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December 4, 2006

Via Electronic and U.S. Mail

Public Utility Commission
Attn: Filing Center
550 Capitol St. NE #215
P.O. Box 2148
Salem OR 97308-2148

Re: In the Matter of PORTLAND GENERAL ELECTRIC COMPANY
Request for a General Rate Revision
Docket Nos. UE 180/UE 181/UE 184

Dear Filing Center:

Enclosed please find an original and five copies of the nonconfidential version of the Opening Brief of the Industrial Customers of Northwest Utilities ("ICNU") in the above-referenced docket numbers. This version of ICNU's Opening Brief is being filed based on PGE's agreement to remove the confidential designation of Exhibit ICNU 412. There is no longer any confidential information contained in ICNU's Opening Brief.

Please call me at (503) 241-7242 if you have any questions. Thank you for your assistance.

Sincerely yours,

/s/ Christian Griffen
Christian W. Griffen

Enclosures
cc: Service List

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing Opening Brief of the Industrial Customers of Northwest Utilities upon the parties, on the official service list, by causing the same to be served via electronic mail.

Dated at Portland, Oregon, this 4th day of December, 2006.

/s/ Christian Griffen
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BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 180/UE 181/UE 184

In the Matter of PORTLAND GENERAL ELECTRIC COMPANY Request for a General Rate Revision (UE 180),	))))))))
In the Matter of PORTLAND GENERAL ELECTRIC COMPANY Annual Adjustments to Schedule 125 (2007 RVM Filing) (UE 181),	)))))))))
In the Matter of PORTLAND GENERAL ELECTRIC COMPANY Request for a General Rate Revision relating to the Port Westward plant (UE 184).	))))))))))

OPENING BRIEF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

November 17, 2006

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I. INTRODUCTION

Portland General Electric Company ("PGE" or the "Company") has failed to meet its burden to demonstrate that its proposed rates and cost recovery mechanisms will result in just and reasonable rates for customers. The Industrial Customers of Northwest Utilities ("ICNU") urges the Public Utility Commission of Oregon ("OPUC" or the "Commission") to reject PGE's proposals regarding the remaining disputed issues in this case for the following reasons:

1. PGE's proposed "power cost framework" includes multiple, redundant power cost recovery mechanisms that would update baseline power costs on an annual basis and true-up forecast power cost to actuals within the year. These mechanisms are designed with one purpose in mind—shifting the risk and expense of power cost variation to customers.

2. PGE's net variable power cost ("NVPC") forecast overstates 2007 power costs. The Commission should adopt ICNU's adjustments to PGE's forecast to ensure that NVPC reflect the extrinsic value of PGE's thermal generating facilities, to remove the cost of capacity tolling agreements that are not dispatched in the rate year, and to better reflect the value of Port Westward.

3. PGE's excessive forced outage rates for its thermal generating facilities reflect the higher actual outage rates for certain Company facilities in the last four years, but there is no evidence that PGE prudently operated and maintained those plants. ICNU recommends using forced outage rates based on objective data from the National Electric Reliability Council.

4. PGE's equity-rich capital structure and inflated return on equity ("ROE") proposal is unnecessarily expensive and unjustified given the Company's overall risk, and PGE's high cost of debt reflects the lingering impact of Enron ownership. ICNU recommends adopting ICNU's proposed capital structure and ROE, along with Staff's adjustment to PGE's cost of debt.

PGE relies on rating agency reports regarding the Company's financial health and Oregon's regulatory climate to justify its requested rate increase and power cost framework, but the evidence demonstrates that at least one of those reports deserves no weight, because PGE significantly influenced the substance of the report prior to its release. As described below, PGE

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provided a September 25, 2006 Standard & Poor's ("S&P") report to demonstrate the ratings community's view of the Company and the Commission, and to justify PGE's proposals in this case. Late discovery in the case revealed, however, that PGE reviewed drafts of this report prior to release and edited it to address specific issues in this case. See ICNU/412.[1/] PGE's witnesses then cited statements that the Company added as an independent assessment of the Company's risk. Id. at 17; PGE/2400, Lesh/16. Given that PGE and other northwest investor-owned utilities portray such reports as objective, independent views of a utility's financial status and circumstances, the fact that PGE drafted certain passages of such a report is extremely troubling.

PGE has presented a number of allegedly "independent" research reports to justify its power cost framework and cost of capital proposals, and the revelation that the Company directly influences rating agency statements about the Company suggests that all such evidence should be ignored. ICNU requests that the Commission assign no weight to the S&P report and treat PGE's other purportedly independent research reports with skepticism.

II. BACKGROUND

On March 15, 2006, PGE filed a general rate case requesting a revenue requirement increase of approximately $98 million, which would increase rates by an average of 8.9%. PGE also requested that the Commission approve: 1) an annual variance tariff, which is simply another name for a power cost adjustment mechanism ("PCA"); 2) an annual update tariff that replaces, but is similar to, the resource valuation mechanism ("RVM") that has been in place since 2001; and 3) a number of changes for direct access and partial requirements customers.

[1/] ICNU has notified PGE that ICNU disputes the Company's designation of the documents in Exhibit ICNU/412 as confidential, and the parties are discussing resolution of this issue. If PGE does not agree to remove the confidential designation from the documents in ICNU/412, ICNU intends to file a motion on November 20, 2006, requesting that Administrative Law Judge Hayes remove the confidential designation.

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The filing also proposed a restructured method for calculating the cost of service rate, and a new method for rate spread and rate design. PGE requested an authorized return on equity ("ROE") of 10.75%, based on a common equity ratio of 56% and an 8.97% cost of capital.

PGE subsequently filed two additional cases that were consolidated with this proceeding. Prehearing Conference Report (Apr. 5, 2006); Ruling (May 12, 2006). PGE filed its annual adjustment to the RVM for 2007 in UE 181. In addition, PGE filed a request in UE 184 to include the Port Westward plant in rates as of the facility's March 2007 projected in-service date. Including Port Westward increased PGE's requested revenue requirement to $143 million. The timing of these cases has created a confusing array of potential rate changes. Rates are expected to change on January 1, 2007, when the 2007 RVM is implemented. Rates will then change again when the general rate case rates take effect in mid-January. Rates will change yet again when Port Westward is put in rates in March 2007.

On August 9, 2006, Staff and intervenors filed response testimony. ICNU recommended rejecting PGE's proposed power cost framework, reducing the NVPC forecast, modifying the proposed rate spread, and rejecting certain changes to the direct access program and the partial requirements tariff. ICNU and the Citizens' Utility Board ("CUB") submitted joint testimony recommending an appropriate cost of capital for PGE.

The parties have resolved a number of issues in this proceeding by the following stipulations:

1. A stipulation resolving all direct access issues, which the Commission approved in Order No. 06-528 on September 14, 2006;

2. ICNU, CUB, Staff, and PGE settled issues related to the 2007 RVM update on August 24, 2006, reducing the 2007 NVPC forecast by $8.6 million. The Commission approved this stipulation in Order No. 06-575 on October 9, 2006;

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3. All revenue requirement issues, except cost of capital, NVPC, Port Westward, and advanced metering, were settled on August 24, 2006, reducing PGE's requested revenue requirement approximately $20 million;

4. A stipulation resolving rate spread and rate design, including disputed issues related to partial requirements service under Schedule 75, with the exception of Schedule 76R, was filed on October 4, 2006; and

5. A stipulation resolving issues related to economic replacement power under Schedule 76R was filed on November 9, 2006.

In light of these settlements and other compromises, the following issues remain to be resolved: PGE's proposed power cost framework, the amount of forecast NVPC, and the cost of capital. After making changes in surrebuttal testimony, ICNU currently proposes adjustments to reduce PGE's forecast NVPC by approximately $16.7 million. In addition, ICNU supports changes to PGE's proposed cost of capital that would reduce the requested revenue requirement by approximately $21.4 million.[2/] Finally, ICNU supports Staff's proposed cost of debt adjustment, which would reduce PGE's proposed revenue requirement by $5.3 million.

III. LEGAL STANDARD

PGE has the burden of proof to demonstrate that its proposed rates are just and reasonable. ORS § 757.210(1); Pacific Northwest Bell Tel. Co. v. Sabin, 21 Or. App. 200, 213-14 (1975). The Commission also has the independent responsibility to ensure that PGE's customers are charged just and reasonable rates. ORS § 756.040(1); Pacific Northwest Bell Tel. Co., 21 Or. App. at 213. The burden of proof is borne by the Company "throughout the proceeding and does not shift to any other party." Re PacifiCorp, OPUC Docket No. UE 116,

[2/] ICNU recalculated the value of its capital structure and return on equity adjustments based on modifications that PGE proposed in sur-surrebuttal testimony. See PGE/2700, Hager-Valach/5.

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Order No. 01-787 at 6 (Sept. 7, 2001). When other parties dispute the proposed rates, PGE retains the burden to show that all its suggested changes are just and reasonable. Id.

The Commission generally sets utility rates based on the cost of service. Id. at 5. Cost of service is "the utility's reasonable operating expenses to provide utility service[.]" Id. PGE must demonstrate that its costs are reasonable and prudent before the Commission will include them in rates. Re US West Communications, Inc., OPUC Docket Nos. UT 125 and UT 80, Order No. 00-191 at 15 (Apr. 14, 2000). The Commission examines prudence based on existing circumstances and what the Company knew or should have known when it made its decision. Re Northwest Natural Gas Co., OPUC Docket No. UG 132, Order No. 99-697 at 52 (Nov. 12, 1999). The Commission reviews the prudence of the utility's decision making and the amount of money expended. Id. In addition to removing imprudent costs, the Commission makes adjustments to the test period for events that are not expected to reoccur and for known future changes. Re PGE, OPUC Docket No. UF 3518, Order No. 80-021 at 24 (Jan. 14, 1980).

IV. CONTESTED ISSUES

A. Power Cost Framework

PGE has made at least seven filings since the Company's last general rate case ended in August 2001, requesting a PCA or power cost-related deferred account to address power costs incurred between rate cases. In support of its current PCA proposal, PGE relies heavily on the financial community's view that the Company needs a "sufficiently supportive" PCA. As described below, however, PGE's claims are based, in part, on a S&P research report that PGE reviewed prior to release and edited to specifically address the Company's proposed power cost framework. The Commission should assign no weight to the evidence that PGE has

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provided regarding the rating agencies' recent views and open an investigation of the extent and nature of communications between the utilities and "independent" research agencies.

The Commission has provided substantial guidance regarding its power cost recovery policies in resolving the numerous power cost filings that PGE has made since UE 115, yet the parties are back at square one in this case, arguing the same issues in response to inadequate and unjustified proposed power cost recovery mechanisms. PGE has packaged its power cost recovery proposals as a "power cost framework," but this "framework" is merely a series of duplicative and unnecessary mechanisms that shift the risk of power cost variation from PGE to customers. The Company requests that the Commission approve: 1) the annual variance tariff, which essentially is a PCA that tracks the difference between forecasted NVPC and actual NVPC each year; and 2) the annual update tariff, which replaces the resource valuation mechanism ("RVM") and would allow PGE to update baseline NVPC on an annual basis.

The Commission should reject PGE's proposed power cost framework. PGE's proposed annual variance tariff fails to comply with the Commission's policy objectives for PCAs. Furthermore, although Staff and CUB have proposed alternative PCAs, the Commission should not impose on PGE and customers a long-term PCA mechanism that the Company opposes. PGE has the burden to demonstrate that its rate proposals are just and reasonable, and the Company has not met that burden with respect to its proposed PCA. The Commission should not rehabilitate PGE's flawed proposal by substituting an alternative mechanism. If the Commission does decide that a PCA is justified, however, ICNU recommends adopting the CUB proposal.

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The Commission should reject PGE's proposed annual update tariff, especially if the Commission authorizes a PCA. The annual update merely extends the annual update under the RVM, and PGE has demonstrated no need for multiple power cost recovery mechanisms. Approving both mechanisms would largely insulate the Company from power cost variation and represent a dramatic shift in the basis upon which the Commission has set rates in the past.

