Exhibit ___T (KLE-1T)
Docket UE-061546
Witness: Kenneth L. Elgin

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 PACIFIC POWER & LIGHT COMPANY For an Accounting Order Approving Deferral of Certain Costs Related to the MidAmerican Energy Holdings Company Transition.	DOCKET UE-060817

TESTIMONY OF

Kenneth L. Elgin

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WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

PCAM Cost of Capital Offset and Rate of Return

February 16, 2007

Table of Contents

Q. Please summarize your financial analysis of the Staff's proposed PCAM.

A. My analysis shows that like the Company's proposed PCAM, the operation of the Staff's proposed PCAM also shifts significant risk to ratepayers for variations in power supply costs that should be absorbed by the Company absent a PCAM. However, the risk shift is less than under the Company's proposed PCAM.

If the Commission adopts the Staff's PCAM proposal, the Commission should adjust the Company's ratemaking common equity ratio from 46 percent to 42 percent. Staff's revenue deficiency calculation is based upon a rate of return developed using a 42 percent common equity ratio.

III. DISCUSSION

A. Commission Policy On PCAMs And Their Impact on Cost Of Capital

Q. What is the Commission's policy regarding the cost of capital impact of a PCAM or like mechanism?

A. The Commission's policy is that adopting a PCAM or like mechanism requires a reduction in the utility's cost of capital. The Commission recently reiterated this policy in the last PacifiCorp rate case, Docket UE-050684 ("2005 Rate Case"):

> Ratepayers should receive the benefit of a reduction in cost of capital, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders.[1]

[1] Order 04 at 35, ¶ 91 (April 17, 2006).

Q. Has this been a consistent Commission policy?

A. Yes. In the passage I just quoted, the Commission supported its statement of policy by citing three prior Commission orders ranging in dates from 1988 to 2000.[2]

Q. Does the Commission policy make sense from a financial perspective?

A. Yes. As I explain in more detail later in my testimony, a PCAM reduces the utility's exposure to excess power cost conditions. In doing so, it reduces the potential of the utility to suffer adverse financial consequences due to excess power costs. This lowers its cost of capital. A cost of capital offset is therefore appropriate.

Q. In implementing that policy, has the Commission been consistent in requiring an explicit link to the cost of capital impacts as a condition of implementing a PCAM?

A. Yes. In my review, I found: 1) examples where the Commission rejected a mechanism when the utility did not adjust for any related cost of capital impacts; 2) an example where the Commission approved a mechanism, and the cost of capital was adjusted to reflect the impact of it; but also 3) an example where the Commission approved a mechanism without an explicit adjustment to cost of capital- there was apparently no analysis that the utility's cost of capital reflected the mechanism.

[2] In footnote 135 of Order 04 in the 2005 Rate Case, the Commission cited *WUTC v. Puget Sound Power & Light Co.*, Docket U-81-41, Sixth Supplemental Order at 21-22 (Dec. 1988) (PSE ECAC); *Petition of Washington Water Power for PCA Mechanism*, Docket U-88-2363-P, First Supplemental Order Denying Petition at 8 (Sept. 1989); and *WUTC v. Avista Corp.*, Dockets UE-991606 & UG-991607, Third Supplemental Order at 50, 52 (Sept. 2000).

impact on cost of capital "was too difficult to measure."[9] Puget had calculated the impact of ECAC to be a 30 basis point reduction to the cost of equity, but the utility admitted this difference "could be due to measurement error rather than the effect of the ECAC."[10]

Q. What conclusions should the Commission draw from these examples?

A. While the Commission may not have implemented its policy perfectly by requiring an explicit reduction in the cost of capital each and every time it has been asked to approve a power cost adjustment mechanism, the Commission has been consistent in its pursuit of reductions to the utility's cost of capital related to such mechanisms.

B. How Staff Analyzed The Financial Impact Of Each PCAM Proposal

1. The financial parameters Staff used

Q. What financial parameters should be used to analyze the link between a power cost adjustment mechanism and the utility's cost of capital?

A. The link between a power cost adjustment mechanism and the utility's cost of capital should be evaluated by measuring the impact of the mechanism on the utility's ability to service debt when variations in power supply costs adversely affect the company's earnings.

