BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, vs. PACIFICORP dba Pacific Power & Light Company, Respondent.	DOCKET UE-061546
In the Matter of the Petition of PACIFICORP dba Pacific Power & Light Company For an Accounting Order Approving Deferral of Certain Costs Related to the MidAmerican Energy Holdings Company Transition.	DOCKET UE-060817 (Consolidated)

REPLY BRIEF

ON BEHALF OF COMMISSION STAFF

May 7, 2007

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I. WCA Methodology

1 **Response to ICNU.** ICNU is simply wrong in claiming that Staff has "abandoned" prior positions by allegedly seeking to allocate "higher power costs to Washington" in this case, and by allegedly failing to evaluate various benefits of inter-control area transactions.[1] In fact, Staff is consistent by proposing a method that fairly allocates costs to Washington. It is ICNU who is wrong to suggest that the WCA methodology makes Washington's power costs 62 percent higher than the Eastern control area.[2] Moreover, Staff's Eastern Market Modification Adjustment 5.4 addresses inter-control area transactions.

2 Instead of embracing Adjustment 5.4, ICNU claims that adjustment is "arbitrary and unsupported," and ignores "actual interconnections."[3] In fact, Adjustment 5.4 is well supported,[4] and it is a legitimate way to capture the limited incremental benefits from sales from the Western control area into a higher margin market. While it is true that the WCA model is not based on "actual interconnections," that is because by definition, a control area-based model does not model the Company's entire system. If ICNU wants to propose a system-wide allocation model based on "actual interconnections," it should do so.

3 ICNU's thirst for a system-wide allocation method is showcased again in its complaint that the WCA methodology excludes the Dave Johnson and Wyodak plants. In fact, these plants have always been located in a control area that does not include Washington.[5] The WCA methodology initially considers these plants to be Eastern control area resources, based on the way the Company's system is structured, planned, and operated. In other words, they are like any other Eastern control area resources that have no dedicated

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[1] ICNU Opening Brief at 11, ¶ 18.
[2] *See* Staff Opening Brief at 9-11, ¶¶ 31-34.
[3] ICNU Opening Brief at 16-17, ¶¶ 30-31.
[4] Buckley, Exh. 7:7 to 9:4 and Exh. 262.
[5] ICNU Opening Brief at 19 and 20, ¶¶ 36 and 39 and Buckley, Exh. 265 at 12:20 to 13:8.

transmission paths to the Western control area.[6] On this record, they have not been shown to provide benefits to Washington sufficient to be considered "used and useful" to Washington.

II. PCAM

4 **Response to ICNU and Public Counsel.** ICNU says the PCAM is flawed because it includes costs that are not beyond PacifiCorp's control.[7] In fact, Staff's proposed PCAM includes *only* costs that are beyond PacifiCorp's control.[8] ICNU also complains that the PCAM relies on "fake" costs,[9] but once again, ICNU is exaggerating. As Staff testified, this problem "is pretty minimal in the context of the whole proposal."[10] The PCAM will derive a reasonable level of Washington power costs. In any event, Staff's proposal to increase the dead band from $3 million to $4 million addresses any latent concerns on this issue.[11]

5 ICNU then speculates that there will be an "automatic" $5 million rate increase if the Commission approves a PCAM, based on ICNU's alleged impact of an expiring power contract.[12] In fact, no rate increase is "automatic" under the PCAM. If a power contract expires, how PacifiCorp replaces that power will be subject to a prudence review either in a rate case or in a PCAM review proceeding, or both. By the same token, all else equal, if power costs prudently increase or decrease, so should rates, once the dead band is exceeded.

6 In any event, ICNU fails to recognize that Staff's proposed PCAM only includes the variable costs of new contracts under a two-year term and under 50 average MWs, and even

[6] Buckley, Exh. 265 at 12:20 to 13:22 and Staff Opening Brief at 11-12, ¶¶ 36-39.
[7] *E.g.*, ICNU Opening Brief at 21, ¶ 41.
[8] Buckley, Exh. 261 at 32:16 to 33:10.
[9] *E.g.*, ICNU Opening Brief at 21, ¶ 41. Public Counsel makes a similar argument. Public Counsel Opening Brief at 9-10, ¶¶ 18-19.
[10] Buckley, TR. 339:16-17.
[11] Buckley, Exh. 261 at 40:8-20. ICNU never explains why the dead band needs to be greater than $4 million to address this issue. ICNU Opening Brief at 25, ¶ 50. Nor can ICNU reconcile its push for a larger dead band with its claim that PacifiCorp faces minimal power cost volatility. *E.g.*, ICNU Opening Brief at 23, ¶ 47.
[12] ICNU Opening Brief at 26, ¶ 52.

those contracts are subject to adjustment as part of the annual review process.[13] Like Avista's ERM, rate recovery of other new contract costs must await a general rate case.

