BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 180/UE 181/UE 184

STAFF REPLY BRIEF

December 1, 2006

I. Introduction.

Portland General Electric Company ("PGE") attempts to rely on regulatory decisions in other jurisdictions for its proposals regarding cost of equity ("COE") and an Annual Variance mechanism. Specifically, PGE's high COE estimate is predicated in large part on results from its Risk Positioning Model (the "RPM"), which relies on authorized COEs in other jurisdictions. Second, PGE supports its Annual Variance mechanism by pointing to power cost adjustment mechanisms allowed in other states. PGE's reliance on decisions from other jurisdictions is misplaced.

The Commission has previously held that although it is willing to use COEs authorized in other jurisdictions as a check on the reasonableness of a COE set in Oregon, it will not rely on such decisions as the actual foundation for a COE.[1] The Commission has explained that "the authorized ROE is just one component of setting rates and is often tied to other, unknown elements in a case[,]" and that it is reluctant to set base a COE on unknowable parameters from other cases, set in other jurisdictions and different capital conditions.[2]

The Commission's decision to limit its reliance on decisions from other jurisdictions to determine a utility's COE should apply in this case, and should also apply to its determination regarding power cost mechanisms. A power cost mechanism is also just one component of setting rates, and the Commission should not assume that mechanisms allowed in other jurisdictions, in unknown market conditions and unknown circumstances, are probative of the type of mechanism that should be allowed in Oregon.

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[1] OPUC Order No. 01-777 at 33; *citing* OPUC Order No. 99-697 at 19.

[2] Order No. 99-967 at 23.

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Furthermore, when considering the merit of PGE's annual variance and COE proposals, the Commission must consider the link between the two proposals. PGE explains that,

> [c]ost of service risk imposed on PGE requires compensation, including an ROE that recognizes this risk, and a capital structure that enables PGE to withstand the impacts of that risk. PGE's ROE recommendation in this docket is made on the assumption that the Commission adopts a power cost framework that is fair and in line with comparable companies. If the Commission instead adopts a less comprehensive power cost framework, it will need to raise PGE's authorized ROE accordingly.[3]

Staff agrees that the method of PGE's power cost recovery is linked to its COE, and in fact, this link undermines both PGE's COE and Annual Variance proposals. As noted by the Citizens' Utility Board ("CUB") in its opening brief, a power cost adjustment mechanism "that shifts to customers the risk of normal power cost variations profoundly changes the established risk and reward balance in Oregon regulation."[4] PGE's Annual Variance mechanism does in fact shift risk of normal power cost variations to customers (what PGE refers to as "cost-of-service" risk). Although PGE proposes to radically lessen its power cost risk by shifting it to customers, PGE's COE analysis does not recognize this potential reduction in risk.

PGE's failure to in fact recognize the relationship between its Annual Variance proposal and its COE estimate undermines both proposals. Most importantly, PGE's failure recognize in its COE analysis the reduced power cost risk it would face under its Annual Variance mechanism strips its COE estimate of credibility.

In the following argument, staff addresses PGE's reliance on decisions from other jurisdictions, and replies to some of the arguments PGE makes in support of its

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[3] Opening Brief of PGE at 2-3.

[4] CUB Opening Brief at 7-8.

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COE and Annual Variance proposals, as well as arguments PGE makes regarding its cost of debt, capital structure and forecast of net variable power costs ("NVPC"). In addition, staff replies to arguments raised by the City of Portland.

II. Argument.

a. Cost of capital.

1. Capital structure.

Both staff and the Industrial Customers of Northwest Utilities ("ICNU") recommend that the Commission use a capital structure to determine PGE's overall rate of return that differs from the capital structure proposed by PGE. PGE asks the Commission to set PGE's RoR assuming PGE's capital structure is 53 percent equity and 47 percent debt. PGE asserts that it anticipates that this will be its capital structure during the 2007, which is the test year in this case. Staff and ICNU recommend that the Commission assume that PGE's capital structure includes a 50 percent equity ratio.

The primary underpinning of staff's recommendation regarding capital structure is the Commission's order in PGE's last general rate case, Docket No. UE 115. In that case, as in this one, the parties estimated PGE's COE using sample groups of proxy companies. In Docket No. UE 115, the Commission made a downward adjustment to the COE it derived from estimates based on proxy companies to recognize the fact that PGE's equity level was higher than that of the proxy companies. The Commission explained the adjustment as follows:

> It is well understood by finance practitioners and theoreticians that the cost of equity drops as the percentage of common equity in the capital structure increases. Because the average amount of common equity in the capital structure of the comparable group of electric companies was 45.14 percent compared to 52.16 percent for PGE, it necessarily follows that PGE has a lower cost of equity. PGE's capital structure is therefore

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> less risky, and its cost of common equity should be adjusted accordingly.[5]

Rather than adjusting PGE's COE estimate downward to recognize the difference in the capital structure of PGE and the comparable companies, staff recommends that the Commission determine PGE's RoR assuming a capital structure comparable to those of the proxy companies. The result obtained by this recommendation would theoretically be the same as the result obtained by a downward adjustment to PGE's COE. In the alternative, however, the Commission could adjust PGE's COE downward.

Staff's recommendation to recognize the difference between the equity level of the proxy companies and PGE by imputing a 50/50 capital structure instead of adjusting PGE's COE, as the Commission did in Docket No. UE 115, is driven by three factors. First, staff's proposed capital structure mirrors PGE's target capital structure for 2007-09. Although PGE testifies in this case that it anticipates a 53 percent equity ratio in 2007, this testimony is not supported by statements PGE has made to the financial community and its internal financial plans.

A hand-out accompanying a presentation made by PGE executives at the Edison Electric Institute Financial Conference on November 7, 2006, reflects that PGE's target debt ratio is 50 percent for 2007.[6] PGE made a similar representation at the Edison Electric Institute Financial Conference in May 2006, but at that time anticipated a 51 percent debt ratio in 2007.[7] Furthermore, PGE's responses to staff data requests show that PGE plans to manage its capital structure to achieve a 50%

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[5] Order No. 01-777 at 36.

[6] Staff Exhibit 1925 at 30.

[7] Staff/1003, Morgan/439.

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common equity ratio over the period 2007-2010. PGE's internal planning reflects the same assumptions.[8]

In other words, PGE's near-term capital structure may include 53 percent equity, but PGE intends to reduce this ratio as soon as 2007. Accordingly, it makes no sense to use PGE's current capital structure, which is equity rich, to determine PGE's rates going forward. Instead, it is appropriate to use the capital structure that PGE anticipates for the period that rates will be in effect for the purpose of setting PGE's rates. Adopting a 50 percent equity assumption helps ensure rates are most representative of costs over the time that rates are in effect.

The second factor underlying staff's recommendation to recognize the difference between PGE's equity ratio and those of the proxy companies by adjusting PGE's capital structure, rather than its COE, is that PGE's current level of equity is attributable to Enron.

