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DEPARTMENT OF JUSTICE
GENERAL COUNSEL DIVISION

July 13, 2005

Public Utility Commission of Oregon
Attn: Filing Center
550 Capitol St NE #215
PO Box 2148
Salem OR 97308-2148

Re: UE 170

Dear Filing Center;

Enclosed for filing is an original plus 5 copies of Staff's Prehearing Brief and Staff's Cross-Examination Statement from David B. Hatton.

Thank you for your assistance.

Sincerely,

Neoma Lane
Legal Secretary
Regulated Utility & Business Section

Enclosures
cc: Service List
NAL:nal/GENN2415

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UE 170

In the Matter of PACIFIC POWER & LIGHT COMPANY (dba PacifiCorp) Request for a General Rate Increase in the Company's Oregon Annual Revenues	STAFF'S PREHEARING BRIEF

Pursuant to ALJ Logan's May 27, 2005, Ruling and June 14, 2005, Memorandum, the staff of the Public Utility Commission of Oregon ("Staff") submits its PreHearing Brief.

I. COST OF CAPITAL

The following chart summarizes Staff's recommended overall cost of capital:

	Staff Recommended Cost of Capital		
Capital Component	**Cost**	**Ratio**	**Weighted Cost**
Long-Term Debt	6.14%	51.40%	3.16%
Preferred Stock	6.44%	1.10%	0.07%
Common Equity	9.50%	47.50%	4.51%
TOTAL		100.00%	7.74%

A. Capital structure

As an introductory matter, it is important to recognize that the capital structure and return on equity are inextricably linked and must be considered together. For example, the Commission has stated:

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

See Docket UE 115, Order No. 01-777 at 36.

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Therefore, the capital structure must be aligned with the sample used to calculate return on equity or an adjustment must be made to the return on equity to reflect the difference between the adopted capital structure and the capital structure of the sample used to estimate the market required return on equity.

Staff's recommended capital structure is: 51.4 percent long term debt, 1.1 percent preferred stock, and 47.5 percent common equity. This capital structure is more appropriate than the Company's because the return on equity is being calculated in relation to the peer-group, comparable company analysis. Because the return on equity is related to the capital structure, the same peer-group analysis should be used instead of a Company-specific structure that does not reflect the relationship between return on equity and the peer-group of comparable companies analyzed.

In this case, Staff's analysis concludes that the appropriate return on equity is 9.5 percent with a capital structure that contains 47.5 percent equity. The return on equity is directly linked, however, to comparable companies with comparable capital structures. A change in the capital structure will change the appropriate return on equity. For example, if the capital structure were set at 50 percent equity, the overall risk of default would lessen and, therefore, the appropriate return on equity would be less as well.

Adopting a capital structure for determining the appropriate overall rate of return does not limit, or constrain, the Company's ability to choose its actual capital structure. Rather, Staff recommends adopting its proposed capital structure because it aligns with the sample used to calculate the return on equity and, taken together, results in an appropriate overall rate of return.

An alternative approach, if the Commission adopts the Company's actual capital structure, would be to adjust the return of equity downward to reflect increased common equity, therefore, less risk and less return required. Staff's approach, however, is better because it dispenses with the need to adjust the cost of equity since the cost estimate is based on the average capital structure of the sample. The main point remains that capital structure and return

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on equity are linked together and changes to one require changes to the other in order to result in an overall reasonable rate of return. Staff's recommended capital structure - in conjunction with its recommended return on equity - reflects a reasonable overall rate of return.

B. RETURN ON EQUITY

Staff's's recommended return on equity is 9.5 percent, which is based upon a capital structure containing 47.5 percent common equity. Although return on equity is often a contentious issue in rate proceedings, this case is simplified by the fact that the appropriate <u>growth rate</u>, contained in the discounted cash flow ("DCF") models, is the predominant disputed issue in this case.

Consistent with recent Commission decisions on return on equity, Staff implemented single and multi-stage DCF models in formulating its recommended return on equity. *See* Docket UE 115, Order No. 01-777 at 27 (adopting Staff's recommendation to reject the single-stage DCF analysis in favor of multi-stage DCF results); *see also* Docket UE 116, Order No. 01-787 at 24 (favoring multi-stage DCF models). The Company also employs single and multi-stage DCF analysis to estimate return on equity. The difference between Staff's and the Company's multi-stage DCF analysis is predominantly related to their different estimates of the long term <u>growth rate</u>.

1. The Company's use of historic Gross Domestic Project growth as an estimate for growth in the public utility sector is unsupported and inappropriate.

The Company's DCF analysis uses a historic Gross Domestic Project ("GDP") growth rate of 6.6 percent for its future growth estimate in its DCF analysis. Boldly assuming that a regulated utility – which is less risky and pays more of its earnings as dividends as compared to other industries – will grow at historic GDP rates is inappropriate and unsupportable.

In fact, the evidence does not support the proposition that the regulated utility industry will grow at the same rate of the overall economy. Rather, the evidence suggests that the regulated utility industry does not grow at the same rate as the overall economy. For example,

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growth is a function of both investment and return on that investment. Companies, such as regulated utilities, that pay out a large portion of their earnings in dividends will grow at a slower pace than those companies that pay out lesser or no portion of earnings as dividends. Additionally, the overall market contains smaller, private companies, which are faster growing. Inclusion of these faster growing companies further suggests that historic GDP growth as a proxy for the regulated utility sector growth is misplaced.

As Staff's testimony demonstrates, there are more appropriate ways to estimate future growth than the adoption of a historic number that measures growth in the overall economy. In considering the appropriate future growth rate, it may be helpful to ponder why the Company's future growth rate is based upon the simplistic assumption that the regulated utility industry and the overall economy will grow at the same historic GDP growth rate? Presumably, the answer is related to the fact that a future growth rate of 6.6 percent is necessary to result in the Company's requested return on equity. However, as Staff's testimony demonstrates, a future growth rate of 6.6 percent is not supported by recent growth rates in the regulated utility industry, financial analysts' estimate of future growth, sustainable growth rates estimates, future GDP growth estimates, and the Company's own average earnings growth forecast.

a. Even if the Commission decided to use GDP growth as a proxy for future growth in the regulated utility industry, it should use estimates of future GDP growth.