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[9] *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.,* Docket U-89-2688-T, Third Supplemental Order at 14 (January 17, 1990).
[10] *Id.* at 12.

Q. What financial metrics should be used to make this evaluation?

A. The critical financial metric is pre-tax interest coverage, which is sometimes called times interest coverage, or coverage ratio. As I explain later, my analysis focuses on this important financial metric and how power supply cost variations affect this metric.

Q. What is a "pre-tax interest coverage," "times interest coverage" or "coverage ratio," and why is this metric useful?

A. This metric measures the ability of a firm to make payments on its debt from pre-tax operating income. It is the simplest and most direct indication of a firm's ability to not only service debt but also tells prospective lenders the firm's ability to service new debt. It lends itself easily to calculating the impacts of adverse power supply conditions on the financial flexibility of the firm, and its cost of capital.

Q. Please explain the correlation between coverage ratio and the utility's cost of capital.

A. Higher coverage ratios for utilities are directly correlated to both the capital structure adopted for ratemaking purposes, and the return on that equity investment that ratepayers pay for in utility rates. A utility with a lower bond rating will typically have lower coverage than a utility with a higher bond rating, all else equal.

For example, if a firm has sufficient pre-tax operating income to pay its interest expense twice, it has a 2.0 times interest coverage, or a 2.0 times pre-tax coverage ratio. A firm with an interest coverage ratio of 3.0 times would be on even

firmer financial footing, because its pre-tax operating income covers its interest expense three times.

Moreover, most utility bonds contain covenants that prescribe specific ratios for interest coverage the utility must maintain before it can issue additional debt. This further confirms that the coverage ratio is a key indicator of financial health, and thus it is directly correlated to the cost of capital.

Q. How does the coverage ratio analysis lend itself easily to calculating the impacts of adverse power supply conditions on the utility's cost of capital?

A. The interest coverage metric is very useful here because it is the one indicator that enables the analyst to focus on a single change in expense, *i.e.*, power supply, and then translate these power cost changes into changes in earned returns, and then translate these changes in earned returns to the utility's ability to service its debt as measured by the coverage ratio.

I should add at this juncture that the most critical aspect in reviewing a utility's performance is to evaluate the downside risk the company has when adverse power supply conditions occur, and how this impacts the utility's financial performance, *i.e.,* its ability to service its debt and thus continue to finance and satisfy its public service obligations.

Q. Why is this analysis appropriate to an analysis of a PCAM?

A. This analysis is appropriate because a power cost adjustment mechanism protects the utility against the downside risk of increasing power supply costs. Therefore, a

PCAM reduces the risk of default to a prospective lender, which in turn enhances the utility's ability to access external sources of capital on reasonable terms during adverse power supply conditions.

Indeed, the definition of 'risk' involves the concept of the possibility of suffering loss, hazard and uncertainty. While it is true that a power cost adjustment mechanism also impacts "upside risk" (that is, it limits the utility's ability to keep all benefits of lower power costs), it reduces power cost variability to the utility. From a cost of capital perspective, this reduces the potential of the utility to suffer adverse, i.e. downside, financial consequences, and thus lowers its cost of capital.

This provides strong support for the Commission's policy requiring a cost of capital reduction when the Commission approves a PCAM.

Q. Do bond rating agencies agree a power cost adjustment mechanism protects against significant financial harm from power cost variability?

A. Yes. Standard & Poor's (S&P) is a well-recognized bond rating agency. In a publication dated January 27, 2007, S&P states:

> Because a significant component of a utility's operating expenses relate to fuel and purchased power, one of the keys to rating stability is the level of support that state regulators provide to utilities for fuel cost recovery, particularly as gas and coal prices have risen. Utilities…without access to fuel and purchase power adjustment clause…can face reduced operating margins, increased exposure to cash flow volatility, and greater demand for working capital.[11]

[11] "Ratings Direct," found on page 7 of S&P's "Ratings Roundup: Pace of U.S. Utility Rating Activity Moderated in 2006" (January 23, 2007).

In my review of ratings reports, this is typical of the concerns expressed by bond rating services. It also reflects their focus on the downside protection afforded by power cost adjustment mechanisms.

2. The financial information Staff used

Q. In using interest coverage ratios to evaluate the impact on PacifiCorp's cost of capital by the power cost adjustment mechanisms proposed in this case, what financial information do you use?