Both staff's conclusions that PGE's capital structure is equity rich because of its relationship to Enron, and its conclusion regarding PGE's target capital structure for 2007-09, is supported by joint testimony submitted by CUB and ICNU. These parties assert that the Commission should adopt a capital structure that differs from that proposed by PGE because PGE's "equity-rich capital structure" reflects the lingering effects of Enron ownership and unnecessarily increases PGE's proposed revenue requirement[,]" and conflicts with the assumptions about a 2007 capital structure in PGE's internal planning.[9]

The third factor underlying staff's recommendation to adjust PGE's capital structure, rather than its COE, to account for the difference between PGE's capital

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[8] Staff/1400, Morgan/6 and Staff/1403, Morgan/26.

[9] Opening Brief of ICNU at 35.

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structure and those of the proxy companies on which PGE's COE estimate is based, is that adjusting the capital structure eliminates some of the subjectivity of the adjustment. In Docket No. UE 115, the Commission found a range of possible adjustments to the COE from nearly four to 14 basis points for each percentage difference in the capital structure. There is less subjectivity in determining the capital structure that best represents the capital structures of the proxy companies used to obtain PGE's COE.

PGE asserts that staff's adjustment to capital structure ignores the impact on revenue requirement associated with allowing an equity return based on a 50% equity ratio if PGE's actual equity ratio is 53%. PGE notes that "[f]ollowing Staff's 'recommendation' would provide PGE with an equity return for only the first 50% of its actual capital structure, and any equity over and above 50% would be allowed the *lower* return associated with debt."[10] PGE's description of the impact of staff's recommendation is accurate, and is what staff intends. Staff's COE estimate is too high for the capital structure proposed by PGE. Staff's COE estimate is appropriate for a company with an equity ratio like the average equity ratio of the proxy companies used by staff to obtain its COE estimate for PGE, which is 50 percent equity. The remedy is to either lower PGE's COE or adjust the capital structure.

The same is true for the COE estimates presented by ICNU-CUB and PGE. ICNU-CUB makes clear that their COE estimate is based on a 50 percent equity ratio. While PGE's COE estimate assumes a 53 percent equity ratio, the proxy companies it used to create its estimates had equity ratios between 45 to 52 percent.[11] In other words, assuming *arguendo* that the Commission decides ICNU-CUB's 9.9 percent or

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[10] Opening Brief of PGE at 16.

[11] ICNU-CUB/300, Gorman/12.

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PGE's 10.75 percent COE estimate is appropriate, based on the analysis presented in this docket, neither estimate is appropriate for a company with a 53 percent equity ratio.

Finally, PGE's reliance on the Maine Supreme Court's opinion in *New England Telephone Company v. Public Utilities Commission,*[12] for the proposition that an adjustment to PGE's capital structure is only appropriate upon a showing that PGE's proposed capital structure is "clearly unreasonable," and for the proposition that staff's proposed adjustment is coercive, is misplaced.[13]

A significant number of jurisdictions have accepted the concept of an imputed capital structure for rate making.[14] Not all specify that such an imputation is appropriate only if the utility's actual capital structure is "clearly unreasonable" and inefficient. For example, the New Mexico Supreme Court explains a regulatory agency's decision to impute a capital structure as follows:

> While the actual debt ratio carried by the utility is a matter for the utility's management, a capital structure which results in higher than necessary rates is properly treated by the Commission as economically inefficient. In rate making, the Commission may set rates based on an optimum, or at least an average, capital structure. Otherwise, the utility's choice of capital structure would always dictate rates, which would exaggerate the interests of investors over those of consumers.[15]

Even assuming *arguendo* that the Maine Supreme Court's opinion is instructive in this case, the testimony of CUB-ICNU and staff showed precisely what

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[12] 390 A.2d 8, 39 (Me. 1978).

[13] Opening Brief of PGE at 17.

[14] *See In the Matter of Petition by Zia Natural Gas Company v. New Mexico Public Utility Commission*, 128 NM 728, 998 P2d 564 (2000)(Court citing decisions by Idaho Supreme Court and D.C. Circuit Court in which these two courts cited several cases in which regulatory agencies had imputed a capital structure)(citations omitted).

[15] *Id.*, at 732(citations omitted).

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is required under that opinion, that PGE's proposed capital structure is unreasonable because it contains excessive equity due to its relationship with Enron and also, is inconsistent with PGE's target capital structure for the period that rates will be in effect.

Furthermore, an examination of an opinion from a court other than the Supreme Court of Maine supports staff's position that an adjustment to capital structure is not intended to be punitive or coercive:

> The Commission has not suggested that [the utility] adjust its actual capital structure to conform to the imputed structure. * * * Because the Commission is not insisting on any change to [the utility's] management, [the utility's] argument confuses actual structure with use of a hypothetical structure in establishing a reasonable rate of return.[16]

2. Cost of equity.

A. The analysis on which PGE relies for its high COE estimate is not persuasive.

PGE argues that the issue presented by the parties' COE testimony is whether the Commission should consider all available information in determining PGE's COE, or whether the determination should be based solely on the results of the discounted cash flow ("DCF") method.[17] PGE's argument is misleading because it suggests that there is a wealth of reliable or probative analysis and information, other than the parties' DCF analyses, on which to base a COE estimate. This is not the case.

More specifically, PGE asserts that the Commission should rely on the following sources to estimate and confirm the reasonableness of PGE's COE: risk positioning and risk premium models offered by PGE and ICNU-CUB; earned and

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[16] *Id.,* at 733.

[17] Opening Brief of PGE at 18.

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authorized ROEs from other jurisdictions; other models, such as the capital asset pricing model ("CAPM"); and "other information," which is an order by the Colorado Public Utility Commission ("CPUC") affirming a stipulation authorizing a 10.5 COE for a Colorado utility.[18] These sources are either unreliable, not probative, or do not support PGE's high COE estimate.

i. Authorized COEs in other jurisdictions.

Neither the authorized COEs in other jurisdictions, taken alone, nor the order of the CPUC are probative of the appropriate COE for PGE. As staff points out in its testimony, focusing only on COEs authorized in other jurisdictions, without considering the capital structure of the companies, is misleading. Accordingly, an examination of COEs authorized in other jurisdictions, in and of itself, is not necessarily probative of the appropriate COE for PGE in Oregon.[19]

Although PGE provides several details underlying the CPUC's determination of COE in the CPUC order, including the capital structure authorized for the utility, the CPUC is not probative of the appropriate COE for PGE. As the Commission noted in Order No. 01-777, "[c]apital market conditions, not regulatory decisions, determine a utility's cost of equity."[20] A regulatory decision regarding one utility in one state is simply not indicative of the appropriate COE for a different utility in Oregon.

ii. Capital Asset Pricing Mechanism

ICNU and CUB's expert witness performed an analysis using the capital asset pricing mechanism ("CAPM"), which produced a COE point estimate of 10.4 percent.

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[18] Opening Brief of PGE at 25-30.

[19] Staff/1400, Morgan/13-15.

[20] Order No. 01-777 at 34.