1. PGE Drafted Portions of a S&P Research Report Addressing the Company's Proposed Power Cost Framework and Oregon's Regulatory Climate

PGE's sur-surrebuttal testimony includes the following statement from a S&P report attempting to justify the Company's proposed cost framework:

> Recently, S&P changed its outlook on PGE to 'negative' and cited 'an uncertain regulatory environment,' and 'power cost variations that cannot currently be passed through to customers' as concerns. S&P also stated that it could restore PGE's outlook to stable if, among other items, 'a sufficiently supportive PCA mechanism is adopted in addition to extension of the RVM.' Whether S&P believes that a deadband results in a 'sufficiently supportive PCA' has yet to be seen. Because most comparable utilities to PGE pass their actual costs of power and fuel (higher or lower) to customers without a deadband, however, it is difficult to see how the rating agencies would consider such a construct 'supportive'.

PGE/2400, Lesh/16. Although PGE correctly claims that the S&P report includes the quoted statements, it was PGE that drafted certain of those statements, not S&P. The revelation that PGE edited a report from a purportedly independent rating agency prior to its release is extremely disturbing and casts doubt on all rating agency reports in the record. The Commission

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should not assume that any of the rating agencies' statements were formed without PGE's influence. The extent of PGE's influence on the rating agencies is unknown.[3/]

Exhibits ICNU/412-414 are copies of PGE's response to ICNU data requests seeking communications and other information exchanged between PGE and S&P between January 1, 2005, and September 25, 2006. ICNU/412-414. PGE responded by providing three email messages sent from Kristin Stathis, PGE's Assistant Treasurer, Corporate Finance, to Leo Carillo, a S&P Primary Credit Analyst, on September 22 and 25, 2006.[4/] ICNU/412 at 3, 8, and 13. Attached to each email was a draft of S&P's report with PGE's proposed changes in redline form. The S&P report was published on September 25, 2006, and Mr. Carillo is listed as the author. PGE/2705, Hager-Valach/7.

Ms. Stathis' first email states: "Leo, attached are our redlines to your draft report. Could you please let me know when you intend to issue this? Thanks again for the chance to review." ICNU/412 at 3. The second email states "[a]ttached is a redline per our conversation," and the attached redline includes, among other changes, an entire new paragraph that did not appear in the first redline. Id. at 8, 9. The third email states that "we have one more word to change that we feel is importants [sic]," and PGE suggests changing S&P's description of the City of Portland's investigations. Id. at 13. The final report includes most of PGE's edits in one form or another. See PGE/2705, Hager-Valach/7-9.

[3/] ICNU urges the Commission to investigate the extent and nature of communications between Oregon utilities and both the ratings agencies and other "independent" research agencies. PGE's response plainly does not include all information and communications between PGE and S&P that ICNU requested. See ICNU/413 at 1. For example, PGE did not provide the communication in which S&P first sent the draft S&P report. ICNU/412 at 8. S&P describes itself as "the world's foremost provider of *independent* credit ratings, indices, risk evaluation, investment research and data," but the Commission should give little weight to the views of entities that are not truly independent. S&P Press Release, "Standard & Poor's Releases Updated Code of Conduct," Oct. 11, 2005 (emphasis added).

[4/] The email headings on the top of pages 3, 8, and 13 of ICNU/412 reflect Ms. Stathis forwarding her correspondence with S&P to Patrick Hager, PGE's Manager of Regulatory of Affairs, on October 31, 2006.

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a. PGE Disagrees with the Commission's PCA Policies, Not S&P

The redline documents demonstrate that PGE made significant substantive changes to S&P's report regarding issues that the Commission is deciding in this case. PGE claims that S&P is concerned about Oregon's regulatory environment, but PGE pushed the issue on this topic more than S&P. The draft report provided in PGE's first email to S&P states:

> Supportive regulation by the [OPUC] has historically been a key to credit strength, although recent recommendations by the commission staff suggest that the regulatory environment has become much less favorable for the company.

ICNU/412 at 4. The unedited statement refers only to Commission Staff, but PGE suggested changing the statement to refer to the *Commission* as well:

> Supportive regulation by the [OPUC] has historically been a key to credit strength<u>, although recent recommendations by the *commission* [UE 165] and commission staff [GRC testimony] suggest that the regulatory environment has become much less favorable for the company.</u>

ICNU/412 at 9 (emphasis added). PGE's suggestion to refer to the Commission and its "recommendations" directly relate to issues in this case. In UE 165, the Commission recommended criteria to apply to a hydro-only PCA, and PGE has strongly disagreed with Staff and intervenors about the applicability and meaning of these criteria in this proceeding. <u>Re PGE</u>, OPUC Docket Nos. UE 165 and UM 1187, Order No. 05-1261 at 8-11 (Dec. 21, 2005). PGE complains at length about the Commission's "dual deadband" from UE 165, and the Company did not even attempt to address the "revenue neutrality" criterion, claiming that doing so was impossible. PGE/2400, Lesh/9-21; PGE/400, Lesh-Niman/45. In other words, instead of proposing a PCA that complies with the OPUC's criteria, PGE attempted to create evidence to

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demonstrate that the rating agencies view Oregon's regulatory environment as becoming less favorable.

S&P took a more reasonable approach than PGE suggested, and the final report refers to only Staff's recommendations. PGE/2705, Hager-Valach/7. Nevertheless, PGE urging a rating agency to describe an unfavorable Oregon regulatory environment is inappropriate.

b. PGE Drafted the Statements Calling for a Sufficiently Supportive PCA in Addition to an RVM Update

The final S&P report includes statements that PGE drafted regarding the alleged need for PGE's proposed power cost framework. PGE added the statement that Ms. Lesh quotes in the passage cited above, stating that S&P could return PGE's outlook to stable if "a sufficiently supportive PCA mechanism is adopted in addition to extension of the RVM."

S&P's unedited statement apparently read:[5/]

> In contrast, the outlook could be restored to stable in the event of positive developments, such as a modification to the RVM that allows for a hydro tariff adjustment and successful resolution of other medium term risks, such as the Trojan litigation and the Portland city investigation.

ICNU/412 at 7. In PGE's first redline, the Company proposed modifying this statement to read:

> In contrast, the outlook could be restored to stable in the event of positive developments, such as ~~a modification to~~ the adoption of a PCA in addition to the extension of the RVM that allows for improved power cost recovery~~a hydro tariff adjustment~~ and successful resolution of other medium term risks, such as the Trojan litigation and the Portland city investigation.

Id. PGE apparently was dissatisfied with this language, however, because the Company subsequently added language to qualify that only a "sufficiently supportive" PCA was sufficient:

5/ ICNU has attempted to recreate the unedited statement from the redline document that was provided.

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> In contrast, the outlook could be restored to stable in the event of positive developments, such as the adoption of a [sufficiently supportive] PCA in addition to the extension of the RVM that allows for improved power cost recovery and successful resolution of other medium term risks, such as the Trojan litigation and the Portland city investigation.

Id. at 12. Consistent with PGE's edits, the published report states that "the outlook could eventually be restored to stable if . . . a sufficiently supportive PCA mechanism is adopted in addition to the extension of the RVM . . . ." PGE/2705, Hager-Valach/9.

PGE disingenuously quotes this statement in its testimony to attempt to demonstrate that: 1) the Commission must adopt *both* a PCA and an annual update if PGE is to return to a stable outlook; and 2) only a PCA *without* a deadband, such as PGE's annual variance tariff, would be "sufficiently supportive." PGE/2400, Lesh/16.

c. S&P Focused on the Impact of Hydro Variability Rather Than All Power Cost Variations

PGE fundamentally altered S&P's report by broadening statements about hydro variation into concerns about power cost variation in general. Prior to incorporating PGE's edits, the draft report stated that PGE's RVM sufficiently addressed most power cost variation, but the Company lacked a mechanism to address hydro variation:

> Although the company's RVM mechanism allows PGE to pass most power cost variability through to retail customers, there is no mechanism to share the risks and rewards of hydro variability.

ICNU/412 at 4. PGE edited this sentence to imply that a comprehensive PCA was needed in addition to the RVM rather than just a mechanism to address hydro variation:

> Although the company's RVM mechanism allows PGE to pass most power cost forecast changes based on normal conditions~~variability~~ through to retail customers, there is no mechanism to share the risks and rewards of hydro variability or

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> other factors which could cause actual power costs to deviate from forecast power costs.

Id. The statement reads as follows in the published report:

> Although the company's RVM mechanism allows PGE to pass through to retail customers most of the company's projected power cost variation in November of each year, there is currently no mechanism to share the risks and rewards of hydro variability or other costs that could cause actual power costs to deviate from forecasted levels during the subsequent months.

PGE/2705, Hager-Valach/7. As a result of PGE's edits, this sentence no longer addresses the fact that the RVM does not update hydro generation. It now addresses PGE's proposals in this case: a November update of forecast power costs each year, along with a true-up of forecast power costs to actuals within the year. PGE's manipulation of evidence to justify the Company's power cost framework is inexcusable and provides no basis to adopt PGE's proposals.

2. Annual Variance Tariff

a. PGE's Annual Variance Tariff Fails to Comply with the Commission's Guidance Regarding PCAs

PGE proposes the annual variance tariff to track the difference between forecasted NVPC and actual NVPC. The parties have discussed PCAs and other power cost recovery issues at length in recent years, and the testimony reflects the frustration with PGE's never-ending requests for mechanisms that are either inadequate or that the Company withdraws prior to a Commission decision. See CUB/200, Jenks-Brown/19. PGE's proposal in this case is no more consistent with Commission policy than past proposals.

PGE agrees with Staff that one objective of a power cost framework is to "achieve a permanent and fair allocation of power cost risk between shareholders and customers." PGE/2400, Lesh/9. The Company's view of fair risk allocation, however, is a PCA that forces

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customers to bear 90% of <u>all</u> power cost increases. Indeed, PGE's proposed PCA includes no deadband, one sharing band with 90/10 sharing of all power cost variances, and an earnings test that is unlikely to ever apply. PGE/400, Lesh-Niman/33. PGE's mechanism is unfair, unlike any PCA that the Commission approved for PGE in the past, and ignores both recent and past OPUC policies governing PCAs.

i. PGE's Previous PCAs Were Limited Mechanisms Approved for Specific Reasons

Oregon utilities traditionally have <u>not</u> had long-term, comprehensive PCAs, and adopting one in this case would substantially change OPUC policy. Reviewing PGE's PCAs from the past helps to demonstrate why PGE's current proposal is so inadequate.

Docket No. UF 3091. The Commission first authorized a PCA for PGE in a 1974 general rate case in which the Company requested approval of an automatic adjustment to billings in the event that average power costs exceeded 5 mills/kWh. <u>Re PGE</u>, OPUC Docket No. UF 3091, Order No. 74-657 at 1 (Sept. 3, 1974). The Commission granted PGE's request, citing staggering inflation, PGE's financial state, and the probability that power costs would increase through the winter. <u>Id.</u> at 2-3. The Commission found that "PGE is not now in a position to absorb these increased costs without jeopardizing its financial position[.]" <u>Id.</u> at 4. PGE was authorized to implement a 2 mills/kWh flat charge on power costs in excess of 4.8 mills/kWh for six months, but the Commission terminated the surcharge early because the extraordinary circumstances dissipated. <u>Id.</u> at 6; <u>Re PGE</u>, OPUC Docket No. UF 3091, Order No. 75-089 (Dec. 31, 1974).

Docket No. UF 3339. In 1977, the Commission authorized a billing surcharge for a nine-month period due to extreme drought conditions. <u>Re PGE</u>, OPUC Docket No. UF 3339,

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Order No. 77-456 at 8 (July 7, 1977). As in Docket No. UF 3091, the Commission ultimately terminated the surcharge early, finding that it resulted in revenues above PGE's excess costs and that hydro conditions had improved. Re PGE, OPUC Docket No. UF 3339, Order No 77-813 (Nov. 30, 1977).

