by Staff and by the Company address the Commission's concern that the mechanism focus on short-term costs subject to market volatility or other extraordinary events beyond the Company's control.[83] Mr. Buckley further testified that this conclusion is warranted because the PCAM proposed by Staff and the Company allows the Company to track the effects on net power supply expense due to variations in hydro-related production, as well as variations in thermal fuel costs, some contract costs, market prices, loads, and forced outages.[84] With respect to the Commission's concern about a 90/10 sharing band, Mr. Buckley clarifies that the Commission rejected a 90/10 sharing band when there was *no* dead band, but both Staff's and the Company's proposed PCAMs have dead bands.[85]

[81] Exh. No. 88 at 44:2-3 (Widmer Rebuttal).
[82] Exh. No. 161 at 56:7-9 (Falkenberg Direct).
[83] Exh. No. 265 at 19:21–20:5 (Buckley Cross-Answering).
[84] *Id.*
[85] *Id.* at 21:19-21.

31 As noted above, the Company has expressed its willingness to accept Staff's proposed larger dead band and sharing bands with lower sharing in the first sharing band and a modified water year adjustment.[86] Concerns about balancing risks between customers and the Company should be satisfied by virtue of the fact that the proposed bands are larger than those contained in the ERM approved for Avista.[87] As stated by Mr. Buckley, "[b]oth Staff's and PacifiCorp's proposed PCAMs have a substantial dead band before any sharing occurs," thereby satisfying the Commission's concern.[88]

32 ICNU makes various assertions respecting power cost volatility, questioning whether a PCAM is warranted. Mr. Falkenberg offers Exhibit 170 showing results of his analysis of GRID model data which he claims demonstrates that the Company has very little power cost sensitivity to any factor other than hydro generation.[89] In contrast, on cross-examination, Staff witness Mr. Buckley responded that "I think the Company is subject to significant variability in the Western Control Area."[90] In the Company's view, the Commission should disregard Mr. Falkenberg's analysis because it fails to look at the cumulative impact of a combination of events such as poor hydro conditions coupled with high market prices and loads.[91] For example, Mr. Falkenberg's use of a 10 percent variance in the price of electricity to portray the Company's exposure to market prices is misleading because it significantly understates potential market price volatility.[92] Significantly, Mr. Widmer makes note of last summer's heat wave when market prices approached $190 to $200 per MWh.[93]

[86] Exh. No. 88 at 45:4-8 (Widmer Rebuttal).
[87] *Id.* at 45:8-10.
[88] Exh. No. 265 at 20:8-9 (Buckley Cross-Answering).
[89] Exh. No. 161 at 65:21–66:2 (Falkenberg Direct).
[90] Buckley, TR. 332:24-25.
[91] Exh. No. 88 at 48:14-15 (Widmer Rebuttal).
[92] *Id.* at 48:20–49:2.
[93] *Id.* at 49:1-2; Widmer, TR. 221:2-8. Mr. Widmer described the issue of volatility as follows during the hearing: "[I]f you had a thermal plant outage during a season which had higher market prices, it would produce a significant amount of volatility for the Company's power costs because the thermal units have such a low variable cost. On the other hand, if the outage occurred during a spring period or a shoulder period, the volatility wouldn't be that great, but it's the difference between the highs and lows that demonstrates the volatility of power costs based upon things that could happen in the operation of a utility system." Widmer, TR. 219:8-18.

33 In response to Mr. Falkenberg's assertion that the Company's exposure is reduced because it purchases energy forward to cover shortages, Mr. Widmer acknowledges that although this *helps* reduce exposure it does not protect the Company from factors beyond the Company's control, such as poor hydro conditions, unanticipated forced plant outages, extreme temperatures and other events that are not known in advance or within the Company's ability to control.[94] In addition, Mr. Falkenberg's hydro variability analysis is misleading because it uses one standard deviation as being the range of hydro generation volatility, when there is nothing statistically valid or significant about this measure.[95] Finally, Mr. Widmer also criticizes the measure chosen by Mr. Falkenberg because it does not vary market prices with extreme changes in hydro generation.[96]

34 In the event that the Commission adopts a PCAM for the Company, Mr. Falkenberg proposes an alternative which he refers to as a "hydro hedge" PCAM, which would require customers to compensate the Company for a specific dollar amount in the event of poor hydro conditions.[97] As explained by Mr. Falkenberg, the hedge is implemented when power costs depart from normal or average conditions by more than one standard deviation from the mean.[98] Under this alternative, the Company would be required to "pay" to Washington customers a $1.2 million annual premium for being the counter party in the hedge with the Company.[99]

35 The proposed hydro hedge PCAM alternative is simply a payment "for the right to have customers pay the Company for poor hydro conditions and the Company to pay customers for good hydro conditions."[100] But both hydro conditions are beyond the Company's control and represent situations that justify a simpler, more administratively workable PCAM. Moreover, the hydro hedge PCAM alternative relies on a one standard deviation measure that has not been proven to be statistically significant for hydro generation volatility.

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[94] Exh. No. 88 at 49:5-8 (Widmer rebuttal).
[95] *Id.* at 49:10-12.
[96] *Id.*
[97] Exh. No. 161 at 70:1-2 (Falkenberg Direct).
[98] *Id.* at 70:2-4.
[99] *Id.* at 70:7-12. It should be noted that this premium would be ***in addition to*** the $25 million rate reduction advocated by ICNU and Public Counsel and the 30-basis point reduction recommended by Mr. Gorman.
[100] Exh. No. 88 at 49:20-22 (Widmer Rebuttal).

36 Public Counsel witness Johnson also recommends that the Commission reject the Company's requested PCAM for many of the same reasons offered by Mr. Falkenberg. However, Mr. Johnson recommends that the Commission defer a decision on adoption of a PCAM to allow for a PCAM designed to reflect the cost allocation method the Commission ultimately resolves to adopt in this proceeding and offers additional criticisms of the Company's proposed PCAM.[101] It is indeed curious that Public Counsel is now taking the position that a second phase should be used to address PCAM-related issues following resolution of the cost allocation issue; Public Counsel opposed a settlement proposal from Staff and the Company that would have done just that: implement a second phase of the proceeding for resolving issues surrounding the implementation of a PCAM.[102]

37 In addition, Mr. Johnson implies that there is a hydro reliance threshold that a utility must pass before a PCAM can be adopted,[103] which is refuted by Staff witness Mr. Buckley in his cross-answering testimony in which he makes it clear that the Commission has never identified such a requirement.[104] Mr. Buckley also criticizes Mr. Johnson's calculation of Washington's share of company-wide hydro at 0.2 percent because it is irrelevant to setting Washington rates using any form of WCA-based allocation methodology.[105] In addition, Mr. Buckley notes that Mr. Johnson's comparison of variations in hydro production to total generation is meaningless because he fails to take a critical fact into account, namely, the fact that when hydro production declines due to

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[101] Exh. No. 241 at 2:3-5 (Johnson Direct).

[102] On January 17, 2007, Staff, the Company, and The Energy Project filed a multi-party settlement that proposed a revenue requirement increase of $10.0 million to be effective as of April 1, 2007, and provided for a second phase of the proceeding for resolving issues surrounding the implementation of a PCAM. Public Counsel and ICNU opposed the bifurcation. *See* Letter to Carole J. Washburn from Melinda J. Davison of ICNU and Simon ffitch of Public Counsel, filed January 22, 2007 ("[T]he cost allocation methodology, overall level of power costs assumed in rates, and PCAM involve related issues, and should be considered at the same time.") Chairman Sidran observed during the hearing his recollection that Public Counsel opposed the proposal of the "attempted settling parties" to bifurcate this case "to, in effect, try to determine some of these issues with respect to allocation methodology and so on and put the PCAM off for subsequent resolution." In response to an inquiry as to the rationale for opposing such an approach – given Mr. Johnson's testimony seemingly supporting this very approach – Mr. Johnson misstated the terms of the proposed stipulation. Johnson, TR. 297:7-25.

[103] Exh. No. 241 at 6:9-10 (Johnson Direct).

[104] Exh. No. 265 at 3:1-4 (Buckley Cross-Answering).

[105] *Id.* at 3:12-14.

adverse weather conditions or similar factors, the Company and its customers are fully exposed to the costs of much more expensive incremental generation, in the form of thermal plants or market purchases.[106] At the hearing, Mr. Buckley was questioned as to whether the normalization procedure adequately addresses variability of power costs to which Mr. Buckley responded by expressing his repeated preference for a PCAM.[107] Furthermore, Mr. Widmer contests Mr. Johnson's assertion that the use of historical hydro generation is not a reasonable basis to establish exposure to hydro conditions by noting that it is a long-standing Commission policy to use historical generation adjusted for current operating capabilities to determine a normalized level that is included in rates.[108]

38 There are other flaws in Public Counsel's analysis. For instance, Mr. Johnson is not correct when he states that 17.9 percent of WCA load is met by hydro generation and that this is less than half the level of exposure to Puget Sound Energy ("PSE") and Avista Utilities ("Avista").[109] In fact, hydro generation meets 30 percent of the Company's WCA load requirements.[110] Mr. Johnson also suggests that it is appropriate to compare the Company's hydro exposure and other net power cost risks on a total Company basis, but Mr. Widmer disagrees and explains that such a suggestion implies that the determination should be impacted by the relative risk of other states, an approach inconsistent with the Commission's findings in the 2005 Rate Case.[111] Mr. Johnson also states that an 18 percent variation in hydro production constitutes a "once in a decade" event. In fact, four of the worst water years occurred in the last 12 years of the 40-year period used in the Company's filing and, when updated through 2006, six of the worst water years occurred in the last 15 years.[112] This demonstrates that the Company's hydro variability exposure has the potential to be greater than once in a decade.[113] Finally Mr. Johnson is critical of the Company's proposal to include new

[106] *Id.* at 3:18-21.
[107] Buckley, TR. 335:18-23, 336:5-15, 341:20-22.
[108] Exh. No. 88 at 50:8-10 (Widmer Rebuttal).
[109] Exh. No. 241 at 5:19–6:1 (Johnson Direct).
[110] Exh. No. 88 at 51:7-9 (Widmer Rebuttal).
[111] *Id.* at 52:4-6.
[112] *Id.* at 52:14-17.
[113] *Id.* at 52:16-17.

resources with a term longer than two years in the PCAM if they are under a 50 aMW threshold,[114] but this issue could be addressed by authorizing the Company to file for a power-cost-only mechanism.[115]

C. The Commission Should Reject the Proposals to Adjust the Company's Cost of Capital to Account for Alleged Risk Shifting Associated With Implementing a PCAM.

39 In the interests of minimizing the issues to be litigated in this proceeding, the Company accepted the Commission's determinations in the 2005 Rate Case Order with respect to (1) capital structure, and (2) ROE. The Company also accepted the inclusion of and cost for short-term debt of 4.50 percent as determined in that proceeding, notwithstanding the higher actual cost at the time of the Company's application. The Company updated only those capital cost elements which were in the customers' interests due to declining costs: the embedded cost of long-term debt, and preferred stock.[116] The overall rate of return requested by the Company after updating the costs of long-term debt and preferred stock is 8.057 percent, calculated as follows:

Component	Ratio (%)	Cost (%)	Wtd. Cost (%)
Equity	46	10.200	4.6900
Long-term Debt	50	6.335	3.1675
Preferred	1	6.455	0.0645
Short-term Debt	3	4.500	0.1350
TOTAL	**100**		**8.0570**

40 The only contested issue is whether or not it is necessary to make a downward adjustment in the Company's cost of capital in the event the Commission authorizes implementation of a PCAM. While some parties would suggest that implementation of a PCAM requires a cost of

[114] Exh. No. 241 at 11:11-15 (Johnson Direct).
[115] Exh. No. 88 at 52:21–53:1 (Widmer Rebuttal).
[116] In its rebuttal testimony, the Company proposed a further update to its long-term debt costs of 6.392% (Exh. No. 116 at 4:7 (Williams Rebuttal)). Subsequent to filing rebuttal testimony but prior to the hearing, the Company issued debt pursuant to Order 01 in Docket UE-070450. *See PacifiCorp, Petitioner For an Order Establishing Compliance with RCW 80.08.040*, Docket UE- 070450, Order 01 (Mar. 8, 2007). Following the debt issuance, the Company agreed to withdraw those portions of Mr. Williams' rebuttal testimony which proposed to update the cost of long-term debt and to revert back to the 6.335% cost of long-term debt as originally proposed in the Company's direct testimony (Exh. No. 111 at 4:22-23 (Williams Direct)). As stated by Company counsel, after the movement in the weighted average cost of capital with the issuances and other updates, "we pretty much landed at the same place that we started" and so "the Company's weighted average cost of capital in this case would just revert to what was in Mr. Williams' original testimony." Van Nostrand, TR. 283:21 – 284:6.

capital reduction as a matter of Commission practice, a review of Commission orders suggests otherwise. In fact, the Commission has been careful to avoid a rigid practice on this issue. As stated in the 2005 Rate Case Order:

> 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 part of the overall analysis of how the mechanism shifts risks between investors and ratepayers.*[117]

41 Although the Commission has expressed the view that customers should receive the benefit of a reduction in cost of capital in connection with implementation of a PCAM, such an adjustment has been implemented explicitly only once: when Puget Sound Power & Light Company ("Puget"), the predecessor to PSE, was authorized to implement its Periodic Rate Adjustment Mechanism ("PRAM").[118] With respect to the two power cost adjustment mechanisms currently in place in Washington for PSE and Avista, neither had an explicit reduction in cost of capital at the time they were implemented. The question then, if one remains, is not the amount of a cost of capital reduction, but whether the mechanisms implemented by these companies adequately balance risks between customers and the utility.

