

ENTERED AUG 14 2001

This is an electronic copy. Attachments may not appear.

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UF 4180

In the Matter of the Application of PACIFICORP)
for Authority to Enter into Various Arrangements)
with Financial Institutions to Manage Exposure to) ORDER
Interest Rate Fluctuations.)
)

DISPOSITION: APPLICATION APPROVED; WITH REPORTING REQUIREMENTS

On July 16, 2001, PacifiCorp (the Company) filed an application with the Public Utility Commission of Oregon (Commission), pursuant to ORS 757 and OAR 860-027-0030, requesting authority to enter into interest rate swaps, caps, floors, collars, and other derivative products with financial institutions to manage exposure to interest rate fluctuations.

The basis for the current request is detailed in Staff's recommendation memo, attached as Appendix A. Based on a review of the application and the Commission's records, the Commission finds that this application satisfies applicable statutes and administrative rules. At its public meeting on August 7, 2001, the Commission adopted Staff's recommendation and approved PacifiCorp's current request.

ORDER

IT IS ORDERED THAT the application of PacifiCorp for authorization to enter into Interest Rate Swap products, is granted, subject to the conditions and reporting requirements, as further specified in Appendix A.

Made, entered and effective _____.

BY THE COMMISSION:

Vikie Bailey-Goggins
Commission Secretary

A party may request rehearing or reconsideration of this order pursuant to ORS 756.561. A party may appeal this order to a court pursuant to ORS 756.580.

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT**

PUBLIC MEETING DATE: August 7, 2001

REGULAR AGENDA _____ CONSENT AGENDA X EFFECTIVE DATE

DATE: July 25, 2001

TO: Phil Nygaard through Marc Hellman and Bryan Conway

FROM: Ming Peng

SUBJECT: UF 4180 — PacifiCorp's Application for Authority to Enter into Interest Rate Swaps, Caps, Floors, and Collars

SUMMARY RECOMMENDATION:

I recommend approving the application with reporting requirements.

DISCUSSION:

On July 16, 2001, PacifiCorp (the Company) filed an application requesting that the Commission authorize the PacifiCorp to enter into interest rate swaps, caps, floors, collars and other derivative products with financial institutions to manage exposure to interest rate fluctuations. The notional principal amount in new arrangements entered into pursuant to such authorization would not exceed \$400,000,000. The Company requests that this authority remain effective so long as the Company's senior secured debt has investment grade ratings from two nationally recognized rating agencies. The application is filed pursuant to ORS Chapter 757 and OAR 860-27-030. (The Commission previously granted authorization to the Company for arrangements of this type in Docket No. UF 4020.)

PacifiCorp's Reason to Use Financial Derivative Products:

In recent years, many sophisticated products have been developed that permit companies to manage interest rate exposure. These products include interest rate swaps, caps, floors, collars and other derivative products (A financial derivative is a financial instrument or security that derives its present value from the current value of another security. Kinds of derivatives include forward contracts, futures contracts, options and swaps, etc.). These arrangements are hereinafter referred to as "Interest Rate Swap Products." By this application, the Company seeks authority to enter into transactions involving Interest Rate Swap Products for the purpose of better managing interest cost and volatility, providing protection against catastrophic market events and "locking in" or "capping" favorable interest rates. Interest Rate Swap Products are not intended to be used for speculative purposes.

Interest Rate Swaps and Derivative Interest Rate Swap Products:

An **interest rate swap** is simply an exchange of interest payments between two parties. Typically, one party pays a floating interest rate and the other party (called a counterparty) pays a fixed interest rate. These rates are paid on a "**notional**" principal amount. The principal amount of the transaction is called notional because principal is never exchanged; rather, it serves as an assumed principal amount simply used to calculate the actual interest payments.

If the parties decide that the interest rate swap will begin in the future then, it is called a **forward swap**. If the parties arrange a forward swap contract which is exercisable at only one of the parties' discretion, then the agreement is called a **swaption**.

In addition to the basic interest rate swaps, **derivative interest rate swap products** have been developed. These products include forward rate swaps and swaptions. The Company believes that interest rate swaps and derivative interest rate swap products provide opportunities to achieve lower cost funding of existing or prospective debt placements. They also provide the Company enhanced flexibility to manage its exposure to interest rates as market conditions permit.

