NO. 46009-2-II

COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

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PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY,
Appellant,

vs.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, a Washington state agency,
Respondent,

PUBLIC COUNSEL DIVISION OF THE WASHINGTON ATTORNEY GENERAL'S OFFICE,
Intervenor-Respondent,

PACKAGING CORPORATION OF AMERICA
f/k/a BOISE WHITE PAPER, L.L.C.,
Intervenor-Respondent.

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# REPLY BRIEF OF APPELLANT

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# I. INTRODUCTION

This appeal challenges Order 05, issued by the Washington Utilities and Transportation Commission (Commission) in appellant PacifiCorp d/b/a Pacific Power & Light Company's (PacifiCorp or Company) 2013 general rate case. In Order 05, the Commission included the benefits of renewable energy developed under the Public Utility Regulatory Policies Act of 1978 (PURPA) in customer rates, but illegally shielded customers from paying the associated costs. The Commission also included the benefits of PacifiCorp's healthy balance sheet in rates, but refused to also include the actual costs of this beneficial capital structure. Together these unlawful decisions deny PacifiCorp recovery of over $12 million annually in necessary costs to serve Washington customers.[1] These one-sided actions violate the Washington Administrative Procedures Act's (WAPA) prohibition against agency orders that are illegal, unconstitutional, arbitrary, or unsupported by substantial evidence.

The Commission largely sidesteps the Company's legal arguments and instead attempts to characterize Order 05 as a reasonable exercise of its discretion to set rates. But under federal preemption principles, the Commission does not have the discretion to issue ratemaking orders that conflict with PURPA. Similarly, the U.S. Supreme Court has made clear that state commissions do not have discretion to issue ratemaking orders

[1] AR 1355, Ex. GND-7CT; AR 2944-45, Ex. BNW-1T; AR 2347, Ex. SRM-6T; AR 854, Order 05 ¶ 73.

that violate the U.S. Constitution. And under the WAPA, the Commission does not have the discretion to issue orders that are arbitrary or lacking substantial evidentiary support. Order 05 must be reversed.

## II. REPLY TO STANDARD OF REVIEW

The Commission argues that the Court may disregard the illegal aspects of Order 05 because PacifiCorp did not challenge the "end result" of the order under the *Hope* test, which focuses on the overall reasonableness of a Commission order, not the specific methods employed.[2] Washington law is clear, however, that the end results test applies only when a utility challenges a Commission order as confiscatory and not, as here, when the challenge is under the WAPA, federal law, or other provisions of the U.S. Constitution.

In *POWER*, the Washington Supreme Court held that although the "classic statements" from *Hope* continue to "provide guidance in the judicial review of rate cases," "modernly a reviewing court's role in this State is delineated by the administrative procedures act."[3] In *US West v. Washington Utilities and Transportation Commission*, the court reaffirmed that the "end results" test is used "to determine if rates are confiscatory," and is inapplicable to other challenges to Commission orders.[4]

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[2] Commission Br. at 31, 43; *see also* Public Counsel Br. at 33.

[3] *People's Org. for Washington Energy Res. v. WUTC*, 104 Wn.2d 798, 812, 711 P.2d 319, 327 (1985).

[4] *US West Comm. v. WUTC*, 134 Wn.2d 48, 54-55, 69, 949 P.2d 1321, 1344 (1997).

## III. REPLY ARGUMENTS

### A. The Commission's Disallowance of PacifiCorp's Out-of-State QF PPAs Violates Federal Law.

PURPA requires PacifiCorp to purchase electricity from specific types of generation facilities, known as qualifying facilities (QFs).[5] PURPA mandates that the price PacifiCorp pays to the QFs must be equal to the cost PacifiCorp would have incurred to either generate or purchase the electricity (*i.e.*, the avoided cost).[6] This mandate is designed to ensure utility and customer indifference to QF transactions.[7] PURPA also mandates utility recovery of "all prudently incurred costs associated with the purchase" from the QF.[8] Together, these provisions require PacifiCorp to pay avoided cost prices to QFs and require the Commission to reflect these QF costs in PacifiCorp's rates.

The result of Order 05 is to: (1) deny PacifiCorp recovery of its prudent out-of-state power purchase agreements (PPAs) with QFs in Washington, even though these QF PPAs reflect avoided cost prices under PURPA; and (2) re-price the power from these QF PPAs at current market prices. This outcome is illegal under PURPA. The argument that the Commission's cost allocation policy allows it to disregard PURPA for the

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[5] 16 U.S.C. § 824a-3(a).

[6] 16 U.S.C. §§ 824a-3(b), (d); 18 C.F.R. § 292.101(b)(6); 18 C.F.R. § 292.304(b)(2).

[7] *Indep. Energy Producers Ass'n, Inc. v. Calif. Pub. Utils. Comm'n*, 36 F.3d 848, 858 (9th Cir. 1994); 16 U.S.C. § 824a-3(m)(7).