42 In the case of PSE, the Commission in March 2002 approved a stipulation providing for resolution of certain issues in the general rate case portion of the proceeding.[119] This stipulation provided for a return on equity of 11.0 percent, which purportedly took into account "the development and implementation of a Power Cost Adjustment (PCA) consistent with the principles stated [in the stipulation] for a PCA."[120] Those principles express the parties' agreement that "a power cost adjustment mechanism (PCA) which properly shares the risk of power cost variations

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[117] 2005 Rate Case Order at ¶ 97 (emphasis added).
[118] *Washington Utilities and Transportation Commission v. Puget Sound Power & Light Company*, Docket UE-901183-T; *In the Matter of the Petition of Puget Sound Power & Light Company for an Order Approving a Periodic Rate Adjustment Mechanism and Related Accounting*, Docket UE-901184-P (Third Supplemental Order) (Apr. 1, 1991); *see also* Exh. No. 304.
[119] Dockets UE-011570 and UG-011571.
[120] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Dockets UE-011570 and UG-011571 (consolidated), et al., Ninth Supplemental Order (Mar. 28, 2002) at App. A, ¶ 13.

between customers and shareholders is appropriate and will be implemented as part of the General Rate Case."[121] Three months later, the Commission approved and adopted a second stipulation which included a proposed PCAM and a PCORC review process whereby PSE could initiate a proceeding to add new resources to the power cost rate.[122] The Commission's June 2002 order approving this second stipulation included no reference to cost of capital issues.

43 Pursuant to the PCORC process, PSE received an increase in electric rates of $45.3 million (5.95%) in June 2006.[123] In its recent rate case, the Commission increased PSE's ROE from 10.3% to 10.4%.[124]

44 In the case of Avista, the Commission in March 2002 in Docket UE-011595 approved and adopted a stipulation which resolved Avista's petition concerning the prudence of certain deferred power costs and Avista's request for interim rate relief. The Commission also approved that portion of the stipulation which provided that Avista's cost of capital for purposes of the general rate proceeding would be the same as determined by the Commission in Avista's preceding general rate case (Dockets UE-991606 and UG-991607). On this point, the stipulation stated as follows:

> The cost of common equity will be the same as determined by the Commission in Avista's *last* general rate case, except that the parties reserve the right to argue in the pending general rate case for an adjustment to that return on equity based on the disposition of issues surrounding the Company's request for a power cost adjustment, or similar mechanism.[125]

45 In the subsequent phase of the proceeding, however, the parties did not exercise their right to argue that Avista's ROE should be reduced to reflect the implementation of a power cost adjustment; the return on equity issue was not reopened or otherwise addressed. In its June 2002 order in the same proceeding, the Commission adopted a second stipulation among the parties that

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[121] *Id.* at App. A, ¶ 22.
[122] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Dockets UE-011570 and UG-011571 (consolidated), et al., Twelfth Supplemental Order (Jun. 20, 2002).
[123] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Docket UE-060783, Open Meeting Memorandum (Jun. 28, 2006).
[124] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267 (consolidated), Order 08 (Jan. 5, 2007).
[125] Exh. No. 305 at 28.

authorized Avista to implement an ERM.[126] Under the ERM as originally implemented by Avista, the utility was permitted to flow through to customers 90 percent of fluctuations in power costs, either positive or negative, outside of a $9 million dead band. Neither the stipulation nor the Commission order contained any discussion of any cost of capital impacts associated with implementation of the ERM.

46 Only in the case of Puget's PRAM order in 1991 was a cost of capital reduction explicitly effected at the time the mechanism was implemented. The PRAM was a very broad adjustment mechanism, which included dollar-for-dollar recovery of power cost variations (including hydro-related impacts), as well as a decoupling mechanism that allowed preservation of margin per electric customer.[127] Upon implementation of the PRAM, the Commission adopted a Staff proposal to adjust Puget's capital structure to reflect a lower equity ratio to purportedly adjust for the increased leverage that could be maintained with the PRAM. The magnitude of the adjustment was a ***six basis point reduction*** in Puget's overall weighted average cost of capital, from 10.22 percent to 10.16 percent.[128]

47 In sharp contrast to the limited cost of capital reduction imposed in connection with implementation of a very broad PCAM, Staff in this case is proposing a ***sixteen basis point reduction*** in PacifiCorp's overall cost of capital – from 8.06 percent to 7.90 percent – upon implementation of the PCAM proposed by PacifiCorp. This PCAM, as discussed below, includes a dead band, a 50/50 percent sharing band, and 90/10 percent outer band, which requires the Company to bear a substantial portion of increases in power costs.[129] The PCAM proposed by PacifiCorp is far less comprehensive, and provides far less recovery of increased power costs for the Company than Puget's PRAM, for which a six basis point reduction in overall rate of return was found appropriate. Given these previous Commission decisions, the Company submits that its

[126] Exh. No. 306 at 14-16 (¶¶ 34-40).
[127] Exh. No. 304 at 5-6.
[128] Exh. 295 at 1.
[129] Under the Company's proposal, as revised to reflect Staff's recommendations, the Company would bear $7 million in excess power costs before reaching the 90/10 outer band. Hadaway, TR. 194:22–195:1.

PCAM meets the test of adequately balancing risks between the customer and the Company. Therefore, the cost of capital adjustment proposed by Staff is inappropriate, punitive, and unprecedented.

1. No Cost of Capital Reduction Is Warranted.

48 The Company respectfully submits that no explicit cost of capital reduction is warranted in connection with implementation of a PCAM in this proceeding.

a. The Company's ROE implicitly includes a cost of capital adjustment.

49 In the 2005 Rate Case, three witnesses – Dr. Hadaway on behalf of the Company, Mr. Gorman for ICNU and Mr. Rothschild for Staff – used the same seventeen comparable group companies for purposes of estimating the Company's ROE. Exhibit 55 presents a survey of the comparable companies' fuel and purchased power cost recovery mechanisms. Fourteen of the seventeen companies used to estimate ROE in the 2005 Rate Case have such cost recovery mechanisms. Public Counsel witness Hill also offered ROE testimony in the 2005 Rate Case, and of the thirteen companies used in his comparable group, all but two have PCAMs.[130] Therefore, any risk reduction for shareholders associated with the implementation of a PCAM is already included in the current 10.2 percent ROE established for the Company in the 2005 Rate Case.[131]

50 Mr. Gorman has recognized in other proceedings that the presence or absence of regulatory mechanisms in place for the companies included in his proxy group "are factors that should be recognized in establishing the return on equity."[132] In a recent Public Service of Colorado ("PSCo") proceeding, Mr. Gorman undertook an analysis of such regulatory mechanisms with respect to the companies included in his proxy group for purposes of demonstrating that PSCo was less risky as compared to the proxy group.[133] Having performed such a comparison in that

[130] Hadaway, TR. 166:19-20.
[131] Hadaway, TR. 170:4-7.
[132] Exh. No. 188 at 10:15-16.
[133] Mr. Gorman testified that he "reviewed the regulatory mechanisms in place for the companies included in my proxy group, and found that many of them have more risk of under-recovery of fuel, purchased power energy and capacity costs than does PSCo under both its current and proposed PCCA and ECA mechanisms," and thus PSCo's ROE should be set at the low end of his recommended range of 9.4 percent to 10.4 percent. *Id.* at 10:3-18. His analysis of his proxy group companies is at Exhibit 188 at 51-59. The Colorado PUC ultimately approved a settlement in the PSCo case

proceeding, he can hardly dispute PacifiCorp's contention in this proceeding that the composition of the comparable group used in the 2005 Rate Case effectively imputes to PacifiCorp the risk profile of a utility having a power cost recovery mechanism. No further adjustment is necessary.

b. The mechanism on which the Company's PCAM proposal was modeled, Avista's ERM, was implemented without a cost of capital adjustment.

51 As discussed in Mr. Widmer's direct testimony, the variable net power cost portion of the Company's proposed mechanism is very similar to Avista's ERM.[134] Specifically, the dead band and sharing bands are consistent with those adopted for the ERM, based on the ratio of dead band and sharing bands as a percentage of the Company's Washington retail revenues.[135] In addition, the Company's proposed PCAM includes an adjustment for variances in Washington retail load that is the same as the "retail revenue requirement" feature of Avista's ERM.[136]

52 As discussed above, Avista's ERM was implemented without making any adjustment to reduce Avista's allowed cost of capital. Presumably, a reduction in the cost of capital was determined to be unnecessary for the ERM "as part of the overall analysis of how the mechanism shifts risks between investors and ratepayers."[137] Given the design of the Company's proposed PCAM – which mirrors the sharing percentages and dead bands of Avista's ERM – the Company similarly should not face a cost of capital reduction in connection with approval of its proposed PCAM. There is insufficient risk-shifting to warrant such a reduction.

c. The Company faces uncertainty associated with implementation of the WCA Method.

53 As described in Ms. Kelly's direct testimony, the Company is implementing a new inter-jurisdictional cost allocation methodology in this proceeding for a five-year evaluation period.[138]

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providing for a 10.5 percent ROE. *Re: The Investigation and Suspension of Tariff Sheets Filed by Public Service Company of Colorado for Advice Letter No. 1454 – Electric and Advice Letter No. 671 – Gas*, Docket 06S-234EG, Colo. PUC Decision No. C06-1379 (Nov. 20, 2006); see also Exh. No. 192 at 12-14.

[134] Exh. No. 81 at 28:8-9 (Widmer Direct).

[135] *Id.* at 29:9-11.

[136] *Id.* at 30:21-22.

[137] 2005 Rate Case Order at ¶ 97.

[138] Exh. No. 11 at 7:11-12 (Kelly Direct).

The WCA method was developed expressly for the purpose of meeting the requirements prescribed by the Commission in the 2005 Rate Case Order, and Washington is the only state in which this method is being proposed by the Company. The WCA method is thus relatively untested, and there is some uncertainty about its impact and the financial results that it will produce. In the Company's view, the uncertainty associated with implementation of the WCA methodology outweighs any potential positive cost of capital impacts associated with implementation of a PCAM. Any potential risk-reducing aspects of a PCAM should be evaluated alongside the potential risk-increasing aspects of a Washington-only inter-jurisdictional allocation method.[139] The potential impact of these risks is best addressed in a rate case filed during or after the five-year evaluation period.[140]

2. The Cost of Capital Adjustment Proposed by Staff and ICNU Are Excessive and Unfounded.

a. Staff's adjustment is based upon a fundamental misunderstanding of the analysis conducted by rating agencies.

54 Staff's entire financial analysis is focused on the evaluation of a single financial metric—the pre-tax interest coverage ratio. Staff calculated interest coverage ratios under various Company and Staff power supply cost scenarios, and concluded that the Company's financial condition would be adequate with the equity ratio reduced from 46 percent to 42 percent.

55 A detailed review of Staff's analysis reveals a number of unreasonable assumptions[141] and conclusions as well as outright technical errors. As stated by Dr. Hadaway during the hearings:

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[139] *Id.* at 12:1-4.

[140] *Id.*

[141] Staff assumes, for example, that "without a PCAM, when excess power costs become a financial burden, the Company may petition the Commission for deferred accounting of excess power costs, or emergency rate relief" and, in this way, "the Company is protected from adverse power costs without a PCAM." Exh. No. 300 at 1. Yet when the Company actually faced a situation of higher power costs following the Western energy crisis and petitioned in Docket UE-020417 for rate relief, Staff opposed any relief and argued that because "the Company must access external sources of capital for its *entire* utility operations across *all* of the jurisdictions in which it operates," the necessary showing using Washington-only financial results could not be made. Exh. No. 303 at 15:8-11 (emphasis added). Rather, the Company would be required to file "contemporaneous interim relief requests in Oregon and Utah . . . to determine the immediate essential cash needs of the Company," as was required under Section 11 of the Stipulation at issue in that case. *Id.* Thus, the availability of emergency rate relief for the Company in the event of adverse power costs without a PCAM is far from certain.

> [Staff] used what is called the EBIT interest coverage ratio, which S&P has rejected. It doesn't use that anymore, since 2004. He also made mistakes in that analysis *when* he left out imputed debt and he also simply calculated EBIT wrong by tax effecting the impact of a power cost absorption by the Company. His is a pre-tax ratio. He reduced the effect of excess power cost by multiplying them essentially by one minus the tax rate. He should not have done that. His analysis is just wrong.[142]

56 Staff's singular focus on the pre-tax interest coverage ratio is much too narrow and Staff's conclusion from the analysis is improper. For example, Staff claims that "[a] 2.50 coverage ratio still satisfies S&P's criteria for a "BBB" bond rating, which is an investment grade rating."[143] This conclusion is incorrect on a technical basis given the rejection of the interest coverage ratio by Standard and Poor's ("S&P"). In addition, S&P has never relied exclusively on one metric in the rating process. S&P currently publishes benchmarks for three financial metrics: (1) Funds from operations ("FFO") to total debt, (2) FFO interest coverage; and (3) Total debt to total capital.[144] If the correct measures are used, Staff's recommendation would lead to a significant weakening of the Company's financial integrity and, if generally applied to PacifiCorp, a likely credit rating downgrade.[145] Further, from a policy perspective, it would be entirely inappropriate, especially after the credit protecting conditions imposed during the MEHC acquisition proceeding, to suggest that the Company's existing single-"A-" credit rating need not be maintained.

57 In addition to relying on one ratio that is outdated and obsolete rather than the three financial ratios currently used by S&P, Staff's analysis contains technical errors in calculation, as discussed in the next section.

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142 Hadaway, TR. 175:6-16.

143 Exh. No. 291 at 17:12-13 (Elgin Direct).

144 Exh. No. 51 at 9:7-11(Hadaway Rebuttal).

145 Exhibit 53 shows an analysis of Staff's position: Page 1 of that exhibit shows the results of Staff's recommendation to reduce the Company's equity ratio to 42 percent, with no adverse power costs. Based on the three S&P benchmarks, the Company would be placed in the triple-"B" to double-"B" category. Pages 2-4 of Exhibit 53 show the outcomes if the Company experiences adverse power costs. With $5 million of adverse power costs (and Staff's sharing mechanism), two of the three S&P ratios are weakened further and, most strikingly, the Company's ROE falls 130 basis points to 8.90 percent. These trends continue as additional adverse power costs are considered. If $10 million of adverse power costs are incurred, the S&P ratios drop to the weak triple-"B"/double-"B" category and ROE would drop to 8.18 percent. With $25 million of adverse power costs, the Company's ROE would drop to 7.74 percent and the remaining credit metrics would place the Company in a seriously threatened financial position.

b. Staff's adjustment contains errors in calculation and understates the financial impact of the cost of capital adjustment.