Although GDP growth is not an appropriate indicator of future growth in the regulated utility industry, the Company's use of selective historic GDP growth rate is untenable because it does not consider current information and current prospects for future growth, including the impact of inflation. Therefore, if the Commission were to determine that GDP growth was an appropriate proxy for future growth cases involving public utilities, it should employ forecasted, future GDP growth rates, not historic, irrelevant GDP growth rates.

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For example, during the 1990's the economy experienced tremendous growth. Instead of relying of forecasts that utilize current information, the Company seeks to exploit a selective historic GDP growth rate that ignores current knowledge and forecasts of future GDP.

Recently, the Congressional Budget Office estimated GDP growth of approximately 4.8 percent for 2006-2009 and 4.4 percent for 2010-2014.[1] If these current projections of growth rates were used, the Company's DCF models would produce results similar to Staff's recommended return on equity of 9.5 percent. Furthermore, the Commission has stated that forward-looking projections of growth rates are preferable to historical growth rates. *See* Docket UG 132, Order No. 99-697.

Staff notes that the GDP growth rates are expressed in nominal terms, not real terms. Hence when historic growth rates are used, it encompasses both real growth and the effects of inflation. The Company, in using historic growth rates, unadjusted for inflation, is assuming in essence that the past periods of inflation will continue. This is an error because inflation, on average since 1980, has been much higher than future inflation. This is a key reason why interest rates are at historic lows.

2. Staff's recommended return on equity and supporting DCF analysis utilizes a reasonable future growth rate that is supported by a principled analysis of the information currently available.

In contrast to the Company's unsupported and unreasonable use of a selective historical GDP growth rate period as a proxy for future growth in the regulated utility sector, Staff performed a detailed analysis that employs numerous methods of estimating future growth. Because of the overriding importance of the appropriate growth rate, Staff adopted the company sample selected by the Company.

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[1] Pursuant to OAR 860-014-0050(1)(b), which provides that the Administrative Law Judge may take official notice of reports of government agencies, Staff requests that the Administrative Law Judge take official notice of this report. The report is published by the Congressional Budget Office and may be found online at http://www.cbo.gov/showdoc.cfm?index=5773&sequence=3.

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Consistent with the Commission's reliance on DCF models in Docket Nos. UE 115 and UE 116, Staff used current market data from several sources, including *Value Line*, in order to develop a series of DCF models.[2] Staff's detailed analysis on growth concludes that a reasonable growth rate is between 4 to 5 percent. Employing the upper-bounds of Staff's growth rate analysis and accepting a growth rate of 5 percent, of Staff's DCF analysis results in a range of estimates from 9.00 to 9.5 percent.

3. Staff's growth rate analysis included review of future growth rates estimates from five different sources.

In order to estimate reasonable future growth rates, Staff reviewed the current future growth rates estimates from five different sources. Staff's review of these five sources concludes as follows:

- 2.7 percent to 4.8 percent from *Value Line*. *See* Staff/200 Morgan/34
- 4.58 percent from *Kiplingers; Thomson/Firstcall*. *See* Staff 203, Morgan/18
- 4.38 percent from *Zack's*. *See* Staff/ 203, Morgan/18
- 4.49 percent from *Reuters*. *See* Staff/203, Morgan/18
- "Confidential number" from the Company's own internal analysis spanning ten years into the future. *See* Staff/122, Morgan/10 at 20.

4. Staff also considered forward–looking sustainable growth rate calculations in determining a reasonable growth rate.

In addition to the growth estimates detailed above, Staff also forecasted growth rates by completing a sensitivity analysis of sustainable growth rate calculations, which are a minor variation of the retention growth rate method. *See* Staff/200, Morgan 25. The results of Staff's sustainable growth rate calculation sensitivity analysis range from 3.09 percent to 4.82 percent,

[2] In fact, Staff used the DCF model that the Commission adopted in Docket Nos. UE 115 and UE 116 and simply updated the model with current forecasts from *Value Line*. This analysis resulted in a return of equity of 8.8 percent. *See* Staff/200, Morgan/5, line 16 ("3-Stage 40-year DCF"); Staff/203, Morgan 27.

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which are all below the 5 percent maximum growth rate utilized in Staff's DCF analysis. *See* Staff/200, Morgan/30, lines 9-10.

5. Stall also reviewed the actual growth rates achieved by the comparable companies.

Staff also reviewed the comparable companies selected by the Company and concluded that their actual growth rates averaged less than four percent over the past 5 and 10 year periods (*See* Staff/200, Morgan/32) and averaged less than five percent over the past 15-year period. *See* Staff/200, Morgan/30. Based upon this review alone, Staff concludes that a reasonable growth rate range would be 3.5 to 4.0 percent. *See* Staff/200, Morgan/39 at 26.

6. A reasonable expectation of growth rates ranges from 4 to 5 percent.

Staff's estimated growth rates are based upon analysis and review of recent growth rates in the regulated utility industry, financial analysts' estimate of future growth, sustainable growth rates estimates, future GDP growth estimates, and the Company's own average earnings growth forecast. In contrast, the Company's growth rates are based upon only one factor - a selective average of historical GDP growth as proxy for future growth in the regulated utility industry. Based upon the evidence in this case, the Commission should adopt Staff's estimated growth rate.

7. The Company's attempts to distract the focus from future growth rates should be ignored.

After Staff and Intervenor testimony was filed questioning the Company's use of a historic GDP growth rate, it is unfortunate that the Company's rebuttal testimony focuses on unrelated and misguided arguments that only distract from the core disputed issue – the appropriate growth rate. The Company's rebuttal testimony begins by comparing Staff's recommended return on equity to to what other commissions adopted as the average return on equity of other electric utilities.