7 **Response to PacifiCorp.** Instead of focusing on its own circumstances, PacifiCorp wants the Commission to focus on PSE and Avista. According to PacifiCorp, neither PSE nor Avista has an explicit cost of capital offset related to their PCAMs, so neither should PacifiCorp.[14] For the most part, this argument evaporates by force of the Company's admission that the mechanisms for PSE and Avista were implemented as part of settlements.[15] Settlements do not set precedent.

8 Indeed, both PSE and Avista were suffering from the adverse effects of the Western power crisis. Consequently, each company was given a PCAM and a hypothetical equity ratio designed to meet minimum financial targets in order to avoid further bond rating downgrades.[16] No similar circumstances apply to PacifiCorp.

9 On the other hand, if PacifiCorp wishes to be treated like Avista, then it should get the same ratemaking equity ratio as Avista: 40 percent.[17] Or, if PSE is to be the guide, the Commission should consider the order it just issued in PSE's latest power cost only rate case. In that case, PSE attempted to change its PCAM to shift more risk to ratepayers, without a cost of capital offset. The Commission rejected that attempt, ruling that "a PCA designed to insulate [PSE] from fifty percent of the cost risk of normal variations in hydro

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[13] Buckley, Exh. 261 at 29:11-21.

[14] PacifiCorp Opening Brief at 21-23, ¶¶ 41-45. In the same vein, PacifiCorp argues that no cost of capital offset is required because the Company's PCAM is modeled after Avista's ERM. PacifiCorp Opening Brief at 25, ¶¶ 51-52. However, this argument is worthless absent a showing of how each mechanism affects each utility's operations. PacifiCorp offers no such showing.

[15] *Id.* at 21, ¶ 42 and at 22-23, ¶¶ 44-45. In any event, the cost of capital offset issue will be addressed in Avista's just-filed general rate case. *See Re Petition of Avista Corp.,* Docket UE-060181, Order 03 at 5, ¶ 10 (June 16, 2006).

[16] *WUTC v. Puget Sound Energy,* Dockets UE-011570 & UG-011571, 9th Supp. Order (March 28, 2002) at 10, ¶ 18 and Appendix A at 6-7, ¶¶ 15-18, and 12th Supp. Order (June 20, 2002) at 9, ¶ 19; *WUTC v. Avista Corp.,* Dockets UE-050482 & UG-050483, Order 05 (December 21, 2005) at 25-26, ¶¶ 54-55, and Docket UE-011595, 4th Supp. Order (March 4, 2002) and 5th Supp. Order (June 18, 2002).

[17] *WUTC v. Avista Corp.,* Dockets UE-050482 &UG-050483, Order 05, (December 21, 2005) at 26, ¶ 55.

should necessarily be accompanied by an adjustment to the return on equity."[18] Similarly, in this case, PacifiCorp is proposing to insulate itself from variations in power costs that exceed the dead band. An adjustment to the cost of capital is required.

10 PacifiCorp goes on to suggest that Staff's proposed 16 basis point cost of capital offset is excessive because when the Commission previously approved an offset for PSE in 1991, the offset was 6 basis points for a broader mechanism.[19] However, PacifiCorp neglects a critical distinction: at that time, PSE had a ratemaking common equity ratio of 41.5 percent,[20] which provided much less of a cushion than the 46 percent equity ratio of PacifiCorp.

11 In other words, PSE ratepayers were not paying for as much protection from adverse power conditions as PacifiCorp's ratepayers would. Consequently, PSE had less financial flexibility due to its ratemaking equity ratio of 41.5 percent, and less of an adjustment was necessary. By contrast, PacifiCorp is regulated using a 46 percent equity ratio, giving the Company a significant cushion with which to manage power cost variations. If PacifiCorp's ratemaking equity ratio were 41.5 percent, the adjustment would be much smaller.

12 Ultimately, however, the issue is not how PacifiCorp stacks up with PSE or Avista. The issue is how the Commission should implement its cost of capital offset policy for PacifiCorp in this case, on this record. The record in this case proves that PacifiCorp's equity ratio should be reduced to 42 percent to account for PCAM-related risk reduction.[21]

13 PacifiCorp hopes to convince the Commission to abandon its cost of capital offset policy altogether in this case, because the Company thinks the WCA method creates

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[18] *WUTC v. Puget Sound Energy*, Docket UE-060266, Order 08 (January 5, 2007) at 11, ¶ 21.
[19] PacifiCorp Opening Brief at 23, ¶¶ 46-47.
[20] Exh. 295, Response 2a.
[21] *See* Staff's Opening Brief at 20-28, ¶¶ 67-91.

uncertainty, thus adding risk.[22] Obviously, the Company has it backwards. The uncertainty is caused by the Company having no approved allocation method. If the Commission approves the WCA methodology, that will eliminate uncertainty and thereby reduce risk.