58 Staff's analysis contains two technical errors that, if corrected, would change the results significantly. First, Staff did not consider off balance sheet ("OBS") debt in any of its calculations. Rating agencies and financial analysts consider long-term purchased power agreements to be debt-like and will impute debt and related interest to the utility's financial statements based on the fixed payments the utility is required to make under such agreements. For example, S&P will adjust PacifiCorp's published results and add debt and interest resulting from purchased power agreements when assessing PacifiCorp's creditworthiness. It does so in order to obtain a more accurate assessment of the financial commitments and fixed payments that the Company has.

59 Second, Staff determined Net Operating Income ("NOI") and then subtracted the impact of adverse power costs to arrive at its estimates of interest coverage and ROE. The NOI value was determined by multiplying a "Pre-PCAM ROR" by the Washington State rate base. In this calculation, Staff mistakenly used a Pre-PCAM ROR of 8.06 percent rather than Staff's own recommended ROR of only 7.90 percent.[146]

c. Staff's adjustment is inconsistent with an MEHC Transaction Commitment, which requires an equity ratio of 48 percent.

60 Staff's proposed capital structure adjustment is specifically inconsistent with Commitment No. 18 from the Commission's order in Docket UE-051090 involving PacifiCorp's acquisition by MEHC.[147] Commitment No. 18 specifies that, for PacifiCorp to avoid dividend restrictions, it must maintain certain minimum equity ratios through 2011—all of which are higher than Staff's 42 percent equity ratio recommendation. The Company would thus be precluded from paying dividends if the Commission set rates based upon, and the Company actually implemented, the

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[146] Exhibit 54 shows the Staff analysis rerun with the two technical errors corrected. When OBS debt and Staff's Pre-PCAM ROR of 7.90 percent are used, Staff's results change significantly. Rather than an interest coverage ratio of 2.50 times and an ROE of 8.12 percent as shown on page 11 of Exhibit 293 ($25 million adverse power cost case), the revised data show a coverage ratio of 2.25 times and an ROE of only 7.74 percent. Likewise, the new data that corresponds to page 12 of Exhibit 293 ($10 million adverse power cost case) shows a coverage ratio of 2.32 times and an ROE of 8.18 percent.

[147] *In the Matter of the Joint Application of MidAmerican Energy Holdings Company and PacifiCorp d/b/a Pacific Power & Light Company For an Order Authorizing Proposed Transaction*, Docket UE-051090, Order 07 (Feb. 22, 2006).

increased leverage reflected in Staff's adjustment.[148] As explained by Ms. Kelly in cross-examination, while the Commission has the ability to use for ratemaking purposes a hypothetical capital structure with a lower equity ratio than the Company's actual capital structure, if the Company actually ***implements*** such a hypothetical capital structure, it would run afoul of this transaction commitment. Furthermore, Staff's proposal to set rates at a considerably lower equity ratio is inconsistent with the credit protecting provisions of Commitment No. 18 and the ring fencing structures agreed to in Docket UE-051090,[149] and is inconsistent with the recent movement to strengthen the Company's structure, which had a 49 percent equity ratio as of December 31, 2006.[150]

d. ICNU's proposed adjustment is based upon an assumed, unproven relationship between "A" and "BBB" bond ratings.

61 While ICNU accepts the Company's proposed capital structure and cost rates for debt and preferred stock, ICNU recommends a 30 basis point reduction to ROE if a PCAM is adopted. The effect of ICNU's recommendation is to reduce the overall ROR to 7.92 percent.

62 ICNU's 30 basis point adjustment, however, is not based on any analysis related to the existence or lack of a fuel and purchased power cost adjustment mechanism. ICNU witness Gorman simply assumes that the bond yield spread between "A" and "BBB" rated utilities is representative of the equity risk of a PCAM; he provides no analysis whatsoever to support this contention, and admits that he has not "done a detailed review of the volatility of the Company's fuel mix or purchased power expenses."[151] While his yield spread "analysis" correctly measures the recent "A"/"BBB" spread for utility bonds, it has nothing to do with the value of a PCAM, its structure, or any other mutual risk sharing mechanism that may ultimately result. Mr. Gorman performed no analysis of the relationship between utility bond ratings and the presence or absence of a PCAM,[152] which would seem to be a necessary foundation for his theory. Moreover,

[148] Kelly, TR. 158:25 – 159:5.
[149] Kelly, TR. 160:14-25.
[150] Exh. No. 116 at 3:7-9 (Williams Rebuttal).
[151] Gorman, TR. 309:7-9.
[152] Exh. No. 187.

Mr. Gorman admits that his adjustment would "possibly" or "probably" be different if the Commission adopts a mechanism other than what the Company is proposing;[153] he fails to explain how this difference would be calculated.[154]

e. ICNU's proposed adjustment is inconsistent with testimony filed by Mr. Gorman in other proceedings.

63 In Portland General Electric's ("PGE") recent General Rate Case in Oregon (Docket UE 180), Mr. Gorman offered rate of return testimony on behalf of ICNU and the Citizens' Utility Board ("CUB"). PGE requested, and the Public Utility Commission of Oregon ("OPUC") approved, implementation of a power cost recovery mechanism for PGE. Yet Mr. Gorman's testimony in that proceeding[155] neither mentions nor proposes any downward adjustment to PGE's capital costs "to reflect its risk reduction and to compensate customers for taking a proportion of [the utility's] power cost volatility risk" as he is proposing for PacifiCorp in this case.[156] As in PacifiCorp's 2005 Rate Case in Washington, Mr. Gorman recommended that PGE be allowed an ROE below 10 percent, but that recommendation was not based on any downward adjustment for a cost recovery mechanism.[157] Similarly, in January 2007, in Aquila's General Rate Case in Missouri (Case No. 2007-0004), Mr. Gorman recommended a 10.0 percent ROE, but again with no mention of Aquila's request for a fuel and power cost recovery mechanism and no suggestion that a downward adjustment to Aquila's allowed ROE would be necessary if such a mechanism were approved.[158]

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[153] Exh. No. 189 at 2.
[154] In response to a question from Commissioner Jones, Dr. Hadaway described how a proper analysis could be performed. It would require "a large enough sample of publicly traded companies that didn't have PCAMs," and "then one might do an analysis and average the results of the various models and see if that factor was big enough in the whole scheme of things to indicate a difference." Dr. Hadaway summarized that, given that "there are very, very few companies that don't have forms of purchased power and fuel cost recovery clauses, . . . there is no sample that I'm aware of that would be big enough to make that test." Hadaway, TR. 192:24 – 193:11.
[155] Exh. No. 195.
[156] Exh. No. 181 at 2:20-22.
[157] ICNU will likely attempt to distinguish the PGE case on the grounds that its position in that case was that a PCAM should not be approved, and thus it was unnecessary for Mr. Gorman to address an ROE reduction in his testimony. However, Mr. Gorman's other client in that proceeding, CUB, offered a proposed PCAM mechanism (Exh. No. 196 at 8, 14-16) that was ultimately adopted by the OPUC. *Id.* at 17-18.
[158] Exh. No. 194.

D. The Commission Should Reject the Unreasonable and Unsupported Adjustments To PacifiCorp's Net Power Costs Proposed by Staff, Public Counsel and ICNU.

64 The Company proposes pro forma normalized WCA net power costs of $417 million for the test period ended March 2006 based on the Company's production cost model, the GRID model. The Washington share of the Company's WCA proposed net power costs is approximately $95.5 million. Staff recommends a Washington base net power supply expense level of $92.4 million. In contrast, ICNU/Public Counsel's recommendations would decrease the Washington share of net power costs by $38 million.[159] However, ICNU/Public Counsel's recommendation to make certain adjustments to net power costs related to short-term firm transactions, long-term contracts, and modeling is flawed and should be rejected.

1. The Company Accepts Staff's Miscellaneous Power Supply Adjustments.

65 Staff's proposed Miscellaneous Power Supply adjustments consists of several corrections to remove expenses related to PACE that were inadvertently included in the Company's filing. The specific adjustments are for (1) Mead/Phoenix and Sierra Pacific transmission expense; (2) Idaho Power transmission expense associated with moving Wyoming resources to Bridger (Dynamic Overlay); (3) east regulating margin expense, and (4) updates of WCA loads. The proposed adjustments reduce Washington net power costs by $0.48 million. The Company believes it is appropriate to correct the mistakes and to match loads to GRID inputs and the pro forma test period.

2. Staff's Eastern Market Modification Adjustment to Net Power Costs Should be Rejected or Accepted Subject to Conditions.

66 As previously discussed, Staff's proposed Eastern Market Modification adjustment captures the alleged benefits of an assumed sale from the WCA to PACE at the Borah / Brady interconnection to account for market price differences between the Mid-C and Four Corners wholesale markets hubs located in each control area. The proposed adjustment reduces Washington net power costs by $1.0 million. Also as previously discussed, the Company does not

[159] Exh. No. 161 at 5, Table 1 (Falkenberg Direct).

believe that Staff's proposed Eastern Market Modification adjustment provides benefits that are tangible and quantifiable, as required under the Commission's used and useful standard. However, the Company is willing to accept the adjustment under the condition that the monitoring committee proposed by Mr. Buckley is adopted and this adjustment is reviewed in the future.

3. Staff's Water Year Adjustment to Net Power Costs Should be Rejected or Accepted Subject to Conditions.

67 Staff's proposed water year adjustment, which applies ***only*** if a PCAM is adopted, removes net power costs associated with extreme, or "outlier," water years from the base level net power costs. The adjustment is used to support implementation of the PCAM proposed by the Company with adjustments and would reduce Washington net power costs by $1.5 million. The Company does not believe that Mr. Buckley's adjustment comports with the apparent intent of the Commission's rulings in this area insofar as his decision to exclude water years greater than one standard deviation distance from the mean does not recognize the fact that the Commission's adoption of the forty-year window had the express intent of excluding extreme hydrology conditions that occurred during the first half of the 20th century.[160] In addition, it does not recognize the Commission's preference for greater emphasis on recent historical trends, which are believed to be more indicative of near-term future conditions.[161] Furthermore, the Company notes that PSE and Avista do not have a similar adjustment in connection with the mechanisms they currently have in place.[162]

68 There are also methodological issues with Mr. Buckley's underlying analysis. First, as explained by Mr. Widmer, Mr. Buckley's use of the mean to define the central tendency assumes that the distribution of total generation by water year is normal.[163] However, Mr. Widmer explains that the adjustment Mr. Buckley makes departs from his underlying assumption that hydro generation is normally distributed.[164] Although Mr. Buckley's adjustment does reduce the variance of

[160] Exh. No. 88 at 5:9-13 (Widmer Rebuttal).
[161] *Id.* at 5:12-13.
[162] *Id.* at 5:1-4.
[163] *Id.* at 6:7-9.
[164] *Id.* at 6:9-11.

the annual hydro generation by excluding the upper and lower tails of the distribution, on an overall hydro performance basis this adjustment significantly changes the proportion of above-normal to below-normal water years.[165] What was a relatively equal ratio of above-normal to below-normal water years swings by 6 percent and thus results in a presumed expectation that approximately 60 percent of the time the Company will experience better-than-normal hydro conditions.[166]

69 Second, removing the extreme effects of the tails is presumed not to alter the statistical properties that define the underlying water year variability.[167] Mr. Widmer describes his analysis showing that while Mr. Buckley's assumption about the normality of total generation by water year in the forty-year sample may be defensible, the adjusted sample has an appreciable effect on the statistical characteristics of the underlying data.[168] Mr. Buckley's one standard deviation adjustment reduces the variance and transforms the hydro generation data into another probability distribution.[169]

70 If the Commission is inclined to adopt an adjustment to exclude some presumed "extreme" water years from the data set based on an assumption that hydro generation is normally distributed, the Company believes that understanding the data on a percentile rank basis is a superior approach to Mr. Buckley's proposed method. As such, the Company recommends that the proposed water year adjustment be modified to exclude all water years above the 83.5th percentile and below the 16.5th percentile which would produce a reduction in WCA net power costs of $2.5 million, or approximately $0.6 million on a Washington allocated basis.[170]

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165 *Id.* at 6:12-16.
166 *Id.* at 6:16-20.
167 *Id.* at 7:11-12.
168 *Id.* at 7:12–8:3.
169 *Id.*
170 Widmer, TR. 209:2-4.

4. ICNU/Public Counsel's Adjustments Relating to Short-Term Firm Transactions, Long-Term Contracts, and Modeling Should be Rejected.

a. Mr. Falkenberg's proposal to remove short-term firm transactions is based on a flawed analysis and unfounded criticism of GRID.

71 Mr. Falkenberg proposes removal of short-term firm transactions modeled in GRID, which Mr. Falkenberg states show a disproportionate number of below-market sales.[171] Mr. Falkenberg asserts that the Company has not demonstrated that these transactions are prudent or necessary to provide service to Washington, and they fail the Commission's used and useful test.[172] The proposed adjustment reduces proposed net power costs by $35.2 million on a total WCA basis.[173]

72 Staff witness Mr. Buckley remarks that it is not appropriate to eliminate all short-term firm power transactions in determining Washington net power supply expense because the Company uses a combination of short-term firm transactions and economy market transactions to balance its WCA and system requirements.[174] Therefore, Mr. Buckley concludes, the WCA GRID model should, to the extent possible, include any actual short-term firm transactions in as timely a manner as possible.[175] In addition, Mr. Buckley notes that most of the discrepancies between the short-term firm transactions that are assumed in the base power supply expense and more current short-term firm transactions are mitigated through the use of a PCAM because the PCAM would capture the actual short-term firm transactions.[176] Furthermore, the prudence of short-term firm transactions can be reviewed as part of the Staff's proposed annual PCAM review process.[177]

73 In addition, Mr. Falkenberg committed several flaws and errors in the analysis supporting his proposed adjustment for short-term firm transactions. Mr. Widmer refutes Mr. Falkenberg's assertion that the GRID model does not include an estimate for additional transactions that may occur during the test year by explaining how the GRID balancing and optimizing process estimates

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[171] Exh. No. 161 at 3:8-13 (Falkenberg Direct).
[172] *Id.*
[173] Exh. No. 88 at 28:2-4 (Widmer Rebuttal).
[174] Exh. No. 265 at 16:3-6 (Buckley Cross-Answering).
[175] *Id.*
[176] *Id.* at 16:13-21.
[177] *Id.*

additional short-term transactions with a linear program to develop the lowest possible cost.[178] In response to Mr. Falkenberg's criticism that GRID produces a lower volume of short-term firm transactions than occurs on an actual basis, Mr. Widmer points out the fact that this is true of any hourly production dispatch model and that, for a variety of reasons, actual volume will always be higher than the volume calculated with GRID.[179] In the end, the best method to capture the difference between actual and normalized transactions is through a PCAM.[180] Mr. Widmer also refutes various other positions offered by Mr. Falkenberg, including his assumption that future transactions will always appear economic at the time of delivery and his assertion that excluding all actual short-term firm transactions demonstrates that the transactions were demonstrably detrimental.[181]

b. Mr. Falkenberg's proposed adjustments for transactions associated with various long-term contracts are based on flawed or simply incorrect analyses.