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The Company's witness, Dr. Hadaway, testifies that the average allowed rate of return on equity in decisions during 2004 was 10.73 and the average allowed rate of return on equity in the first quarter of 2005 was 10.44. Seemingly, the Company believes that average, past return on equity decisions from other jurisdictions are a better indictor of the appropriate return on equity than rigorous analysis of the DCF models. The market sets the required return on equity, not state commissions.

As the Company notes, the Commission has previously stated how it will use the return on equity allowed by other state regulators. However, the Company only quotes one sentence of the Commission's discussion of the issue. Because of the Company's substantial reliance on other utilities' past return on equity decisions, the Commission's discussion of this issue should be quoted in more length. In Docket No. UE 116, Order No. 01-787 at 32, the Commission stated:

> We adhere to our prior determination that, while other ROE determinations may provide confirmation of a decision, they should not be used as an independent method on which to base an award. Capital market conditions, not regulatory decisions, determine a utility's cost of equity. While we agree that regulatory agencies generally make every effort to capture those market conditions, a review of past decisions cannot replace an independent analysis of current market conditions and how they affect the particular utility. Moreover, ROE determinations are made not just in traditional rate cases, but also in a range of other proceedings, such as industry restructuring plans, merger approval cases, or performance-based regulatory plans. Thus, the ROE awards may have been based, in part, on other unknown parameters relevant in that particular docket.
>
> Accordingly, we will continue to review ROEs authorized in other jurisdictions to help gauge the reasonableness of the cost of equity estimates derived from independent methodologies. We will not, however, rely on such decisions as the basis for an ROE award for the utility.

(Emphasis added).

The Commission correctly concludes that simply looking at return on equity awards in the past cannot replace the independent analysis of current market conditions. The Commission should decline the Company's invitation to ignore current market conditions and, instead, adopt a return on equity based independent analysis. In fact, the Company's averages do indicate a

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trend of lower return on equity awards in the first quarter of 2005. Nonetheless, the return on equity adopted in this case should be based upon independent analysis of current conditions and circumstances – including the appropriate growth rate.

C. COST OF DEBT

Staff estimates for the embedded cost of long-term debt and cost for preferred stock are reasonable, allow the Company flexibility to prudently manage its cost of debt, and should be adopted. Staff estimates the Company's embedded cost of long-term debt at 6.14 percent and the Company's cost of preferred stock at 6.44 percent.

1. The Commission should adopt Staff's cost of preferred stock.

Staff estimates the cost of preferred stock at 6.44 percent, which compares with the Company's most recent estimate of the cost of preferred stock at 6.590 percent. The difference between Staff's and the Company's estimate is 0.15 percent, which is a result of Staff's exclusion of the unamortized expense associated with the Company's Quarterly Income Debt Securities ("QUIDS"). *See* PPL/312, Williams/6, lines 15-18.

In the Company's last general rate case, UE 116, the Commission excluded the unamortized expense associated with QUIDS because the Company was unable to demonstrate that customers benefited from the Company's actions and the Commission found that the expense was non-recurring. *See* Order No. 01-787 at 19. There is no reason why the Commission should depart from that decision. In this proceeding, the Company has provided no specific evidence that customers benefited from the early redemption of QUIDS and the expenses are non-recurring in nature. While PacifiCorp identified a couple of debt issuances that occurred after the QUIDS were redeemed, there is no specific connection between the two actions. If the identified debt issuances would have occurred anyway, the more appropriate replacement cost of QUIDS would have been equity. Assuming equity replaced the QUIDS, the result is a higher cost of capital. The Commission should adopt Staff's estimate of the cost of preferred stock of 6.44 percent.

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2. The Commission should adopt Staff's estimate of the cost of long-term debt.

Staff's estimate of the cost of long-term debt is 6.14 percent as compared to the Company's estimate of the cost of long-term debt at 6.288 percent. The difference between Staff's and the Company's estimates involve two issues.

First, Staff assumes that the interest rate of new debt replacing existing debt will be equal to the average of 5-, 7-, and 10-year bonds, while the Company assumes that the cost of the new debt will equal that of 20-year bonds. Historically, Staff has employed the use of the average of 5-, 7-, 10-year terms as a reasonable proxy for the interest rate of the Company's future debt issuances. This is not to speculate on how the Company will actually manage the term length of future debt issuances. Rather, it is simply a reasonable method of estimating the cost of future debt issuances. Importantly, the Company is not bound by these estimates and may still prudently manage its future debt issuances. Staff's use of a mix of 5-, 7, 10-year terms is more reasonable than the Company's adoption of 20-year term. Furthermore, in the Company's last rate case the Commission determined that the Company would likely issue long-term debt with a variety of maturity dates and assumed that long-term debt should have a ten-year average maturity date. *See* Order No. 01-787 at 17. At a minimum, the Commission should retain that approach.

Second, the Company uses analysts' forecasts of future interest rates and Staff uses current interest rates. The use of current interest rates as Staff's forecast of replacement costs of soon-to-be maturing long-term debt is a long-standing Staff practice. If applied consistently, this practice is symmetrical and fair to both customers and the Company. When analyst forecasts are for higher interest rates, the result of Staff's practice is a slightly lower cost of replacement debt. When analyst forecasts predict falling interest rates, the results of Staff's practice is a slightly higher cost of replacement debt. However, Staff's practice is measurable and not subject to manipulation. Furthermore, because the time period over which the long-term debt will mature is short, the current conditions are likely more reflective of the cost of replacement debt than

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other forecasts of interest rates. Staff's estimated cost of long-term debt is reasonable and should be adopted.