Interest Rate Caps, Floors and Collars:

The structure of these products involves two parties that, either through an intermediary or directly, enter into an agreement where one party purchases from the other party protection from interest rate volatility. **Interest rate caps** are purchased to provide an issuer of floating rate obligations protection from increases in interest rates on the underlying obligation exceeding a predetermined level. The purchaser of an **interest rate floor** seeks to establish a minimum rate its portfolio of securities would earn during a declining interest rate period. In both cases, an up-front fee is paid to the party that provides such protection. From time to time, a party may simultaneously purchase an interest rate cap and sell an interest rate floor to create an **interest rate collar**, which provides protection from rising interest rates but limits the benefit of declining interest rates to the floor established in the transaction. This has the effect of reducing, but not eliminating, exposure to interest rate volatility. The principal benefit to the Company of selling an interest rate floor to establish an interest rate collar is to receive a premium to offset the cost of purchasing an interest rate cap.

PacifiCorp stated in its application that in the past, the Company has maintained a portion of its capital structure as floating rate, which generally results in lower cost sources of capital during times of a positive sloping yield curve and enables the Company to provide service to its customers at lower cost. Caps, collars and floors give the Company and its customers the opportunity to benefit from the use of floating rate securities, while protecting the Company from rising interest rates or increased volatility of interest rates, which may adversely affect customer rates.

Impact:

PacifiCorp expects to use Interest Rate Swap Products in order to better manage its interest rate exposure. In many instances, the Company views its outstanding debt as a portfolio of liabilities to be managed. The use of the Interest Rate Swap Products will help the Company to capture the economic benefits associated with changes in capital markets, or to decrease the risks associated with such changes. It is expected that the use of Interest Rate Swap Products will, on average, result in lower or

less volatile expense, reduced earnings volatility and improved financing flexibility. As a result, the Company's cost of capital should be reduced to the benefit of its customers.

Use of Proceeds:

The proposed transactions are not financings and any cash ultimately received will not be the normal "proceeds" of a securities issuance. Even though an Interest Rate Swap product may not generate normal proceeds, they can be designed to be of such financial benefit for one party that it is willing to pay for the right to that benefit. If any proceeds are generated, then PacifiCorp will use those proceeds for the following purposes: the acquisition of utility property or the construction, extension or improvement of utility facilities; the improvement or maintenance of service; the discharge or lawful refunding of its obligations (such as relatively higher-coupon debt and maturing debt previously authorized by the Commission); and, refunding the company's treasury expended on utility purposes. To the extent the company's treasury is refunded, the original expenditures, or their precedents, were made for purposes described by ORS 757.415 (1) (a), (b), or (e). To the extent that obligations are discharged or refunded, those obligations or their precedents were used for purposes described by ORS 757.415 (1) (a), (b), or (e). Any up-front fees or payments received will be credited to unamortized premium or discount on long-term debt. Any cash received and any cash paid will be treated as a decrease or increase in the cost of capital and should be reflected in future rate proceedings as appropriate.

STAFF RECOMMENDATION:

I recommend the Commission approve PacifiCorp's application to enter into Interest Rate Swap products, this authority remain effective so long as the Company's senior secured debt has investment grade ratings from two nationally recognized bond rating agencies.

I also recommend the following reporting requirements:

1. PacifiCorp shall file the usual Report of all initial and final documents signed by PacifiCorp and any other party in the matter (including counterparty and agent) clearly providing information on the nature of the product, its maturity, all rates involved, and other pertinent terms and conditions. The documents should be filed as soon as available after each transaction.
2. PacifiCorp shall demonstrate that the product is cost-effective, providing market data and correspondence with agents and counterparties in support of that demonstration.

For ratemaking purposes, the Commission reserves judgment on the reasonableness of the Company's capital costs and capital structure. The Commission reserves ratemaking treatment for these products until the next rate proceeding. In its next rate proceeding, PacifiCorp will be required to show that its capital costs and structure are just and reasonable. During the next rate proceeding, PacifiCorp will file testimony in support of any transaction authorized under this order.