(i) SMUD Contract

74 The SMUD contract is a 30-year agreement signed in 1987 that involved a $94 million upfront payment from SMUD to PacifiCorp accompanied by a sale to SMUD at a rate that was below the then-current rate for power.[182] In its previous two rate proceedings, the Company has imputed revenue at $37 per MWh for sales under this contract based on a benchmark contract entered into with Southern California Edison ("SCE") at about the same time, and proposed to continue this treatment. Mr. Falkenberg proposes that the contract be removed in its entirety – producing a $12.3 million reduction in WCA power costs – because he does not consider the $37 per MWh revenue imputation to be compensatory and because the benchmark SCE wholesale sales contract expired in October 2006.[183] Staff, for its part, believes the adjustment proposed by the Company of the contract sales price to $37 per MWh is a reasonable and appropriate response to

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[178] Exh. No. 88 at 28:13-18 (Widmer Rebuttal).
[179] *Id.* at 29:7-8.
[180] *Id.* at 29:8-10.
[181] *Id.* at 29:14–30:22.
[182] *Id.* at 31:15-20.
[183] Exh. No. 161 at 34:8–35:3 (Falkenberg Direct).

potential prudence concerns in 2007 for a contract that was entered into twenty years ago.[184] Additionally, Staff witness Mr. Buckley confirms that no specific Commission decision regarding the imprudence of the contract has been made, due to consideration of various stipulated agreements between parties.[185]

75 The SCE contract was used to determine an appropriate revenue imputation price because it was the only contemporaneous contract; there is no reason the $37 per MWh revenue imputation should not continue.[186] Notwithstanding the previous renegotiation of the SCE contract and conversion to an HLH product priced at $60 per MWh, the revenue imputation continued at $37 per MWh.[187] Moreover, Staff has not raised a concern with imputed revenue at $37 per MWh in the Company's two previous Washington rate proceedings (Docket UE-032065 and the 2005 Rate Case).[188] Using current market prices as the basis for imputing revenues – which is the practical effect of Mr. Falkenberg's approach – is an inappropriate and unsupported remedy for evaluating a contract signed over twenty years ago.

(ii) Centralia Replacement Power

76 At issue is whether the Company should bear a portion of higher power costs incurred to replace the output of the Centralia generating unit, the sale of which the Commission approved in March 2000 in a decision involving PacifiCorp, Avista and PSE, all former joint owners of the plant.[189] Mr. Falkenberg's adjustment is based on the position, unsupported by any language in the Centralia Order, that the selling utilities should be held responsible, in part, in the event replacement power costs turn out to be higher than estimated in that proceeding.[190] To determine the share of costs for which PacifiCorp should be held responsible, Mr. Falkenberg originally

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[184] Exh. No. 265 at 19:2-4 (Buckley Cross-Answering).
[185] *Id.* at 18:11-17.
[186] Exh. No. 88 at 31:21–32:3 (Widmer Rebuttal).
[187] *Id.* at 32:12-14.
[188] *Id.* at 32:22–33:1.
[189] *In the Matter of the Application of Avista Corporation for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant, et al.*, Dockets UE-991255, UE-991262 and UE-991409, Second Supplemental Order Approving Sale with Conditions (Mar. 6, 2000) ("Centralia Order").
[190] Curiously, neither Mr. Falkenberg nor ICNU has taken this position with respect to the other selling utilities, Avista and PSE.

proposed an adjustment to net power costs on the basis of his claim that 50 percent of the ***gain*** from the sale of the Centralia plant accrued to shareholders. As originally filed, Mr. Falkenberg's testimony reasoned that "[b]ecause the Company retained 50% of the gain on the Centralia sale, it should assume 50% of the risk associated with its failure to replace all of the associated capacity and energy."[191] In his rebuttal testimony, Company witness Mr. Wrigley pointed out that the Centralia Order allocated the vast majority of the ***gain*** – 87.5 percent – to ratepayers, not 50 percent as claimed by Mr. Falkenberg.[192] As made clear in the Centralia Order, it was only the portion of the sales proceeds that represented an amount in excess of original cost – defined by the order as ***appreciation*** – that was allocated 50 percent to shareholders.[193] Presented with evidence that a correct reading of the Centralia Order failed to support Mr. Falkenberg's theory that 50 percent of any higher power prices should be borne by shareholders, Mr. Falkenberg simply submitted errata to his testimony on March 14, 2007 in which he replaced the word "gain" with "appreciation."[194] Mr. Falkenberg did not, however, change his recommendation that the adjustment nonetheless be made on the basis of a 50 percent sharing, notwithstanding that it was premised on an incorrect reading of the Centralia Order.

77 It is clear from the Centralia Order that the Commission drew a clear distinction between how the ***gain*** should be allocated versus the allocation of ***appreciation.***[195] The theory cited by Mr. Falkenberg as the basis of his proposed 50 percent sharing adjustment is simply not supported by the Centralia Order, if that order is interpreted and applied correctly. More fundamentally, however, there is no support in the Centralia Order for the notion that any of the selling utilities would assume an obligation to hold customers harmless – even in part – in the event the projected power prices upon which the sale was analyzed prove to be incorrect. The Commission determined in the Centralia Order that the sale was in the public interest, after weighing all the

[191] Exh. No. 161 at 3:24-29 (Falkenberg Direct).
[192] Exh. No. 136 at 21:9-14 (Wrigley Rebuttal).
[193] Centralia Order at ¶¶ 78-86.
[194] Falkenberg, TR. 312:20–315:18.
[195] *See* Centralia Order at ¶¶ 78-86.

evidence regarding not only projected future power prices but also testimony regarding plant life expectancy, the structure of the retail electricity industry, and expected increases in Centralia costs due to compliance with environmental regulations.[196] With respect to power cost forecasts in particular, the Commission noted in the Centralia Order that "the most important contribution of forecasts to decision-making is that they help us to understand the uncertainty of the future."[197] Nowhere in the Centralia Order does the Commission impose on the selling utilities the obligation to bear that uncertainty, which is the implicit premise upon which Mr. Falkenberg's adjustment is based.

(iii) GP Camas Cogeneration Facility

78 Mr. Falkenberg proposed to reflect decreased generation from the GP Camas cogeneration facility during the test period based on a 48-month historical trend line, which would reduce proposed net power costs by $0.03 million total Western Control Area.[198] The most recent 12-month period of generation, however, shows that the trended level proposed by Mr. Falkenberg is too low.[199] In fact, actual 2006 calendar generation was 162,750 MWh compared to 164,608 MWh included in the Company's filing, and thus, while the generation has declined in the past, the trend is not continuing.[200]

c. Mr. Falkenberg's proposed modeling adjustments are extreme, fail to match benefits with burdens, lack a sound basis or are clearly wrong.

(i) Hydro Water Year Modeling

79 Mr. Falkenberg's proposed modification to Hydro Water Year Modeling is the same as that water year adjustment proposed by Staff witness Buckley, except that Mr. Falkenberg recommends its adoption even if a PCAM is not approved by the Commission. As such, it has the potential to systematically deny the Company an opportunity to recover 100 percent of its costs and should be

[196] *Id.* at ¶ 63.
[197] *Id.* at ¶ 43.
[198] Exh. No. 161 at 40:15-21 (Falkenberg Direct).
[199] Exh. No. 88 at 33:17-20 (Widmer Rebuttal).
[200] *Id.*

rejected under all circumstances.[201] As discussed above, the Company is agreeable to the water year adjustment proposed by Mr. Buckley – which would be adopted only upon implementation of a PCAM – with the revisions suggested by the Company.

(ii) Monthly Outages

80 Mr. Falkenberg's proposal to reverse the adjustment proposed by the Company related to Monthly Outages would reverse the Company's monthly modeling of forced outage rates and substitute annual forced outage rates, thereby increasing proposed net power costs by $0.15 million total Company.[202]

81 Even though the revised proposed adjustment increases Washington net power costs, the Commission should nevertheless reject it because it fails to provide a proper match between costs and benefits.[203] Mr. Falkenberg's adjustment, which relies on annual outage rate modeling, would not match the timing of outages with the cost of outages, which is necessary in order to ensure the Company has a reasonable opportunity to recover its costs and customers are not paying too much.[204] On the other hand, the use of the Company's monthly 48-month rolling average outage methodology will ensure that costs and benefits are matched.[205]

(iii) Regulation Margin Requirements

82 The regulating margin adjustment proposed by Mr. Falkenberg would reduce the 225 MW maximum limit regulating margin GRID model input to a 125 MW maximum limit.[206] Mr. Falkenberg believes this is appropriate because he was informed during 2004 that the maximum limit used by the Company was 125 MW.[207] Mr. Falkenberg's proposal is based on stale information, however, that is not relevant to the current operation of the system and should not be used.[208] The 225 MW maximum limit used in the Company's modeling is the latest information

[201] *Id.* at 34:7-10.
[202] *Id.* at 35:3-6.
[203] *Id.* at 36:17-20.
[204] *Id.* at 35:11-19.
[205] *Id.*
[206] *Id.* at 38:19-23. The proposed adjustment would reduce net power costs by $0.19 million Washington.
[207] *Id.*
[208] *Id.* at 39:2-3.

available as it is based on a study prepared in 2005, which Mr. Falkenberg is aware of and has seen through his involvement in the Oregon filing, Docket UE 179 but has inexplicably chosen to ignore.[209]

(iv) Thermal Ramping

83 Mr. Falkenberg proposes to reverse the adjustment proposed by the Company related to thermal ramping because he believes GRID understates actual coal-fired generation and the Company's modeling approach is not standard industry practice.[210] Mr. Falkenberg's adjustment would increase Washington net power costs by $0.26 million.

84 As explained by Mr. Widmer, the Company's ramping methodology simply reduces thermal availability to reflect generation not available due to ramping to match costs and benefits.[211] The PGE decision cited by Mr. Falkenberg from Docket UE 139[212] is irrelevant to Mr. Falkenberg's argument. As indicated from the excerpt included in Mr. Falkenberg's testimony, PGE proposed an adjustment that simply assigned "missing generation" to unplanned outages, based on speculation that "up or down ramping periods, generation variances including minor forced derations, or transmission pathway deratings may be responsible."[213] PGE was unable to identify the source of the generation shortfall or to quantify its effect, which led the OPUC to refer to PGE's approach as creating "phantom outages."[214] Mr. Falkenberg simply adopted this pejorative term and claimed that it applied to PacifiCorp's approach,[215] even though the circumstances are entirely different. In the case of PacifiCorp, the Company has determined that its thermal generation is lower as a result of ramping before and after the thermal plants are down

[209] *Id.* at 39:11-14.
[210] Exh. No. 161 at 51:14–53:6 (Falkenberg Direct).
[211] Exh. No. 88 at 38:1-3 (Widmer Rebuttal). Such unavailability results when coal-fired units are not available at full load when ramping down for maintenance and when ramping up from outages. *Id.* at 37:20-22.
[212] *Id.*
[213] Exh. No. 161 at 52:17-22, citing *In the Matter of Portland General Electric Company Application for Annual Adjustment to Schedule 125 Under the Terms of the Resource Valuation Mechanism (RVM)*, Docket UE 139, Order No. 02-772 (Oct. 30, 2002).
[214] *Id.* at 52:23-37.
[215] *Id.* at 51:7-8.

for maintenance and after outages.[216] The Company has merely used an alternative modeling approach to capture the cost of thermal ramping because GRID is not currently structured to capture ramping as some models do.[217]

E. The Commission Should Reject the Consolidated Tax Adjustment Proposed by ICNU.

85 The Commission has a long-standing practice of using a "stand-alone" approach to determining tax expenses for ratemaking purposes. ICNU witness Gorman would have the Commission abandon this practice in favor of an entirely new approach. He proposes to capture for PacifiCorp utility customers the tax benefit of interest on existing debt at PacifiCorp's second-tier parent company, MEHC, thereby decreasing PacifiCorp's Washington revenue requirement by approximately $3.0 million. This adjustment should be rejected for the reasons discussed in the sections that follow.

1. ICNU's Adjustment Is Based Upon an Incomplete Analysis that Selectively Addresses Just One Specific Tax Attribute (Interest Expense) Within the Context of Just One of Berkshire's 500-plus Consolidated Corporate Subsidiaries (MEHC).

86 Mr. Gorman failed to provide the proper consolidated tax setting in which PacifiCorp is required to function as a subsidiary of Berkshire Hathaway ("Berkshire"). Mr. Gorman acknowledges that PacifiCorp "consolidates its taxable income with Berkshire Hathaway and all its affiliates, not just MEHC" and then proceeds to address only one tax attribute of MEHC.[218] Mr. Gorman has selectively addressed just one specific tax attribute (interest expense) within the context of just one of Berkshire's 500-plus consolidated corporate subsidiaries (MEHC), and then proposes to extract and allocate the tax benefit of that item to the customers of yet another corporate subsidiary (PacifiCorp).