II. PENSION COSTS

Staff is challenging PacifiCorp's use of calendar year 2005 calculations for FAS 87 as the proxy for calendar year 2006 FAS 87 costs and revised FAS 106 costs. The Commission should not adopt a FAS 87 cost based on PacifiCorp's revised discount rate. PacifiCorp decreased the discount rate by 75 basis points from its initial testimony based on economic assumptions, yet PacifiCorp is also presenting cost of capital testimony demonstrating that these economic assumptions are improving. The discount rate is one of many assumptions used in the FAS 87 calculation, and customers should not be required to pay for calculated pension costs using recent, historically low assumptions for the discount rate, especially since PacifiCorp's Plan returned sufficient funds to cover actual payments to retirees.

Additionally, when all the information on past costs, current short-term interest rates, and performance of the equity markets is considered cumulatively, Staff's recommendation of $31.5 million for FAS 87 costs more reasonably reflects the costs that PacifiCorp will actually bear in calendar year 2006, especially considering earnings on the Plan have fully covered benefits paid in the last two years. This trend of increased returns is likely to continue based upon the recent performance of the equity markets.

The Commission should also not adopt a deferral mechanism for pension costs since pension benefit costs are calculated costs that are based on many variables. Since pension benefit costs can be significantly affected by small changes in the variables, customers will pay for pension costs that are at historically high levels recently, and assume all the risk concerning this deferral mechanism

The Commission should adopt Staff's Surrebuttal testimony recommendation for FAS 106 cost of $21.4 million. Additionally, the Commission should also adopt Staff's FAS 122 and pension administration costs listed in Staff UE 170 Dougherty Exhibit 1101.

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In summary, the Commission should adopt Staff's calendar year 2006 test year recommendation (System costs) of $33 million for pension costs ($31.5 for FAS 87 cost, $1.5 million for PacifiCorp's contribution to the PacifiCorp/IBEW 57 Trust Fund), $21.4 million for FAS 106 costs, $5.70 million for FAS 112 costs, and $1.02 million for pension administration costs.

The Oregon allocation for these costs are $9.7 million for pensions, $6.3 million for FAS 106 cost, $1.68 million for FAS 112 cost, and $299 thousand for pension administration costs. Total Staff recommended Oregon adjustment from PacifiCorp's amounts equals $5.73 million; $4.17 million towards Operation & Maintenance accounts and $1.35 million for capital accounts.

A. PACIFICORP'S CALENDAR YEAR 2006 FAS 87 COST IS BASED ON CALCULATIONS

FAS 87, *Employers' Accounting for Pensions*, establishes standards of financial reporting and accounting for an employer that offers pension benefits to its employees. The net periodic pension benefit cost of FAS 87 is a single net amount that includes various inputs concerning past, present, and future events and transactions. The calendar year 2006 costs are based on calculations and estimates (including low discount rates, lower than actual rates of return, and higher than actual changes in compensation rates) that can significantly affect the cost computation of FAS 87 and result in an increased net periodic pension benefit cost. Other actuarial estimates include: employee turnover rates, employee mortality rates, and employee retirement ages. As an example, a lower discount rate will result in an increase of net periodic pension benefit costs, while a higher discount rate will result in a decrease of net periodic pension benefit costs. This is also true for the rate of return on Plan assets used in actuarial calculations.

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B. PACIFICORP USED A RECENT HISTORICAL LOW DISCOUNT RATE TO CALCULATE ITS CALENDAR YEAR 2006 FAS 87 COST. THE USE OF THIS LOW DISCOUNT RATE RESULTED IN INCREASE OF COST FROM $42.2 MILLION IN DIRECT TESTIMONY TO $48.4 MILLION IN REBUTTAL TESTIMONY

PacifiCorp's increased pension expense resulted from PacifiCorp adjusting its discount rate from 6.50 percent in its original projections for 2005 to 5.75 percent in its revised 2005 projections. According to PPL 1104; Rosborough/6, this change was made because PacifiCorp's external auditor would not approve a rate above 5.75 percent. PacifiCorp is using its calendar year 2005 calculated pension cost as a proxy for the calendar year 2006 calculated pension costs. As a result of these changes in the discount rate, PacifiCorp is using a recent historically low discount rate for test year pension cost calculations. PacifiCorp's 2005 discount rate is 50 basis points lower than its 2004 discount rate, 100 basis points lower than its 2003 discount rate, and 175 basis points lower than its 2002 discount rate. In its original application, PacifiCorp used 6.75 percent for its calendar year 2006 discount rate. By utilizing a 5.75 percent discount rate as a proxy of calendar year 2006, PacifiCorp's is lowering its calendar year 2006 discount rate by 100 basis points.

Although there are many variables that affect the calculation of pension costs, the discount rate can affect calculated costs in a significant manner. In response to Staff Data Request No. 22, PacifiCorp demonstrates that lowering the calendar year 2006 discount rate from 6.75 percent to 6.25 percent would result in an increase in calculated pension costs of $6.7 million. An additional significant increase in calculated pension costs would occur by reducing the discount rate an additional 50 basis points from 6.25 percent to 5.75 percent. The overall estimated effect of decreasing the discount rate by 100 basis points is an increase in pension costs of approximately $12 million. Again, this is a calculated cost and not actual cost incurred by PacifiCorp.

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C. PACIFICORP'S COST OF CAPITAL TESTIMONY INDICATES HIGHER INTEREST RATES WILL OCCUR IN 2005 AND 2006, BUT THE COMPANY IS NOT CONSIDERING THESE HIGHER INTEREST RATES IN ITS PENSION CALCULATIONS

In both direct and rebuttal testimony, PacifiCorp makes a case that interest rates will increase. Dr. Hadaway provided an excerpt from Standard & Poor's supporting his assertion of higher interest rates at PPL/200; Hadaway/18 and 19 by stating: (emphasis added)

> "The GDP growth rate compares to a rate of less than 2 percent in 2001 and 2.4 percent for 2002. Consistent with these improving economic conditions, S&P also forecasts unemployment below 5.5 percent and **that interest rates will rise an additional 80 to 100 basis points (0.8% to 1.0%) from current levels."**

(Emphasis supplied). Additionally, D. Douglas Larson at PPL/1700; Larson/9 and 10 states:

> "Yes, interest rates are rising….After falling for three years, the bellwether Federal Funds interest rate rose for most of 2004 and continues to rise in 2005. As discussed in Dr. Hadaway's rebuttal testimony, *interest rates for corporate bonds are projected to increase in 2006*."