14 PacifiCorp also offers a "straw man" argument by claiming that Staff tried and failed to create an S&P bond rating analysis.[23] In fact, Staff did not purport to do a bond rating analysis. Staff's pre-tax interest coverage analysis was done exclusively for the purpose of implementing the Commission's cost of capital offset policy by calculating the degree of risk shifting under the PCAM, compared to the non-PCAM environment.

15 In any event, PacifiCorp's use of Exhibit 53 to prove its "straw man" argument is unavailing. Exhibit 53 is the Company's attempt to replicate an S&P bond rating analysis,[24] yet it bears no resemblance to an actual S&P bond rating analysis. Exhibit 53 focuses on PacifiCorp's financial results, while S&P focuses "primarily on MEHC's financial profile."[25] Moreover, S&P uses GAAP-basis financial results, but PacifiCorp did not prove the figures in Exhibit 53 were based on GAAP.[26] In sum, Exhibit 53 proves nothing.

16 The Company then questions a foundation assumption of Staff's "benchmark" analysis, *i.e.*, that the Company would be eligible for extraordinary relief when its interest coverage degraded due to adverse power costs. PacifiCorp says its failure to obtain such relief in Docket UE-020417 means "the availability of emergency rate relief for the Company in the event of adverse power costs without a PCAM is far from certain."[27]

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[22] PacifiCorp Opening Brief at 25-26, ¶ 53.
[23] *Id.* at 27, ¶¶ 56-57.
[24] *Id.* at 27, ¶ 56 and footnote 145.
[25] Exh. 59 at 1, 1st ¶. Thus, according to S&P, PacifiCorp's utility bond rating "reflects the consolidated credit profile of parent MEHC." Id. at 2, 4th ¶.
[26] Hadaway, TR. 177:15-19.
[27] PacifiCorp Opening Brief at 26, footnote 141.

17 Actually, this proves Staff's adjustment is conservative, because if PacifiCorp is correct that it cannot obtain emergency rate relief in the current regulatory environment, then a PCAM will be even more favorable to PacifiCorp than Staff assumed in its analysis.

18 Finally, PacifiCorp persists in advocating that Commitment 18 from Docket UE-051090 "requires an equity ratio of 48 percent," and Staff's proposed 42 percent equity ratio is "inconsistent" with this Commitment.[28] However, PacifiCorp already conceded the point:

> Q: So you agree that Commitment 18 does not have any impact on what capital structure the Commission approves for ratemaking?
> A: That's correct.[29] [30]

The Commission has discretion to adopt a ratemaking equity ratio of 42 percent in this case.

III. Rate Base and Operating Expenses

A. Working Capital

19 **Response to PacifiCorp.** PacifiCorp says Staff did not show that its investor supplied working capital analysis (ISWC) was appropriate.[31] In fact, Staff fully explained why and how the ISWC methodology correctly measures the working capital that investors supply.[32] By contrast, the Company failed to demonstrate that its proposed working capital allowance reflects capital supplied by investors.[33]

20 PacifiCorp also states that Staff failed to justify removing various amounts of materials and supplies, prepayments, and fuel stock which the Company places in rate base,

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[28] PacifiCorp Opening Brief at 28 (quotes are from the argument heading).
[29] Kelly, TR. 159:6-9.
[30] PacifiCorp's argument also lacks credibility because if PacifiCorp is correct, the Company itself violated Commitment 18 by proposing an equity ratio less than 48 percent in this case. Williams, Exh. 111 at 5, table after line 16 (46 percent equity ratio). Moreover, the Commission adopted an equity ratio less than 48 percent in the last case, without drawing a Commitment 18 challenge from PacifiCorp. *WUTC v. PacifiCorp,* Docket UE-050684, Order 04 (April 17, 2006) at 79-80, ¶¶ 225-26 and at 83, ¶ 233.
[31] PacifiCorp Opening Brief at 52, ¶ 106.
[32] Schooley, Exh. 311 at 14:1 to 23:17.
[33] *See* Staff Opening Brief at 46-48, ¶¶ 155-160. PacifiCorp also says that evolving GAAP requirements create complexities that render the ISWC method unreliable. *Id.* at 52, ¶ 106. However, at hearing, the Company acknowledged that those complexities relate to proper accounting for pensions and financial derivatives, and Staff indicated that its ISWC analysis handled those complexities. Wrigley, TR. 268:13 to 269:2.

in addition to a "cash working capital" amount.[34] The Company assumes these amounts are supplied by investors, but the Company has the burden to prove these items are indeed investor-supplied, and thus belong in rate base.[35] PacifiCorp failed to bear its burden.