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[216] Exh. No. 88 at 38:10-12 (Widmer Rebuttal).
[217] *Id.* at 37:14-16.
[218] Exh. No. 181 at 3:20-22 (Gorman Direct).

87 Berkshire is a publicly owned company which, in turn, has partial or full ownership of over 1,100 entities.[219] Berkshire owns greater than 80 percent of the stock of over 500 of the corporate entities within its investment portfolio and, pursuant to federal tax law and its own election, therefore includes those 500-plus corporate entities in its consolidated federal income tax return. All federal tax attributes of each subsidiary are separately listed within Berkshire's consolidated federal return schedules filed with the Internal Revenue Service ("IRS").[220]

88 Mr. Gorman chose to isolate MEHC as the basis for his adjustment because MEHC is the only entity in the PacifiCorp ownership structure with sufficient debt upon which to base his adjustment. In the case of Berkshire – at the top of the ownership structure – its Form 10-K for year ended December 31, 2005, showed assets of $214.4 billion and consolidated cash and cash equivalents of $45 billion, while consolidated payables and borrowings amounted to $37.3 billion.[221] Thus PacifiCorp's "parent" for consolidated tax and proposed allocation of interest tax benefit purposes – which Mr. Gorman represents to be MEHC, but really is Berkshire – truly had no net debt just prior to the acquisition of PacifiCorp. There is economically no consolidated parent interest for Mr. Gorman to capture and allocate all the way down to PacifiCorp.[222] Similarly, the first-tier parent of PacifiCorp – PPW Holdings – is owned 100 percent by MEHC, and has no debt.[223] Thus there is no interest at PPW Holdings for Mr. Gorman to capture as the

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[219] Among the many corporations within the Berkshire consolidated federal income tax return filing are MEHC (owned 88 percent by Berkshire), PPW Holdings (owned 100 percent by MEHC), and PacifiCorp (owned 100 percent by PPW Holdings). Exh. No. 21 at 4:19-22 (Evans Rebuttal).

[220] In response to a question from ICNU's counsel about the percent of Berkshire's total tax liability that PacifiCorp bears, Company witness Evans responded:

> Warren Buffett, in his letter to shareholders, indicated that Berkshire's estimates for 2006 were $4.4 billion of taxes paid, that's billion with a "B," to the federal government. PacifiCorp is a portion of that. If they had several hundred million dollars of taxable income, then it's going to be roughly 30 – well, the federal, 35 percent roughly, of the taxable income would become part of this ultimate $4.4 billion tax payment that Berkshire makes to the federal government. So it's there, and it's there in full. (Evans, TR. 204:17–205:2.)

[221] Exh. No. 21 at 5:9-12 (Evans Rebuttal).

[222] As Company witness Evans stated during the hearings, "had [Mr. Gorman] looked to that ultimate taxpayer, the tax attributes, the financial attributes, that his adjustment, even his own methodology, would have been zero." Evans, TR. 201:1-4.

[223] Commitment No. Wa11 from Docket UE-051090 provides that PPW Holdings will have no debt in its capital structure. *In the Matter of the Joint Application of MidAmerican Energy Holdings Company and PacifiCorp d/b/a*

basis for his PacifiCorp ratemaking adjustment. There is no reason to isolate MEHC as the basis for his adjustment other than the obvious one: MEHC is the only entity in the PacifiCorp ownership structure with any debt (and associated interest) that can be seized for purposes of his adjustment.

2. ICNU's Adjustment Disregards the Principle of Regulatory Cost Causation.

89 Long-standing regulatory principles establish that a Company's rates are "just and reasonable" when they are cost-justified. In determining whether rates are cost-justified, a commission looks for a causal link between the service the company provides ratepayers and the expenses the company incurs to provide that service. Mr. Gorman's proposal seeks to take the tax benefit of interest imputed from the debt portion of the capital structure of its second-tier parent, MEHC. Ignoring the separate business functions, risks, expenses and revenues, Mr. Gorman simply reaches up and out to capture the tax benefit interest deductions originating from one of its parents. In this way, the proposed adjustment disregards well-known cost-causation principles that the Commission has embraced. The proposed adjustment seeks to allocate to customers the tax value of the imputed interest on debt at MEHC even though the MEHC interest costs which produced them are not included in rates.

3. ICNU's Adjustment Dismisses the Long-Standing Regulatory Principle and Practice of Matching "Benefits and Burdens."

90 The concept of the "benefits-burdens" test is similar to cost-causation. Under this ratemaking concept, before the Commission can allocate the *benefits* of a consolidated tax adjustment to ratepayers it must first determine that ratepayers bear the *burden* that created the consolidated tax adjustment—*i.e.,* are the expenses or losses that created the tax credits or deductions included in the relevant cost of service? By aligning benefits and burdens, the requirement is consistent with the principle of cost-causation or cost responsibility. Mr. Gorman's proposed adjustment totally disregards this regulatory principle by seeking to assign to customers

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Pacific Power & Light Company For an Order Authorizing Proposed Transaction, Docket UE-051090, Order 08 (Mar. 10, 2006) at App. A at p 16.

the tax benefits of interest incurred by the parent company when the shareholders or parent affiliates, not the customers, have paid the expenses creating those losses.

91 The Commission has adopted a "benefits and burdens" concept in previous decisions. In the consolidated cases regarding the sale of the Centralia generating station, the Commission apportioned profits between investors and customers on the basis that benefits should follow burdens. According to the Commission's decision:

> *In general, the Commission relies on the broad principle that reward should follow risk and benefit should follow burden.* In this particular transaction, both ratepayers and shareholders have and will incur risks and burdens. In addition to the financial risks and burdens borne by ratepayers, shareholders bear legislative and market risks, and additionally bear the regulatory burden of prudently managing their resources, which multiple ownership can make difficult. As both shareholders and ratepayers have incurred risks and burdens, both should also share in the benefits of the sale. The remaining gain is thus one of the benefits, which, when considered with other benefits and burdens, must be fairly allocated.[224]

92 The Commission could not adopt Mr. Gorman's proposal without violating the benefits-burdens test. Contrary to Mr. Gorman's assertion that the benefits-burdens test is met, the substance of his proposal, if adopted, would violate that key concept. Mr. Gorman proposes to allocate the tax benefits of one tax attribute – interest expense – from PacifiCorp's second-tier parent within the Berkshire consolidated group without any regard as to whether customers bore the underlying interest expense that created the tax deduction. In other words, if the proposal were adopted, MEHC (and therefore shareholders above MEHC) would absorb all of the costs for which the customers would be receiving the corresponding related tax benefits.

4. ICNU's Adjustment Violates the Ring Fencing Provisions Adopted by the Commission for PacifiCorp.

93 The six state utility commissions that regulate PacifiCorp have gone to great lengths to ensure adequate separation between PacifiCorp and its non-regulated affiliates in order to protect customers. PacifiCorp has also taken steps, encouraged and approved by its commissions, to

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[224] Centralia Order at ¶ 53 (emphasis added).

maintain separation of its utility operations for the benefit of customers. This is apparent from Commitment No. 11 adopted by the Commission in approving MEHC's acquisition of PacifiCorp (Docket UE-051090), which states that:

> a) Any diversified holdings and investments (*e.g.*, non-utility business or foreign utilities) of MEHC following approval of the transaction will not be held by PacifiCorp or a subsidiary of PacifiCorp. This condition will not prohibit MEHC or its affiliates other than PacifiCorp from holding diversified businesses.
>
> b) Ring fencing provisions for PPW Holdings LLC will include the provisions in Appendix 1. These provisions have been derived from those in effect for NNGC Acquisition, LLC as of December 1, 2005.[225]

The Commission's ruling in the 2005 Rate Case Order cites the "state of the art" ring fencing, which insulates utility customers from the operations at the MEHC level. The practical effect of ring fencing is to financially isolate and protect the Company from its parent and other affiliates.[226] ICNU's proposal not only violates the integrity of the ring fence, it irresponsibly risks the financial stability of the utility and its ability to provide safe and reliable service.

5. ICNU's Adjustment Is an Inappropriate Attempt to Re-Apply Double Leverage Concepts the Commission Rejected in the 2005 Rate Case.

94 ICNU's "consolidated tax adjustment" is nothing more than a replay of the double leverage adjustment firmly rejected by the Commission in the 2005 Rate Case Order. In essence, Mr. Gorman's adjustment consists of the following elements which, when take together, replicate the double leverage adjustment from the 2005 Rate Case.

1) Mr. Gorman starts with the MEHC parent-only capitalization shown on Exhibit 185, page 2, which shows a book value capital structure of 34.31 percent debt and 65.69 percent equity.[227]

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[225] *In the Matter of the Joint Application of MidAmerican Energy Holdings Company and PacifiCorp d/b/a Pacific Power & Light Company For an Order Authorizing Proposed Transaction*, Docket UE-051090, Order 08 (Mar. 10, 2006 at App. A at p. 2.

[226] For example, in the event of a bankruptcy of an affiliate, the breaching of the ring fence by a regulatory agency to claim tax advantages from a parent for the benefit of a subsidiary invites creditors of the bankrupt affiliate to use the regulatory agency's actions in breaching the ring fence as justification to raid the assets of the regulated utility to satisfy claims against the affiliate.

[227] While Mr. Gorman purports to base his adjustment on the "debt portion of that capital" actually used by [MEHC] to fund its investment in PPW (Exh. No. 181 at 4:22-25 (Gorman Direct)), in fact his adjustment is unrelated to the source of the funds used by MEHC to finance its investment in PPW, which was financed 100 percent with equity. Rather, the adjustment is a moving target, based on whatever the capital structure of MEHC happens to be at the time Mr. Gorman

2) Mr. Gorman assumes that the MEHC parent-only capital structure implies that the underlying composition of PacifiCorp's equity is 34.31 percent debt and 65.69 percent equity. With this assumption, Mr. Gorman increases the leverage of PacifiCorp's capital structure by replacing 34.31 percent of PacifiCorp's equity with debt priced at MEHC's parent cost of 6.25 percent.

3) Mr. Gorman then imputes additional interest to PacifiCorp's income tax calculation based on the percentage of PacifiCorp's equity which he pretends is parent company debt. This fictional interest, in the amount of $5,469,271, produces a reduction of $1,914,245 in income taxes which, in turn, produces the $3.0 million reduction in revenue requirement proposed by Mr. Gorman's adjustment.[228]

The end result is that Mr. Gorman has employed MEHC debt to apply interest to an indirect subsidiary's cost of service in order to impute an interest deduction to that subsidiary's income tax calculation.[229] The assumption of additional leverage to the subsidiary was done, however, without (1) imputing a compensating increase in the subsidiary's cost of equity as a result of the imputed additional leverage, or (2) any other allocation of parent company costs incurred by that parent in order to obtain the alleged tax benefits.[230] This is squarely contrary to the 2005 Rate Case Order, which stated:

> 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."

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takes a snapshot for purposes of his adjustment. In this case, it happens to be as of September 30, 2006 (*Id.* at 6:10), when MEHC had 34.31 percent debt, which is far different from MEHC's capital structure before, at, and after the time it acquired PacifiCorp. That the calculation of the adjustment changes as MEHC's capital structure changes confirms that the adjustment really has nothing to do with how MEHC funded its investment in PacifiCorp at the time of the acquisition, but in fact is a thinly veiled double leverage adjustment.

[228] The adjustment is produced by the following calculation: 34.31 percent of PacifiCorp's 46 percent equity capital is assumed to be parent company debt; *i.e.*, 34.31 percent times 46 percent equals an additional 15.7826 percent debt. The additional debt is assumed to carry MEHC's embedded cost of 6.25 percent, so the weighted cost of this imputed debt is 15.7826 percent times 6.25 percent, or 0.9864 percent. The weighted cost of the imputed debt is multiplied by ICNU's proposed rate base for PacifiCorp to impute the amount of additional interest to add to the income tax calculation. Thus 0.9864 percent times ICNU's rate base for PacifiCorp of $554,460,866 equals imputed interest expense of $5,469,271. (*See* Exh. No. 184 at 3:8-12 and fn. 1.) Mr. Gorman calculates that his imputed interest expense would reduce income taxes by $1,914,245 (*Id.* at 1:22) and lower PacifiCorp's revenue requirement by $3,079,254. (*Id.* at 2:9.)

[229] Exh. No. 51 at 16:6-8 (Hadaway Rebuttal).

[230] *Id.* at 16:8-12.

> 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. 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. If the risks and costs of 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.[231]

95 Thus, the Commission has ruled that if customers of a utility subsidiary are insulated from the costs incurred by the subsidiary's parent, then those customers should not share in any benefits that derive from the costs incurred by the parent entity. For this and the other reasons set forth above, ICNU's proposed consolidated tax adjustment should be rejected.

F. The Commission Should Reject the Unreasonable and Unsupported Adjustments to PacifiCorp's Revenue Requirement That Are Proposed by Staff, Public Counsel and ICNU.

96 As presented through the testimony of Mr. Wrigley, the Company has updated the revenue requirement that the Company is seeking to $18.58 million.[232] This represents an increase of 8.2 percent over current rates and is a reduction of $4.62 million from the amount requested by the Company in its original filing. This revenue requirement incorporates all adjustments and updates to which the Company agreed in the rebuttal testimony.[233] The Company agreed to the following adjustments made by Staff witness Schooley: Out of Period Adjustments, Pro Forma Wages, Revised CAGW & SO factors, Production Tax Change, and Customer Deposits.[234] Also as recommended by Mr. Schooley, the Company updated its filing to incorporate the WUTC regulatory fee. The Company has recently decided that it will not be a member of Edison Electric

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231 2005 Rate Case Order at ¶¶ 284-85.

232 Exh. No. 136 at 2:9-11 (Wrigley Rebuttal). In its rebuttal testimony, the Company requested a revenue increase of $19,043,000 (*id.*), which was based in part on a cost of long-term debt of 6.392% (Exh. No. 116 at 4:7 (Williams Rebuttal)). Subsequent to filing rebuttal testimony but prior to the hearing, the Company issued debt pursuant to the Commission's Order No. 01 in Docket UE-070450. As a result of the debt issuance, the Company agreed to withdraw those portions of Mr. Williams' rebuttal testimony which stated the cost of long-term debt and to revert back to the 6.335% cost of long-term debt as originally proposed in the Company's direct testimony (Exh. No. 111 at 4:22-23 (Williams Direct)). The Company has updated its requested revenue increase to $18.58 million to reflect the revised cost of long-term debt. Supporting calculations are included herewith as Attachment 1.