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ICNU-CUB's range of COE estimates is 9.5 to 10.4 percent. ICNU-CUB's CAPM estimate, which provides the upper bound of its COE range, is below PGE's 10.75 estimate. ICNU-CUB's CAPM analysis does not support the conclusion that PGE's COE estimate is reasonable.

iii. Risk Positioning Method and Risk Premium Method

Staff explained in its testimony and opening brief why the Commission should not rely on PGE's risk positioning method ("RPM") and will not repeat those arguments here. Staff has not yet addressed the risk premium method advanced by ICNU-CUB. Staff notes that it is a methodology that has not previously been used by this Commission. As such, it is not clear that it is appropriate to use this method as a basis to estimate COE or as a tool by which to measure the reasonableness of a COE estimate.[21] In any event, ICNU-CUB's risk premium model also produced a point estimate of 10.4 percent. This estimate does not support the conclusion that PGE's 10.75 estimate is reasonable.

B. DCF analysis performed by staff, ICNU-CUB, and PGE supports staff's COE estimate.

PGE, CUB, ICNU and staff all presented DCF analyses. When PGE's DCF analysis predicated on an unrealistic estimate of terminal growth (based on historic gross domestic product (GDP)) growth is discarded, the ranges produced by all the DCF analyses are similar.[22]

[21] *See* Order No. 01-777 at App. A; Guidelines for Cost of Equity Witnesses ("When advocating a new approach * * * a witness should explain why the Commission should adopt the proposed methodology in the present docket.").

[22] In its opening brief, staff reported incorrect numbers for PGE's range of results for its *(br + vs)* and historic GDP DCF analysis.

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Model	Range of Results
Staff	
Single-stage DCF	8.56 percent to 9.4 percent
2-stage 150-year DCF	8.5 percent to 9.4 percent
3-stage 40-year DCF	8.8 percent to 9.8 percent
PGE	
Multi-stage (Trend (GDP Forecast))	8.36 percent to 8.99 percent
Multi-stage DCF (*br + vs)*	8.2 percent to 10.1 percent
Multi-stage DCF (historic GDP)	*8.3 percent to 11.3 percent - Discard*
ICNU-CUB	
Constant Growth DCF	9.4 point estimate

As discussed in testimony and briefs presented by staff and ICNU-CUB, PGE's DCF analysis based on historic Gross Domestic Product ("GDP") growth estimates should be discarded because the growth estimates are unrealistic. For example, the cost of capital witnesses for staff and ICNU-CUB testified that the long-term growth assumptions for the proxy companies assumed in PGE's historic GDP DCF analysis is higher than the projected growth rate of the economy. Both the cost of capital witness for staff and for ICNU-CUB concluded that this level of growth is extremely unlikely, if not impossible.[23]

The remaining DCF analyses all include long-term growth estimates between 4 and 5 percent. These long-term estimates, while uniform, were derived by a variety of methods. Further, 4 to 5 percent is in fact PGE's target growth rate.[24] The range

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[23] ICNU-CUB/300, Gorman/19.

[24] *See* Staff Exhibit 1925 at 29 and 31.

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of COE estimates produced by the parties' DCF analysis using growth rate estimates between 4 and 5 percent is 8.2 percent to 10.1 percent. This range supports staff's COE recommendation of 9.4 percent.

B. PGE's criticisms of staff's COE analysis are without merit.

PGE offers several criticisms of staff's DCF analysis in its testimony, and reiterates them in its opening brief. They include the following:

- Staff's sample selection process was flawed because staff's sample group of companies (1) has a less risky profile than PGE (3.9 for the sample group versus 5.0 for PGE); (2) has an average bond rating that is higher than PGE's ("A" versus PGE's "BBB+"); (3) has much less reliance on purchased power than PGE (35% versus 49%); (4) failed to take into account the impact of a utility cutting its dividend; and (5) includes several utilities that are "poles and wires" only companies and not subject to purchase power and generation risk.[25]

- Following its DCF analysis of the sample group of companies, staff made no adjustment to the sample group DCF to reflect PGE-specific risks, such as the risks associated with heavy dependence on purchased power, the absence of a power cost recovery mechanism, the perceived negative regulatory environment as a result of the enactment of SB 408, and PGE's lack of jurisdictional diversity.

- Staff's DCF inappropriately relies on a one-day spot price to calculate the dividend yield component.

- The recommended 9.4% COE is only 220 basis points higher than a consensus of analysts' forecasts of investment grade ("Baa") bond rates for the second quarter of 2007, which, when compared to past data, is a very low premium above investment grade bond rates.

- Staff's DCF analysis contains calculation errors because staff (1) omits a portion of sustainable growth and (2) fails to include estimates of historic growth;

[25] Opening Brief of PGE at 22.

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- Staff's analysis involves the mismatch of capital structure considered by investors when they buy stocks and the capital structure used in an original cost jurisdiction like Oregon.

i. PGE did not establish staff's sample selection process was flawed.

Comparisons between staff's DCF results, and results obtained by DCF analysis performed by PGE and ICNU-CUB undermine PGE's argument that staff's sample selection process was flawed. As already discussed, when PGE's DCF analysis relying on an unreasonably high estimate of terminal growth is omitted, the results obtained by the remaining DCF analyses (three by staff, two by PGE and one by ICNU-CUB) are very similar. The fact that all these parties obtained similar results using different groups of proxy companies, but applying DCF analysis relying on similar estimates of long-term growth, belies PGE's assertion that staff's sample selection process was flawed. Notably, PGE asserts that the ICNU-CUB sample selection process was "well-defined and correctly applied[.]" CUB-ICNU obtained a point-estimate of 9.4 from their DCF analysis, which is the COE recommended by staff.

In any event, PGE does not support its critique of staff's sample selection process with persuasive testimony. PGE argues that staff's selection process was flawed in several particulars, but does not specify which companies in staff's sample were improperly selected or demonstrate how the selection of these companies impacted staff's analysis. For example, PGE argues that some of the companies in staff's sample are only distribution and transmission companies, have a lower bond rating than PGE, or are companies that rely less on purchased power than PGE. PGE does not identify these companies, does not show that these factors impacted the COE of these companies, and does not show how inclusion of the companies impacted staff's analysis. Without such evidence, PGE's argument that staff used a flawed sample selection process has little relevance.

ii. Staff properly relied on a one-day spot price to calculate the dividend yield component for its DCF analysis.

The Commission prefers the use of a one-day spot price to calculate the dividend yield for the DCF analysis, rather than an average stock price, explaining in a 1994 case that,

> [c]onceptually, the stock price to use is the current price of the security at the time of estimating the cost of equity. In an efficient market, the current stock price provides the best information of future prices. An efficient market implies that prices adjust instantaneously to the arrival of new information. Therefore, current prices reflect the fundamental economic value of the security.[26]

The Commission has noted that it will use an average stock price, rather than a one-day stock price, to calculate the dividend yield if there is a showing of wide fluctuations in the utility's stock.[27] PGE did not make such a showing in this docket. Instead, PGE asserts that "it takes a huge leap of faith to actually believe markets are as extremely efficient as one has to believe when using spot prices."[28] Without the showing of price aberrations required by the Commission in previous dockets, the Commission should reject PGE's criticism that staff used a one-day spot price.

iii. Staff did not err by not adjusting its COE estimate for PGE risk.

PGE's argument is inconsistent with the use of proxy companies to determine COE. Each company in staff's proxy group has unique risks. PGE's argument implicitly assumed that PGE is more risky than all the companies in staff's sample group of proxy companies. No evidence supports this assumption.