[8] 16 U.S.C. § 824a-3(m)(7).

vast majority of QFs serving Washington is contrary to the Supremacy Clause of the U.S. Constitution.[9]

The Commission's denial of out-of-state QF PPA cost recovery is unprecedented—including in Washington, where the Commission has allowed full cost recovery of out-of-state QF PPAs.[10] No party cited another instance where a state regulator denied out-of-state QF PPAs cost recovery and re-priced the PPAs at market prices.[11] Even in cases where states differ over the proper calculation of avoided cost prices (a fact not at issue in this case), no state ever replaced the avoided cost price with current market prices.[12] Order 05 violates PURPA and must be reversed.

### 1. PURPA mandates recovery of PacifiCorp's avoided cost prices in rates regardless of the location of the QF.

The Commission argues that PURPA does not dictate full recovery of PacifiCorp's QF PPA costs, claiming that Washington customers are only required to pay for QF electricity if the QF is physically located in Washington.[13] The premise that the Commission is required to follow

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[9] U.S. Const. art. VI, cl. 2. *See Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 373, 108 S. Ct. 2428, 2440, 101 L. Ed. 2d 322 (1988).

[10] AR 1226, Ex. GND-1CT (Avista's rates include QF PPAs located in Idaho).

[11] The Commission claims that when the West Control Area inter-jurisdictional allocation methodology (WCA) was adopted, situs assignment "was reasonably consistent with" the approaches of other states in PacifiCorp's territory. Commission Br. at 8, 17-19. In fact, when the WCA was approved, no other state in which PacifiCorp operated situs assigned QF costs. AR 868-69, 871, Order 05 ¶¶ 103, 110; *see also*, *WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 32 (Apr. 17, 2006) (explaining that the allocation method used in PacifiCorp's other states did not situs assign QF costs). The WCA is the only methodology PacifiCorp has ever used, in Washington or any other state, which situs assigns QF PPAs.

[12] *See State ex rel. Utilities Comm'n v. N. Carolina Power*, 450 S.E.2d 896, 901 (1994).

[13] Commission Br. at 14-15; *see also* Public Counsel Br. at 24; PCA Br. at 22.

PURPA only for QFs located in Washington is false.[14] PURPA is a federal law that applies equally to QFs regardless of their geographic location. If Washington customers are served by a QF, the Commission must allow recovery of the avoided cost prices paid to the QF under the PPA.[15]

The Commission argues that because PURPA does not expressly address multistate cost allocation, it is free to disallow all out-of-state QF costs by using a state situs approach to cost allocation.[16] But shortly after PURPA's enactment, the Federal Energy Regulatory Commission (FERC) made clear in *Middle South Services* that allocation of QF PPA costs among multistate utility operations must satisfy PURPA's customer and utility indifference requirement.[17] That case involved the treatment of QF PPAs among four operating companies in different states in the integrated Middle South Utilities, Inc. (MSU) system. Middle South Services, Inc. (Middle South) administered the coordination agreement for the MSU system. FERC required Middle South to use state QF capacity determinations in system cost assignment because failing to do so "would be inconsistent with the intent of section 210 and our regulations, which is

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[14] AR 866-67, Order 05 ¶ 98.

[15] *See* 18 C.F.R. §§ 292.304(b), (d); 16 U.S.C. § 824a-3(m)(7).

[16] Commission Br. at 13. The parties argue that FERC has not adopted rules explicitly requiring cost recovery when the QF provides electricity that serves customers in another state, which indicates that FERC has left this issue up to the states. Commission Br. at 14; PCA Br. at 22; Public Counsel Br. at 21. On the contrary, as early as 1988 FERC acknowledged that "different state avoided cost determinations in the multistate utility context could become a serious problem," and FERC expressed a willingness to take action if this occurred. *Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Interconnection Facilities*, Docket No. RM88-6-000, 53 F.R. 9331, 55 F.R. 31882, 2009 WL 4645881 (Mar. 16, 1988).

[17] *Middle South Services, Inc.*, 33 F.E.R.C. ¶ 61,408 (1985).

that utilities should be no worse off financially as a result of [QF] purchases."[18]

FERC also found that QF energy sold among the four operating companies must be priced at the state-determined avoided cost price.[19] Like the Commission in Order 05, Middle South argued that if QF energy was resold between the companies at the state-determined avoided cost price, "there is a danger that States may force ratepayers in other States to subsidize [QF] development in the home State by requiring purchases at a price greater than avoided cost" determined by Middle South.[20] FERC dismissed this concern because no state set prices higher than avoided costs.[21]

Under *Middle South Services*, the Commission cannot adopt an allocation scheme that disregards valid avoided cost determinations made by other states. By denying recovery of PacifiCorp's out-of-state QF PPA costs, the Commission made PacifiCorp "worse off financially as a result of [QF] purchases," in violation of PURPA.

The Commission claims that *State ex rel. Utilities Commission v.*

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[18] *Id.* at ¶ 61,788.