233 Exh. No. 136 at 1:7-10 (Wrigley Rebuttal).

234 *Id.* at 1:14-17.

Institute in 2007, and Adjustment 9.1 removes the dues from the calculation of revenue requirement.[235] The Company accepted the recommendation of Staff and ICNU to exclude computer upgrade costs from the deferral.[236] With respect to IRS settlement amortization, the Company agreed that it is appropriate to remove normalized items from this adjustment as described by Staff witness Kermode.[237] Additionally, the adjusted A&G expense is now lower than the A&G refund threshold and, therefore, the Company's original adjustment to reduce A&G is eliminated.[238] The Company takes issue with several of the remaining adjustments proposed by Staff witness Schooley and ICNU witnesses Iverson and Falkenberg.

1. The Commission Should Reject the Adjustments to MEHC Transition Savings Recommended by Staff and ICNU Because They Are Unsupported or Fail to Match Benefits and Burdens.

97 Staff and ICNU propose adjustments to reduce or eliminate severance payments given to departing employees as a result of the March 2006 acquisition for which the Company has sought recovery in its accounting petition in Docket UE-060817. ICNU recommends that the accounting petition be denied.[239] ICNU's proposed adjustment is not well-founded, and would result in PacifiCorp employees being compensated at a level below the market and a mismatch of costs and benefits.

98 ICNU's adjustment, as proposed by Ms. Iverson, would accept all of the savings caused by departing employees and then disallow all severance payments paid during the historic test year that gave rise to the savings.[240] Staff does not agree with Ms. Iverson's recommendation; Staff witness Schooley remarks that "ICNU's proposal is an extreme example of taking all the benefits of a utility's cost cutting efforts, but none of the costs incurred to achieve those reduced cost levels. This violates the matching principle of accounting."[241] Mr. Wrigley similarly characterizes Ms.

[235] *Id.* at 5:3-5.
[236] *Id.* at 11:10-12.
[237] *Id.* at 18:15-16.
[238] *Id.* at 11:12-15.
[239] Exh. No. 201C at 8 (Iverson Direct).
[240] Exh. No. 136 at 6:8-11 (Wrigley Rebuttal).
[241] Exh. No. 328 at 3:8-10 (Schooley Cross-Answering).

Iverson's recommendation as asymmetric because it fails to match costs and benefits.[242] Mr. Schooley notes that Ms. Iverson's comparison of the $42.1 million expense figure to the $35.9 savings figure to conclude no net gain is a poor analysis at best or is simply self-serving because it is a comparison of a one-time cost to annual savings.[243] Furthermore, Staff points out that Ms. Iverson's proposed severance expense of $15.3 million is just plain wrong because it contains severance expenses not related to the MEHC acquisition, and consequently, these expenses are not included in the accounting petition.[244]

99 Additionally, Mr. Wrigley notes that a safeguard for Washington customers exists because the Company has accepted a refund threshold on its A&G expenses in Washington as part of the transaction commitments adopted by the Commission in Docket UE-051090.[245] This commitment provides that in the event that A&G expenses exceed $222.8 million, the Company will refund customers for amount incurred over that amount, but not to exceed $6 million.[246] To the extent that the severance expense causes A&G expenses to exceed $222.8 million, they are not recoverable. Currently, the Company's A&G expenses are below the refund threshold.[247] Additionally, as previously explained, the adjusted A&G expense is now lower than the A&G refund threshold and, therefore, the Company's original adjustment to reduce A&G has been reversed.[248]

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[242] Exh. No. 136 at 6:13-14 (Wrigley Rebuttal). In addition, Mr. Wrigley is critical of the document Ms. Iverson offers in support of her proposed adjustment, namely an OPUC Staff proposal addressing MEHC transition costs. This document is a settlement offer from another state that was never accepted by the Company, was never introduced into evidence in that state and was never accepted by regulators in that state. *Id.* at 7:5-9. Furthermore, Mr. Wrigley explains how the analysis contained in the OPUC staff proposal does not actually support Ms. Iverson's own proposal. *Id.* at 8:9 – 9:9.

[243] Exh. No. 328 at 5:11-14 (Schooley Cross-Answering).

[244] *Id.* at 4:18-19.

[245] Exh. No. 136 at 8:3-6 (Wrigley Rebuttal).

[246] Wrigley, TR. at 256:22–257:3.

[247] During cross-examination, ICNU attempted to refute Mr. Wrigley's testimony that A&G expenses are below the refund threshold by noting a positive figure of $265,875 under "Total Normalized Administrative& General" at page 44 of Exhibit 137, suggesting that the Company is over the threshold by this amount. Davison, TR. at 260:13-18. Mr. Wrigley responded to ICNU's attack by explaining that the positive figure is due to Staff's adjustment to pro forma wages, which was placed on the A&G line at page 44 for simplicity, and does not, in fact, increase A&G. Wrigley, TR. at 259:13-19. Mr. Wrigley further explained that reference to page 6 of Exhibit 137 showing $15.2 million of Washington-adjusted A&G expense reduces total company A&G to less than the refund threshold amount. *Id.* at 260:19–261:4.

[248] *Id.* at 11:12-15.

100 The Company does not oppose Staff's recommendations to record the transition costs in Account 182.3 and to begin amortization over a three-year period beginning with the month that rates are in effect in this general rate case. The Company agrees with Staff that, while the annual revenue requirement may be less per year with ICNU's proposed longer five-year amortization period, the revenue requirement over time is greater, and that therefore a three-year amortization is better from a ratepayer perspective.[249] Staff finds ICNU's proposed condition that the Company perform a cost-benefit study in its next rate case "unnecessary" because, for Washington, this docket is the next rate case and because, according to Staff, the data in the record show that the benefits of the severance programs exceed the costs over the three-year amortization period.[250] In addition, Staff corrects its earlier failure to take into account certain of Staff's adjustments on Adjustment 4.9, A&G Expense Commitment, resulting in a "zeroing out" of that adjustment.[251]

101 The Company opposes Staff's recommendation to disallow the expense associated with employees notified of displacement prior to May 2006 because the savings associated with the A&G refund threshold have accrued to customers since the closing of the transaction (April 2006).[252] Recognition of the costs incurred by the Company in achieving the savings associated with the A&G refund threshold should also begin with the closing of the transaction. Prohibiting the Company from including the pre-May 2006 costs as part of the deferral would run counter to the objective of matching savings and costs.

102 Staff witness Schooley also proposed a separate adjustment to reduce the severance package to executives to correspond to the severance payments received by non-executives.[253] This adjustment was offered without any supporting rationale or analysis, and disregards the common practice of providing an enhanced severance program for executives that offers greater benefits than the plan for the broad-based employee population, given the greater risk of

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[249] Exh. No. 328 at 6:7-9 (Schooley Cross-Answering).
[250] *Id.* at 6:14-17.
[251] *Id.* at 7:12-20.
[252] Exh. No. 136 at 10:2-5 (Wrigley Rebuttal).
[253] Exh. No. 321 at 37:13-16 (Schooley Direct).

termination borne by senior executives in the event of a change in control and the greater time needed to secure a comparable position with another employer.[254] The Company's program is supported by Exhibit 123C, which is a study performed by M Benefit Solutions assessing the design of the Company's program against the market. Mr. Schooley undertook no such study to evaluate the adequacy of severance arrangements as part of an overall executive compensation package.[255]

103 The Company also opposes Staff's recommendation to include the transition costs in rate base as part of a working capital calculation, which seems punitive.[256] The severance costs are real costs and should not be included in a working capital calculation.[257]

2. The Commission Should Reject the Adjustment to Cash Working Capital Recommended by Staff Because it Is Based on an Inaccurate Characterization of the Lead Lag Study Approach and Because Staff Has Not Sufficiently Justified its Own Approach.

104 The Company opposes Staff's proposed adjustment to cash working capital, which is based on Mr. Schooley's recommendation that the Commission adopt the investor-supplied working capital ("ISWC") method for measuring cash working capital.[258] In support, Mr. Schooley makes a speculative claim that the Company's use of a lead lag study creates an incentive for the Company to pay invoices sooner than necessary and argues that other states prefer the ISWC or balance sheet method used by Staff to calculate working capital.

105 In response to Mr. Schooley's argument that use of the lead lag study encourages prepaying invoices earlier than necessary thereby increasing lag days and cash working capital requirements, Mr. Wrigley criticizes Mr. Schooley for ignoring the many prudent business reasons for paying invoices on time, if not a few days early, including to prevent the payment from being received late.[259] The Company's decision to pay invoices a few days early falls within a reasonable range

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[254] Exh. No. 121 at 12:4-11 (Wilson Rebuttal).
[255] Exh. No. 336.
[256] Exh. No. 136 at 10:24–11:2 (Wrigley Rebuttal).
[257] *Id.*
[258] Exh. No. 321 at 15:2-3 (Schooley Direct).
[259] Exh. No. 136 at 14:13-19 (Wrigley Rebuttal).

dictated by prudent business practices.[260] Additionally, Mr. Wrigley explains how the Company has invested in automated meter reading and other operating improvements that have resulted in a reduction of net lag days.[261]

106 With respect to Mr. Schooley's proposal to calculate working capital using the ISWC method, Mr. Wrigley notes several weaknesses to the approach. First, Mr. Wrigley notes that the balance sheet approach provides only a snapshot in time with thirteen fixed data points over a twelve-month period and therefore does not accurately capture the fluidity of a company's cash liquidity needs for maintaining operations and providing service.[262] Second, Mr. Schooley admits his ISWC method necessitates refinements and improvements along the way due to "evolving requirements in Generally Accepted Accounting Principles that have increased the complexity of corporate balance sheets over time."[263] Mr. Wrigley notes that this does not address the unreliability of the ISWC methodology and conversely does not cast doubt upon the reliability of the Company's more-robust lead lag methodology.[264] Mr. Schooley is able to identify only two, possibly three states preferring some type of balance sheet approach in defense of the ISWC.[265] Rather, the evidence offered by Mr. Schooley shows, if anything, strong support for the lead lag approach used by the Company. In response to a PacifiCorp data request, Staff provided results of a survey of state public utility commission approaches to calculating working capital, in which at least *seven* states that supplied a response indicated that the preferred method is to utilize a lead lag study.[266] In sum, Staff has not submitted anything to substantiate adjustments to the Company's figures or to demonstrate that there is a standard, reliable, accurate balance sheet approach that will

260 *Id.*
261 *Id.* at 15:1-3.
262 *Id.* at 15:15-20.
263 Exh. No. 321 at 22:17-21 (Schooley Direct).
264 Exh. No. 136 at 16:5-10 (Wrigley Rebuttal).
265 Exh. No. 321 at 23:3-4 (Schooley Direct).
266 *See* Exh. No. 332 at 4 (Arizona), 10 (Illinois), 11 (Virginia), 12 (Oregon), 14 (Pennsylvania), 17 (Minnesota), 19 (Response of Randy M. Allen of USDA Rural Development Utilities Programs), 20 (Oklahoma).

prove to be a consistent method that is theoretically defensible and not overly complex, which Mr. Schooley defines as the objective.[267]

107 Mr. Wrigley also recommends that the Commission reject Mr. Schooley's recommendation to exclude prepayments, materials and supplies, and fuel stock from the Company's rate base because this recommendation was arrived at using the ISWC method, which, as discussed above, Staff has failed to sufficiently justify. In addition, the survey information offered by Mr. Schooley suggests that separate rate base recognition should be given to fuel stock, prepaid accounts and materials and supplies.[268]

3. ICNU's Proposed Adjustment to Pension Expense Is Unsupported, Violates the "Known and Measurable" Test for a Proper Pro Forma Adjustment, and Should Be Rejected.

108 ICNU has proposed to adjust pension expense to the average of FY 2005 and FY 2006 pension expense. ICNU witness Iverson acknowledges in her testimony that the ramifications of PacifiCorp's changes to its traditional defined benefit plan "are ***undetermined*** at this time," but that it "must be ***assumed*** that PacifiCorp is doing so in order to reduce both its expenses as well as the uncertainty regarding its pension requirements"[269] and thus it is "not unreasonable to provide a normalizing adjustment in this case."[270] Ms. Iverson has never previously offered testimony regarding the calculation of pension costs.[271]

109 In the 2005 Rate Case Order, the Commission found that the Company's method for calculating FAS 87 pension expense was correct and that this method should continue to be used.[272] Ms. Iverson's adjustment in this case amounts to an indirect attempt to substitute a new discount rate to pension expense by averaging two years of costs, and is at odds with the method approved in the 2005 Rate Case Order.[273] Staff, for its part, criticizes Ms. Iverson's adjustment for not being

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[267] Exh. No. 136 at 16:12-17 (Wrigley Rebuttal).
[268] *See* Exh. No. 332 at 4 (Arizona), 10 (Illinois), 11 (Virginia), 14 (Pennsylvania), 17 (Minnesota), 20 (Oklahoma).
[269] Exh. No. 201C at 9:8-11 (Iverson Direct) (emphasis added).
[270] Exh. No. 216.
[271] Exh. No. 214.
[272] 2005 Rate Case Order at ¶ 131.
[273] Exh. No. 136 at 19:14-16 (Wrigley Rebuttal).

based on any known and measurable change to the plan.[274] Staff witness Schooley notes that while the Company's pension plan may change, there is no evidence of what the changes will be, and concludes that ICNU's adjustment is speculative, violates the "known and measurable" test for a proper pro forma adjustment, and should be rejected.[275]

4. ICNU's Proposed Adjustments to Incentive Compensation Are Unsupported and Fail to Recognize that Incentives are Reasonable and Part of an Overall Competitive Compensation Plan.