Docket No. UF 3518. PGE's next request for a PCA was based on variations in "hydro availability, fuel costs, thermal plant efficiency, and cost of purchased power." Re PGE, OPUC Docket No. UF 3518, Order No. 79-830 at 1 (Nov. 15, 1979). PGE's proposal subjected power cost variations to 80/20 sharing with a cap on rate increases of 0.4 cents per kWh for any three-month period. Id.

The Commission approved PGE's request, finding that the PCA was necessary due to "increased costs of oil and natural gas . . . and of purchased power which are not reflected in existing rates." Id. at 3. In January 1980, the Commission noted that unless oil and natural gas prices increased dramatically, PGE should fully recover the unanticipated power costs within six months and the PCA surcharge should be reduced to zero. OPUC Docket No. UF 3518, Order No. 80-021 at 5.

Despite the Commission's expectation that the PCA charge would be short-term, the mechanism remained in effect until 1987. ICNU has found no clear record why this occurred. In addition, PGE claims that it added other expenses to the PCA balance while the mechanism was in effect, despite the fact that the original mechanism was limited in scope. PGE/2600, Tinker-Schue-Drennan/29. In other words, it appears that the operation of the mechanism ultimately departed from expectations.

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The Commission criticized PCAs in general when it terminated this PCA in 1987:

> The Commission finds that the power-cost adjustment should be eliminated. The original need for the power-cost adjustment, volatility of power costs, no longer exists to the same degree as existed in 1979. PGE can absorb the anticipated increases in power costs. If it faces large unanticipated increases in costs or a reduction in sales for resale, it can request a rate increase. If PGE can lower its power costs or increase its sales for resale, it can keep the additional net income until the next rate adjustment.
>
> Furthermore, none of the other electric utilities regulated by the PUC have power-cost adjustment clauses. PGE's system characteristics are not so unique that a power-cost adjustment clause is necessary.
>
> Finally, elimination of the PCA will limit opportunities for abuse of the rate process. In Oregon, power cost adjustment changes have never been reviewed in public hearings. PGE could manipulate its earnings by failing to recognize its sales for resale in a particular PCA revision. The lack of public review creates an opportunity for mischief which cannot be tolerated.

Re PGE, OPUC Docket Nos. UE 47 and UE 48, Order No. 87-1017 at 33 (Sept. 30, 1987).

Docket No. UE 115. The OPUC last approved a PCA for PGE in UE 115. The UE 115 PCA tracked variations between forecast and actual power costs and energy revenues, had a $28 million deadband, sharing bands from 50% to 95%, and was in effect for fifteen months. Re PGE, OPUC Docket No. UE 115, Order No. 01-777 at 19-20 (Aug. 31, 2001).

Although the OPUC and parties expected the UE 115 PCA to result in a rate credit due to declining power costs, the PCA was a disaster for customers because energy revenues declined once PGE's high rates took effect. Customers reduced usage after the unprecedented rate increase, and the resulting energy revenue decline lead to a substantial PCA balance. Re PGE, OPUC Docket No. UM 1039, PGE/200, Niman-Hager-Tooman/2, 6 (Jan. 30,

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2004). In the end, customers paid PGE approximately $37 million. Re PGE, OPUC Docket No. UM 1039, Order No. 04-293 at 3 (May 24, 2004).

ii. The Commission's Decisions Regarding PGE's Previous PCAs Provide Guidance in this Docket

The Commission's reasons for terminating the 1979-1987 PCA and the lessons learned from the UE 115 PCA provide guidance regarding PGE's request in this Docket. The Commission has not traditionally approved long-term, comprehensive PCAs, and the basis for eliminating the 1979-1987 PCA still applies. No other Oregon electric utility has a PCA, and PGE's system is not unique. Furthermore, both PGE and PacifiCorp have annual update mechanisms that allow passing "through to retail customers most of the company's projected power cost variation . . . ." PGE/2705, Hager-Valach/7. This makes a PCA unnecessary.

Utilities also retain the option to request rate relief if unanticipated circumstances occur. In fact, the Commission has been willing to authorize rate relief when unanticipated circumstances arise in multiple cases since 1987. See Re PacifiCorp, OPUC Docket Nos. UM 995 et al., Order No. 02-469 (July 18, 2002); Re PGE, OPUC Docket Nos. UE 81 et al., Order No. 91-1781 (Dec. 20, 1991).

The UE 115 PCA demonstrates that uncertainty in implementing a PCA can have a substantial and unintended detrimental impact on customers. PGE's power cost framework proposal is unprecedented in that the Company seeks simultaneously operating power cost recovery mechanisms. Furthermore, in sur-surrebuttal testimony, PGE put forth alternative proposals to calculate the appropriate deadband, but these proposals are untested and have not been previously discussed. PGE/2400, Lesh/21. The Commission should not approve these novel ideas without thoroughly analyzing the potential results.

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Finally, the Commission noted when it eliminated the 1979-1987 PCA that PGE would keep additional net income if power costs decreased. That is exactly what happened in the 1990s, which PGE describes as having "a nascent wholesale market awash in surplus power and abundant natural gas at record low prices[.]" PGE/2400, Lesh/3. PGE had no PCA during this period and benefited substantially. The notion in the Company's testimony that implementing a PCA at this time will somehow result in balance between customers and company is a fallacy. PGE only seeks a PCA when it benefits the Company.

b. PGE's Proposed PCA Is Inconsistent with the UE 165 Criteria

In Order No. 05-1261, the Commission stated that a hydro-related PCA should: 1) be limited to unusual events; 2) result in no recovery if overall earnings are reasonable; 3) be revenue neutral over time; 4) operate over the long term; and 5) apply to only those customers that were taking the cost-of-service option while the PCA was in effect. Order No. 05-1261 at 8-10, 13. Although the UE 165 order discusses these criteria in terms of a hydro-only mechanism, most are equally applicable to the comprehensive PCA that PGE proposes. PGE's proposed PCA fails to comply with these standards.

i. PGE's Proposal Is Not Limited to Unusual Events

The basis for the Commission's decision in UE 165 that a hydro-only PCA should provide recovery in response to unusual events is the determination that the utility is required to bear a certain amount of power cost variation between rate cases. Id. at 9; Re PGE, OPUC Docket No. UM 1071, Order No. 04-108 at 9 (Mar. 2, 2004). Although the Commission applied the unusual event standard to a hydro-only PCA, the reasons for that standard apply to PCAs in general. ICNU has assumed that the unusual event standard applies for purposes of analyzing

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the annual variance tariff, and PGE's proposal plainly does not meet that standard. Nevertheless, a more rigorous standard should apply to evaluating a more comprehensive PCA, because there is a broader range of potential cost variations at issue. The Commission has recognized that a deadband is the most effective method to limit recovery to unusual events. Id.

PGE's annual variance tariff completely ignores the reason for limiting recovery to unusual power cost variations. PGE's proposal includes no deadband and lacks any other means to exclude normal power cost variation. Under PGE's proposal, the Company would recover for *any* deviation from forecast power costs. This is inconsistent with all of PGE's previous PCA mechanisms, as well as the Commission's recent decisions. Furthermore, this is a significant step backward from previous PGE proposals. Re PGE, OPUC Docket No. UE 137, PGE/100, Dahlgren/1-2 (May 8, 2002) (proposing PCA with $22.4 million deadband).

PGE half-heartedly recognizes the inequity of proposing to shift 100% of all power cost variability within the year to customers who currently do not bear that risk. The Company includes a 90/10 sharing band in the annual variance tariff, but this falls well short of the "fairness" criteria that PGE cited in testimony. Moreover, it ignores that the Company must absorb some threshold amount of costs before customers will share the burden. Under PGE's proposed sharing band, customers would bear 90% of the very first dollar of excess power costs.

PGE attempts to justify its proposed sharing band by referencing the practice of other state commissions. PGE/400, Lesh-Niman/37-40. It is impossible to make such a comparison, however, because all utilities have different circumstances justifying their need for a specifically designed PCA. ICNU/103, Falkenberg/39. PGE has simply not demonstrated that it

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is any less able to bear certain power cost risk without jeopardizing its financial integrity. Without such evidence, the Company has not justified a PCA based on the result in other states.

ii. PGE's Earnings Test Does Not Comply with Order No. 05-1261 and Likely Will Have No Effect

PGE proposes a complicated earnings test that does not resemble the earnings test discussed in Order No. 05-1261 and likely would never apply. PGE/400, Lesh-Niman/48-49. Under PGE's earnings test, customers and the Company would share 50/50 the amounts by which PGE's "normalized actual ROE" exceeds by 100 basis points a "baseline ROE" that the Company would update annually. Id.

In Order No. 05-1261, the Commission described an earnings test with a deadband that would result in recovery of PCA balances up to the bottom of a reasonable range around the Company's authorized ROE. Order No. 05-1261 at 9-10. The Commission suggested that an earnings test deadband of 100 basis points would be reasonable for a hydro-only PCA. Id. PGE disagrees with the Commission's proposed earnings test structure and admits that it has not attempted to create an earnings test that complies with the Commission's suggested design. PGE/400, Lesh-Niman/49-50. Although the annual variance tariff fails on this basis alone, PGE's proposed earnings test is flawed in other ways as well.

PGE's proposed earnings test is merely "window dressing;" it likely would have no real effect. PGE explains that "the annual update to ROE will ensure that if interest rates change (up or down), the baseline ROE (and hence, threshold ROE) will move accordingly." Id. at Lesh-Niman/49. Under these circumstances, to the extent that PGE's actual earnings move at all in tandem with interest rates and the overall economy, the Company's normalized ROE will increase as the baseline ROE increases. The 100 basis point cushion that PGE has built in above

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the baseline ROE assures that PGE's earnings growth would have to substantially exceed the growth of the overall economy for this earnings test to actually apply. Indeed, the evidence demonstrates that PGE would have collected $137 million under its proposed PCA from 2002-2005, and the earnings test would not have mitigated the collection of those amounts in any of those years. PGE/1902, Tinker-Schue-Drennan/1.

iii. PGE Did Not Address the Revenue Neutrality Criteria

The Commission has stated that a reasonable PCA should be revenue neutral over time and has acknowledged CUB's claims that doing so may require asymmetric deadbands. Order No. 05-1261 at 10. The Commission rejected the mechanism at issue in UE 165, in part, because of a lack of evidence showing that it would be revenue neutral. Id. at 12. PGE once again fails to present any evidence in this docket showing that its proposed PCA will be revenue neutral. PGE claims that ensuring revenue neutrality is difficult or impossible, and the Company states that it will not attempt to do so without additional information. PGE/400, Lesh-Niman/45.

iv. PGE Provides No Assurance That the PCA Will Operate for the Long Term

The Commission concluded that a revenue-neutral PCA must operate for an extended length of time to allow power cost variations to balance out. Order No. 05-1261 at 10. PGE does not address the length of time that the Company's proposed PCA is expected to operate. PGE also does not address whether the Company can request to eliminate or modify the PCA in the future. Similarly, PGE does not propose any procedure for future review of the annual variance tariff. If the Commission adopts a PCA mechanism, it should include a provision requiring review of the mechanism within the first five years of operation to determine if modifications are necessary.

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v. PGE Disagrees with the Commission About Applying a PCA to Direct Access Customers

The Commission unequivocally stated in UE 165 that it expected "any future PCA filing" to incorporate a provision establishing that a PCA rate adjustment for a particular time period would apply to only those customers on the cost-of-service rate during that time period. Order No. 05-1261 at 13. Despite the Commission's statement, PGE disagrees with Staff's proposal to exclude all direct access customers from a PCA. PGE/1800, Lesh/61. PGE proposes to exclude only those customers who have waived their right to a cost-of-service rate or who are purchasing economic replacement power to displace on-site generation. See PGE/1302, Kuns-Cody/93.

PGE states that applying a PCA to direct access customers is "a matter of judgment." PGE/1800, Lesh/61. ICNU disagrees. The Commission has established standards and PGE should comply with them. PGE argues that excluding direct access customers from a PCA would be poor judgment because customers that choose "temporary direct access options" have only "partly disconnected themselves from cost-of-service ratemaking[.]" Id. According to PGE, each customer is subject to a transition credit that is intended to represent the customer's share of PGE's resources. Id. PGE explains that because those transition credits are established using the assumptions used to forecast NVPC, excluding "temporary" direct access customers from a PCA will allow those customers to shift their risk of power cost variation to cost-of-service customers.