(Emphasis supplied). Based on PacifiCorp's assertions that interest rates[3] will rise in 2005 and 2006, and because PacifiCorp's discount rate should reflect the interest rate of high-quality corporate bonds that have maturities that match the expected payments to retirees, PacifiCorp's use of a 5.75 percent discount rate is low, which results in increased calculated costs for the calendar year 2005 FAS 87 cost.

D. PACIFICORP CALCULATED CALENDAR YEAR 2006 TEST YEAR COST IS SIGNIFICANTLY HIGHER THAN THE FIVE-YEAR AVERAGE CONTRIBUTION TO THE PENSION PLAN, HISTORICAL FIVE-YEAR AVERAGE FAS 87 COST, AND TEN-YEAR AVERAGE FAS 87 COST

Although PacifiCorp's contributions have been high in the previous few years, the five-year average of contributions is $31.68 million, extremely close to the calendar year 2004 FAS

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[3] Staff notes that the Federal Funds interest rate is short-term. As indicated in Alan Greenspan's recent Congressional testimony, long-term interest rates, such as those Staff assumed for replacement costs when calculating the embedded cost of debt have been falling in response to increases to the Federal Fund rate. Specifically, Alan Greenspan testified that: "Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates of U.S. Treasury securities despite a 2-percentage-point increase in the Federal Funds rate. This is clearly without recent precedent. The yield on ten-year Treasury notes, currently at about 4 percent, is 80 basis points less than its level of a year ago. Moreover, even after the recent backup in credit risks spreads, yields for both investment-grade and less-than investment-grade corporate bonds have declined even more than Treasuries over the same period." Pursuant to OAR 860-014-0050(1), Staff requests that the Administrative Law Judge take official notice of this Congressional testimony, which can be found online at http://www.federalreserve.gov/boarddocs/testimony/2005/200506092/default.htm

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87 cost of $31.5 million that Staff recommended be used for the test year cost. Additionally, PacifiCorp' five-year average FAS 87 cost was $26.32 million and ten-year FAS 87 average cost was $29.29 million. Both these average costs are lower, but within a reasonable range of the calendar year 2004 FAS 87 net periodic pension benefit cost of $31.5 million.

E. PacifiCorp was actually able to fully fund its pension costs through the return on plan assets in Fiscal Year 2005 and Fiscal Year 2004

According to page 99 of PacifiCorp's Fiscal Year 2005 SEC Form 10-K[4], actual return on Plan assets was $87.5 million. This actual return is significant in a many ways. First, it is $9.8 million higher than the expected return on Plan assets. This difference demonstrates the variance between actuarial calculations and actual results and supports Staff's recommendation of $31.5 million for pension costs. Second, the actual return on Plan assets demonstrates that PacifiCorp used a low estimated rate of return on plan assets in its actuarial calculations. PacifiCorp's actual return was 12.6 percent greater than its expected return. Third, the actual return on plan assets was $8.3 million greater than the benefits paid in fiscal year 2005, which was $79.2 million. In essence, the PacifiCorp Plan returned sufficient funds to fully fund the fiscal year 2005 pensions paid to PacifiCorp's retirees.

In the fiscal year ending March 31, 2004, PacifiCorp's actual return on Plan assets was $128.3 million, which was $47.6 million higher than its expected return and $15.4 million greater than actual benefits paid.[5]

F. PacifiCorp's actual pension costs have shown a decrease in the past few years

PacifiCorp's SEC Forms 10-K, shows that the actual benefits paid by PacifiCorp has steadily decreased from $129.6 million in fiscal year 2002 to $79.2 million in fiscal year 2005. If the trends of increasing market performance and decreasing costs persist, PacifiCorp's funded

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[4] PacifiCorp's SEC Form 10-K, as of March 31, 2005.
[5] PacifiCorp's SEC Form 10-K, as of March 31, 2005.

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status of its Plan will continue to grow resulting in actuarial calculations that reflect lower FAS 87 net periodic pension benefit costs.

G. PACIFICORP'S CALCULATED CALENDAR YEAR 2006 COST SHOULD NOT BE ADOPTED BY THE COMMISSION WITH A DEFERRAL MECHANISM THAT USES PACIFICORP'S CALCULATED COST OF $48.4 MILLION WITH LOWER SUBSEQUENT YEAR COST REFUNDED TO CUSTOMERS WHEN COSTS DO NOT REACH $48.4 MILLION

Because FAS 87 costs are based on numerous variables that can significantly affect calculated costs, the use of a deferral mechanism should not be adopted by the Commission. As previously mentioned, calendar year 2006 cost is based on calculations and estimates (including low discount rates, lower than actual rates of return, and higher than actual changes in compensation rates) that can significantly effect the cost computation of FAS 87 and result in an increased net periodic pension benefit cost. Other actuarial estimates include: employee turnover rates, employee mortality rates, and employee retirement ages. By using estimates recommended by the Company, PacifiCorp's calculated FAS costs could possibly continue to reflect higher than actual costs and result in harm to customers. This deferral mechanism places all the risks on customers and none of the risk on PacifiCorp.

H. PACIFICORP'S FAS 106 COSTS INCLUDE AN INCREASE IN COSTS DUE TO AMENDED PLAN BENEFITS

This increase is not consistent with national trends concerning retiree health benefits. Although the "legacy" cost increases for the American automobile and airline industries are well-documented, other industries are also faced with the rising costs of retiree health care and have made changes to their respective plans to mitigate these costs. By amending its plan to increase benefits, PacifiCorp is not following national trends, resulting in customers paying a premium for PacifiCorp's retiree health benefits. As a result, the Commission should adopt Staff's Surrebuttal testimony recommendation of $21.4 million. Although this amount is higher than the calendar year 2004 cost in Staff's direct testimony, it is reasonable because of the updated information on savings associated with the Medicare Modernization Act.