110 ICNU proposes two separate adjustments related to the incentive element of the compensation portion of the package. First, Ms. Iverson proposes to exclude 100 percent of the executive incentive cost.[276] Second, Ms. Iverson proposes to reduce the non-executive expense by 50 percent.[277] As the only rationale offered in support of the adjustment to executive incentive compensation, Ms. Iverson simply states "it is inappropriate to include additional compensation for PacifiCorp's top nine executives" and "[a]ny additional compensation . . . should come from shareholders."[278] Ms. Iverson also observes that "a portion of the incentives are tied to the 'PacifiCorp Balanced Scorecard' which is tied to corporate or business performance."[279] Ms. Iverson conducted no analysis or developed any evidence showing that this "additional compensation" is excessive or unreasonable."[280] Nor did Ms. Iverson undertake any review of the PacifiCorp Balanced Scorecard to determine which objectives were performance-related and which were-earnings related, other than to acknowledge that one of the four elements of the Business Unit Balanced Scorecard is "financial."[281]

111 As recognized in the 2005 Rate Case Order, the ultimate issue is whether total compensation is reasonable and provides benefits to ratepayers.[282] Company witness Mr. Wilson

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[274] Exh. No. 328 at 8:10-13 (Schooley Cross-Answering).
[275] *Id.*
[276] Exh. No. 201C at 10 (Iverson Direct).
[277] *Id.*
[278] *Id.* at10:20-23.
[279] *Id.* at 10:24–11:1.
[280] Exh. No. 219.
[281] Exh. No. 220.
[282] 2005 Rate Case Order at ¶128.

explains the reasonable nature of the Company's incentive plan. With respect to ICNU's proposal to disallow executive compensation costs, Mr. Wilson responds that the incentive plan was structured to deliver a target incentive level for achieving performance objectives and that awards received above these stated target levels are for exceptional performance.[283] Mr. Wilson explains that the incentive element is not a "bonus" but an integral portion of a complete and symmetrical compensation package necessary to attract and retain an exceptional executive management team.[284] Accordingly, Mr. Wilson concludes that it is appropriate for the Company to seek recovery of the executive incentive levels because the incentive plan benefits customers by ensuring that exceptional individuals will be attracted to lead the organization.[285]

112 With respect to ICNU's proposal to reduce the non-executive expense by 50 percent, Mr. Wilson responds that there has been an industry shift in compensation philosophy over the past few years to deliver compensation to all employees in the form of both base pay and incentive.[286] In addition, Mr. Wilson refutes Ms. Iverson's contention that the balanced scorecards are tied to corporate performance by explaining that it is evident by viewing the objectives outlined in each scorecard that they are intended to improve the Company's operational effectiveness, customer satisfaction and safety.[287] This is the type of analysis that is necessary under Commission precedent, and which Ms. Iverson did not perform with respect to PacifiCorp's Balanced Scorecards. In a 2005 PSE rate decision, the Commission stated the following with respect to a Staff proposal to disallow 40 percent of incentive payments on the grounds that they were tied directly to PSE's earnings:

> We find that while a portion of PSE's incentive plan payments turn on the Company reaching certain earnings goals, there is a second threshold for such payments that is based on service quality, safety, and reliability considerations. These are the criteria we have looked for in authorizing, or not, the recovery of

[283] Exh. No. 121 at 6:5-9 (Wilson Rebuttal).
[284] *Id.* at 6:1-2, 6:14-16.
[285] *Id.* at 6:11-13.
[286] *Id.* at 6:21-23.
[287] *Id.* at 7:2-6.

incentive payment costs. Since they are present here, we find it is not appropriate to disallow a portion of the costs as Staff advocates.[288]

113 As is apparent from the Balanced Scorecards included as Exhibit 122, the objectives are set forth to improve the Company's operational effectiveness, customer satisfaction and safety.[289] ICNU's proposed reduction to non-executive expense should be rejected as inconsistent with Commission precedent on this issue. In addition, any reduction beyond the competitive target incentive level would place the Company in a position of not being able to offer competitive pay levels and placing operational and customer objectives at risk.[290]

5. ICNU's Proposed Health Care Adjustment Should Be Rejected.

114 ICNU's adjustment restates the level of employee contributions to the Company's medical plan. ICNU claims the Company contributes "roughly 85 percent" of the cost of medical insurance for its employees, and thus the employees contribute 15 percent. ICNU then compares this 15 percent figure to figures contained in two surveys[291] that suggests that employees in firms across the country contribute an average 22 percent. Based on this comparison, ICNU concludes that PacifiCorp employees are not contributing enough. ICNU reduces the Company's medical benefits expense to reflect an employee contribution at the 22 percent level.[292]

115 As explained by Staff witness Mr. Schooley, ICNU should have calculated the employee contribution based on an analysis of the actual dollars employees contributed.[293] Mr. Schooley concludes that because ICNU provided no such analysis it has not shown that the 15 percent figure is valid.[294] Company witness Wilson takes note of recent changes with respect to medical benefits, including the Company's decision to shift to a cost sharing tiered approach due in large part to the continued rise in medical cost/rates.[295] Mr. Wilson explains that this structure passes more of the

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[288] *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, Dockets UG-040640 and UE-060641 (consolidated), et al., Order 06 (Feb. 15, 2005) at ¶144.
[289] Exh. No. 121 at 7:4-6 (Wilson Rebuttal).
[290] *Id.* at 7:6-9.
[291] Exh. No. 223.
[292] Exh. No. 201C at 11–12 (Iverson Direct).
[293] Exh. No. 328 at 11:7-8 (Schooley Cross-Answering).
[294] *Id.* at 11:8-10.
[295] Exh. No. 121 at 8:2-9 (Wilson Rebuttal). As described in Mr. Wilson's rebuttal testimony, the Company is moving to have all employees at an 80/20 cost sharing effective as of January 1, 2008. *Id.*

increasing expense on to employees rather than the customers. Mr. Wilson explains that Ms. Iverson's approach of taking an average of total industry rather than actual and industry specific would be punitive and neither prudent nor in line with market practices during the test period.[296] In addition, he explains that to apply an increased sharing to an historical expense level is selective and asymmetric.[297]

6. ICNU's Loss Factor Adjustment Should Be Rejected.

116 Mr. Falkenberg departs from the use of test period data in the case of line losses and proposes to use historical losses for the five most recent fiscal years, the effect of which is to replace 10.95 percent with 10.107 percent.[298] Adjustments to a normalized test period are for known and measurable changes and should be applied consistently across all aspects of the rate case. It is inappropriate to simply remove the year-to-year variability in line losses by use of a simple average, since this same approach cannot be applied to all other aspects of the rate case. Line losses are a complicated function of many variables and their interactions.[299] Because it is impossible to correctly model these complex interactions, they cannot be applied consistently across all aspects of the case. To apply a line loss adjustment to net power costs without applying the appropriate adjustment caused by the same circumstances affecting line losses would bias the results in the case.[300] When dealing with an historical test year adjusted for known and measurable changes, it is appropriate to use the actual losses in the test year.

G. The Commission Should Adopt the Company's Proposed Rate Design and Rate Spread, Which Are Uncontested.

117 The Company's proposed allocation of the revenue requirement in this case is similar to the final rate spread ordered by the Commission in Docket UE-032065, approved in November 2004, and is identical to the revenue allocation method proposed by Staff, Public Counsel, ICNU and the Company in the 2005 Rate Case. The proposed rate design and rate spread are not contested.

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[296] Exh. No. 121 at 8:18-21 (Wilson Rebuttal).
[297] *Id.*
[298] Exh. No. 121 at 20:11-13 (Wilson Rebuttal).
[299] *Id.* at 20:13-19.
[300] *Id.* at 20:19–21:2.

118 The Company is proposing to allocate the Base Case revenue increase of $18.58 million (8.2 percent) across customer classes by applying a uniform increase to most customer classes, including residential, Schedule 48T Large General Service, and Schedule 40 Agricultural Pumping customers.[301] The Company proposes two exceptions to the uniform allocation proposal. For Schedule 24, Small General Service the Company proposes an increase equal to 75 percent of the average increase, and for Schedule 36, Large General Service, the Company proposes that the jurisdictional average percentage increase be applied.[302] The Company's rate design proposals continue to reflect cost of service results in order to send proper price signals to customers while recovering the proposed revenue requirement.[303] For most rate schedules, the proposals result in larger increases to fixed charges and demand charge components with smaller impacts on energy charges.[304]

H. The Commission Should Make a Determination With Respect to Compliance With Certain MEHC Acquisition Commitments.

119 The Company respectfully requests that the Commission make a finding that the Company has complied with the following commitments from the MEHC transaction (Docket UE-051090): Commitment Wa4 – Affiliate Management Fee;[305] Commitment Wa6 – Affiliate Cross Charges;[306] Commitment Wa7 – A&G Cost Reduction;[307] and Commitment 37 – Long-term Debt Yield Reduction.[308]

I. The Commission Should Make a Determination of Prudence For Acquisition of Supply-Side Resources.

120 The Company and Staff recommend that the Commission find that the Company has sufficiently demonstrated that the Eurus contract, the Leaning Juniper 1 project, and the New Grant Contracts were prudently acquired by the Company, that and they should be considered used and

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[301] Exh. No. 31 at 2:20–3:1 (Griffith Direct).
[302] *Id.* at 3:2-5.
[303] *Id.* at 3:5-7.
[304] *Id.* at 3:7-9.
[305] Exh. No. 131 at 15:1-5 (Wrigley Direct).
[306] *Id.* at 15:9-13.
[307] *Id.* at 15:14-16.
[308] Exh. No. 111 at 6:1–7 (Williams Direct)

useful for Washington customers.[309] No other party takes issue with the prudence of the investment in these resources.

J. The Commission Should Make a Determination With Respect to Low-Income Assistance.

121 The Company proposes to increase the low-income collection rate which funds the Low Income Bill Assistance ("LIBA") Program by a percentage amount equal to the total percentage of all residential price increases from general rate cases, including the price increase ordered in this case, since the program was implemented.[310] The Energy Project supports this proposal, but recommends that the Company increase funding at least to a level in the range of that provided by Avista and PSE in their low-income assistance programs.[311]

122 In the Company's rebuttal testimony, Mr. Griffith explains that the Company's proposed increase would result in a monthly surcharge increase from 23 cents per month to 29 cents per month, an increase of 26 percent.[312] Using the Avista level, a monthly residential surcharge of 40 cents per month would result, an increase of 74 percent.[313] If the PSE level were applied, it would produce a monthly residential surcharge of 64 cents per month, an increase of 178 percent over the present surcharge level.[314] The Company will support any of the three approaches, as determined by the Commission in its order in this proceeding.[315]

III. CONCLUSION

123 For the reasons stated above, PacifiCorp seeks the following relief in this proceeding:

- Approval of the WCA methodology for inter-jurisdictional cost allocations for a five-year evaluation period;

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309 Exh. No. 261 at 47:1–50:20 (Buckley Direct).
310 Exh. No. 31 at 19:23–20:9 (Griffith Direct).
311 Exh. No. 231 at 6:1-8 (Ebert Direct).
312 Exh. No. 45 at 2:23–3:8 (Griffith Rebuttal).
313 *Id.*
314 *Id.*
315 *Id.* In that regard, Mr. Griffith urges the Commission to consider the Company's entire low-income assistance program, which includes a weatherization program, an educational program, and Project Help. Griffith, TR. 275:12-19, 279:20–280:15.

- An increase in electric rates of $18.58 million, which reflects an overall rate of return of 8.057 percent, to be spread according to the rate spread and rate design recommendations above;
- Approval of the Company's proposed PCAM, modified to reflect Staff's recommendations as described above;
- Authorization to make a filing for an expedited process for reflecting the inclusion of new resources, such as a power cost only rate case;
- A finding of prudence as to certain new resources within the western control area; and
- Certain determinations with respect to the Company's compliance with transaction commitments from Docket UE 051090 and the appropriate level of low-income assistance.

DATED: April 23, 2007.

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By ______________________________

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ATTACHMENT 1

ATTACHMENT 1a:

Current Revenue Requirement Calculation

(Using 6.335% Cost of Long-Term Debt As Proposed in Company's Direct Testimony)

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
12 Months Ended MARCH 2006

		(1) Total Adjusted Results	(2) Price Change	(3) Results with Price Change
1	Operating Revenues:			
2	General Business Revenues	226,563,997	18,580,036	245,144,033
3	Interdepartmental	-		
4	Special Sales	67,631,778		
5	Other Operating Revenues	12,432,635		
6	Total Operating Revenues	306,628,410		
7				
8	Operating Expenses:			
9	Steam Production	39,041,486		
10	Nuclear Production	-		
11	Hydro Production	5,309,949		
12	Other Power Supply	122,520,645		
13	Transmission	18,723,250		
14	Distribution	11,393,848		
15	Customer Accounting	7,834,493	90,082	7,924,575
16	Customer Service & Info	511,164		
17	Sales	-		
18	Administrative & General	15,205,663		
19	Total O&M Expenses	220,540,498		
20	Depreciation	28,343,041		
21	Amortization	3,915,890		
22	Taxes Other Than Income	12,717,730	754,907	13,472,637
23	Income Taxes - Federal	3,475,865	6,207,267	9,683,132
24	Income Taxes - State	-	-	-
25	Income Taxes - Def Net	5,472,804		
26	Investment Tax Credit Adj.	-		
27	Misc Revenue & Expense	(399,757)		
28	Total Operating Expenses:	274,066,071	7,052,256	281,118,327
29				
30	Operating Rev For Return:	32,562,338	11,527,781	44,090,119
31				
32	Rate Base:			
33	Electric Plant In Service	1,059,765,583		
34	Plant Held for Future Use	1,546		
35	Misc Deferred Debits	2,750,089		
36	Elec Plant Acq Adj	-		
37	Nuclear Fuel	-		
38	Prepayments	2,599,684		
39	Fuel Stock	2,516,964		
40	Material & Supplies	6,970,931		