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[26] Order No. 94-336. *See also* Order Nos. 99-697 at 14; 97-171 and 94-336.

[27] Order No. 99-697 at 15 (Commission noting that it has used short-term average stock price in previous case when wide fluctuation in utility's stock price, but declining to do so in present case because no evidence of price aberrations to warrant consideration of an averaged stock price for the DCF model).

[28] PGE/2100, Zepp/26.

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Furthermore, the Commission has not previously made ad hoc adjustments to COE estimates obtained from proxy companies. The factors PGE cites as PGE-specific risks are not new, with the exception of Senate Bill ("SB") 408. The Commission has not previously adjusted PGE's COE to acknowledge these factors. Under the Commission's Guidelines for Cost of Equity Witnesses, it is incumbent on PGE to explain why the Commission should adopt this new methodology in this case. It did not do so.

Furthermore, to the extent PGE relies on "the perceived negative regulatory environment as a result of the enactment of SB 408" as a PGE-specific risk, the reliance is misplaced. As discussed extensively in the opening briefs filed by ICNU and staff, the evidence PGE submits in support of its assertion that Oregon is a negative regulatory environment, a September 2006 S&P report, is unreliable.

Furthermore, it is not clear that an adjustment to PGE's COE to take into account the impact of SB 408 is appropriate. Meaning, it would not be appropriate for the Commission to replace the dollars that PGE sends to ratepayers as a result of SB 408 with an increased return on PGE's equity because such an adjustment would defeat the purpose of the legislation.

iv. Staff's DCF analysis does not contain calculation errors.

As discussed in staff's opening brief, PGE attempts to discredit staff's DCF analysis by re-creating it, but altering some of the assumptions. Specifically, PGE's expert witness, Dr. Zepp, calculates PGE's COE using staff's three-stage DCF model, but includes a higher terminal ROE, adjusts for the "v x s" factor, and applies initial growth rates based on a calculation of historic growth he believes should be applied on a going-forward basis

Staff's cost of capital witness addressed Dr. Zepp's revisions to staff's DCF analysis in surrebuttal testimony:

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> The ROE that I assumed in the sensitivity analysis and which generates the terminal growth rate already implicitly includes the impact of the "v x s" factor. The "v x s" formula considers the impact of earnings from issuing new equity shares at a price that is greater than book value. This factor has the impact of increasing earnings per share. The factor is a simple calculation: it subtracts 1 from the market-to-book ratio and is then multiplied by the average percentage of common equity sold each year to arrive at the percentage increment to book value. This percentage increment to book value is then multiplied by the average book value to arrive at the increment to book value in dollars. Although Dr. Zepp calls the exclusion an "obvious flaw", (See PGE/2100, Zepp/18, line 12), the omission was intentional. The "terminal ROE" already includes the return from all sources. Because Dr. Zepp "double-counts" the impact of selling shares, he generates a higher growth rate factor in the model.[29]

Dr. Zepp's inclusion of the "v x s" factor is unsupported theoretically, and practically. If Dr. Zepp's criticism is correct, the Commission must conclude that Value Line estimates of growth (relied on by Mr. Morgan) exclude growth from sale of stock (i.e, the "v x s" term). PGE did not present evidence to support the conclusion that Value Line underestimates growth by excluding growth generated by the sale of stock above book value.

Staff acknowledges that it has included the "v x s" factor when estimating COE in previous dockets. For example, staff's cost of capital witness utilized the factor in a 1997 rate case involving a telephone company. However, in that case, the witness specifically noted that he added the "v x s" factor because the market to book ratio was well above 1.0.[30] The same is not true in this case.[31]

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[29] Staff/1400, Morgan/38-39.

[30] OPUC Order No. 94

[31] Staff used a consultant in Docket Nos. UE 115 and UE 116 and he also used the "v x s" factor to calculate sustainable growth. His methodology is not necessarily representative of staff's methodology.

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In any event, Dr. Zepp's "v x s" adjustment is also unsupported as a practical matter. As Mr. Morgan notes in his testimony, Dr. Zepp's "v x s" adjustment to staff's analysis results in a terminal ROE of 12.97 percent, which is outside the bounds of reasonableness.[32]

Finally, even if the Commission concluded that staff erred by not including the "v x s" factor in its analysis, PGE's assertion regarding the impact of this omission is incorrect. PGE contends that by omitting this factor, staff has omitted almost 50 basis points of growth from all of its estimates of sustainable growth.[33] However, this calculation includes the growth of two companies excluded from staff's sample group in staff's surrebuttal testimony. When this mistake in PGE's calculation is corrected, the resulting impact is a twenty basis point increase to staff's estimate of sustainable growth.

Mr. Morgan's surrebuttal testimony also rebuts PGE's other criticism that he did not include historic growth in his analysis:

> At Staff/100, Morgan/13, I provide three paragraphs pertaining to "historic" growth rates. I indicated that historic growth could provide "guidance" regarding future growth. I also indicated that past dividend growth, if stable, could be assumed to continue, all else being equal. The last ten years' of growth for my sample of companies did not approach the rate [Dr. Zepp] assumes, but averages less than three percent.
>
> When I analyzed historic growth rates, my growth rate recommendation was based on growth rates that are supportable into perpetuity. The historic data I referenced served as a check of reasonableness for my future projections.[34]

[32] Staff/1400, Morgan/39.

[33] Opening Brief of PGE at 24.

[34] Staff/1400, Morgan/40-41.

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In other words, contrary to PGE's assertion, it is inappropriate to assume that historic growth rates are an accurate indicator of future growth. Instead, it is more prudent to rely on reasonable estimates of forward-looking growth.

v. PGE's argument regarding a mismatch of capital structure is without merit.

PGE's argument regarding a mismatch of capital structure is unpersuasive for several reasons. First, although PGE argues that staff's COE estimate should be adjusted upward by 75 basis points to reflect the difference in market leverage and leverage used to set rates, PGE's own COE estimate does not include such an adjustment. It does not make sense that it is necessary to correct this "mismatch" in staff's COE estimate, but not in PGE's estimate.[35]

Second, PGE's argument is predicated on an assumption that investors do not understand the distinction between the market and book value of equity. No evidence supports this assumption.

Third, when the market value of equity is greater than the book value of equity, market leverage implies less risk for the company. In other words, as the value of equity rises, the overall capital structure of the company becomes richer. This results in reduced risk to shareholders and a corresponding decrease in the required return. The DCF model recognizes this influence. The adjustment suggested by PGE would reduce the impact of the market mechanism.

Finally, the adjustment described by PGE to correct the "mismatch" is a departure from any methodology previously used by the Commission.

[35] *See* PGE/2100, Zepp/28 (Witness noting that he did not adjust PGE's DCF equity cost estimates to address capital structure mismatch and discussed mismatch only to explain "why we should not be surprised if DCF models produce cost of equity estimates that are lower than equity costs indicated by other models.").

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vi. PGE's argument that staff's COE estimate is 210 basis points above a "baa" rating is factually incorrect.