A. I use PacifiCorp's 8.060 percent overall rate of return for its Washington operations. This figure is based on the capital structure and corresponding cost rates the Commission found to be appropriate in the 2005 Rate Case, Order No. 04 at ¶ 287, adjusted for the changes to the cost of debt which PacifiCorp presents in its direct case. *See direct testimony of Mr. Williams, Exhibit ___ (BRW-1T) at 5, the Table after line 16.* This capital structure and overall rate of return produce a strong pre-tax coverage ratio of 3.22 times.

I also used the Washington rate base in the amount of $535 million. This figure was developed by Staff witness Mr. Schooley. Applying the rate of return to the rate base produces net operating income of $43,121,000.

In addition, I assumed a 35 percent federal income tax rate. Changes in power supply expense must be adjusted for federal income tax effects to produce a change in net operating income. Therefore, in my analysis, I adjust changes in power supply expense for federal tax impacts in calculating the impact of power cost

variances on PacifiCorp's net operating income, rate of return, and return on equity and coverage ratio.

Finally, I used the specific characteristics of both the Company and Staff proposed PCAMs, namely the dead bands and sharing bands, and the amounts of excess power costs, if any, the Company absorbs in each band under adverse power supply conditions. Once I have calculated a change in the overall rate of return due to a change in power supply expense reflected by these bands, I am then able to calculate the impact of expense changes on the Company's return on equity and pre-tax interest coverage.

These figures all appear in my analysis in my Exhibit ___ (KLE-3), page 1 and are consistently used throughout the exhibit. (All figures are rounded.)

3. The "benchmark" Staff used to compare the proposed PCAMs to the existing, non-PCAM environment

Q. Does your interest coverage analysis for each proposed PCAM provide you enough information to determine the extent to which PCAM shifts risk?

A. No. The Commission cannot determine how a PCAM shifts risk unless it first understands how risk is allocated in the non-PCAM environment. Consequently, the Commission needs a "benchmark" measure of risk reflecting the non-PCAM environment, so that it can see how risk is re-allocated by a PCAM.

Q. How is risk allocated between ratepayers and the Company in the non-PCAM environment?

A. In the absence of a PCAM, the Company absorbs excess power costs, but only up to a certain point. It is the Commission's policy to permit a utility to defer excess power costs or if necessary grant a temporary rate increase, when that utility's financial health is directly threatened by highly adverse power costs. Put another way, under the existing allocation of risks between ratepayers and the Company, ratepayers will be called upon to bear the risk of adverse power cost variability, and pay increased rates, to enable the Company to weather that financial storm.

Therefore, the level where a utility would in all probability be provided that sort of relief is the "benchmark" against which to compare a PCAM. This comparison would reveal the extent to which the PCAM shifts risk to ratepayers, over and above the status quo.

Q. Can you cite an example where the Commission applied its policy for granting relief in circumstances of highly adverse power costs?

A. The most recent example of this policy involves Avista. Docket UE-000972 began on June 23, 2000. The Company requested Commission approval to defer excess power costs, and amortize them if the Commission did not approve a PCAM Avista was requesting in a pending rate case, Docket UE-991606. The Commission did not approve a PCAM in that rate case. On August 9, 2000 the Commission entered its order authorizing that accounting treatment.[12]

Later that year, on December 20, 2000, Avista requested further amendments to the original order to change the calculation of excess deferred power costs. On

[12] *Utilities & Transp. Comm'n v. Avista Corp.,* Docket UE-000972, Order Approving Establishment of a Deferral Mechanism to Track Power Costs (August 9, 2000).

January 24, 2001 the Commission granted the amended accounting treatment for excess deferred power costs.[13]

These accounting mechanisms were in place as the "Western Energy Crisis" further unfolded. That crisis and the adverse power costs Avista incurred and deferred ultimately led the utility to seek interim rate relief in Docket UE-010395. The Commission ultimately approved an emergency or "interim" rate increase for Avista to recover its deferred power costs.[14]

Q. What should the Commission conclude from this example?

A. The Commission should conclude that under the current risk allocation scheme between customers and utilities, ratepayers bear the risk of excess power costs when such costs begin to substantially impede a utility's access to new sources of external capital.