Subjecting direct access customers that have not chosen long-term options to a PCA will effectively charge those customers twice for power cost variability. For example, a customer choosing an energy option based on the Mid-Columbia Daily Firm Price index would

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be subject to the power cost variability that is accounted for in PGE's NVPC on a daily basis through the Mid-C prices. Assessing that customer an additional PCA charge at the end of the year would result in the customer paying for power cost variations both in real time and after-the-fact.

Imposing PCA charges on direct access customers also is inconsistent with the Commission's mandate to eliminate barriers to the development of a competitive retail energy market. ORS § 757.646. One of the purposes of pre-determining the transition charges for direct access customers is to provide those customers with some certainty in deciding between energy options for the future. Subjecting those customers to an unspecified PCA charge eliminates certainty about energy future charges, which will deter direct access-eligible customers from choosing options other than cost-of-service.

PGE also argues that switching between direct access and cost-of-service options will create billing difficulties and administrative problems. PGE/1800, Lesh/62. The legislatively expressed interest in developing a competitive retail electricity market far outweighs concerns about administrative difficulties. In the end, PGE's proposed PCA fails to comply with at least four of the five criteria from UE 165, and the Commission should reject PGE's proposal.

3. Annual Update Tariff

PGE's proposed annual update tariff is unnecessary, particularly if the Commission adopts a PCA. The annual update essentially is an extension of the current annual update under the RVM, but PGE proposes updating a more limited subset of inputs to forecast NVPC. PGE/400, Lesh-Niman/25. Even with this narrowed scope, the annual update is unjustified and unnecessary.

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a. The Dramatic Decrease in NVPC After UE 115 Provides No Basis to Conclude That Customers Will Benefit from Future Annual Updates

PGE attempts to justify the annual update on the basis that both customers and the Company are at risk if changes in forecast NVPC are not included in rates in a timely manner. Id. at Lesh-Niman/26. PGE states that the 2003 RVM passed through to customers a 49% decrease in the cost of the company's power contracts, and that this pass through would not have occurred in a timely manner without the annual update. Id. at Lesh-Niman/25. PGE's forecast power costs in UE 115 were over $800 million, and the substantial decrease that occurred in the 2003 RVM reflected the significant reduction following the western power crisis. PGE/1800, Lesh/34. The Commission and the parties in UE 115 expected this result. Such a substantial decrease does not justify approving the annual update tariff in this case, because there is no similar expectation of a substantial power cost decrease.

b. The NERA Economic Consulting Report Does Not Demonstrate That Most Utilities Have a Similar Power Cost Framework

PGE also claims that a survey that it commissioned NERA Economic Consulting to conduct regarding PCAs across the country demonstrates that most electric utilities have a power cost framework similar to PGE's proposal. PGE/2400, Lesh/2; PGE/400, Lesh-Niman/12. Contrary to PGE's claims, the NERA report does not demonstrate that most vertically integrated electric utilities have a power cost framework consisting of mechanisms that update power costs both on an annual forecasted basis as well as a true up within the year. The report focuses on PCAs only and does not appear to even address an annual update mechanism such as PGE's proposal. See PGE/401, Lesh-Niman/6 ("This report is a survey of Power Cost Adjustment (PCA) mechanisms across the United States . . . ."). As such, the NERA report provides no basis

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to conclude that PGE's proposed dual mechanisms are anything more than redundant and unnecessary.

PGE specifically cited Avista Corporation and Puget Sound Energy ("PSE") as examples of utilities with PCAs. Neither of these utilities has an annual update mechanism. PacifiCorp has an annual update mechanism but no PCA in Oregon, and the Company has neither mechanism in Washington. All that the NERA report and PGE's other claims demonstrate is that some utilities have a PCA and others do not. PGE has provided no evidence to demonstrate uniform coverage of comprehensive PCAs for U.S. electric utilities or that there are *any* utilities with both a PCA and an annual update.

B. Net Variable Power Cost Forecast

1. The Commission Should Adopt ICNU's Proposed Adjustments to Reduce PGE's NVPC Forecast by $16.7 Million

PGE's initial filing requested approximately $847.3 million in total NVPC. ICNU's power cost witness Randy Falkenberg demonstrated that PGE's 2007 NVPC forecast was significantly overstated due to inappropriate and unrealistic assumptions in the Company's Monet production cost model. Mr. Falkenberg proposed the following adjustments to PGE's NVPC: 1) account for the extrinsic value of PGE's thermal generating facilities; 2) remove the cost of PGE's "cold snap" contract; 3) remove the cost of PGE's "super peak" contract, unless the Commission accepts extrinsic value analysis for ratemaking purposes; 4) more appropriately account for the Port Westward dispatch benefit; and 5) incorporate forced outage rates based on National Electric Reliability Council ("NERC") data. Adopting these adjustments reduces PGE's proposed NVPC forecast by approximately $16.7 million.

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a. PGE's Monet Model Fails to Account for Extrinsic Value

PGE uses its Monet production cost model to forecast NVPC for the rate year. Monet is premised on the notion that resources are "economically dispatched" according to a combination of future price predictions. PGE/400, Lesh-Niman/14. According to PGE, this means that lowest cost resources should be used to serve customers first, moving up the price curve as those resources are dispatched. Id.

PGE has used Monet to update NVPC each year since 2002, but, as the parties have discussed in previous proceedings, one of the model's major shortcomings is its use of a fixed, single value for fuel inputs that fails to recognize that prices vary throughout the year. ICNU/103, Falkenberg/4. As a result, PGE may be able to economically run certain thermal resources more than assumed in the NVPC forecast under certain market conditions, and the Company derives a benefit under these circumstances based on the margin between the cost of gas to run the resource and the cost that Monet assumed for equivalent power purchases. Monet fails to recognize this "extrinsic value" or "optionality" associated with the operational flexibility of PGE's resources, because the model relies on a deterministic point price input that does not account for price fluctuations. Staff/200, Wordley/9.

Stochastic modeling would account for the fact that gas and power prices will vary from the point forecast in PGE's NVPC estimate and would recognize the extrinsic value of PGE's generating facilities in two ways: 1) accounting for the value of unused generation from gas-fired power plants when less expensive than the market price of power; and 2) valuing the off-loading of gas-fired power plants when market prices prove less costly. ICNU/103, Falkenberg/6. The problem, however, is that PGE currently does not have stochastic modeling

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capabilities. In the absence of PGE using such modeling, Mr. Falkenberg proposed an adjustment to account for extrinsic value based on using historical spreads and calculating the probability of cost-savings from each particular gas-fired resource. Id. at 7-8. Mr. Falkenberg's extrinsic value adjustment lowers PGE's NVPC by $5.9 million.

i. The PA Report Is Unreliable

PGE suggests that stochastic power cost modeling would increase the NVPC forecast, relying on a PA Consulting Group report that the Company commissioned. PGE/1800, Lesh/17-18; PGE/1900, Tinker-Schue-Drennan/15. According to PGE, the PA Report demonstrates that extrinsic value is just one of many factors that causes power cost variations and that Monet understates NVPC by approximately $10 million when all the relevant factors are considered. PGE/1800, Lesh/18.

PGE's reliance on the PA Report's results is misplaced. Both PGE and PA Consulting admit that the report is inadequate for ratemaking purposes. PGE/1900, Tinker-Schue-Drennan/15; ICNU/110, Falkenberg/1; ICNU/111, Falkenberg/1. Moreover, the PA Report results vary so significantly from the Monet results that the PA Report's value has to be seriously questioned. ICNU/108, Falkenberg/4-5.

ii. PGE's Claims That Its Historic Forecast NVPC Have Not Exceeded Historic Actual NVPC Are Meaningless

PGE also argues that, if Monet overstated NVPC because it failed to consider extrinsic value, then actual NVPC should have exceeded forecast NVPC in previous years. PGE/1900, Tinker-Schue-Drennan/16. As Mr. Falkenberg explained, PGE's actual NVPC are due to factors other than failing to consider extrinsic value. PGE uses actual NVPC for 2002-2005 to attempt to demonstrate that the failure to account for extrinsic value in those years did

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not result in forecast NVPC exceeding actual NVPC, but the Company fails to account for the extended Boardman outage and below-normal hydro generation during this period, both of which increased actual NVPC. ICNU/108, Falkenberg/10.

In addition, ICNU's proposed $5.9 million extrinsic value adjustment is negligible (less than 1%) compared to the approximately $780 million in NVPC that PGE requests in this proceeding. Even if the Commission had adopted ICNU's extrinsic value adjustment in recent years, it hardly would have been enough to consistently ensure that forecast NVPC exceeded actual NVPC. Id. at 9-10.

iii. PGE's Hypothetical Examples Are Unpersuasive

PGE offers a hypothetical example to attempt to show that an extrinsic value adjustment is unnecessary, but Mr. Falkenberg demonstrated that the Company's example is based on unrealistic assumptions about electric and gas prices during a regional cold spell. PGE/1900, Tinker-Schue-Drennan/25-26; ICNU/108, Falkenberg/14. PGE assumes that national natural gas prices are substantially impacted by regional weather events in the Pacific Northwest. PGE's is incorrect. Events that occur on a larger scale determine natural gas prices. A Pacific Northwest cold spell will have little to no impact on the natural gas prices in the national market. ICNU/108, Falkenberg/14.

Second, PGE erroneously assumes that natural gas prices and the market heat rate increase simultaneously. As explained above, however, natural gas prices are determined on a larger scale, while market heat rates are determined by the supply and demand of power in the local markets. ICNU/118 illustrates this point, as it shows that gas prices and heat rates do not

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increase at the same times, and that sometimes the two even move in opposite directions. Id. Thus, the correlation that PGE claims between gas prices and heat rates is baseless.

b. The Commission Should Remove the Costs of PGE's Capacity Tolling Contracts

PGE has included in NVPC the cost of certain capacity tolling agreements that the Company claims provide the opportunity to obtain additional energy at below-market costs when market prices are high. ICNU/103, Falkenberg/17-18. PGE's Monet model, however, indicates that these contracts will not be dispatched in 2007, and the model did not dispatch these contracts in the past years that the Company included them in rates. Id. The Commission's policy in previous cases has been that "[o]nly expenditures necessary for furnishing utility service should be reflected in rates," and PGE has failed to demonstrate that contracts that are not expected to provide energy during the rate year are "necessary." Re US West Communications, Inc., OPUC Docket No. UT 125, Order No. 97-171 at 74 (May 19, 1997) (citing OPUC Docket No. UT 43, Order No. 87-406 at 42; OPUC Docket No. UF 3218, Order No. 76-601 at 13). The Commission should: 1) disallow the cold snap contract ($1.8 million); and 2) remove the super peak contract ($1.4 million) unless the Commission accepts extrinsic value for ratemaking purposes.

i. The "Cold Snap" Contract Provides No Benefit to Customers and Is Unnecessary for Providing Utility Service

PGE included the cold snap contract in both 2005 and 2006 NVPC, but Monet has never dispatched the contract based on expected market conditions. ICNU/103, Falkenberg/18. Furthermore, the cold snap contract's spread is so large that the agreement reflects no extrinsic value as well. Id. PGE has not disputed this. The contract simply represents a "dead weight" cost that provides no benefit to customers, even under the extreme market conditions that PGE

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claims justify the expense. Id. at Falkenberg/19. Both ICNU and Staff opposed including the cold snap contract cost in previous RVM updates, but the parties resolved those proceedings through settlement, and the Commission has never resolved the issue. Id. at Falkenberg/19-20. Ratepayers should not bear the burden of contracts that provide no benefit.