[19] *Id.* at ¶ 61,792. On rehearing, FERC affirmed that Middle South could not re-price the QF energy and must use the state-determined avoided cost price. While FERC granted Middle South the authority to allocate the QF energy costs in the same manner as capacity costs, FERC was clear that the discretion to allocate was "not absolute" and could not violate PURPA's utility and customer indifference standard. FERC also indicated that the discretion to deviate from state-approved avoided costs was appropriate only when the state established rates exceeding avoided costs. *Middle South Services, Inc.*, 34 F.E.R.C. ¶ 61,342 (1986).

[20] *Middle South Services, Inc.*, 33 F.E.R.C. at ¶ 61,792.

[21] *Id.* at ¶¶ 61,789, 61,792; *Middle South Services, Inc.*, 34 F.E.R.C. at ¶ 61,641.

*North Carolina Power* supports its position against recognition of avoided cost determinations made by other states.[22] In that case, however, the court upheld the commission's order because it allowed recovery of the utility's actual avoided costs and disallowed only an (improper) Virginia state incentive.[23] Unlike in *North Carolina Power*, the Commission here did not purport to more accurately reflect PacifiCorp's avoided cost prices; rather it disallowed the QF PPA costs altogether by re-pricing the QF PPAs at current market prices.

A previous Commission order supports *North Carolina Power* and conflicts with Order 05. In *Washington Water Power*, the Commission concluded that in allowing cost recovery for an out-of-state QF PPA, the Commission "must make the underlying determination whether the [QF PPA] is based on a proper methodology to calculate the avoided cost as defined by federal and state laws and rules."[24] In that case, the Commission disallowed cost recovery of the amounts that exceeded the utility's properly calculated avoided costs.[25] Here, there is no challenge to the avoided cost calculations, so under *Washington Water Power*, PacifiCorp is entitled to full recovery of its out-of-state QF PPA costs.

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[22] Commission Br. at 15-17.

[23] *N. Carolina Power*, 450 S.E.2d at 900; *Re N. Carolina Power*, E-22, SUB 333, 1993 WL 216264 (Feb. 26, 1993) *aff'd sub nom. N. Carolina Power*, 450 S.E.2d 896.

[24] *WUTC v. Wash. Water Power Co.*, 56 P.U.R.4th 615, 617 (Nov. 9, 1983).

[25] *Id.* at 624 ("amount to be paid under the [PPA] is in excess of properly determined avoided costs").

### 2. The Commission illegally re-priced the out-of-state QF PPAs using market prices, not avoided costs.

The Commission claims that it did not disallow, deny, or re-price the out-of-state QF PPAs.[26] But Order 05 expressly provides—and the Commission's brief expressly reiterates—that the electricity generated by out-of-state QFs that serve Washington is "priced at market rates."[27] Previous Washington cases recognize that the practical effect of a PPA disallowance is the re-pricing of the PPA at current market rates—ignoring the actual terms and vintage of the PPA.[28]

The Commission has not previously used market prices to set PacifiCorp's avoided costs because they lack a capacity component.[29] In suspending action on PacifiCorp's recent proposal to use market prices for future avoided costs prices in Washington, the Commission referred to its staff's position that an "avoided cost rate that is based on projected market prices . . . would only capture the energy component of the avoided cost, and would not include the value of the capacity that a [QF] provides to [PacifiCorp's] system."[30]

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[26] Commission Br. at 15.

[27] AR 866-67, Order 05 ¶ 98; Commission Br. at 9-10.

[28] *WUTC v. PacifiCorp*, Dockets UE-061546, *et al.*, Order 08 ¶ 123 (June 21, 2007) (disallowance of PPA results in market re-pricing).

[29] AR 1363, Ex. GND-7CT; *Wash. Water Power*, 56 P.U.R.4th at 623 (avoided costs must include capacity if capacity is avoided). Current market prices also fail to account for the vintage of the QF PPA. *WUTC v. PacifiCorp*, Dockets UE-061546, *et al.*, Order 08 ¶ 121 (June 21, 2007) ("the fact the contract is below-market today is not relevant to whether it was prudent 20 years ago"); 18 C.F.R. § 292.304(b)(5). Public Counsel improperly compares current avoided cost prices to historical prices. Public Counsel Br. at 8-9.

[30] *WUTC v. Pacific Power & Light Co.*, Docket UE-144160, Order 01 ¶ 3 (Feb. 12, 2015) (referring to Staff's Open Meeting Memo available here: http://www.utc.wa.gov/docs/Pages/DocketLookup.aspx?FilingID=144160).