PGE's argument that staff's COE estimate is 220 basis points above "a consensus of analysts' forecasts of investment grade (Baa) bond rates" fails to take into account staff's updated COE estimate of 9.4. In fact, staff's COE estimate exceeds the investment grade bond rates by 300 basis points.[36]

In sum, PGE failed to establish staff's DCF methodology was flawed or that the results obtained from its analysis are unreasonable. The results obtained from staff's DCF analysis are similar to those obtained from DCF analysis conducted by PGE and ICNU-CUB, excluding PGE's analysis relying on unrealistic growth estimates. These results support staff's 9.4 COE estimate. The analyses and information PGE relies on for its 10.75 COE estimate are either unreliable, not probative, or do not support PGE's high COE estimate.

3. Cost of debt.

As discussed in staff's opening brief, PGE modified its cost of debt estimate in its sursurrebuttal testimony. PGE did so because it decided to issue additional debt in 2007. Rather than asking for the opportunity to submit additional testimony to address how PGE's issuance of additional debt in 2007 impacts staff's cost of debt estimate, staff simply provided an updated cost of debt estimate in its opening brief. Staff obtained its updated estimate by applying the same adjustment to the newly anticipated debt issuances that staff applied to the debt issuances anticipated by PGE in its supplemental direct testimony.

Staff does not believe that its re-calculation of its cost of debt estimate constitutes new evidence. However, in the event the administrative law judge concludes that staff's characterization of its recalculated cost of debt estimate is

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[36] Staff/1400, Morgan/46.

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incorrect, staff asks that the administrative law judge admit staff's calculation into the record. In the alternative, if the Commission agrees with the rationale underlying staff's adjustments to the debt issuances that are described PGE's supplemental direct testimony, staff recommends that the Commission direct PGE to modify its cost of debt at the time of its compliance filing in this docket so that debt issuances described for the first time in PGE's sursurrebuttal testimony also reflect these adjustments.

A. Staff's adjustments to PGE's cost of debt to remove Enron-effects are supported by the record.

PGE's arguments opposing staff's Enron-related adjustment to PGE's cost of debt are not persuasive. First, PGE fails to address the evidence in the record establishing that PGE's relationship with Enron negatively affected PGE's access to financial markets in 2001, 2002, and 2003. Second, PGE's arguments are internally inconsistent. PGE argues that staff's "entire approach" is to assume that any decline in PGE's credit rating during the period beginning in late 2001 and continuing to 2002 was due "solely" to PGE's relationship with Enron.[37] PGE argues this is not appropriate because "almost all other electric utilities operating in the Western power markets were downgraded at about the same time as the PGE downgrading cited by Staff."[38] Nonetheless, PGE also takes issue with staff's use of another Oregon utility's projected spreads for January 2003 as a proxy for its adjustment to an October 28, 2002 debt issuance. By using this company as a proxy, staff attempted to isolate the Enron impact felt by PGE from other negative impacts stemming from the Power Crisis.

[37] Opening Brief of PGE at 8.

[38] Opening Brief of PGE at 9.

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In any event, the evidence supports staff's conclusion that PGE's high debt costs for the six 2002 and 2003 debt issuances adjusted by staff were due to PGE's relationship with Enron. In an order issued on July 26, 2002, the Commission authorized PGE to issue and sell up to $300 million of First Mortgage Bonds ("FMBs"). The order notes that the Commission previously authorized PGE to issue up to $250 million FMBs (on April 24, 2002), that PGE had been unable to issue under the previous order, and that the current order was intended to allow more flexible terms.[39] The order also specifies that the high interest rates authorized under the order were due to PGE's relationship with Enron:

> The interest rate spreads appear to be somewhat high, though given the financial pressures that the Company has faced since the Enron bankruptcy filing, such would be anticipated and are in line with recent Commission financing decisions.[40]

Review of subsequent Commission orders reflects that PGE continued to be hindered by Enron-related financial pressure through 2003.[41] An order issued on **May 17, 2003**, authorizing PGE to secure its 364-day Revolving Line of Credit with up to $200 million of FMBs, notes that PGE needed the security due to Enron-related financial pressure:

> PGE represents that the requirement for the FMBs as a security for the Revolver is due in large part to the economic pressures that fact the Company resulting from Enron's bankruptcy filing. It is not clear when the pressures will be reduced and when the Company can cost-effectively remove the underlying security offered by the FMBs from the [Line of Credit]."[42]

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[39] Staff/1201, Conway/39, Order No. 02-477 at App A, p 4l, and Staff/1201, Conway/30-34, Order No. 02-292.

[40] Staff/1201, Conway/40, Order No. 02-477 at App A, p 4.

[41] *See* Staff/1200, Conway/9-13.

[42] Staff/1200, Conway/13 *quoting* Order No. 03-317; *See also* Staff/1201, Conway/43-47, Order No. 03-317.

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(503) 378-6322

In sum, these and other Commission orders discussed in staff testimony reflect that PGE repeatedly told the Commission in 2002 and 2003 that its inability to access the capital markets during that time period was due to its relationship with Enron.[43] In light of this evidence, it was incumbent on PGE to produce evidence showing that staff's adjustments removing costs stemming from that effect were inappropriate. PGE did not do so.

While PGE points out that the Western Power Crisis and lower-than-average hydro production occurred during the period at issue, it did not attempt to quantify the effect of these events on its debt costs.[44] Instead, PGE essentially asks the Commission to ignore the evidence that PGE's access to markets was negatively impacted by Enron and assume any high debt costs incurred from 2001 to 2003 were due to the other factors noted by PGE. PGE's request is inappropriate in light of the evidence discussed above.

In any event, staff's adjustments to five of the issuances do take into account financial pressures from other sources. For two of the three issuances authorized by Commission Order No. 02-477, staff re-priced the bonds assuming an interest rate based on projected spreads for NW Natural in January 2003 and PGE's fees for a ten-year issuance in 2003. Staff's adjustments predicated on interest rates available to PGE, and another Oregon utility, in 2003, necessarily take financial pressures other than Enron into account.

Similarly, staff's adjustments to the three debt series issued on August 10, 2003, use PacifiCorp as a proxy. PacifiCorp was downgraded in 2001, in part due to

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[43] Staff/1200, Conway/9-13 (discussing OPUC Order Nos. 01-911, 01-1048, 02-292, 02-384, 02-444, 02-477, and 03-317).

[44] *See* Opening Brief of PGE at 10.

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(503) 378-6322

the Western Energy Crisis, but was not downgraded to the extent that PGE was. PacifiCorp issued ten-year debt in September 2003 at a lower interest rate than PGE issued its debt in August 2003. Staff predicated its adjustments to PGE's debt costs for the three August 10, 2003, debt series on the assumption that the difference in the costs of PGE's August 10, 2003, debt and those of PacifiCorp, was due to PGE's relationship with Enron.[45]

Notwithstanding that staff used a proxy company to recognize the impact of non-Enron-related market pressures on PGE's cost of debt, PGE criticizes staff's use of a proxy company. PGE argues that PacifiCorp is too dissimilar to PGE to be of value. PGE also argues that using PacifiCorp's September 2003 debt costs to measure the influence of Enron on PGE's August 2003 debt is inappropriate because interest rates declined by 18 points between PGE's issuance and PacifiCorp's.[46]

PGE makes a similar argument regarding staff's use of NW Natural's projected spreads for January 2003 to estimate Enron's impact on debt PGE issued in October 2002. PGE argues that spreads for "A" rated utilities (like NW Natural) and "BBB" rated utilities (like PGE) narrowed considerably between October 2002 and January 2003.[47]

PGE's criticisms of staff's adjustments are notable because in one instance, PGE uses a decline in Treasury rates as the basis for the criticism and the in the other, changes in spreads. In fact, an examination of either of these factors, in isolation, does not inform the Commission of how the time lapse between PGE's issuances and the NW Natural spread or the PacifiCorp issuance impacted staff's adjustments. For

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[45] Staff/1200, Conway/18.