PGE argues that the cold snap contract is necessary in winter when the Company's capacity needs increase by approximately 450 MW. PGE/1900, Tinker-Schue-Drennan/37. The evidence proves, however, that the contract is unnecessary even under extreme conditions. PGE experienced substantial outages at the Boardman plant last winter, reducing the Company's available resource capacity by approximately 380 MW. ICNU/108, Falkenberg/16. Neither the cold snap nor the super peak contract dispatched under these extreme conditions, because the large contract spreads prevented the agreements from being "in the money." Id.

ii. The Commission Should Disallow the "Super Peak" Contract Costs Unless It Accepts Extrinsic Value Analysis

Mr. Falkenberg recommended that the Commission disallow the cost of the super peak contract unless the Commission accepts extrinsic value analysis for ratemaking purposes and adopts an extrinsic value adjustment as described above. ICNU/103, Falkenberg/20.

Similar to the cold snap contract, Monet does not dispatch the super peak contract in 2007, and Mr. Falkenberg's extrinsic value analysis revealed that the contract has no extrinsic value. Id. at Falkenberg/18. Nevertheless, PGE performed its own extrinsic value analysis of the super peak contract as part of the 2003 request for proposals process, and PGE justified the contract on the basis that it had some extrinsic value. Id. at Falkenberg/18-19. Mr. Falkenberg essentially accepted PGE's claim about the super peak contract's extrinsic value (despite his conclusions to the contrary), urging the Commission to include the contract in NVPC if it accepts

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extrinsic value analysis for ratemaking purposes and adopts his extrinsic value adjustment. Id. at Falkenberg/20. If the Commission rejects extrinsic value analysis, however, it should disallow the contract, because PGE lacks any other basis to demonstrate that it is prudent or necessary.

PGE misleadingly testified in response to Mr. Falkenberg's adjustment that "ICNU selectively uses its own calculations" in recommending that the Commission disallow the contract unless it accepts PGE's extrinsic value analysis. PGE/1900, Tinker-Schue-Drennan/36. To the contrary, ICNU attempted to give PGE the benefit of the doubt regarding the Company's analysis despite the fact that Mr. Falkenberg failed to find any extrinsic value. The fact remains the disallowing the super peak contract would be appropriate in any event because the contract is not expected to be necessary to provide service during the rate year.

c. PGE Underestimated the Port Westward Dispatch Benefit

PGE has understated the value of annualizing the Port Westward dispatch benefits by approximately $2 million. ICNU/103, Falkenberg/21. PGE calculated its value for the dispatch benefit by multiplying the ratio of the ten-month benefit to the ten-month load by the load for all twelve months. Id. Contrary to PGE's assumptions, however, the dispatch benefit is not proportional to load. Id. at Falkenberg/22.

Mr. Falkenberg demonstrated that examining the Port Westward dispatch according to the unit's dispatch cost and PGE's forward curve assumptions is more realistic, because those factors determine how much the plant runs in Monet. Id. Considering the Port Westward dispatch according to these assumptions demonstrates that PGE understated the dispatch benefit by approximately $2.0 million. Id. at Falkenberg/3. This adjustment would not take effect until after March 1, when PGE proposes to include Port Westward in rates.

PGE and ICNU appear to agree that, if the Commission rejects the annual update and variance tariffs, PGE should perform a new Monet run to determine the Port Westward dispatch benefit for all twelve months of 2007. ICNU/108, Falkenberg/20; PGE/1900, Tinker-Schue-Drennan/51.

d. The Commission Should Adopt Forced Outage Rates Based on National Electric Reliability Council Data

PGE's use of a four-year rolling average of historical forced outages rates for its thermal generation to develop forced outage rate assumptions in this case overstates the Company's NVPC. ICNU/103, Falkenberg/11. In Monet, PGE implements its forced outage rate assumptions based on thermal deration factors that depict the amount of generation that is expected to be available from thermal generating units when unplanned outages are considered. Forced outage rates have a direct correlation to NVPC—the higher a unit's outage rate is, the higher PGE's power costs will be. Id. Using a four-year average has been the Commission's policy since the early 1980s, and the purpose of this method was to smooth out the effects of extreme events and depict future plant availability based on recent results. Outages at PGE's thermal generating facilities in recent years, however, have demonstrated that that the four-year rolling average methodology is not the best method for determining a normalized expectation of plant availability. Id. at Falkenberg/11-12; Staff/1500, Galbraith/19. In addition, use of the four-year rolling average may provide a disincentive for utilities such as PGE to improve plant reliability. ICNU/103, Falkenberg/13. As a result, ICNU recommends that the Commission adopt a forced outage rate methodology that instead relies on NERC data. Id. at Falkenberg/14.

The first problem with the four-year rolling average is that it can include unusual outages that are not reasonably expected to recur over a four-year period. Staff/100, Galbraith/6.

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This issue is demonstrated by the 70-day outage that PGE experienced at its Boardman plant from October 23 to December 31, 2005. The Company included this extreme event when it calculated the Boardman forced outage rates for this proceeding. ICNU/103, Falkenberg/11. This inclusion is improper because it unreasonably inflates the outage rate by including an abnormal event. Moreover, the Company has not demonstrated that it acted prudently with respect to the cause of the Boardman outage. Because of the extreme nature of the Boardman outage, it should not be used to normalize outage rates, especially absent a finding of prudence. Id. at Falkenberg/12.

A second problem with the four-year rolling average methodology is that it may provide a disincentive for utilities to maintain or improve plant reliability. Id. at Falkenberg/13. Every time a forced outage occurs, it is factored into the four-year rolling average, thus "rewarding" the utility with an increase in rates. Although the utility typically must bear the cost of replacement power, the four-year average will usually insulate the utility from most of the effects of the outage. Furthermore, in times of increasing power prices, utilities may be more than compensated for replacement power costs over the four years following the outage. Id.

To address these problems, Mr. Falkenberg recommends that the Commission use NERC average outage rates for plants that are comparable to PGE's plants. Mr. Falkenberg also recommends that the Commission use NERC statistics to implement stochastic modeling for PGE's plant outage rates. ICNU/103, Falkenberg/14; ICNU/106, Falkenberg/1. Mr. Falkenberg's proposed stochastic model uses the NERC Equivalent Availability Factor ("EAF") to create distribution margins for PGE's plants. ICNU/103, Falkenberg/14-15.

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By relying on industry-wide statistics, Mr. Falkenberg's approach provides an objective and verifiable means of estimating PGE's power costs without the need to examine the prudence and efficiency of PGE's resource management. This method also removes any disincentive for PGE to maintain power plants reliably, because it will allow the Company to reap the rewards of good performance while suffering the consequences of poor performance. Finally, if the Commission were to rely on the NERC data when establishing rates, it could also use the same data to set standards for deferrals resulting from future outages. Id. at Falkenberg/15-16.

PGE concedes that it has higher than average forced outage rates, but argues that its higher outage rates are offset by lower planned maintenance outage rates. PGE/1900, Tinker-Shue-Drennan/38. This position is unreasonable, because unlike planned outages, unplanned outages are by their very nature not coordinated to occur when replacement power is available at the lowest cost. The Boardman outage provides a good example of the fact that unplanned outages can occur when replacement power costs are high. It is therefore not a good practice to reduce planned maintenance outages at the expense of higher cost unplanned outages. ICNU/108, Falkenberg/17-18.

ICNU recommends that the Commission require PGE to replace the four-year rolling average outage rates in Monet with stochastic modeling based on NERC data. This would reduce PGE's proposed NVPC by approximately $5.7 million. Id. at Falkenberg/18. Even if the Commission does not accept ICNU's stochastic modeling proposal, it should not allow PGE to include the 2005 Boardman outage when calculating outage rates.

C. Cost of Capital

ICNU and CUB jointly sponsored Michael Gorman's testimony on cost of capital issues, and Mr. Gorman demonstrated that PGE's requested cost of capital is excessive because the Company's underlying assumptions are unrealistic. PGE initially proposed an 8.97% rate of return, based on a 10.75% ROE and 56% equity ratio. PGE/1100, Hager-Valach/2. PGE revised its proposals in sur-surrebuttal testimony, requesting an 8.87% rate of return, based on a 10.75% ROE and a 53% common equity ratio. PGE/2700, Hager-Valach/5. PGE's new proposals reflect approximately $200 million in additional debt that the Company claims it recently decided to issue in 2007. Id.

Even if PGE's last minute revision is appropriate, PGE's additional debt does not mitigate the inflationary impact of the Company's equity-rich capital structure and excessive ROE proposal on the overall cost of capital. Mr. Gorman proposed an 8.3% rate of return, based on a 9.9% ROE and a 50% equity ratio, and he demonstrated that his proposals were sufficient to maintain PGE's current credit ratings and access to capital. ICNU-CUB/300, Gorman/1-2. The Commission should adopt these values as a reasonable return for PGE in the rate year.

1. OPUC Cost of Capital Standards

Two U.S. Supreme Court decisions form the basis for the Commission's standards for determining an appropriate rate of return. Re PGE, OPUC Docket No. UE 115, Order No. 01-777 at 23 (Aug. 31, 2001) (citing Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)); Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Virginia, 262 U.S. 679 (1923). Under these decisions, a utility's authorized return should: 1) be sufficient to maintain financial integrity; 2) allow the utility to attract capital under

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reasonable terms; and 3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk. OPUC Docket No. UE 115, Order No. 01-777 at 23. ORS § 756.040 includes language codifying these standards.

The Commission undertakes a multi-step process to determine a utility's rate of return. Id. The Commission first identifies the costs and components of the utility's capital structure. The Commission then estimates the cost of each capital component and weighs each component according to its percentage of total capitalization. Finally, the Commission combines the weighted costs of capital to calculate the overall cost of capital. This overall cost of capital is the utility's allowed rate of return on rate base. Id.

2. Capital Structure

a. PGE's Equity-Rich Capital Structure Unreasonably Inflates the Company's Proposed Cost of Capital

Mr. Gorman demonstrated that PGE's equity-rich capital structure reflects the lingering effects of Enron ownership and unnecessarily increases PGE's proposed revenue requirement. Even including the additional debt that PGE discussed in its last round of testimony, PGE proposes a 53% common equity ratio. This substantially exceeds the average common equity ratio for Mr. Gorman's proxy group of comparable utilities, as well recently authorized equity ratios for Northwest utilities. In addition, it conflicts with the assumptions about a 2007 capital structure in PGE's internal planning.

Mr. Gorman proposed a capital structure with 50% common equity, 49.71% long-term debt, and 0.29% preferred equity. ICNU-CUB/300, Gorman/1-2. PGE has since accepted Staff's proposal to eliminate preferred equity from its capital structure, because the preferred equity is a small percentage and matures in mid-2007. PGE/2000, Hager-Valach/2-3. ICNU

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does not oppose removing the preferred equity as an alternative to Mr. Gorman's proposal; however, PGE should continue to consider using preferred equity to reduce the cost of capital. Removing the preferred equity would result in a capital structure with 50% equity and 50% debt.

i. A 50% Common Equity Ratio Achieves PGE's Stated Objectives at a Lower Cost to Customers

PGE argues that the Company's proposed capital structure would allow it to: 1) maintain financial strength, flexibility, and liquidity; 2) maintain reliable and economic access to capital markets; 3) minimize its overall cost of capital to customers and shareholders; and 4) offset debt equivalents of purchased power contracts. PGE/1100, Hager-Valach/44. Mr. Gorman demonstrated that his proposed capital structure is superior, because it achieves PGE's stated objectives but at a lower cost to customers. ICNU-CUB/300, Gorman/2, 9.

Mr. Gorman developed his capital structure proposal after constructing a proxy group of electric utilities that are comparable to PGE in terms of risk and determining that the group average common equity was 49%. Id. at Gorman/12, 15. Mr. Gorman then tested PGE's ability to maintain its credit ratings and access to capital under his proposed capital structure by comparing S&P credit rating benchmark financial ratios to the total debt ratio under his proposed capital structure, along with S&P's estimate of PGE's off-balance sheet debt. Id. at Gorman/9-10. S&P evaluates utility credit ratings by assessing the utility's financial and business risk, to develop the utility's total credit risk. Id. at Gorman/29. S&P publishes a matrix of financial ratios that defines the level of financial risk as a function of business risk. The three primary ratios are: 1) funds from operations ("FFO") to debt interest expense; 2) FFO to total debt; and 3) total debt to total capital. Id. Examining these financial ratios indicates what capital structure will support a company's current bond ratings. S&P rates a utility's business risk based on a risk

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profile scale of one to ten, with one being the lowest risk. Id. Most vertically integrated electric utilities have a business risk profile between four and six. Id.