### 3. The Commission's *post hoc* power flow arguments are inconsistent with Order 05 and fail as a matter of law.

In its response brief and for the first time, the Commission argues that PacifiCorp failed to prove that out-of-state QFs serve Washington, justifying its determination to exclude these PPAs from Washington rates.[31] This argument is inconsistent with Order 05 where the Commission: (1) made no finding that electricity from the out-of-state QFs served only local load; (2) acknowledged that the out-of-state QFs generate electricity that serves Washington customers; and (3) stated unequivocally that power flow is immaterial to its decision.[32] *Post hoc* rationalizations, such as this, cannot be considered on appeal.[33]

The U.S. Supreme Court has observed that "any electricity that enters the grid immediately becomes a part of a vast pool of energy that is constantly moving in interstate commerce," and that "contentions that electricity. . . can be controlled, directed and traced . . . [are] inaccurate

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Staff concluded that market prices "result in an understated avoided cost rate that would be discriminatory to [QFs]."

[31] Commission Br. at 9, 22-23; *see also* Public Counsel Br. at 7, 23-24.

[32] AR 866-68, Order 05 ¶¶ 98, 100; *see also WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 68 (Apr. 17, 2006). The Commission's new power flow argument also applies to no other generating resources. *See, e.g.,* AR 858, Order 05 n. 105 (the WCA includes the California, Oregon and Washington loads and resources).

[33] *Sec. & Exch. Comm'n v. Chenery Corp.*, 332 U.S. 194, 196, 67 S. Ct. 1575, 1577, 91 L. Ed. 1995 (1947) ("fundamental rule of administrative law" is that "a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency" in its final order); *see also, e.g., Burlington Truck Lines, Inc. v. U.S.*, 371 U.S. 156, 168-169, 83 S. Ct. 239, 246, 9 L. Ed. 2d 207 (1962); *Nw. Envtl. Def. Ctr. v. Bonneville Power Admin.*, 477 F.3d 668, 688 (9th Cir. 2007).

and highly misleading."[34] The Commission's power flow argument is directly contrary to this precedent.

Furthermore, the Commission's explicit acknowledgment that out-of-state QFs serve Washington customers is inconsistent with its "cost causation" rationale. The Commission defends Order 05 by claiming that it has discretion to implement PURPA while also applying cost causation principles.[35] But as a matter of federal preemption, the Commission's authority to implement PURPA does not allow it to act in conflict with the law or thwart its key provisions.[36]

Situs assignment of QF PPA costs violates PURPA's customer indifference requirement because it fails to account for the QF electricity actually consumed in Washington. Situs assignment of QF PPA costs results in Washington customers receiving benefits for which they do not pay.[37] QF PPA costs are "caused" by the consumption of electricity by PacifiCorp's customers—including Washington customers—not by the location of the QF.[38] The Commission allows all other PacifiCorp

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[34] *See New York v. FERC*, 535 U.S. 1, 7, n. 5, 122 S. Ct. 1012, 1018, 152 L. Ed. 2d 47 (2002) (emphasis in original) (internal quotations omitted); *see also N. Dakota v. Heydinger*, 15 F. Supp. 3d 891, 917 (D. Minn. 2014) (electricity on the interstate grid does not recognize state boundaries and "all of a utility's resources are matched to all of a utility's load, regardless of state boundaries"); Patrick R. Jacobi, "Renewable Portfolio Standard Generator Applicability Requirements: How States can Stop Worrying and Learn to Love the Dormant Commerce Clause," 30 Vt. L. Rev. 1079, 1112 (2006) ("Demonstrating that the physical path of electricity ends with in-state consumption . . . is nearly impossible.").

[35] Commission Br. at 8.

[36] 16 U.S.C. § 824a-3(m)(7).

[37] AR 1363, Ex. GND-7CT.

[38] *WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 50 (Apr. 17, 2006).

generation resources in Oregon and California in Washington rates under this Commission interpretation of its cost causation theory.[39] There is no legitimate basis for a different standard for QFs.

**4. PacifiCorp's claim is properly before the state courts.**

PCA incorrectly claims that the Company's "dispute lies with FERC, not the Commission or this Court."[40] It is well established that state courts have jurisdiction over "as applied" claims under PURPA.[41] An "'as-applied' claim involves a contention that the state agency's ... implementation plan is unlawful, as it applies to or affects an individual petitioner."[42] PacifiCorp's PURPA claim is clearly an as applied challenge, especially since the Commission has allowed other multi-state utilities to recover their out-of-state QF PPA costs.[43]

**5. PacifiCorp's previous agreement to situs assignment of QF PPAs is irrelevant.**

The parties refute the Company's challenge to the Commission's allocation of QF PPA costs because the Company previously agreed to this approach.[44] To be clear, as a part of an overall settlement, PacifiCorp agreed to a five-year trial period of the West Control Area inter-jurisdictional allocation methodology (WCA), which included situs assignment of QF PPA costs. As soon as the initial five-year period

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[39] *See, e.g.,* AR 858, Order 05 n. 105.
[40] PCA Br. at 22.
[41] *Power Res. Group v. Pub. Util. Comm'n of Tex.*, 422 F.3d 231, 235-37 (5th Cir. 2005).
[42] *Id.* at 235 (citations omitted).
[43] AR 1226, Ex. GND-1CT.
[44] Commission Br. at 8, 23; Public Counsel Br. at 17-18, 33-34; PCA Br. at 9, 20.

expired, PacifiCorp sought to change this approach in this case. PacifiCorp's previous acquiescence to situs assignment of QF PPA costs does not validate the Commission's illegal actions under PURPA.[45] The fact that these illegal actions have occurred over many years makes this case more compelling, not less.