Q. How did you use this risk allocation analysis to determine the appropriate benchmark to apply in this case?

A. The benchmark relates to the point where the Company's ability to access external sources of capital would begin to be threatened under adverse power supply conditions in a non-PCAM environment. I believe this point is when the Company's coverage ratio falls to 2.50 times.

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[13] *Utilities & Transp. Comm'n v. Avista Corp.,* Docket UE-000972, Order Granting Request to Modify Power Cost Deferral Mechanism (January 24, 2001).
[14] *Utilities & Transp. Comm'n v. Avista Corp.,* Docket UE-010395, Sixth Supplemental Order Rejecting Tariff Filing; Granting Temporary Rate Relief, Subject to Refund; and Authorizing and Requiring Compliance Filing (September 24, 2001).

In other words, in an adverse power supply cost situation, if the Company's coverage ratio degrades to 2.5 times, the Company's financial flexibility begins to be impacted. At that point, and assuming the adverse power supply conditions were continuing and beyond the Company's control, it would be reasonable for the Commission to permit the Company to defer excess power costs for recovery from ratepayers, again, in a non-PCAM environment.

Indeed, my analysis of the Avista petition in Docket UE-991606 shows that Avista had around a 2.3 coverage ratio when it sought Commission permission to defer excess power costs.

Q. Why is a 2.50 coverage ratio an appropriate benchmark?

A. A 2.50 coverage ratio still satisfies S&P's criteria for a "BBB" bond rating, which is an investment grade rating. However, if a utility's coverage ratio was degraded to that point, and if the excess power cost situation was continuing, the Commission would likely take action. If the Commission allowed substantial power cost deferrals at that point, it would send the signal to the market that the utility is recovering these short-term adverse power supply costs going forward. This protects bondholders from earnings attrition that impacts both the utility's ability to service debt, and to obtain additional financing.

Deferrals of excess power costs at this point would eliminate adverse power supply conditions as the contributing factor to the earnings attrition that was causing the Company's debt coverage to approach a below investment grade bond rating.

Q. Without a PCAM, at what level of increased power supply costs for its Washington operations would PacifiCorp's coverage ratio be at risk of falling below 2.50 times?

A. A $13 million increase in power supply costs would place the Company at the risk of having its coverage ratio falling below 2.50 times. As I explained, in a non-PCAM environment, and at a $13 million level of excess power supply costs (the term "excess power supply costs" means costs above the normalized level used for ratemaking purposes), the Commission would be likely to grant some form of relief, either by permitting deferrals, or interim rate relief, depending on the circumstances.

Q. How can the Company absorb $13 million in increased power costs, and yet still maintain a 2.50 times coverage ratio?

A. The equity ratio and cost of equity the Commission found appropriate for PacifiCorp in the 2005 Rate Case provides the Company significant financial flexibility to weather such a significant event.

In the 2005 Rate Case, the Commission determined PacifiCorp was entitled to a ratemaking capital structure containing a 46 percent equity ratio, plus a 10.2 percent cost of equity. This will provide PacifiCorp significant operating margins and a" cushion," that is, an ability to absorb significant cost variances, including power cost variances.

Q. Why is this 2.50 coverage ratio a "benchmark?"

A. In my opinion, under the existing allocation of risk between ratepayers and the Company, it is the point where Commission would likely authorize the Company to begin to defer excess power costs. Beyond that, ratepayers would be responsible for a substantial amount of excess power costs, *e.g.* 90 percent. This is a benchmark because if a PCAM does more to protect the Company than that, it is shifting risk to ratepayers.

Consequently, a 2.50 interest coverage at $13 million in excess power costs for PacifiCorp constitutes the "benchmark" against which any proposed PCAM should be measured. This benchmark can be used both to determine the extent of risk shifting, and to measure the magnitude of the appropriate cost of capital offset.

Q. Have you prepared an exhibit showing your calculation of the 2.5 coverage ratio at $13 million in excess power costs?

A. Yes. It is in my Exhibit ___ (KLE-3), at page 1.

Q. Please explain page 1 of your exhibit.

A. The calculation on page 1 is premised upon the PacifiCorp's current capital structure and cost of capital. As line 1 and 5 indicate, this calculation assumes PacifiCorp does not have a PCAM and the Company absorbs all of the $13 million in excess power supply costs. As lines 13 and 14 show, under this scenario, PacifiCorp's return on equity would fall to 6.77 percent, and it would have a 2.48 times pre-tax interest coverage ratio, respectively.