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III. TRANSITION ADJUSTMENT MECHANISM

Staff recommends the use of PacifiCorp's GRID power cost model to calculate annual transition adjustment rates. PacifiCorp's proposed methodology provides an accurate accounting of the likely impacts of direct access on PacifiCorp's system operations and can be expected to result in transition adjustment rates that achieve the goal of preventing unwarranted cost shifts between direct access customers and utility investors. Staff also supported an annual update provision in its direct and surrebuttal testimonies. *See* Staff/700, Galbraith/16-17.

Staff opposes ICNU's "market-plus" approach to calculating transition adjustment rates. ICNU's approach would not accurately account for the likely impacts of direct access on PacifiCorp's system operations.

Staff also opposes CUB's recommendation to limit the annual NVPC update to direct access eligible customers. CUB's recommendation would add complexity to the ratemaking process by creating two sets of cost-of-service rates, one for direct access eligible customers and one for non-eligible customers.

A. THIRD PARTIAL STIPULATION

Staff and the company agreed that if the Commission approves a Transition Adjustment mechanism (also called RVM) of the type proposed by the company, the final GRID power cost model run will include all the adjustments proposed by the company in PPL/604-606 and PPL/607-608 except the Deferred Maintenance, Thermal Ramping, Station Service, and Planned Outages adjustments.

1. Waiver of new resource rule.

The Company has requested a waiver from application of the New Resource rule for West Valley CTs, Gadsby CTs, and Current Creek Phase One. PacifiCorp has demonstrated including these plants in rates at cost provides benefits for customers. The acquisition process, cost and impact on customers of the West Valley CTs were analyzed in UI 196 and UE 134. The Commission concluded that the West Valley lease agreement is fair, reasonable, and not contrary

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to the public interest in Order 02-361 in UI 196. Staff's alysis in UE 134 concluded the company was prudent in entering into the West Valley lease agreement (UE 134, Staff/200). The Gadsby CTs were included in rates at the same time as West Valley, June 1, 2002, by UE 134 Order 02-343. The resource was acquired at the same time and at a similar cost as West Valley as part of a plan to meet a large summer resource need on the east side of PacifiCorp's system. Current Creek resulted from RFP 2003A and is coming online this summer. The Utah PSC issued a Certificate of Public Convenience and Necessity for Current Creek on March 5, 2004. Staff analyzed the economic evaluation conducted by the company supporting the acquisition of Current Creek in discovery and in a meeting with the company, and concludes that the plant was the least cost option and will provide benefits to customers. Staff supports the company's application for waiver and the inclusion of West Valley, Gadsby CTs, and Current Creek at cost in this docket.

2. Allocation of added qualifying facilities contracts.

The Revised Protocol, adopted by the Commission in UM 1050 Order 05-021, treats "new" and "existing" QF contracts differently. The costs of existing QF contracts are assigned situs to the state that approved the contract. The costs of new QF contracts are allocated system-wide. Existing QF contracts are defined by the Revised Protocol as contracts entered into prior to the effective date of the Revised Protocol. ICNU has asserted that the effective date is when the Commission signed the order approving the Revised Protocol in January 2005. The four QF contracts in question were all entered into between August and November 2004. So ICNU claims the contracts are "existing" for allocation purposes. No. Section II of the Revised Protocol approved by the Commission in Order 05-521 states: "The Protocol will be effective and apply to all PacifiCorp retail general rate proceedings initiated subsequent to June 1, 2004". Even though the order was not signed until January 2005 the effective date of the Revised Protocol is June 1, 2004 under Section II of the Revised Protocol. Existing and new QF contracts are treated differently by the Revised Protocol. This is result of the fact that in the past,

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the utility commissions in states served by PacifiCorp have priced QF resources developed in their respective states differently. Avoided costs were calculated and applied to QF contracts in a variety of ways. During the multi-state process (MSP) this was discussed and it was decided that in the Revised Protocol each state would be directly assigned costs of the existing QF contracts approved by their commissions. For "new" QF contracts, the Revised Protocol says: "Costs associated with any New QF contract, which exceed the costs PacifiCorp would have otherwise incurred acquiring Comparable Resources[6], will be assigned on a situs basis to the State approving such contract." Subject to a cost comparison to comparable resources, new QF contract costs are allocated system-wide. Staff reviewed the contracts and the economic evaluations done in support of the four new QF contracts and concluded that the costs were similar to comparable resources. Staff recommends that the Commission reject ICNU's proposed adjustment to treat the four new QF contracts as "existing".

3. Prudence of the West Valley CT Resource.

The initial acquisition of the West Valley resource in 2002 was prudent. In addition, last year PacifiCorp passed on an option in the West Valley lease agreement to terminate the lease, and that decision was prudent. Staff analyzed the initial acquisition of West Valley in UE 134 and concluded the company was prudent in entering into the West Valley lease agreement (UE 134, Staff/200). Through discovery in this docket, Staff reviewed the RFP 2004-X process conducted to solicit alternatives to West Valley from the market. Staff reviewed the economic evaluation of alternatives and concluded that the company's decision to retain the West Valley lease was prudent. Staff recommends the Commission reject ICNU's proposed adjustment related to the prudence of West Valley.

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[6] Comparable Resource means Resources with similar capacity factors, start-up costs, and other output and operating characteristics.

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4. Remove cost of terminated CT Lease from rate base.