PGE currently has a business risk profile of five, and secured and unsecured bond ratings of "BBB+" and "BBB," respectively. Id. at Gorman/10. According to S&P's financial ratios for a company with these attributes, PGE must maintain an adjusted total debt ratio, including off-balance sheet debt, between 50-60% to preserve its bond ratings. Id. PGE's total adjusted debt ratio under Mr. Gorman's proposed capital structure fell squarely in the middle of S&P's acceptable range. Id. PGE's total adjusted debt ratio remains in the acceptable range even if the additional debt that PGE claims it will issue in 2007 is included.

PGE disputes very little about the foundation for Mr. Gorman's proposed capital structure. PGE did not dispute Mr. Gorman's construction of the proxy group or the 49% group average common equity ratio.[6/] See PGE/2000, Hager-Valach/64, 66. PGE also did not dispute Mr. Gorman's calculations demonstrating that the Company would maintain a financial ratios consistent with a strong "BBB" to a weak "A" investment grade utility under his proposed capital structure. ICNU-CUB/319, Gorman/3. In fact, PGE's witnesses relied on proxy groups with common equity ratios in the range of 45% to 52% or lower for the Company's own cost of capital analysis, which are substantially similar to Mr. Gorman's proposal. ICNU-CUB/300, Gorman/12. This not only reflects the reasonableness of Mr. Gorman's approach, but also demonstrates that PGE's proposed common equity ratio is out of line with comparable utilities.

[6/] ICNU describes the specifics of Mr. Gorman's proxy group in detail in the discussion of Mr. Gorman's ROE proposals in Section IV.C.3 of this Opening Brief.

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ii. A 50% Equity Ratio Is Consistent with Comparable Utilities

The evidence demonstrates that Mr. Gorman's proposed capital structure is consistent with comparable utilities' capital structures. The Commission approved a stipulated 50% common equity ratio for PacifiCorp in UE 179. Re PacifiCorp, OPUC Docket No. UE 179, Order No. 06-530 at 4-5 (Sept. 14, 2006). PSE is proposing a 45% common equity ratio in its current rate case before the Washington Utilities and Transportation Commission ("WUTC"). ICNU-CUB/300, Gorman/11. Finally, the WUTC approved a stipulated 40% common equity ratio for Avista in December 2005. WUTC v. Avista, WUTC Docket Nos. UE-050482 and UG-050483, Order No. 05 at ¶¶ 59-60 (Dec. 21, 2005).

Mr. Gorman's proposed capital structure also is consistent with regulatory decisions outside the Northwest. A July 2006 Regulatory Research Associates' survey demonstrates that the average common equity ratios in 2005 and the first half of 2006 were 47.5% and 46.7%, respectively. ICNU-CUB/300, Gorman/11-12. Finally, the five different proxy groups discussed in this proceeding have average common equity ratios below 50% in 2007, and a 50% average across all the groups for 2009 to 2011. PGE/2008, Hager-Valach/1.

iii. PGE Expects to Have a 50% Common Equity Ratio

Staff presented evidence demonstrating that PGE expects to have a capital structure comparable to Mr. Gorman's proposal in 2007, including a total debt ratio of 51%. Staff/1400, Morgan/6; Staff/1402, Morgan/67. PGE's responses to Staff's data requests indicate that PGE plans to manage its capital structure to achieve a 50% common equity ratio over the period 2007-2010, and PGE's internal planning reflects the same assumptions. Staff/1400, Morgan/6; Staff/1403, Morgan/26. PGE argues that this is a "long-run" expectation, but the

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Company's statements outside of testimony in this Docket demonstrate that these expectations apply to the test year. PGE/2700, Hager-Valach/9.

iv. PGE's Equity-Rich Capital Structure Is Attributable to Enron Ownership

PGE's main complaint about Mr. Gorman's proposal relates to the reasons for the Company's excess equity. According to PGE, the Company's high equity ratio (and inflated ROE proposal) is the result of "PGE-specific" risks that require the Company to retain additional equity. ICNU addresses these allegedly Company-specific risks in the ROE discussion below; however, PGE's claims generally reflect generic business risk facing all utilities or concerns that do not justify PGE's inflated proposals. Furthermore, ICNU, CUB, and Staff provided evidence to demonstrate a much more straightforward explanation.

Mr. Gorman and Staff witness Thomas Morgan presented compelling evidence that PGE's equity-rich capital structure was due to Enron ownership, and conditions in the stipulations from the Enron merger and PGE stock distribution proceedings designed to protect customers from paying for Enron-related increases in PGE's cost of capital. ICNU-CUB/300, Gorman/13; Staff/1400, Morgan/4. PGE disagrees that Enron ownership affected the Company's equity ratio, but the Company's explanations are unconvincing. PGE/2000, Hager-Valach/66.

PGE began accumulating the substantial equity in its current capital structure after Enron filed for bankruptcy in 2001, which resulted in the Company losing its access to capital for a period. Staff/1400, Morgan/4. PGE does not dispute this. PGE/2000, Hager-Valach/15. Statements in PGE's SEC filings and OPUC financing applications from this period demonstrate that the Company experienced a "liquidity crunch" after the Enron bankruptcy and, in some

instances, needed an effective "interim solution" to financing difficulties. Staff/1200, Conway/9-15; Staff/1201, Conway/33.

Once financing difficulties arose, Enron suspended PGE's dividend obligations to preserve liquidity and provide funds to continue operations. PGE/1100, Hager-Valach/13; PGE/2000, Hager-Valach/65. PGE acknowledges that it began accumulating equity after Enron filed bankruptcy and suspended PGE's dividend obligations. Id. Enron's bankruptcy ended in November 2004, and by then PGE's equity ratio had ballooned to almost 59%. PGE/1100, Hager-Valach/45. Once the bankruptcy ended, PGE paid a dividend to Enron and began funding capital expenditures through long-term debt again. Id. Those actions reduced PGE's equity ratio to 56%, which was PGE's initial proposal in this case. Id. at Hager-Valach/43, 45. Exhibit PGE/1113 reflects the rise and fall of PGE's equity ratio from 2002-2007.

Given that common equity is the most expensive form of capital and its revenue requirement cost is more than 2½ times greater than debt, the additional equity in PGE's capital structure substantially increases costs for customers, and PGE's inflated ROE proposal only adds to that cost. ICNU-CUB/300, Gorman/12. When the Commission approved Enron's purchase of PGE, it adopted a stipulation in which PGE and Enron agreed that "the allowed return on common equity and other costs of capital will not rise as a result of the merger." Re Enron, OPUC Docket No. UM 814, Order No. 97-196, Appendix A at 2 (June 4, 1997). When the Commission approved the PGE stock distribution to end Enron's ownership, it approved a stipulation in which "PGE agree[d] not to seek recovery of increases in the allowed return on common equity and other costs of capital . . . due to Enron's ownership of PGE. . . . " Re PGE, OPUC Docket Nos. UF 4218 and UM 1206, Order No. 05-1250, Appendix A at 4 (Dec. 14,

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2005). PGE's inflated equity ratio is a direct result of Enron ownership, and it increases the overall proposed cost of capital. The Commission must give effect to the conditions that the parties carefully negotiated to protect customers. Given the direct link between the Enron bankruptcy, PGE's loss of access to capital, suspension of the dividend, and PGE's current high equity ratio, the Company's claims that Enron's collapse and bankruptcy had no impact on its equity ratio are not credible. ICNU's and Staff's capital structure proposals account for the increased costs of Enron ownership. The Commission should reject PGE's proposal because it does not.

3. Return on Equity

a. Mr. Gorman's Proposed ROE Will Maintain PGE's Bond Ratings and Access to Capital at a Lower Cost to Customers

Mr. Gorman recommends a 9.9% ROE for PGE based on applying three different analyses to his proxy group of comparable utilities. As described above, PGE does not disagree with the foundation of Mr. Gorman's analysis—it only disagrees with certain details. PGE does not disagree with how Mr. Gorman constructed his proxy group. PGE/2000, Hager-Valach/66. In fact, PGE stated that the S&P business profile scores and bond ratings that Mr. Gorman reviewed to construct his proxy group "are useful measures in selecting a sample group relatively comparable to PGE . . . ." PGE/2700, Hager-Valach/6. PGE did not dispute that its bond rating and business profile score are identical to the group averages for Mr. Gorman's proxy group. Furthermore, PGE agreed with the range that Mr. Gorman calculated for certain of his analyses, and acknowledged that its analyses include the same range. PGE/2000, Hager-Valach/66; PGE/2700, Hager-Valach/6. Finally, PGE acknowledged that Mr. Gorman calculated what the Company considers the relevant financial ratios for ROE analysis, and PGE did not disagree with

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Mr. Gorman's calculations of those ratios in comparing PGE's financial credit rating metrics at his proposed capital structure and ROE to S&P's credit rating benchmarks. PGE/2000, Hager-Valach/27. Mr. Gorman used this comparison to demonstrate that his proposals would maintain PGE's credit ratings and access to capital. ICNU-CUB/319, Gorman/3.

Perhaps PGE's most meaningful comment about Mr. Gorman's proposals was its very first statement responding to Mr. Gorman's testimony, in which the Company noted that Mr. Gorman's cost of capital proposals represent the middle ground between Staff's recommendation and PGE's inflated 10.75% proposal. PGE/2000, Hager-Valach/64. Indeed, many of PGE's criticisms of Staff's proposal are inapplicable to Mr. Gorman's analysis, because Mr. Gorman either addressed PGE's concerns or performed his calculations as PGE suggests. See id. at Hager-Valach/34. Mr. Gorman's recommendations are reasonable, supported by the evidence, satisfy the OPUC's statutory and policy cost of capital objectives, and reflect a middle-of-the-road alternative to Staff's and PGE's disparate recommendations.

b. Mr. Gorman's Proposed ROE Is the Mid-point of the Range Produced by Applying Three ROE Models to His Proxy Group

Mr. Gorman demonstrated that PGE's appropriate authorized ROE is 9.9%. Mr. Gorman developed his proposed ROE using three well-known models: 1) the constant growth discounted cash flow ("DCF") model; 2) the bond yield plus equity risk premium model; and 3) the capital asset pricing model ("CAPM"). ICNU-CUB/300, Gorman/14-15.

Mr. Gorman applied these models to a proxy group of publicly traded utilities that are comparable to PGE in terms of total risk. Mr. Gorman developed his proxy group by starting with all utilities in the Value Line Investment Survey and narrowing that group based on criteria that reflect bond ratings and overall business risk similar to PGE:

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1. Utilities with bond ratings from S&P in the "BBB" and "A" category, and from Moody's in the "Baa" and "A" category;
2. Utilities with common equity ratios between 40% and 60%;
3. Utilities with S&P business profile scores between 3 and 6;
4. Utilities not involved in significant merger or acquisition activities;
5. Utilities that have not suspended their dividends over the last two years; and
6. Utilities that are not currently involved in industry restructuring transition initiatives, or liquidating investments in non-regulated businesses to reduce debt and shed non-regulated exposure.

Id. at Gorman/15. Exhibit ICNU-CUB/304 shows the utilities in Mr. Gorman's proxy group. The group average bond rating from S&P and Moody's is identical to PGE's. Id. The group average business risk profile is five—also identical to PGE's. Id. The group average common equity ratio is 49%, which is slightly lower than Mr. Gorman's proposal. Id.