This result is not surprising. A utility like PacifiCorp, that is authorized a 46 percent equity ratio a 10.2 percent return on equity, should be expected to finance its ongoing operations in light of short-term power cost variations, including $13 million in excess power costs and no PCAM.

Q. Is this 2.5 times coverage benchmark consistent with the Commission's policy on PCAMs you described earlier?

A. Yes. In effect, the Commission's policy requires that customers do not pay twice for risk: once for the cushion provided by the combined 46 percent equity ratio and a 10.2 percent cost of equity, and then again for power costs variances which that cushion, in part, should cover.

Instead, consistent with the Commission's policy, ratepayers should only pay once for risk. If the Commission adopts a PCAM, it should reduce the equity component in PacifiCorp's capital structure. Rates should not support both the costs of a 46 percent equity ratio and a PCAM.

Q. Continuing on with your benchmark analysis, did you estimate at what point additional power costs would cause PacifiCorp to be at risk of losing its ability to finance?

A. Yes. In my opinion, it is likely that the Company would be able to justify some form of rate relief, *e.g.* interim rate relief, if its coverage ratio went to 2.00 times due to adverse power cost events. My calculations show that if power costs increase $20,000,000 over the normalized level used for setting rates, the Company's

coverage would fall to about two times. Page 2 of my Exhibit ___ (KLE-3) contains this calculation. Under these circumstances, the Company would likely experience difficulty in obtaining new financing on reasonable terms, and if adverse power supply conditions persist, the Company would be faced with the prospect of being unable to obtain external financing.

C. Financial Analysis Of PacifiCorp's Proposed PCAM

Q. Please describe the Company's proposed PCAM.

A. The Company's proposed PCAM has an initial $3 million dead band. The Company would absorb all power cost variations between $0 and $3 million. The next band calls for sharing, with 60 percent ratepayer responsibility for all power cost variation between $3 million and $7.4 million. The Company's outer band also calls for sharing, with 90 percent ratepayer responsibility for any power cost variances above $7.4 million. *See PacifiCorp witness Mr. Widmer's direct testimony, Exhibit ___ (MTW-1T) at page 28, lines 12-21.*

Q. How do you use the bands and their related dollar amounts in your analysis of the Company's PCAM proposal?

A. I assumed the Company would incur increased power costs at the limits of the bands. I then calculated how excess power costs at the band's limits would affect the Company's return on equity and its pre-tax coverage ratio.

Q. What were the results of your analysis?

A. The results are shown in my Exhibit ___ (KLE-3), beginning on page 3. Page 3, lines 1 and 5 show where I assumed the Company absorbed all $3 million in power supply cost variance in the dead band. Line 6 shows the $1.95 million impact on net operating income (NOI). In that scenario, the Company's return on equity would fall to 9.42 percent, and its coverage ratio would be 3.05 times. These figures are shown on page 3, lines 13 and 14, respectively.

I did the same calculation for the first sharing band. This is shown in my Exhibit ___ (KLE-3), at page 4. If the Company incurred excess power costs of $7.4 million, it would absorb $4.76 million of these costs: $3 million through the dead band, and an additional $1.76 million through second band, *i.e.,* 40 percent of the next $4.4 million. In this scenario, the Company's return on equity would fall to 8.95 percent, and its coverage ratio would fall to 2.95 times. These figures are shown on page 4, lines 13 and 14, respectively.

Finally, for the outer band, the Company's PCAM would defer 90 percent of all power cost variances that exceed the $7.4 million for customer responsibility. In this scenario, PacifiCorp's proposed PCAM provides the Company a return on equity floor of about 8.70 percent, and an interest coverage floor of a healthy 2.89 times. Pages 5 and 6 of my Exhibit provide the basis for this conclusion.

Q. Please explain your conclusion that the Company's PCAM provides a return on equity "floor" of about 8.70 percent, when PacifiCorp would continue to be responsible for 10 percent of the deferrals past $7.4 million?