In late 2001, PacifiCorp signed a contract with General Electric (GE) to lease mobile CT peaking units for installation at Gadsby. Prior to the expiration of the lease, GE provided PacifiCorp a turn-key offer to install new, larger and more efficient CTs at Gadsby and waive the remaining $7.5 million lease obligation. GE's offer, even excluding waiving the remaining lease obligation which was included in the offer, was better than the competing Pratt & Whitney CT purchase and installation offer that PacifiCorp had been pursuing. Staff sees no evidence of a conflict of interest in the decision the company made to go with the GE CT deal at Gadsby, and recommends that the Commission reject ICNU's proposed adjustment to decrease the level of the Gadsby CT plant in rate base by $7.5 million.

5. Updated plant outage and heat rates.

Consistent with normal practice, PacifiCorp based the thermal outage and heat rates in its filed case on the average of the last four years of actual plant experience. The company updates these 48-month averages on a semi-annual basis with data ending in March and September of each year. ICNU objected when the company updated the net variable power costs (NVPC) in this docket[7] using an updated 48-month period of outage and heat rates. ICNU claims it had insufficient discovery time to review the new data used. Staff's position is that the updated thermal plant outage and heat rates will not be used in the NVPC included in the base rate change, expected in September. However, the updated rates should be used to develop the NVPC underlying the Transition Adjustment mechanism (also referred to as the RVM), if the Commission decides in this docket that PacifiCorp will implement a RVM of the type proposed by the company, and now opposed by Staff (see Transition Adjustment mechanism). This position on updated plant outage and heat rates is consistent with the last several PGE RVM cases.

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[7] PacifiCorp submitted two sets of supplemental testimony – PPL/604-606 and PPL/607-608 - updating NVPC.

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6. Plant outages during the UM 995 deferral period.

The four-year period used to determine thermal plant outage rates in this docket, includes the November 1, 2000 through September 9, 2001 UM 995 deferral period. ICNU has proposed an adjustment in this case based on excluding all outages that occurred during the UM 995 deferral period in calculating the four-year average outage rates. ICNU says removal of all the UM 995 period outages will remove a "double recovery" of these outage costs, because the company is already collecting these costs as a result of the Commission's UM 995 deferral order. Staff does not support this adjustment. The purpose for using a recent four-year average of outages in the determination of base rates is to reflect a normal level of outages that can be expected to occur during the period the rates are in effect. To exclude all outages for part of the historical four-year period used would distort the four-year average to something different than what would be expected to occur. The only outage excluded from the four years of historical outage data used in this case, was the five and one-half month Hunter 1 outage. An extensive outage such as that is not expected to occur during the period the rates are in effect, and consequently it is excluded from the historical outage data used.

The UM 995 order allows PacifiCorp to recover excess power costs, partly caused by the Hunter 1 outage. All other outages that occurred during the UM 995 deferral period are consistent with the normal four-year average outage level in the NVPC in base rates in effect during that period. Consequently, there is no double recovery by including all the normal outages that occurred during the UM 995 deferral period in outage data used in this case. Staff recommends that the Commission reject ICNU's proposed adjustment regarding UM 995 period plant outages.

IV. CONSOLIDATED TAX ADJUSTMENTS

The Company's Oregon allocated tax expense should be adjusted downward by $4.6 million, which reflects the burden customers are bearing because of the debt at PacifiCorp Holdings Inc. ("PHI").

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Consistent with Staff's recent white paper, the Commission should continue its policy of calculating taxes based upon a stand-alone method, but also adjust the Company's tax expense to reflect the burden that customers are bearing as a result of the debt at PHI, which results in a tax benefit in the form of a tax deduction for the interest paid on the debt. Simply stated, Staff's recommended adjustment seeks to neutralize the impact of PHI's debt on the Company's customers.

The first step in applying the benefits – burden test is determining if customers are bearing a burden. In this case, PHI was created as a holding company as a result of ScottishPower's application under ORS 757.511 (the "Acquisition"). Ring fencing provisions, which are intended to isolate the regulated utility from its parents or other affiliates, were attached to the approval of the Acquisition.[8] Specifically, the debt used to fund the Acquisition was recorded on the books of PHI, not the Company. While this treatment was intended as part of ring-fencing - i.e., isolating the regulated utility from its parent - the evidence will demonstrate that the ring-fencing is imperfect and, thus, the debt of PHI does, to some extent, impact the Company's customers, holding all else equal.

Once it is recognized that the debt at PHI impacts, or "burdens," the Company's customers, the next step is to measure the extent of the burden and recognize that customers should get the benefits to the extent that they bore the burden. In this case, the Company's customers are burdened by the fact that PHI's debt results in higher debt costs for the Company. Specifically, PHI's debt increases the interest rate that the Company has to pay for long-term debt, which is embedded in customers' rates. Therefore, customers are paying higher rates as a result of the debt at PHI.

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[8] An alternative to the downward tax adjustment could be to seek enforcement of the ring fencing conditions approved in the Acquisition, specifically the hold harmless provisions (Merger Conditions 7 and 10, Order No. 99-616). In addition, another alternative would be adjusting the Company's capital structure to acknowledge that the rating agencies incorporate debt from PHI as funding a portion of the Company's equity. However, Staff recommends that the Commission adopt its downward tax adjustment because the other alternatives may require the consideration of additional information to determine compliance with the Acquisition's merger conditions.

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In this situation, the last step in applying the benefits-burden test is to measure the effect of PHI's debt on the Company's cost of long-term debt. Given the information that is available,[9] Staff's analysis best reflects the measurement of burden customers are bearing as a result of the debt at PHI. In order to measure the burden, Staff first implemented calculations of four financial ratios, used by rating agencies, to determine that the Company's rating could be improved by as much as a full rating grade, if not for PHI's debt.

Staff then determined that a full rating grade difference, based upon June 30, 2004, spreads, would result in an approximate increase in costs of 53 basis points. Based upon the debt that the Company has issued from 2000 to the present and using the revenue requirement model in this docket, the 53 basis points results in an approximate $4.6 million downward adjustment annually to Oregon allocated tax expenses.