21 The Company takes issue with Staff's critique of the Company's lead lag study.[36] On rebuttal, the Company showed that it is making payments faster now than in its prior lead-lag study, although customer payments are coming in sooner.[37] Motives aside, there is no need for the Commission to reward the Company for its vendor payment policies or by accepting an out of date lead lag study that is based on a myriad of unproven assumptions.[38]

B. ICNU's Centralia Adjustment

22 **Response to ICNU.** ICNU proposes an adjustment related to the Company's sale of the Centralia Steam Plant.[39] ICNU ignores the fact that the Commission made its decision on the Centralia matter in 1999, and PacifiCorp implemented that decision. Like it or not, the world has changed since 1999, and the issues PacifiCorp faces today are not the issues it faced at that time. There is no use in ICNU pretending otherwise. It is time to move on. The Commission should reject ICNU's newly-conceived Centralia adjustment.

C. Transition Costs

23 **Response to PacifiCorp.** PacifiCorp suggests that its commitment to cap A&G costs renders the Company's transition cost adjustment reasonable.[40] However, that commitment is a stand-alone commitment that has nothing directly to do with transition

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[34] PacifiCorp Opening Brief at 53, ¶ 107. In total, these amounts comprise the Company's proposed working capital allowance. *See* Schooley, Exh. 321 at 13:18-25.
[35] RCW 80.04.130(4).
[36] PacifiCorp Opening Brief at 51-52, ¶¶ 104-05.
[37] Wrigley, Exh. 136 at 15 (table).
[38] *See* Staff Opening Brief at 48-49, ¶¶ 162-163.
[39] *See* ICNU Opening Brief at 34-36, ¶¶ 69-74.
[40] PacifiCorp Opening brief at 49, ¶ 99.

costs.[41] PacifiCorp goes on to say that Staff's removal of pre-May 2006 transition costs results in a mismatch of costs and benefits.[42] If there is a mismatch, it is because of the Company's untimely compliance with Commission orders and rules regarding accounting orders. There is no reason to reward the Company for its failure to more timely comply.[43]

24 PacifiCorp then challenges Staff's reduction of the severance payments the Company paid to executives, saying this is simply part of "overall compensation."[44] With all due respect, it is just not fair for ratepayers to bear the brunt of the average of $1.6 million PacifiCorp paid to each departing executive. Executives do not always make decisions that benefit the ratepayers, or even the utility for that matter (*e.g.,* the nuclear plant abandonment fiasco of the 1980s, or PSE's Tenaska gas contract buy-out and its aftermath). If management wants to pay out these huge amounts, shareholders must bear their fair share.

25 Finally, the Company complains it is "punitive" for Staff to treat the unamortized balance of transition costs as part of the investor supplied working capital analysis.[45] In fact, no one is being punished here. Staff's robust working capital allowance of $10,026,240 (Washington)[46] proves that treatment is fair.

26 **Response to ICNU.** ICNU says rate recovery of transition costs violates the Company's MEHC acquisition commitment to exclude "all costs of the [MEHC acquisition] transaction." According to ICNU, that commitment applies to any cost "that would not have occurred but for the MEHC acquisition."[47] However, the plain meaning of "costs of the

[41] *See* Staff Opening Brief at 55-56, ¶¶ 187-88.
[42] PacifiCorp Opening Brief at 49-50, ¶ 101.
[43] *See* Staff Opening Brief at 52-54, ¶¶ 176-180.
[44] PacifiCorp Opening Brief at 50, ¶ 102.
[45] *Id.* at 51, ¶ 103.
[46] *See* Staff Opening Brief, Appendix B, line 34 + line 40.
[47] ICNU Opening Brief at 53-54, ¶ 108.

transaction" includes the expenses incurred to consummate the transaction, not the expense impact of business decisions the Company made after the deal is consummated.