### B. The Commission's Denial of Recovery of Out-Of-State QF PPA Costs is Not Supported by Substantial Evidence.

The Commission argues that situs assignment of QF PPAs is supported by the evidence because PacifiCorp's out-of-state QF PPA costs are excessive and these QFs do not provide electricity to Washington customers.[46] But it is undisputed that (1) the avoided cost prices in the out-of-state QF PPAs satisfy PURPA, including the requirement of customer indifference, (2) the prices of the out-of-state QF PPAs are comparable to non-PURPA out-of-state PPAs included in rates without dispute,[47] and (3) the Company uses the out-of-state QF energy to serve Washington customers.[48] In 2014, out-of-state QFs provided one million MWh of renewable generation to serve the west control area, including Washington.[49] This is a direct benefit, commensurate with the direct benefit that the Commission found sufficient to include all other Oregon

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[45] *Citizens for Responsible Gov't v. Kitsap Cnty.*, 52 Wn. App. 236, 239, 758 P.2d 1009, 1011 (1988) ("an ordinance that is clearly . . . inconsistent with constitutional or statutory provisions . . . is void and incapable of being validated. It can be attacked at any time, regardless of previous acquiescence or the amount of time since its passage.").

[46] Commission Br. at 20-21, 23; *see also* Public Counsel Br. at 8-9.

[47] AR 1359, Ex. GND-7CT; Tr. 302:9-303:4 (Duvall) (QF PPAs average $77/MWh compared with $72/MWh for non-QF PPAs); AR 1227, Ex. GND-1CT.

[48] AR 866-67, Order 05 ¶ 98; AR 1357, Ex. GND-7CT.

[49] AR 3235-36, Ex. DCG-1CT.

and California generation resources in rates.[50]

## C. Order 05 Violates the Dormant Commerce Clause.

State energy policies have been subject to increased scrutiny under the dormant Commerce Clause, with recent constitutional challenges in more than a dozen states[51] invalidating or modifying state energy laws.[52] This issue is significant enough that the National Association of Regulatory Utility Commissioners (NARUC) recently presented a paper on the topic to "help policymakers recognize the constitutional limits of state power" in regulating energy policy, so that they can "work within constitutional limits to achieve policy goals."[53]

This backdrop stands in contrast to the Commission's approach to out-of-state QFs in Order 05, which entirely disregards Commerce Clause concerns. On its face, Order 05 creates a preference for in-state generation to protect the economic interests of Washington customers. This violates

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[50] *WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 50 (Apr. 17, 2006).

[51] K. Konschnik & Ari Peskoe, *Minimizing Risk: Crafting Energy Policies that Can Withstand Constitutional Scrutiny,* Harvard Law School Environmental Law Program State Power Project, Executive Summary (2014), http://statepowerproject.org/guide/.

[52] *See, e.g., Heydinger*, 15 F. Supp. 3d at 917 (law limiting carbon-intensive electricity imports into Minnesota violated dormant commerce clause); Massachusetts Dept. of Public Utilities, Order Adopting Final Regulations, D.P.U. 10-58-A (Aug. 20, 2010) (responding to commerce clause lawsuit with regulations suspending requirement for in-state generation contracts under state renewable portfolio standard). *See also Rocky Mountain Farmers Union v. Corey,* 730 F.3d 1070 (9th Cir. 2013) (rejecting arguments that California's low carbon fuel standard is facially discriminatory under dormant commerce clause, but remanding the case for a determination of whether it places a burden on interstate commerce that is "clearly excessive" in relation to its local benefits).

[53] The paper was sponsored by Harvard Law School's State Power Project and presented at NARUC's annual meeting in November 2014. It was unveiled by then-Washington Commission member Jeffrey Goltz. A copy of the paper is available at: http://environment.law.harvard.edu/2014/11/19/epi-releases-paper-about-lessons-learned-from-constitutional-challenges-to-states-energy-policies/.

the Commerce Clause in the clearest way possible—as a facially discriminatory order expressly justified by economic protectionism.

### 1. The disallowance of PacifiCorp's QF PPA costs based on location violates the dormant Commerce Clause.

The Commission argues that Order 05 complies with the dormant Commerce Clause because "the Commission's order expressed no preference for locally-produced energy."[54] The Commission also claims that Order 05 "does not discriminate between in-state and out-of-state economic interests" because the order impacts only PacifiCorp and not QFs or customers.[55] These arguments do not refute the fundamental legal point that, because the Commission's treatment of QF cost recovery is expressly based on the "physical location of the QF,"[56] a discriminatory intent or effect is not required to invalidate the order under the Commerce Clause. "[W]hen a regulation contains a limit based on geography or point of origin, regardless of whether or not such a limit indicates a discriminatory intent or effect," the "nearly fatal per se standard applies."[57] Such regulations are "generally struck down . . . without further inquiry."[58]

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[54] Commission Br. at 25.