Applying the three ROE models to Mr. Gorman's proxy group produced a range of ROE estimates from 9.5% to 10.4%. The constant growth DCF analysis produced the low-end estimate, and the risk premium and CAPM analyses produced the high-end estimate Mr. Gorman's proposed 9.9% ROE is the mid-point of the range. The details of Mr. Gorman's analyses are described below.

i. Constant Growth DCF Model Results

The DCF model is based on the theory that the current stock price represents the sum of future dividends, discounted to the present. Re Northwest Natural Gas Co., OPUC Docket No. UG 132, Order No. 99-697 at 7 (Nov. 12, 1999). The DCF model measures what level of equity return investors will demand for a particular company, thus measuring the

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company's cost of money in the equity market. The DCF model has three components: 1) a current stock price; 2) an expected dividend; and 3) an expected growth rate in dividends. Id.

To estimate current stock prices, Mr. Gorman used the average of the weekly high and low stock prices over a 13-week period ending July 7, 2006. ICNU-CUB/300, Gorman/16-17. For expected dividends, Mr. Gorman used the most recently paid quarterly dividend. Id.

To estimate dividend growth, the goal is to determine what the consensus of investors believes about the dividend or earnings growth rate. Id. at Gorman/17. To do this, Mr. Gorman averaged three published sources of customer growth rate estimates available on July 11, 2006. Id. at Gorman/18. The proxy group's consensus growth rate was 4.63%, which Mr. Gorman concluded was "reasonably consistent with the five-year projected Gross Domestic Product ("GDP") growth rate of 5.2%." Id. at Gorman/19. Nominal GDP growth is a proxy for the utility's highest sustainable long-term growth rate, because utility dividend growth cannot sustainably exceed the overall economy's growth rate. Id. Utility growth also has historically been tied to the inflation growth rate, because utilities typically pay out a high percentage of earnings as dividends, limiting reinvestment and growth. The 4.63% growth rate in Mr. Gorman's DCF analysis was higher than expected inflation rates, reflecting a strong estimate. Id. at Gorman/20.

Mr. Gorman's DCF analysis resulted in a 9.4% estimated ROE for the proxy group. Mr. Gorman testified that this result is reasonable in that the proxy group DCF yield reflects current and projected interest rates, and the group's financial metrics under this ROE indicate that the companies will be able to support dividends and produce earnings in the current low capital cost environment. Id. at Gorman/21.

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ii. Risk Premium Model Results

The risk premium model is based on the principle that investors require a higher rate of return to assume greater risk. Id. As a result, the rate of return is typically determined by the current yield to maturity on bonds plus a premium. OPUC Docket No. UG 132, Order No. 99-697 at 8. Mr. Gorman used two methods to develop estimates of the equity risk premium. In one method, Mr. Gorman determined the difference between required return for utility equity investments and contemporary "Baa" rated utility bond yields on an annual basis for the period 1986 through June 2006. ICNU-CUB/300, Gorman/22. Mr. Gorman used 1986-June 2006 because utility bonds consistently traded at a premium to book value during this period, indicating that: 1) authorized ROEs were sufficient to support market prices that exceeded book value; and 2) utilities could issue common stock without diluting existing shares or harming shareholders. Id. Mr. Gorman based the assumptions about the required return for utility equity investments on commission-approved ROEs. This method produced a range of equity risk premiums between 3.0% and 4.5%. Id. at Gorman/23.

To estimate PGE's ROE using these results, Mr. Gorman added the equity risk premium to the current 13-week average yield on "Baa" rated utility bonds for the period ending June 7, 2006, which was 6.60%. Adding the utility bond equity premium of 3.0% to 4.5% to this amount resulted in a ROE in the range of 9.6% to 11.1%, with a midpoint of 10.4%. Id.

Mr. Gorman's other method determined the difference between the required return for utility equity investment and Treasury bonds over 1986-June 2006, using commission-authorized ROEs. Id. at Gorman/21-22. This method resulted in a range of 4.4% to 5.9%. Id. at Gorman/22. To estimate an authorized ROE using these results, Mr. Gorman added the

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estimated equity risk premium range to a projected long-term Treasury bond yield of 5.3%, based on Blue Chip Financial Forecasts. This produced an estimated common equity return in the range of 9.7% to 11.2%, with a midpoint of 10.4% as well. Id. at Gorman/23. In the end, the risk premium analysis produced an estimated ROE of 10.4%.

iii. Capital Asset Pricing Model Results

CAPM analysis is based on the theory that the required return for a security is equal to the risk-free rate of return plus a security-specific risk premium. OPUC Docket No. UG 132, Order No. 99-697 at 8. The CAPM analysis contains three elements: 1) the company's beta; 2) the risk-free rate; and 3) the market risk premium. The beta represents the investment risk that cannot be diversified away when the security is held in a diversified portfolio. In his analysis, Mr. Gorman reviewed the current and historical trend in beta estimates for his comparable group. ICNU-CUB/300, Gorman/26; ICNU/313, Gorman/1. Mr. Gorman explained that his group average beta based on the Value Line Investment Survey is 0.84, but that the group beta has been increasing over the last five years as utility stocks have held their value in the face of worsening market conditions. ICNU-CUB/300, Gorman/26. Mr. Gorman noted that the ability of utility stocks to maintain their value in this period indicated the low-risk nature of those investments rather than reflecting increasing utility risk. As a result, Mr. Gorman explained that the group average beta was too high and used an adjusted beta of 0.80. Id.

To estimate the risk-free rate, Mr. Gorman used the Blue Chip Financial Forecast's projected 30-year Treasury bond yield of 5.3%. Id. at Gorman/25. Mr. Gorman used long-term Treasury bonds because they are considered to have negligible credit risk, and they have an investment horizon similar to that of common stock. Because a Treasury bond yield is

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not a risk-free rate, however, Mr. Gorman noted that using a Treasury bond yield as a proxy for the risk-free rate of return in the CAPM analysis for companies with betas less than one can produce an overstated estimate of the CAPM return.

Mr. Gorman used two estimates of the market risk premium, one that was forward-looking and one based on a long-term historical average. Id. at Gorman/26. The forward-looking estimate was 6.5%, and the historical estimate was 6.3%. Putting the CAPM elements together, Mr. Gorman's CAPM analysis produced an ROE estimate of 10.4%. Id. at Gorman/27.

c. PGE Failed to Sufficiently Rebut Mr. Gorman's ROE Proposals

PGE disagrees with little about the fundamentals of Mr. Gorman's ROE analysis. The Company's primary complaint is that Mr. Gorman relied on a point estimate for ROE in his DCF analysis, but the Commission should consider a range of results to account for the "PGE-specific" risks that allegedly justify the Company's inflated ROE proposal. PGE/2700, Hager-Valach/6. Even if PGE's claims that it is a more risky investment than other publicly traded utilities were true, the Company has provided no quantitative or qualitative evidence to support that claim. The record is devoid of any evidence to quantify the PGE-specific risk. Furthermore, all objective indications of PGE's total risk indicate that the Company is no more risky than the companies in Mr. Gorman's sample group. Finally, the Commission cannot set rates based on a range of estimated ROE—a point estimate is required. ICNU-CUB/319, Gorman/4.

ICNU responds to PGE's specific claims about Mr. Gorman's analysis in the combined discussion of capital structure and ROE that is below.

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d. PGE's Proposed 10.75% ROE Recommendation Is Based on Unrealistic Assumptions

PGE's proposed 10.75% ROE is based on applying multi-stage DCF analyses and a risk positioning model to multiple proxy groups. PGE/1100, Hager-Valach/39-40. PGE concluded that the appropriate authorized ROE falls within the range of 9.25% to 11.3%. As Mr. Gorman explained, however, PGE relied on a number of growth rate estimates that significantly overstate PGE's current cost of equity. Once PGE's unreasonable results and assumptions are removed, the Company's studies demonstrate that PGE's current cost of equity falls within Mr. Gorman's recommended range of 9.5% to 10.4%.

i. PGE's DCF Analysis Uses Growth Rate Estimates That Exceed the Forecasted Growth Rate for the Economy as a Whole

PGE conducted multi-stage DCF analyses using two different growth rate estimates. PGE's initial analysis using a "br+vs" estimate produced a range of ROE estimates from 8.1% to 9.6%. Id. at Hager-Valach/40. PGE updated this analysis in rebuttal testimony, producing a range from 8.2% to 10.1%. PGE/2000, Hager-Valach/5.

The Company's initial analysis using a GDP growth estimate produced a range of 8.9% to 11.2%. PGE/1100, Hager-Valach/40. PGE updated this range to 8.3% to 11.3% in rebuttal testimony. PGE/2000, Hager-Valach/5.

All but one result from PGE's DCF analyses fell within the range from 8.2% to 10.1%, and Mr. Gorman demonstrated that the Commission should disregard the outlying 11.3% estimate from PGE's multi-stage DCF with the GDP growth estimate because it reflects unreasonable growth rate assumptions. ICNU-CUB/300, Gorman/31. GDP growth rate is an unreasonable long-term sustainable growth proxy to use for utility companies, because of the

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relatively high percentage of earnings that utilities pay out as dividends. Utility dividend payout ratios are approximately 70% of earnings. Id. at Gorman/32. The S&P 500 or market index payout ratios, on the other hand, are about 30%. Id. As a result, utilities typically have high dividend yields but lower growth rate prospects, because they do not reinvest a high percentage of earnings to grow future earnings and dividends. PGE's DCF analysis assumes that the Company will have both high dividend yields and strong growth projections, which is an unreasonable assumption for formulating estimated ROE. Id.

Furthermore, the dividend growth rate assumptions that are necessary to produce PGE's high end estimate under the DCF analyses would exceed the overall consensus growth rate for the entire economy. Id. As Mr. Gorman explained, such a result is highly unlikely, if not impossible. Id. at Gorman/19.

Current utility dividend yields are below 5%, and PGE's high-end DCF estimate reflects a weighted long-term average dividend growth rate of approximately 6.2%. Id. at Gorman/32. This growth rate substantially exceeds the overall consensus five-year projected GDP growth rate of 5.2%. Id. As Mr. Gorman testified, the overall GDP growth rate forecast represents the maximum sustainable utility divided growth rate, because utilities' dividend growth cannot sustainably exceed the economy's overall growth rate. Id. at Gorman/19. Utility sales do not grow faster than the overall economy, because a utility's service territory growth will not expand faster than the economy. Id. The Commission should disregard PGE's high-end DCF estimate under these circumstances because of its unreasonable growth rate assumptions. When this unreasonable outlying result is removed, PGE's DCF results in a range from 8.1% to 10.1%, which includes a high-end estimate within Mr. Gorman's range (9.5% to 10.4%).

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ii. PGE's Risk Positioning Analysis Relies on Improper Interest Rate Assumptions

Both Mr. Gorman and Staff disagreed with PGE's risk positioning analysis. This is the same type of analysis that the Commission rejected in UE 115, noting that it was "unconventional and has not been accepted by other regulatory agencies as a reliable means for determining cost of equity." OPUC Docket No. UE 115, Order No. 01-777 at 33. PGE's analysis in this proceeding suffers from many of the same flaws identified in UE 115. See id.

PGE's risk positioning analysis is based on comparing authorized ROEs to the relative yields for corporate bonds and seven-year Treasury bonds. PGE then performed a regression analysis to estimate the current risk premium for a utility's equity investment relative to corporate bond yields and seven-year Treasury bond yields. Staff testified that PGE's analysis suffered from omitted variable bias and lacked relevant explanatory variables. Staff/1100, Conway/3-13. These are some of the same flaws that caused the Commission to reject PGE's risk positioning analysis in UE 115. OPUC Docket No. UE 115, Order No. 01-777 at 33.