[46] Opening Brief of PGE at 11.

[47] Opening Brief of PGE at 11.

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(503) 378-6322

example, if spreads increased as interest rates dropped between August 2003 and September 2003 (between PGE's issuance and PacifiCorp's issuance), PGE's argument is of little merit.

PGE's additional argument that the ring-fencing provision protected it from Enron-related impacts has been addressed in staff's opening brief. PGE's related argument, that only its access to short-term debt was impacted by its relationship with Enron, and that any impact was not felt as late as October 2002, makes little sense. To accept PGE's argument, one has to assume that while a debt investor may have been hesitant to make short-term investments in PGE because of the pending Enron bankruptcy, the investor would not have had similar hesitations with respect to long-term investments. This assumption is difficult to accept.

In any event, the evidence refutes PGE's claim that only its access to short-term markets was negatively affected by PGE's relationship to Enron. The record reflects that on April 24, 2002, the Commission authorized PGE to issue up to $250 million in FMBs.[48] The Commission's authorization was for longer-term debt.[49] The record also reflects that PGE was not able to issue debt under the Commission's April 24, 2002 order, and obtained another order in August 2002, allowing it to issue $300 million of FMBs under more "flexible terms," specifically, higher interest rate spreads.[50] The Commission noted that these higher spreads "would be anticipated" given financial pressures "the Company has faced since the Enron bankruptcy filing."[51] The Commission noted in the August 2002 order, however, that PGE's

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[48] Staff/1201, Conway/18-23, OPUC Order No. 02-292.

[49] *Id.*

[50] Staff/1201, Conway/35-41, OPUC Order No. 02-477.

[51] Staff/1201, Conway/40.

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Salem, OR 97301-4096
(503) 378-6322

authority under the April 2002 order remained intact, in the event PGE could issue debt under the terms of that order

PGE ultimately did issue FMBs in October 2002, under the terms allowed in the August 2002 order. Put another way, PGE was not able to issue long-term debt under the terms authorized in the April 2002 order, but instead, had to rely on the more flexible terms authorized in the August order. The fact PGE issued the October 2002 debt under the August 2002 order, rather than the April 2002 order, belies PGE's argument that its relationship with Enron did not affect debt issued after October 2002.

B. Staff properly removed losses on PGE's reacquired debt.

As discussed in testimony, staff removed losses on debt securities that PGE redeemed early, because the debt securities are no longer outstanding and PGE has identified no replacement debt for the securities or shown how customers benefited from the early redemption.[52] Staff relied on the Commission's decision in Docket No. UE 116 for this adjustment. In that docket, the Commission excluded unamortized expense associated with PacifiCorp's Quarterly Income Debt Securities ("QUIDs") because the securities were no longer outstanding and PacifiCorp had not replaced them with new debt, the expense was non-recurring, and PacifiCorp had not shown how early redemption of the securities benefited customers.[53]

PGE argues that the Commission's order in Docket No. UE 116 is inapposite because "customers obviously benefit from a utility taking advantage of reduced interest rates to re-acquire higher priced debt and replace it with lower-priced debt."[54]

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[52] Staff/1200, Conway/4.

[53] Staff/1200, Conway/4, *citing* Order No. 01-787 at 19.

[54] Opening Brief of PGE at 12.

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PGE's argument ignores the Commission's holding in Docket No. UE 116 that the Commission "could not 'assume' that customers benefited by PacifiCorp's actions."[55] Instead, the Commission held that PacifiCorp had the burden of persuasion to show the Commission that the expenses should be allowed. PGE has the same burden here. PGE did not carry this burden by asserting that "customers obviously benefit[ed]" from its early redemption of the securities.

C. Staff properly adjusted certain debt using contemporaneous interest rates and spreads.

PGE asserts that staff improperly adjusted PGE's cost of debt by using a ten-year maturity to price debt PGE plans to issue in 2007, rather than using "the 30-year debt that PGE *will* issue."[56] Contrary to PGE's assertion, there is no guarantee that PGE will issue debt with a 30-year maturity. If the Commission determines the cost of PGE's debt assuming that PGE will issue 30-year debt in 2007, and PGE issues debt with a shorter term, PGE will receive a windfall.

The cost of debt determined in this case is based both on assumptions regarding the maturity of the debt that PGE will issue in 2007 and the interest rate it will obtain for that debt. Neither assumption is certain. It is not reasonable to determine PGE's cost of debt assuming the highest possible interest rate, nor is it reasonable to assume PGE's cost of debt assuming the most expensive maturity.

Contrary to PGE's assertion, the Commission's order in Docket No. UE 116 does not assist PGE. In that case, staff priced debt that PacifiCorp planned to issue in 2001 using a 7-year maturity. PacifiCorp argued that it was more appropriate to use a longer-term maturity because it planned to issue debt with maturities longer than

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[55] OPUC Order No. 01-787 at 20.

[56] Opening Brief of PGE at 13 (emphasis added).

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seven years, including debt with a maturity of thirty years.[57] The Commission re-priced PacifiCorp's planned issuances assuming a ten-year maturity. Notably, the Commission did not price PacifiCorp's debt assuming that each issuance would have a specific maturity anticipated by PacifiCorp. Instead, it priced the debt that PacifiCorp planned to issue using a ten-year maturity, which the Commission thought would obtain a price reasonably representative of the debt that PacifiCorp would issue.[58]

As noted above, there is no guarantee that PGE will issue debt with a thirty-year maturity in 2007. PGE's plans regarding its 2007 debt issuances have changed since this rate case started, and may change again. Staff priced PGE's debt using reasonable and interrelated assumptions regarding the maturity of the debt PGE may issue, and the price at which PGE may issue it.

Further, PGE's arguments regarding the impact of staff's assumption are not well taken in light of the changing nature of interest rates. For example, the 10-year Treasury Rate has dropped 35 basis points since staff filed its opening testimony. This drop is greater than the spread between debt with a ten-year maturity and thirty-year maturity. The drop in the 10-year Treasury Rate in the last several months demonstrates that PGE's implicit assertion that using a ten-year Treasury Rate results in an unfair result is unfounded.

b. Power cost adjustment mechanism.

Staff, CUB and ICNU criticized PGE's Annual Variance mechanism because the mechanism did not satisfy the primary design criteria the Commission previously identified for a hydro-only power cost adjustment mechanism. The parties also

[57] OPUC Order at 01-787 at 17.

[58] OPUC Order at 01-787 at 17.