[55] *Id.* at 24, 27; *see also* Public Counsel Br. at 29.

[56] AR 866, Order 05 ¶ 98.

[57] Jacobi, 30 Vt. L. Rev. at 1101-02 ("the Court rarely proceeds after recognizing point-of-origin or geographic limitations that might favor local interests to the detriment, however slight, of interstate commerce").

[58] *Brown-Forman Distillers Corp. v. New York State Liquor Auth.*, 476 U.S. 573, 579, 106 S. Ct. 2080, 2084, 90 L. Ed. 2d 552 (1986). *See also Camps Newfound/Owatonna v. Town of Harrison, Maine,* 520 U.S. 564, 575-76, 117 S. Ct. 1590, 1599, 137 L. Ed. 2d 852 (1997) (it is "not necessary to look beyond the text of this statute to determine that it discriminates against interstate commerce" because the law "expressly distinguishes

The U.S. Supreme Court has applied this per se standard in summarily striking down a range of energy-related laws.[59] The Washington Supreme Court applied the per se standard to invalidate a law that restricted only out-of-state wine producers.[60]

### 2. The Commission's preferential treatment for Washington QFs illegally burdens PacifiCorp's participation in interstate commerce.

The Commission's preferential rate recovery for QFs located in Washington rewards PacifiCorp for executing QF PPAs with Washington QFs and punishes PacifiCorp for executing PPAs with QFs located outside of Washington. But PURPA's "must-buy" requirement eliminates PacifiCorp's ability to respond to the economic incentives in Order 05 and protect itself from cost disallowances. As a result, Order 05 illegally burdens PacifiCorp's participation in interstate commerce by requiring it to bear Washington's out-of-state QF PPA costs.[61]

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between entities that serve a principally interstate clientele and those that primarily serve an intrastate market").

[59] *See, e.g., Wyoming v. Oklahoma,* 502 U.S. 437, 112 S. Ct. 789, 117 L. Ed. 2d 1 (1992) (invalidating statute requiring that in-state coal plants burn a minimum amount of in-state coal); *New Energy Co. of Indiana v. Limbach,* 486 U.S. 269, 108 S. Ct. 1803, 100 L. Ed. 2d 302 (1988) (invalidating tax credit for Ohio-produced ethanol); *New England Power Co. v. New Hampshire,* 455 U.S. 331, 102 S. Ct. 1096, 71 L. Ed. 2d 188 (1982) (invalidating law restricting sales of hydro-power to in-state consumers). *See also* Jacobi, 30 Vt. L. Rev. at 1103 ("[T]he Supreme Court and other federal appellate courts have subjected energy regulations containing language favoring in-state interests to the per se test and, consequently, invalidated these policies."); Nancy Rader & Scott Hempling, "The Renewables Portfolio Standard: A Practical Guide," (Feb. 2001), http://www.naruc.org/Publications/rps.pdf (limiting renewable resource eligibility to in-state facilities "will, if challenged, be found unconstitutional").

[60] *Mt. Hood Beverage Co. v. Constellation Brands, Inc.*, 149 Wn.2d 98, 110-11, 63 P.3d 779, 786 (2003), as amended on denial of reconsideration (Apr. 30, 2003).

[61] *See New Energy*, 486 U.S. at 276 (fact that discriminatory tax impacted only one out-of-state manufacturer does not matter); *W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186,

The Supreme Court has invalidated as facially discriminatory a tax on stock issued by corporations engaged in interstate commerce because it discouraged "domestic corporations from plying their trades in interstate commerce."[62] The Court also invalidated a statue that required out-of-state shippers of beer to affirm that their Connecticut prices were no higher than their prices in neighboring states.[63] The court found that the statute "establishes a substantial disincentive for companies doing business in Connecticut to engage in interstate commerce."[64]

**3. Order 05 is premised on illegal economic protectionism.**

The Commission justified its disallowance of PacifiCorp's out-of-state QFs PPAs to protect Washington customers from their "significant financial impact."[65] The order allows Washington customers to pay less than the actual costs of their QF energy and capacity when it is provided by a generator located outside Washington. Regulations like Order 05 that "give local consumers an advantage over consumers in other States" constitute illegal economic protectionism under the Commerce Clause.[66]

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195-96, 114 S. Ct. 2205, 2213, 129 L. Ed. 2d 157 (1994) (inability to respond to discriminatory pricing order does not affect dormant Commerce Clause analysis).

[62] *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333, 116 S. Ct. 848, 855, 133 L. Ed. 2d 796 (1996).

[63] *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 326, 109 S. Ct. 2491, 2494, 105 L. Ed. 2d 275 (1989).

[64] *Id.* at 341.