Staff's adjustment best reflects the benefits-burdens test because it measures the level of burden that customers are bearing related to PHI's debt and recognizes that customers should get the associated benefit from that burden. The evidence will demonstrate that PHI's debt does affect the Company's cost of long-term debt and Staff's adjustment best measures what that effect is and aligns the cause and effects related to the debt at PHI. Therefore, Staff's downward tax adjustment should be adopted.

V. RECOVERY OF RTO-RELATED COSTS

In joint testimony filed June 7, 2005, in this docket, the Company, Staff, the Citizens Utility Board and Kroger supported the stipulation regarding Grid West development costs. Staff recommends that the Commission accept PacifiCorp's Grid West treatment of those costs as ongoing costs. On a total Company basis, PacifiCorp has included $3.057 million in Grid

[9] As Staff's testimony details, the most accurate method of measuring the burden would be to have the Company request that one of the rating agencies prepare an advisory report or study that determines what the Company's rating would be without its relationship to ScottishPower. Once that report established the difference in ratings, an estimate of the different interest rate spreads could be obtained by reviewing historic bond information. Without the Company providing this report within the timeframes of this docket, however, Staff's analysis offers the most reasonable analysis and measurement of the burden customers are bearing as a result of the debt at PHI.

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West costs in its test year revenue requirement. That Stipulation did not include an adjustment to Non-Labor Administrative and General Costs for Grid West.

VI. RATE SPREAD, RATE DESIGN AND COST OF SERVICE

Staff's position regarding rate spread and rate design provides a balanced approach between moving customers toward cost of service rates and the objective of mitigating sharp rate increases for customers that are currently priced below their cost of service.

Staff also takes a position that is between the Company's current practices with regard to billing variability and CUB's recommendations for prorating all customers each month. Billing variability outside the range of normal meter reading cycles raises fairness issues, particularly with block rates. However, the use of a daily block rate would be difficult to explain to customers, and more difficult to administer. The company should maintain monthly block billing for bills issued within the normal meter reading cycle. Even though Staff agrees with Mr. Griffith's proposal to prorate bills issued for periods longer than 34 days and shorter than 26 days, Staff does not agree with his proposal to increase revenue requirement by $175,000. The situation that causes the anomaly in the data used to calculate the $175,000 is related to a "rare" instance associated with the redeployment of meter readers during a winter storm outage. This rare instance should not be the basis of setting ongoing rates.

Staff recommends moving customers toward cost of service rates on the traditional basis of 1.5 times the normal rate change.[10] This rule should be applied based on the current rates that are expected to be in effect at the time the new rates go into effect. Otherwise, the whole process of moving customers to cost of service rates could be thrown off by the vagaries of rate changes that happen to occur between the date of the company's rate case filing and the date the new rates go into effect.

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[10] Staff does agree with Mr. Higgins' recommendation to give a three percent increase to customers even if 1.5 times the overall rate change is less than three percent. For example, if the overall rate increase is 1%, customers would otherwise receive only a 1.5% increase. This is reasonable movement. However, Staff also does not recommend giving some customers decreases to accommodate higher increases for other customers.

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Agricultural pumping customers should not be singled out for a rate change higher than 1.5 times the overall rate change.[11] A 1.5 cent increase would violate the current rate mitigation policy.

In this proceeding, Staff addresses one issue regarding the Klamath irrigators and recommends that if the Klamath Basin irrigators are moved to standard rate schedules, they should be grouped with the other irrigators, not moved to separate schedules. The geographic and cost differences do not warrant a separate schedule. Of course, if the Klamath irrigators continue with the existing contract rates, or are served under a rate mitigation process, it is reasonable to have a separate basic schedule or adjustment schedule that reflects such differences. The other issues regarding Klamath Basin irrigators will be addressed under the separate schedule.

In addressing other issues, Staff does not recommend adoption of Ms. Iverson's proposal to use jurisdictional cost allocation study assumptions rather than the PacifiCorp marginal cost study for the purpose of allocating generation and transmission costs to energy and demand components. PacifiCorp uses a cost causative method. Ms. Iverson asks the Commission to use old negotiated factors for the allocation. The Commission should adopt the PacifiCorp method that is analytically supportable rather than the factors based on historical negotiations.

The Commission should adopt PacifiCorp's proposed time of day pricing for its largest customers because of the benefits related to improved reliability, reduced costs for delivered energy, and lower and more stable electricity rates. Customers on time of day pricing can benefit further to the extent they shift some load to off-peak hours. The Commission should not reject PacifiCorp's time of use pricing as suggested by Ms. Iverson because the initial differential is based on the company's judgment. Portland General Electric has had similar time of day pricing since 1995. Currently, the differential between PGE's on-peak and off-peak rates is about eight

[11] This statement of staff position on this issue applies only to customers on standard irrigation rates. It is not intended to apply to special contract customers. Those issues will be addressed under the separate schedule.

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mills. PacifiCorp's proposed three mill recommendation is a conservative approach to implementing time of day pricing.

Finally, Staff agrees with Mr. Griffith that it is appropriate to adjust the rates for the first blocks of schedule 28 and schedule 30 to reflect the equalization of the schedule 28 and 30 tailblock rates. The equalization of the tailblock rates should not supersede the requirement to set rates based on the unbundled costs to serve that class.

VII. NET VARIABLE POWER COSTS AND FUEL HANDLING COSTS

Staff recommends that the Commission reduce net variable power costs in the amount of $7,324,891 on a system basis to reflect the effect of the Georgia Pacific Camas contract. Staff also concurs with PacifiCorp's request that the Commission include $8,884,703 in fuel handling costs. These adjustments were inadvertently omitted from PacifiCorp's initial filing, but Staff agrees the corrections should be made so that the test year reflects the company's costs.

DATED this 13th day of July 2005.

Respectfully submitted,

HARDY MYERS
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CERTIFICATE OF SERVICE

I certify that on July 13, 2005, I served the foregoing upon the parties hereto by sending a true, exact and full copy by regular mail, postage prepaid and by electronic mail to:

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