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(503) 378-6322

criticized PGE for failing to meaningfully address why the Commission should depart from the policies underlying those design criteria in this docket.

In its sursurrebuttal testimony, and again in its opening brief, PGE identified eight reasons the Commission should not adhere to its first primary design criteria for any power cost adjustment mechanism imposed in this case.[59] These reasons are addressed in staff testimony, or in brief, and for the reasons presented therein, are not persuasive. Staff briefly addresses some of these arguments again, however, to note its agreement with arguments presented by ICNU.

1. A deadband is consistent with the Commission's most recent orders regarding recovery of NVPC.

As discussed extensively by witnesses for CUB, ICNU and staff, the Commission's most recent orders regarding recovery of NVPC establish the Commission's policy of limiting a utility's recovery of excess NVPC incurred between rate cases to those costs that are at least unusual, if not extraordinary. This policy is captured in the primary design criteria for a hydro-only power cost adjustment mechanism that the Commission articulated in its order in Docket Nos. UE 165/UM 1087.

Staff's recommendation that any power cost adjustment mechanism approved by the Commission include a deadband is consistent with the Commission's policy. In fact, staff's proposal for a deadband equal to +/-150 basis points of PGE's ROE is identical to the deadband that the Commission found satisfied its first primary design criteria.

Furthermore, ICNU's examination of previous Commission orders relied on by PGE for its assertion that Commission precedent does not require a deadband reveals

[59] *See* Opening Brief of PGE at 35-37.

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that PGE's reliance on these orders in unfounded. In its opening brief, ICNU examines the Commission orders authorizing a power cost mechanism for PGE in the 1970's and into the 1980's.[60] As ICNU notes, from 1974 to 1979, the Commission authorized PGE to use temporary power cost adjustment mechanisms to address particular circumstances, *i.e.,* "staggering inflation," extreme drought, and variations in hydro variability.[61] In 1979, the Commission approved what it described as a short-term power cost adjustment mechanism for PGE. For reasons that are not clear, the mechanism remained effective until 1987.[62]

The Commission criticized the use of power cost adjustment mechanisms in 1987 when it discontinued the power cost mechanism authorized for PGE in 1979. First, the Commission noted that need for the mechanism no longer existed, noting that if PGE could not absorb unanticipated increases in power costs, it could request a rate increase. The Commission also noted that no other Oregon electric utility had a power cost adjustment mechanism and that PGE's system characteristics were not so unique as to warrant one.[63]

In sum, these orders do not support PGE's assertion that Commission precedent is for utilities to shift risk for any power cost variations to customers. Contrarily, these orders support the conclusion that it is the utility that bears the risk for normal business variability.

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[60] Opening Brief of ICNU at 13-15.

[61] Opening Brief of ICNU, *citing* OPUC Order Nos.74-657, 75-089, 77-456, 77-813, 79-830, and 80-021.

[62] Opening Brief of ICNU at 14.

[63] *See* Opening Brief of ICNU at 15, *quoting* OPUC Order No. 87-1017 at 33.

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2. PGE's reliance on orders from other Commissions is not persuasive.

For the reasons stated in the first section of the brief, PGE's reliance on power cost adjustment mechanisms authorized in other states is not probative of the type of power cost mechanism that should be allowed in this docket. This is particularly true in light of observations made by ICNU in its opening brief. ICNU observes that contrary to PGE's claim, a report by NERA Economic Consulting 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.[64]

c. Power costs.

1. Forced Outage Rate

PGE opposes staff's recommendation to abandon the use of the four-year rolling average methodology to calculate the forced outage rate for PGE's Boardman and Colstrip plants, disagreeing with staff's conclusion that this methodology is "flawed." As staff notes in its testimony, the methodology is flawed because it gives too much weight to extraordinarily long outages, like the outage PGE experienced at its Boardman plant in 2005-06.

In support of its arguments opposing staff's proposal, PGE relies on a staff memorandum prepared in 1984 that underlies staff's original recommendation to use of the four-year rolling average methodology. PGE argues that the memorandum establishes that the four-year rolling average methodology is superior to all others, quoting, for example, the following excerpt:

> The reason I propose using a 48-calendar month rolling average is that it reflects recent plant experience, which I think tends to better portray expected operation over the coming year. Four years of

[64] Opening Brief of ICNU at 23.

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experience is sufficient to average out variations and yet not include generally irrelevant experience from history long past.[65]

In fact, a close examination of this excerpt of the memorandum reveals why replacing the four-year rolling average methodology is appropriate. Staff's current analysis makes clear that four years of experience is *not* sufficient to average out variations when a plant experiences an extraordinarily long outage. In fact, the attempt to incorporate an extraordinarily long outage into the rolling average reveals the methodology will give too much weight to extraordinarily long outages.

Staff's testimony includes the following table, which demonstrates Boardman's actual availability in 2001 through 2005.[66]

BOARDMAN FORCED OUTAGE RATES 2001-2005

	Availability Factor	**Forced Outage Rate**
2001	97.11%	2.89%
2002	91.88%	8.12%
2003	95.79%	4.21%
2004	88.49%	11.51%
2005	75.89%	24.11%

The simple average of Boardman's forced outage rates in 2002-2005 is 12 percent, and gives equal weight to each of the annual forced outage rates 2002-2005. But, it is unreasonable to expect a 24.11 percent forced outage rate (2005) to occur with equal frequency as an 8.2 forced outage rate (2002). The rolling-average methodology ignores the unreasonableness of this assumption, however, and still gives the unreasonably high forced outage rate equal weight.[67] Accordingly, the four-

[65] Opening Brief of PGE at 42.

[66] Staff/100, Galbraith/6.

[67] Staff/100, Galbraith/6.

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year rolling average methodology does not, in all circumstances, accurately "portray expected operation over the coming year."

PGE argues that the appropriate fix for the problem identified by staff and other parties is to remove a portion of extraordinarily-long outages from the rolling average. Staff investigated this possibility, but ultimately recommended against it. Most importantly, it would be difficult to determine how much of an extraordinarily long outage should be removed from the calculation, and the Commission would have no confidence that the calculation using the remaining portion of the outage reflects the unit's "normal" outage rate.[68]

Determining the forced outage rates for PGE's Boardman and Colstrip plants by using industry-wide averages provides normalized estimates of the forced outage rates for these plants. Staff has already addressed PGE's other criticisms of its proposal in testimony and in its opening brief, and will not reiterate them here.

2. Extrinsic Value

PGE argues the extrinsic value adjustments proposed by ICNU and staff "cherry-pick" one aspect of the uncertainty of power costs to justify a reduction in forecast NVPC and that this is inappropriate because the evidence establishes that PGE's power cost modeling methodology understates forecast NVPC. PGE relies on a report from a consultant opining that modeling the impact of uncertainty would increase PGE's proposed NVPC by $10 million and on statements in staff testimony that increases in PGE's NVPC are more likely than decreases.[69] PGE's arguments are without merit.

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[68] Staff/100, Galbraith/8.

[69] PGE Opening Brief at 45.