[65] AR 872, Order 05 ¶ 113.

[66] *Brown-Forman Distillers Corp.*, 476 U.S. at 580.

### 4. The Commission cannot defend its discriminatory treatment of QFs based on retail ratemaking authority.

The fact that the Commission used its ratemaking authority in issuing Order 05 does not negate its unconstitutionality.[67] The Seventh Circuit struck down an Illinois statute that guaranteed rate recovery for utility expenses incurred to allow the continued burning of Illinois coal because guaranteed rate recovery is the "equivalent to [unconstitutional] minimum price fixing for the benefit of local producers."[68] In *New England Power* and *Middle South Energy* (discussed in the Opening Brief), courts invalidated regulatory actions predicated on the same ratemaking authority relied on here.[69]

### 5. Physically limiting the flow of electricity is not required for a violation of the dormant Commerce Clause.

Public Counsel argues that Order 05 "does not affect the flow of electrons."[70] But it is not necessary for the Commission to physically stop the flow of power at Washington's borders for its actions to violate the Commerce Clause. In *New England Power*, the Court struck down a commission order prohibiting the export of hydro generation even though the generator was not required to "sever its connection" to the interstate grid or "contain that electricity within the [state] in any physical sense."[71]

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[67] *See, e.g.,* PCA Br. at 33-34.

[68] *Alliance for Clean Coal v. Miller*, 44 F.3d 591, 595-96 (7th Cir. 1995).

[69] *New England Power,* 455 U.S. at 339; *Middle S. Energy, Inc. v. Arkansas Pub. Serv. Comm'n*, 772 F.2d 404, 417 (8th Cir. 1985).

[70] Public Counsel Br. at 29.

[71] *New England Power*, 455 U.S. at 336.

An absolute prohibition is unnecessary to show unconstitutional discrimination.[72]

### D. The Commission's Use of a Fictitious Capital Structure Violates the WAPA.

#### 1. There is no evidence that this is an exceptional case, warranting application of a fictitious capital structure.

The Commission argues that there is nothing unusual about the Commission's use of a fictitious capital structure.[73] On the contrary, as reflected in the cases cited by the parties, fictitious capital structures are used only in exceptional cases.[74] The Washington Superior Court ruled that: "the commission may disregard the existing capital structure of a regulated company when it finds from the evidence that the existing capital structure is unreasonable so as to impose an unfair burden on the consumer."[75] The court relied on a Massachusetts case, which explains that the actual capital structure must be "so unreasonably or substantially varied from usual practice as to impose an unfair burden on the consumer."[76] The Commission itself previously observed that

[72] *Camps Newfound*, 520 U.S. at 576-78.

[73] Commission Br. at 39; *see also* Public Counsel Br. at 35-36.

[74] James C. Bonbright, Albert L. Danielsen & David R. Kamerschen, *Principles of Public Utility Rates*, 309 (2d ed. Public Utilities Reports 1988) (it is "preferable" to use a utility's actual capital structure, employing a fictitious capital structure only when the actual capital structure is "clearly unsound or is extravagantly conservative"); Leonard Saul Goodman, *The Process of Ratemaking*, 651-52 (2st ed. Public Utilities Reports 1998) ("[c]ertainly the more common of the capitalization ratios used by regulatory agencies is the actual debt ratio shown on the books of the regulated enterprise").

[75] *Pacific NW Bell Tel. Co. v. WUTC*, 98 P.U.R.3d 16 (Wash.Super. 1972).

[76] *New England Teleph. & Teleg. Co. v. Mass. Dept. of Pub. Util.*, 92 P.U.R.3d 113, 275 N.E.2d 493, 509 (1971), abrogated on other grounds by *Boston Gas Co. v. Dept. of Pub. Util.*, 539 N.E.2d 1001 (1989).

"management prerogatives are strongly to be considered in commission consideration of capital structure."[77]

The Commission's position that fictitious capital structures are commonplace is undermined by the fact Washington is the only state among the six in which PacifiCorp operates that uses a fictitious capital structure.[78] FERC also recently reaffirmed the continued use of a utility's actual capital structure unless it is entirely outside the reasonable range.[79]

### 2. The finding that the fictitious equity ratio supported PacifiCorp's credit rating is unsupported by substantial evidence.

The Commission claims the voluminous cost of capital testimony supports the use of a fictitious capital structure with 49.1 percent equity.[80] But very little of the evidence actually addressed capital structure, and none of it supported the Commission's decision, which rests solely on the finding that the fictitious equity ratio supports the Company's strong credit rating. The undisputed evidence demonstrated that PacifiCorp's credit rating is based on its *actual* equity ratio, not the fictitious ratio approved by the Commission in the Company's past rate cases.[81] PacifiCorp's witness testified that "there is little doubt" that PacifiCorp's credit rating

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[77] *WUTC v. Washington Natural Gas Co.*, 32 P.U.R.4th 530, 537 (Sept. 25, 1979).