41 Working Capital	4,107,952		
42 Weatherization Loans	2,256,731		
43 Misc Rate Base	-		
44 Total Electric Plant:	1,080,969,481	-	1,080,969,481
45			
46 Rate Base Deductions:			
47 Accum Prov For Deprec	(404,617,400)		
48 Accum Prov For Amort	(27,607,697)		
49 Accum Def Income Tax	(88,581,278)		
50 Unamortized ITC	(1,644,344)		
51 Customer Adv For Const	-		
52 Customer Service Deposits	(2,001,969)		
53 Misc Rate Base Deductions	(9,428,499)		
54			
55 Total Rate Base Deductions	(533,881,187)	-	(533,881,187)
56			
57 Total Rate Base:	547,088,294	-	547,088,294
58			
59 Return on Rate Base	5.952%		8.0591%
60 Return on Equity	5.619%		10.200%
61			
62 TAX CALCULATION:			
63 Operating Revenue	41,511,007	17,735,047	59,246,054
64 Other Deductions			
65 Interest (AFUDC)			
66 Interest	18,354,812	-	18,354,812
67 Schedule "M" Additions	41,823,407	-	41,823,407
68 Schedule "M" Deductions	53,251,254	-	53,251,254
69 Income Before Tax	11,728,349	17,735,047	29,463,396
70			
71 State Income Taxes	-	-	-
72 Taxable Income	11,728,349	17,735,047	29,463,396
73			
74 Federal Income Taxes + Other	3,475,865	6,207,267	9,683,132
	Ref. Page 2.2	Ref. Page 1.1	

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
12 Months Ended MARCH 2006

Net Rate Base - Oregon Jurisdiction	$	547,088,294	Ref. Page 1.1
Return on Rate Base Requested		8.059%	Ref. Page 2.1
Revenues Required to Earn Requested Return		44,090,119	
Less Current Operating Revenues		(32,562,338)	
Increase to Current Revenues		11,527,781	
Net to Gross Bump-up		161.18%	
Price Change Required for Requested Return	$	18,580,036	
Requested Price Change	$	18,580,036	
Uncollectible Percent		0.485%	Ref. Page 1.3
Increased Uncollectible Expense	$	90,082	
Requested Price Change	$	18,580,036	
Franchise Tax		0.190%	Ref. Page 1.3
Revenue Tax		3.873%	Ref. Page 1.3
Resource Supplier Tax		0.000%	Ref. Page 1.3
Gross Receipts		0.000%	Ref. Page 1.3
Increase Taxes Other Than Income	$	754,907	
Requested Price Change	$	18,580,036	
Uncollectible Expense		(90,082)	
Taxes Other Than Income		(754,907)	
Income Before Taxes	$	17,735,047	
State Effective Tax Rate		0.000%	Ref. Page 2.1
State Income Taxes	$	-	

Taxable Income	$	17,735,047	
Federal Income Tax Rate		35.00%	Ref. Page 2.1
Federal Income Taxes	$	6,207,267	
Operating Income		100.000%	
Net Operating Income		62.044%	Ref. Page 1.3
Net to Gross Bump-Up		161.18%	

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
12 Months Ended MARCH 2006

Operating Revenue	100.000%	
Operating Deductions		
Uncollectable Accounts	0.485%	
Taxes Other - Public Utility Tax	0.190%	1
Taxes Other - Revenue Tax	3.873%	
Taxes Other - Resource Supplier	0.000%	
Taxes Other - Gross Receipts	0.000%	
Sub-Total	95.452%	
State Income Tax @ 0.000%	0.000%	
Sub-Total	95.452%	
Federal Income Tax @ 35.00%	33.408%	
Net Operating Income	62.044%	

1. Updated on Feb. 21, 2007 to correct error identified by Tom Schooley of WUTC Staff per telephone conversation on Oct. 5, 2006

ATTACHMENT 1b:

Prior Revenue Requirement Calculation

(Using 6.392% Cost of Long-Term Debt As Proposed in Company's Rebuttal Testimony)

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
12 Months Ended MARCH 2006

		(1) Total Adjusted Results	(2) Price Change	(3) Results with Price Change
1	Operating Revenues:			
2	General Business Revenues	226,563,997	19,042,969	245,606,965
3	Interdepartmental	-		
4	Special Sales	67,631,778		
5	Other Operating Revenues	12,432,635		
6	Total Operating Revenues	306,628,410		
7				
8	Operating Expenses:			
9	Steam Production	39,041,486		
10	Nuclear Production	-		
11	Hydro Production	5,309,949		
12	Other Power Supply	122,520,645		
13	Transmission	18,723,250		
14	Distribution	11,393,848		
15	Customer Accounting	7,834,493	92,326	7,926,820
16	Customer Service & Info	511,164		
17	Sales	-		
18	Administrative & General	15,205,663		
19	Total O&M Expenses	220,540,498		
20	Depreciation	28,343,041		
21	Amortization	3,915,890		
22	Taxes Other Than Income	12,717,730	773,716	13,491,446
23	Income Taxes - Federal	3,475,865	6,361,924	9,837,789
24	Income Taxes - State	-	-	-
25	Income Taxes - Def Net	5,472,804		
26	Investment Tax Credit Adj.	-		
27	Misc Revenue & Expense	(399,757)		
28	Total Operating Expenses:	274,066,071	7,227,967	281,294,038
29				
30	Operating Rev For Return:	32,562,338	11,815,002	44,377,341
31				
32	Rate Base:			
33	Electric Plant In Service	1,059,765,583		
34	Plant Held for Future Use	1,546		
35	Misc Deferred Debits	2,750,089		
36	Elec Plant Acq Adj	-		
37	Nuclear Fuel	-		
38	Prepayments	2,599,684		
39	Fuel Stock	2,516,964		
40	Material & Supplies	6,970,931		

41	Working Capital	4,107,952		
42	Weatherization Loans	2,256,731		
43	Misc Rate Base	-		
44	Total Electric Plant:	1,080,969,481	-	1,080,969,481
45				
46	Rate Base Deductions:			
47	Accum Prov For Deprec	(404,617,400)		
48	Accum Prov For Amort	(27,607,697)		
49	Accum Def Income Tax	(88,581,278)		
50	Unamortized ITC	(1,644,344)		
51	Customer Adv For Const	-		
52	Customer Service Deposits	(2,001,969)		
53	Misc Rate Base Deductions	(9,428,499)		
54				
55	Total Rate Base Deductions	(533,881,187)	-	(533,881,187)
56				
57	Total Rate Base:	547,088,294	-	547,088,294
58				
59	Return on Rate Base	5.952%		8.112%
60	Return on Equity	5.505%		10.200%
61				
62	TAX CALCULATION:			
63	Operating Revenue	41,511,007	18,176,926	59,687,933
64	Other Deductions			
65	Interest (AFUDC)			
66	Interest	18,354,812	-	18,354,812
67	Schedule "M" Additions	41,823,407	-	41,823,407
68	Schedule "M" Deductions	53,251,254	-	53,251,254
69	Income Before Tax	11,728,349	18,176,926	29,905,275
70				
71	State Income Taxes	-	-	-
72	Taxable Income	11,728,349	18,176,926	29,905,275
73				
74	Federal Income Taxes + Other	3,475,865	6,361,924	9,837,789
		Ref. Page 2.2	Ref. Page 1.1	

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
12 Months Ended MARCH 2006

Net Rate Base - Oregon Jurisdiction	$	547,088,294	Ref. Page 1.1
Return on Rate Base Requested		8.112%	Ref. Page 2.1
Revenues Required to Earn Requested Return		44,377,341	
Less Current Operating Revenues		(32,562,338)	
Increase to Current Revenues		11,815,002	
Net to Gross Bump-up		161.18%	
Price Change Required for Requested Return	$	19,042,969	
Requested Price Change	$	19,042,969	
Uncollectible Percent		0.485%	Ref. Page 1.3
Increased Uncollectible Expense	$	92,326	
Requested Price Change	$	19,042,969	
Franchise Tax		0.190%	Ref. Page 1.3
Revenue Tax		3.873%	Ref. Page 1.3
Resource Supplier Tax		0.000%	Ref. Page 1.3
Gross Receipts		0.000%	Ref. Page 1.3
Increase Taxes Other Than Income	$	773,716	
Requested Price Change	$	19,042,969	
Uncollectible Expense		(92,326)	
Taxes Other Than Income		(773,716)	
Income Before Taxes	$	18,176,926	
State Effective Tax Rate		0.000%	Ref. Page 2.1
State Income Taxes	$	-	

Taxable Income	$	18,176,926	
Federal Income Tax Rate		35.00%	Ref. Page 2.1
Federal Income Taxes	$	6,361,924	
Operating Income		100.000%	
Net Operating Income		62.044%	Ref. Page 1.3
Net to Gross Bump-Up		161.18%	

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Operating Revenue	100.000%	
Operating Deductions		
Uncollectable Accounts	0.485%	
Taxes Other - Public Utility Tax	0.190%	1
Taxes Other - Revenue Tax	3.873%	
Taxes Other - Resource Supplier	0.000%	
Taxes Other - Gross Receipts	0.000%	
Sub-Total	95.452%	
State Income Tax @ 0.000%	0.000%	
Sub-Total	95.452%	
Federal Income Tax @ 35.00%	33.408%	
Net Operating Income	62.044%	

1. Updated on Feb. 21, 2007 to correct error identified by Tom Schooley of WUTC Staff per telephone conversation on Oct. 5, 2006

ATTACHMENT 1c:

Revenue Requirement Calculation

(Comparing "Current" to "Prior" Revenue Requirement Calculations)

PACIFICORP
WASHINGTON
Normalized Results of Operations - West Control Area
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	0 Total Adjusted Results	0 Price Change	0 Results with Price Change
0 Operating Revenues:			
0 General Business Revenues	-	(462,932)	(462,932)
0 Interdepartmental	-		
0 Special Sales	-		
0 Other Operating Revenues	-		
0 Total Operating Revenues	-		
0			
0 Operating Expenses:			
0 Steam Production	-		
0 Nuclear Production	-		
0 Hydro Production	-		
0 Other Power Supply	-		
0 Transmission	-		
0 Distribution	-		
0 Customer Accounting	-	(2,244)	(2,244)
0 Customer Service & Info	-		
0 Sales	-		
0 Administrative & General	-		
0 Total O&M Expenses	-		
0 Depreciation	-		
0 Amortization	-		
0 Taxes Other Than Income	-	(18,809)	(18,809)
0 Income Taxes - Federal	-	(154,658)	(154,658)
0 Income Taxes - State	-	-	-
0 Income Taxes - Def Net	-		
0 Investment Tax Credit Adj.	-		
0 Misc Revenue & Expense	-		
0 Total Operating Expenses:	-	(175,711)	(175,711)
0			
0 Operating Rev For Return:	-	(287,221)	(287,221)
0			
0 Rate Base:			
0 Electric Plant In Service	-		
0 Plant Held for Future Use	-		
0 Misc Deferred Debits	-		
0 Elec Plant Acq Adj	-		
0 Nuclear Fuel	-		
0 Prepayments	-		
0 Fuel Stock	-		
0 Material & Supplies	-		
0 Working Capital	-		
0 Weatherization Loans	-		
0 Misc Rate Base	-		

0	Total Electric Plant:	-	-	-
0				
0	Rate Base Deductions:			
0	Accum Prov For Deprec	-		
0	Accum Prov For Amort	-		
0	Accum Def Income Tax	-		
0	Unamortized ITC	-		
0	Customer Adv For Const	-		
0	Customer Service Deposits	-		
0	Misc Rate Base Deductions	-		
0				
0	Total Rate Base Deductions	-	-	-
0				
0	Total Rate Base:	-	-	-
0				
0	Return on Rate Base	0.000%		-0.053%
0	Return on Equity	0.114%		0.000%
0				
0	TAX CALCULATION:			
0	Operating Revenue	-	(441,879)	(441,879)
0	Other Deductions			
0	Interest (AFUDC)			
0	Interest	-	-	-
0	Schedule "M" Additions	-	-	-
0	Schedule "M" Deductions	-	-	-
0	Income Before Tax	-	(441,879)	(441,879)
0				
0	State Income Taxes	-	-	-
0	Taxable Income	-	(441,879)	(441,879)
0				
0	Federal Income Taxes + Other	-	(154,658)	(154,658)
		Ref. Page 2.2	Ref. Page 1.1	

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Net Rate Base - Oregon Jurisdiction	$	-	Ref. Page 1.1
Return on Rate Base Requested		-0.053%	Ref. Page 2.1
Revenues Required to Earn Requested Return		(287,221)	
Less Current Operating Revenues		-	
Increase to Current Revenues		(287,221)	
Net to Gross Bump-up		0.00%	
Price Change Required for Requested Return	$	(462,932)	
Requested Price Change	$	(462,932)	
Uncollectible Percent		0.000%	Ref. Page 1.3
Increased Uncollectible Expense	$	(2,244)	
Requested Price Change	$	(462,932)	
Franchise Tax		0.000%	Ref. Page 1.3
Revenue Tax		0.000%	Ref. Page 1.3
Resource Supplier Tax		0.000%	Ref. Page 1.3
Gross Receipts		0.000%	Ref. Page 1.3
Increase Taxes Other Than Income	$	(18,809)	
Requested Price Change	$	(462,932)	
Uncollectible Expense		2,244	
Taxes Other Than Income		18,809	
Income Before Taxes	$	(441,879)	
State Effective Tax Rate		0.000%	Ref. Page 2.1
State Income Taxes	$	-	
Taxable Income	$	(441,879)	
Federal Income Tax Rate		0.00%	Ref. Page 2.1

Federal Income Taxes	$ (154,658)	
Operating Income	0.000%	
Net Operating Income	0.000%	Ref. Page 1.3
Net to Gross Bump-Up	0.00%	

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Operating Revenue	0.000%	
Operating Deductions		
Uncollectable Accounts	0.000%	
Taxes Other - Public Utility Tax	0.000%	0
Taxes Other - Revenue Tax	0.000%	
Taxes Other - Resource Supplier	0.000%	
Taxes Other - Gross Receipts	0.000%	
Sub-Total	0.000%	
State Income Tax @ 0.000%	0.000%	
Sub-Total	0.000%	
Federal Income Tax @ 35.00%	0.000%	
Net Operating Income	0.000%	

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