27 While Staff agrees with ICNU's observation that the transition costs related to executives are "excessive," Staff disagrees that these expenses should be denied because they are "one time."[48] As Staff explained, an amortization of this type of expense appropriately matches severance costs with the benefits of the avoided future wages.[49]

28 ICNU also recommends that rates should be reduced when the amortization period expires.[50] However, unless the amortization is in a tariff rider (which no party proposes), ICNU's recommendation is impractical and the Commission should reject it.[51]

D. ICNU's Income Tax Expense Adjustment

29 **Response to ICNU.** Using the euphemism "actual taxes paid,"[52] ICNU defends its proposed Income Tax Expense Adjustment by relying on the 40-year old Supreme Court decision in *Federal Power Commission v. United Gas Pipeline Company.*[53] [54] However, that case simply held that the Federal Power Commission (FPC) had discretion to calculate income taxes using a consolidated return method; the Court did not mandate that method.[55]

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[48] *Id.* at 54, ¶ 109. ICNU also recommends that rates should be reduced when the amortization period expires. ICNU Opening Brief at 56, ¶ 114. However, unless the amortization is in a tariff rider (which no party proposes), that recommendation is impractical and the Commission should reject it.

[49] Schooley, Exh. 311 at 32:1 to 33:2.

[50] ICNU Opening Brief at 56, ¶ 114.

[51] In the case ICNU cites for the idea that expired amortizations "should not stay in rates," the Commission was able to eliminate an abandoned plant amortization from rates outside a general rate case by reducing "base costs" in an existing cost tracking mechanism (called "PRAM"). *WUTC v. Puget Sound Power & Light Co.,* Docket UE-920630, First Supp. Order at 16 (September 24, 1992). PacifiCorp has no mechanism similarly structured to accommodate the elimination of the transition cost amortization.

[52] As the court observed in *City of Charlottesville v. FERC,* 774 F.2d 1205, 1215 (D.C. Cir. 1985), *cert. denied,* 475 U.S. 1108 (1986): "the imprecision of the 'actual taxes paid' formulation is exceeded only by the name of the Holy Roman Empire: two out of three words are wrong. Taxes, yes. But not necessarily *actual* taxes ... [a]nd not necessarily taxes *paid...*" (Emphasis in the original).

[53] 386 U.S. 237 (1967).

[54] ICNU Opening Brief at 47-48, ¶¶ 94-96.

[55] "When Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation." 386 U.S. at 246 (quoting *Colo. Interstate Gas Co. v. FPC,* 324 U.S. 582, 589 (1945)).

ICNU also fails to disclose the fact that the Federal Energy Regulatory Commission (the FPC's successor) abandoned the consolidated return method over 20 years ago.[56] [57]

30 One would at least expect ICNU to use the same method of calculating taxes that the Court condoned in *United Gas Pipeline, i.e.,* by allocating to PacifiCorp a *pro rata* share of the tax liability of all 500+ companies in the Berkshire Hathaway "corporate tree,"[58] after all unregulated company losses are first applied to all unregulated company gains.[59]

31 However, ICNU does not use that method. ICNU looks to only one Berkshire Hathaway company: MEHC. ICNU finds a large tax deduction for MEHC, and gives it to ratepayers.[60] Had ICNU actually used the method condoned in the case upon which it relies, PacifiCorp's income tax expense could well be higher than the taxes calculated based on its own net income;[61] not lower, as ICNU wants. Given all these problems, the Commission should summarily reject ICNU's proposed Income Tax Expense Adjustment.

DATED this 7th day of May, 2007.

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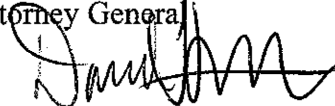

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[56] *Re Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396, Opinion 173 (1983) (rejecting the consolidated tax return method of calculating income taxes, and adopting a "stand-alone" method). The same day, FERC adopted the stand alone method for electric utilities. *Re Potomac Edison Co.*, 23 FERC ¶ 61,398, Opinion 163A (1983).

[57] Some state commissions still use the consolidated return method in some form (*e.g., Re West. Mass. Electric Co.*, 114 PUR 4th 1, 25 (Mass. DPU 1990)). Others have declined to use that method on policy grounds (*Re Potomac Elec. Power Co.*, 124 PUR 4th 1, 22-24 (Md. PSC 1991), or constitutional grounds (*e.g., Re Income Tax Expense for Rate-making Purposes*, 59 PUR 4th 576, 586-87 (Cal. PUC 1984): "We see no public interest that is served by making utility rates a function of profits or losses in non-utility affiliates, as would result from the consolidated return method. Further, we are persuaded that a tax loss is an asset that would be taken either without compensation and without due process of law, or with compensation but for no useful purpose").

[58] Evans, Exh. 21 at 4:13-19.

[59] 386 U.S. at 241-42 (Court describes the consolidated return method the FPC used for United Gas Pipeline).

[60] Gorman, Exh. 181 at 5:18-21.

[61] Kermode, Exh. 314 at 6:5-15.