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First, both staff and ICNU have refuted PGE's claims that their extrinsic value adjustments to NVPC for certain resources are "cherry-picking." Witnesses for staff and ICNU explained why they selected only certain resources for the adjustment. Further, to the extent PGE believes that other adjustments for uncertainty may offset those made by staff and ICNU, it is incumbent on PGE to identify and explain them, not simply suggest that they exist as a reason for the Commission to reject staff and ICNU's adjustments.

In any event, PGE's reliance on staff's testimony stating staff "believes that increases in NVPC are more likely than decreases in NVPC[,]" is entirely misplaced. PGE's assertion that this testimony indicates that staff believes "forecasted power costs in this rate case are more likely understated than overstated" takes staff's testimony out of context. The testimony referred to by PGE did not address the accuracy of PGE's forecast under normalized conditions. Instead, staff's testimony addressed the relevant risk to consider when evaluating PCA mechanisms.

In examples illustrating the relevant risk, staff assumed a world with two possible power cost outcomes, a $55 million increase in NVPC and a $55 million decrease in NVPC.[70] Staff demonstrated that with equal probabilities of occurrence the expected change in shareholder earnings without a PCA mechanism is zero. Staff then argued that given these assumptions, and the fact that PGE is seeking a PCA mechanism, that PGE must either believe the probability of power cost increases is greater than the probability of power cost decreases and/or is risk averse.[71] In the assumed world of two opposite power cost outcomes, a higher probability of a power cost increase, results in the utility's exposure to risk being greater than its opportunity for reward.

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[70] Staff/1500, Galbraith/5.

[71] Staff/1500, Galbraith/6.

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The point of staff's testimony was to articulate the fact that, in general, the utility's exposure to large increases in NVPC is greater that its exposure to large decreases in NVPC. Staff indicated that PGE also supports this general principle. See Staff/1500, Galbraith/8 at footnote 2.

PGE's remaining complaints with staff's extrinsic value adjustment concern staff's methodology. These complaints have been addressed in testimony and in staff's opening brief.

3. Ancillary Services.

PGE opposes staff's adjustment including revenues from the sale of ancillary services to match the costs of these services that PGE includes in its forecast NVPC. PGE argues that there is "considerable uncertainty around making a revenue projection for the test year, given the limited experience to date and the substantial variance in revenues from month to month."[72] PGE's argument is not persuasive.

First, PGE does not suggest it does not intend to continue the sales. Instead, the only uncertainty appears to be the level of revenue PGE can expect on an on-going basis. This is not reason to ignore staff's adjustment. If PGE believes the level of revenues assumed for the adjustment is inaccurate, it was incumbent on PGE to provide evidence to establish this. In absence of any evidence showing that PGE will not continue the sales, or demonstrating staff's estimate of the revenue PGE will realize from the sales is inaccurate, the Commission should accept staff's adjustment.

d. Staff recommends the Commission reject the City of Portland's proposed adjustments and recommendations.

The City of Portland ("the City") asks the Commission to "impute the beneficial tax effects of a corporate reorganization" when setting PGE's rates.[73] The

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[72] PGE Opening Brief at 47.

[73] PGE Opening Brief at 2.

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City's argument is predicated on the assumption that had PGE converted to a limited liability corporation ("LLC") prior to redistributing its stock to Enron creditors, its tax burden would have been significantly reduced for the next 20 years.[74] Because no persuasive evidence supports this assumption, the Commission should reject the City's request.

The City cites examples of public utilities converting to LLCs in support of its argument that PGE would have realized benefits that would have been passed on to customers had PGE made the conversion.[75] However, these examples are not sufficient to show that PGE's tax expense would have been lower had it made the conversion. For example, the City does not establish how other jurisdictions have treated, for ratemaking purposes, the loss of existing accumulated deferred federal income taxes, the potential change in plant-in-service and depreciation expense, and the calculation of income tax expense following an LLC conversion.

Staff asked the City to provide cases that would demonstrate that ratepayers would realize significant benefits from the LLC conversion. The City was unable to provide any.[76] In absence of persuasive evidence showing that the conversion to an LLC would have benefited PGE's customers, the Commission should reject this claim without further consideration.[77]

The City also asks the Commission to direct PGE to refund to ratepayers the payments PGE made to Enron without prior, explicit authorization by the

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[74] COP/100, Jubb/3 and 5-10.

[75] Opening Brief of the City of Portland at 7.

[76] *See* Staff/1900, (City of Portland Response to Staff Data Request No. 1).

[77] Whether the Commission should impute a different corporate structure when determining rates does not simply turn on whether a different corporate structure would have obtained certain benefits for PGE that are not realized under its actual corporate structure. Because the City cannot even make that showing, however, staff recommends that the Commission reject the City's proposal.

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Commission. The City argues that the payments were improper because they were made pursuant to agreements that should have been approved under ORS 757.495 as affiliated interest agreements, but were not.[78]

Putting aside the issue of whether the Commission has authority to order such refunds, the City's argument is without merit. The agreements on which PGE relies for this argument are not affiliated interest contracts. Accordingly, the predicate for the City's argument, that any payments made under the agreements were not authorized because the agreements were not approved under ORS 747.495, is incorrect.[79]

Thirdly, the City asks the Commission to "adjust PGE's deferred tax balances on a going-forward basis," in light of Senate Bill ("SB") 408, and also, to refund to ratepayers approximately $280 million in deferred tax credits.[80] The City argues that if the adjustment it requests is not made, ratepayers will be "double charged for the deferred income taxes (approximately $280 million) on PGE's financial statements as of January 1, 2006.[81]

The City misunderstands how income tax expense is calculated for ratemaking purposes. Ratepayers are not double charged for deferred taxes. Under tax normalization, rates reflect book depreciation, not tax depreciation, which is what the City refers to as temporary differences reversing and increasing the utility's tax liability. Thus, income tax expense in customers rates related to temporary differences is higher in the early years of an asset and lower by the same amount in

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[78] COP/100, Jubb/12.

[79] *See* OPUC Order No. 06-636.

[80] COP/100, Jubb/10-11.

[81] COP/11, Jubb/10.

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later years. Under SB 408, all deferred tax effects will be recognized, including the lower tax expense for ratemaking when the deferred tax liability reverses.[82]

IV. Conclusion.

The Commission should adopt staff's recommendations regarding PGE's cost of capital, its proposed power cost adjustment mechanisms and net variable power cost forecast.

DATED this 1st day of December 2006.

Respectfully submitted,

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Of Attorneys for Staff of the Public
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[82] *See* ORS 757.268(13)(f)(C).

1 **CERTIFICATE OF SERVICE**

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3 I certify that on December 1, 2006, I served the foregoing Staff Reply Brief upon all

4 parties of record in this proceeding by electronic mail and by mailing a copy by postage prepaid

5 first class mail or by hand delivery/shuttle mail to the parties accepting paper service.

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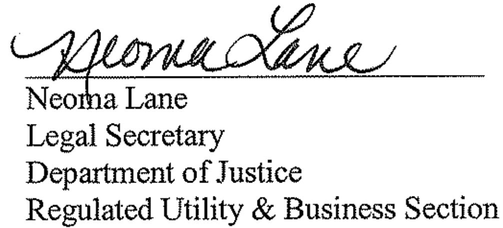

Neoma Lane
Legal Secretary
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Regulated Utility & Business Section

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