Using a seven-year Treasury bond for PGE's risk positioning analysis was inappropriate and unreasonable. ICNU-CUB/300, Gorman/33-34. A seven-year Treasury bond yield is not a reasonable interest rate proxy to use to estimate an equity risk premium, because it reflects the short-term market forces related to Federal Reserve policy control of inflation and other factors, resulting in significant volatility. Id. at Gorman/33. Equity valuations typically reflect longer-term Treasury bonds. Id. PGE performed its risk positioning analysis using 30-year treasury bonds in response to Mr. Gorman's testimony, and it reduced PGE's estimated ROE by 40-45 basis points. PGE/2000, Hager-Valach/70. The significant change that resulted

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from using more realistic interest rate assumptions demonstrates that PGE's high-end estimates from its risk positioning analyses are excessive.

e. PGE Will Maintain Its Credit Ratings and Access to Capital Under Mr. Gorman's Recommended ROE and Capital Structure

Mr. Gorman demonstrated that his cost of capital recommendations will maintain PGE's current credit ratings and access to capital. ICNU/300, Gorman/28. To do so, Mr. Gorman compared key credit rating financial ratios for PGE under his recommendations to S&P's benchmark financial ratios for "A" and "BBB" rated utilities with a business profile risk score of 5. Id. Mr. Gorman calculated each of the three S&P financial ratios described above, using PGE's cost-of-service for retail operations and the Company's off balance sheet debt for the 2007 test year. Id. at Gorman/29. PGE fell within the acceptable range for each of the three ratios, demonstrating that PGE's financial metrics under Mr. Gorman's cost of capital proposals will support a strong "BBB" and a weak "A" bond utility rating at PGE's business risk profile score of five. Id. at Gorman/30. PGE has not disputed these conclusions.

f. PGE Has Failed to Demonstrate that Company-specific Risk Justifies the Company's High Rate of Return Proposal

PGE's claims about the additional risk that it faces rely heavily on unsupported statements by PGE employees who relied on their "judgment and experience" to make the appropriate adjustments to account for allegedly "PGE-specific" risk. PGE/1100, Hager-Valach/39. PGE has not quantified this Company-specific risk in relation to other utilities, nor has it provided sufficient evidence to justify qualitative claims that PGE represents a more risky investment. The WUTC has addressed the need for evidence to support opinion testimony regarding the assumptions to use in cost of capital analysis:

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> While the determination of the cost of common-equity capital requires the exercise of judgment, the use of judgment must be informed by the facts. If meeting the burden of proof through opinion testimony has any meaning, it means that the witness must present a logical connection between the factual evidence presented and the opinion offered.

WUTC v. Avista, WUTC Docket Nos. UE-991606 and UG-991607, Third Supp. Order at ¶ 355 (Sept. 29, 2000). In this case, PGE employees repeatedly opine that the Company is exposed to greater relative risk, but PGE provided insufficient evidence to justify or quantify that claim.

Mr. Gorman pointed out that PGE failed to provide evidence of its relative risk, and PGE responded by citing the allegedly Company-specific reasons that it is a riskier investment. ICNU-CUB/300, Gorman/35; PGE/2000, Hager-Valach/67. PGE did not, however, provide testimony demonstrating or quantifying its relative risk according to the relevant risk factors for its proxy group. ICNU-CUB/319, Gorman/5. Furthermore, in some instances PGE provided comparative data but drew no conclusions from that data. See, e.g., PGE/2006, Hager-Valach/1-10. As a result, the Commission lacks any basis to adjust the ROE estimates to reflect the allegedly PGE-specific risk.

The information that PGE did provide fails to demonstrate that the Company is more risky. PGE provided information reflecting the bond ratings, capital structures, and earnings for Mr. Gorman's, Staff's, and PGE's proxy groups, but that information actually demonstrates that the Company is reasonably risk-comparable to its proxy group. ICNU-CUB/319, Gorman/5. PGE has similar bond ratings from S&P and Moody's as its proxy group, and the group average debt ratio is comparable to the 50% debt ratio that Mr. Gorman recommends. Id.; PGE/2008, Hager-Valach/1.

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PGE also compares the average ROE for PGE over the last five years with the average ROE for the companies in its comparable risk utility group, but this also fails to demonstrate the Company's relative risk. PGE/1107, Hager-Valach/2. First, PGE's earnings fell in the middle of the range for the earnings across its initial comparable group. Id. Second, merely reviewing PGE's earnings over the last five years does not accurately assess the Company's overall risk in relation to other utilities. Enron owned PGE during this period, the Western power crisis occurred, the Company experienced below-normal hydro conditions, and most utilities were not employing risk management strategies to protect themselves from volatile wholesale commodity charges. ICNU-CUB/319, Gorman/5. This period obviously will not reflect circumstances going forward, if not for the mere fact that Enron no longer owns PGE.

Finally, if the information that PGE has provided gives any indication of relative risk, it merely reflects the total risk (i.e., the combination of business and financial risk) that is applicable to all companies. Mr. Gorman took that risk into account by narrowing his proxy group of comparable utilities to companies with S&P business risk profile scores between three and six (to reflect business risk), and bond ratings in the "BBB," "Baa," and "A" categories (to reflect total risk). ICNU-CUB/300, Gorman/15. PGE agreed that these are "useful measures" in constructing a group that was comparable to the Company in terms of risk. PGE/2700, Hager-Valach/6. Thus, Mr. Gorman's ROE estimates reflect PGE's total risk.

g. The Specific Risks that PGE Identifies Are Not Unique to the Company

PGE claims that Company-specific issues justify its excessive 10.75% ROE proposal and equity-rich capital structure. According to PGE, it must: 1) comply with the 48% minimum equity ratio that Order No. 05-1250 requires; 2) maintain liquidity for unexpected

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margin calls and to address unresolved litigation and SB 408 issues; 3) fund capital expenditures, including hydro relicensing and a wind farm; 4) assure equity and bond investors of sufficient cash flow; and 5) maintain an investment grade unsecured bond rating to access the wholesale energy markets. PGE/2000, Hager-Valach/31. In addition, PGE has maintained that its power costs represent a high percentage of overall revenue requirement and that it relies on purchased power and hydroelectric power. Id. at Hager-Valach/65; PGE/1100, Hager-Valach/19.

48% Minimum Equity Ratio. Complying with the 48% minimum equity ratio that PGE agreed to in the stipulation approved in Order No. 05-1250 does not require the Company to maintain the 56% common equity ratio that PGE initially proposed or even the 53% common equity ratio proposed in sur-surrebuttal testimony. PGE's proposals unnecessarily increase costs without any identifiable customer benefit. ICNU and Staff, whom are parties to the stipulation that contains the minimum equity ratio commitment, both want PGE to fulfill its commitments in that stipulation and both recommend a capital structure with a 50% common equity ratio. The ICNU recommendation does not affect PGE's ability to comply with its commitments. Adopting a 50% common equity ratio does not require PGE to manage its capital structure to achieve that ratio. Even if it did, however, that ratio is more than sufficient to satisfy the minimum equity ratio commitment.

Maintaining liquidity. All utilities must maintain liquidity. This is not a PGE-specific risk. PGE maintains that it must maintain liquidity to address unexpected margin calls as wholesale power prices fluctuate and to address unresolved litigation. Again, these are not PGE-specific risks. Many utilities buy and sell power in the wholesale market, and most have

unresolved litigation that may require additional cash to resolve. This is no basis to approve a higher ROE or equity ratio than for comparable utilities.

SB 408. The one Oregon-specific issue that PGE identifies is SB 408. Even assuming that PGE can legitimately consider complying with Oregon law a "risk," PGE has not quantified that risk or demonstrated how it impacts required returns. In fact, PGE has stated publicly that SB 408 will not have as significant an impact now that Enron no longer owns the Company. Ted Sickinger, "Tax filings show refund potential," The Oregonian, Oct. 17, 2006.

Furthermore, the only other electric utility that must comply with SB 408 is PacifiCorp, and PacifiCorp's authorized capital structure and ROE do not resemble PGE's excessive requests. The Commission recently approved a stipulated 50% common equity ratio and 10.0% ROE for PacifiCorp in UE 179. OPUC Docket No. UE 179, Order No. 06-530 at 4. Prior to that, the Commission approved a stipulated 47.56% common equity ratio and 10.0% ROE for PacifiCorp in UE 170. Re PacifiCorp, OPUC Docket No. UE 170, Order No. 05-1050 at 10 (Sept. 28, 2005). These are the only cost of capital decisions for an Oregon electric utility since SB 408 was passed, and they do not indicate that a higher ROE or equity ratio is necessary to compensate for the "risk" of complying with the law.

Funding capital expenditures. Funding capital expenditures also is not a PGE-specific concern. All utilities have capital expenses related to maintaining their systems and meeting customer demand. The fact that PGE identifies specific issues such as hydro relicensing and wind farm construction does not provide a basis to approve an excessive common equity ratio or ROE. PSE is one of the companies in Mr. Gorman's sample group, and PSE currently is funding its investment in the Wild Horse wind project. Nevertheless, PSE is requesting that the

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WUTC approve a 45% common equity ratio. ICNU-CUB/300, Gorman/11. PacifiCorp currently is facing a complex and contested relicensing of its Klamath hydroelectric facilities, and, as described above, it does not have an excessive equity ratio or capital structure as a result of that "risk."

Assuring investors of sufficient cash flow. Every publicly traded utility must assure equity and bond investors that it has sufficient cash flow. PGE is not unique. Mr. Gorman's sample group consists of such publicly traded utilities and adequately represents this risk.

Maintaining an investment grade unsecured bond rating. Mr. Gorman demonstrated that his cost of capital proposals were sufficient to maintain PGE's current secured and unsecured bond ratings when compared to the relevant S&P financial ratios, and PGE did not dispute Mr. Gorman's calculations. ICNU-CUB/300, Gorman/29; ICNU-CUB/319, Gorman/3. Furthermore, this is not a risk that is unique to PGE, and it is adequately captured by the utilities in Mr. Gorman's sample group, which all have bond ratings from S&P in the "BBB" and "A" category. ICNU-CUB/300, Gorman/15.

Power Cost Risk. As described above, PGE has relied on the statements of the rating agencies to justify its proposed power cost framework and has similarly done so to support the Company's claims about its relatively greater risk. The S&P report provides no basis to conclude that the rating agencies believe that PGE's financial health relies on addressing the risk of power cost variation.

In addition, PGE has not demonstrated that the Company is exposed to relatively greater risk than other utilities because its power costs comprise a higher percentage of the Company's overall revenue requirement and its purchased power and hydroelectric power

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comprise a greater percentage of the Company's resource portfolio. PGE/2000, Hager-Valach/65; PGE/1100, Hager-Valach/19. Even if the Commission considers PGE's opinion testimony on this issue, however, PGE has not quantified that risk in a way allows for adjusting ROE. The sample groups used by Mr. Gorman, PGE, and Staff all include utilities with power costs that vary from year-to-year, and PGE provided no evidence to demonstrate that its power costs vary to any greater degree than any other utility.

3. Cost of Debt

ICNU supports Staff's recommendation to reduce PGE's cost of long-term debt to reflect the impact of Enron ownership. Staff's cost of debt adjustment has become only more important since the Company updated in sur-surrebuttal testimony the amount of debt that it claims it will issue in 2007. Staff has convincingly demonstrated that PGE's cost of debt was increasing after the Enron collapse and subsequent bankruptcy and that PGE executives acknowledged that this was due to Enron. Staff/1200, Conway/11. PGE's chief financial officer stated to the Commission at a special public meeting in December 2001 that "clearly, as the market is trying to sort out what is going on with Enron that has had some affect on our credit rating as well as our cost of capital." Id. PGE's counsel confirmed at that time the Company's commitment that the Enron bankruptcy would not increase PGE's overall cost of capital. Id. ("We have made a commitment to the Commission that no issuances under this would affect the [sic], would increase the overall capital that we have." Statement of Jay Dudley, Counsel for PGE). ICNU agrees with Staff regarding the impact of Enron ownership on PGE's cost of debt and urges the Commission to adopt Staff's adjustment to protect customers from those costs, consistent with PGE's commitments.

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V. CONCLUSION

For the reasons stated above, ICNU recommends that the Commission: 1) reject PGE's proposed power cost framework; 2) adopt ICNU's proposed adjustments to PGE's NVPC forecast; 3) adopt ICNU's capital structure and ROE proposals, along with Staff's adjustment to PGE's cost of debt; and 4) investigate the extent and nature of Oregon utilities' communications with the credit rating agencies.

Dated this 17th day of November, 2006.

Respectfully submitted,

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