[78] AR 3039, Ex. BNW-14T.

[79] *Assoc. of Bus. Advocating Tariff Equity, et al. v. Midcontinent Indep. Sys. Operator, Inc., et al.*, 149 F.E.R.C. ¶ 61,049, ¶ 13 (2014) (rejecting a proposed cap on equity ratios because "it is reasonable to assume that individual utilities are subject to different risk factors, have different investment needs, and may pursue different business strategies, all of which could affect capitalization decisions").

[80] Commission Br. at 32-33; *see also* Public Counsel Br. at 43-44.

[81] AR 2945, 2955, Ex. BNW-1T; Tr. 221:15-23 (Williams); Tr. 188:11-18 (Gorman); AR 3050, Ex. BNW-14T.

would be lower if it was actually capitalized at the fictitious equity ratio, a point conceded by the Commission's staff.[82]

The parties argue that the Commission's finding is supported by the reasonable reliance on Mr. Gorman's assumption that ratings agencies accounted for the fictitious capital structure.[83] But Mr. Gorman admitted on cross-examination that ratings agencies examine PacifiCorp on a consolidated basis—based on actual capitalization—and he did not actually know if ratings agencies had reviewed the imputed equity ratio.[84]

PCA also argues that ratings agencies review the Company's total financial health, which includes Washington revenue.[85] Every other state uses PacifiCorp's actual capital structure, thereby contributing to the stable credit rating, and the undisputed evidence showed that PacifiCorp achieved its rating due to its *actual* capital structure.[86] The Company's consistent under-earnings in Washington also contradict the premise that these earnings support its credit rating.[87]

### 3. The Commission improperly relied on the record of the Company's previous rate case.

In Order 05, the Commission concluded that the Company's capital structure should have the same equity ratio the Commission

[82] AR 3050, Ex. BNW-14T.

[83] Commission Br. at 37; PCA Br. at 36-37.

[84] Tr. 188:11-18 (Gorman); AR 4181, Ex. MPG-24CX.

[85] PCA Br. at 36-37.

[86] Tr. 261:5-10 (Williams); AR 3049-50, Ex. BNW-14T.

[87] AR 1423, Ex. WRG-1T.

approved in the 2010 rate case.[88] The Commission claimed that "*all* of the cost of capital evidence and advocacy in this case closely matches that presented in the earlier [2010 rate] case."[89]

The Commission claims that its observation that the record in this case was "strikingly similar" to the record in the 2010 rate case was "merely an editorial comment that placed the parties' respective positions in a historical perspective."[90] Further, it was just "recalling past experience" when it wrote in Order 05, "we conclude again in this case that Mr. Gorman's proposed capital structure . . . best reflects what is appropriate for this Company."[91] But there is no doubt that the Commission relied on the 2010 rate case record because the only other substantive basis for its decision—that the fictitious capital structure maintained PacifiCorp's credit rating—is clearly not supported by the evidence in the record in this case. The Commission's repeated references to the record in the 2010 rate case and the Commission's explicit decision to adopt the same capital structure, despite the lack of evidentiary support in the record in this case, indicate that the Commission improperly relied on evidence outside the record.[92]

Both Public Counsel and PCA attempt to distinguish the recent decision by the superior court concluding that the Commission's order in a

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[88] AR 840-41, Order 05 ¶ 39.

[89] AR 840-42, Order 05 ¶¶ 39-41 (emphasis in original).

[90] Commission Br. at 35.

[91] Commission Br. at 36-37; *see also* Public Counsel Br. at 46; PCA Br. at 39.

[92] RCW 34.05.476(3); RCW 34.05.461(4).

Puget Sound Energy (PSE) case "does not satisfy the requirement of substantial evidence in the record" because it improperly relied on evidence from a previous case.[93] The parties argue that there was a fully developed record in this case, whereas the PSE case had "no evidence at all in the record to support the reasonableness of" the Commission's decision.[94] But in the PSE case, the Commission repeatedly referred to the record from the prior rate case and ultimately maintained the status quo after concluding that the evidence presented did not warrant a change.[95] The court found that the Commission's decision to "keep the status quo" was improper because the Commission "most strongly" relied on its decision setting rates in the prior case.[96] Here, the Commission maintained the status quo after stating explicitly that the evidence in the Company's 2010 rate case was similar to the evidence here, even though the basis for the Commission's decision in 2010 was entirely absent from the record. Like the PSE case, the Commission's decision in Order 05 illegally relied on evidence not in the record.

#### 4. The Company demonstrated under-recovery, which will hinder the advancement of state energy policies.

The Commission argues that PacifiCorp's claim of cost under-

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[93] *Industrial Customers of Northwest Utilities v. WUTC*, Thurston County Superior Case Nos. 12-2-01576-2 and 13-2-01582-7 (consolidated), Order Granting in Part and Denying in Part Petitions for Judicial Review, Appendix A at 5 (Jul. 25, 2014).

[94] Public Counsel Br. at 45-46; PCA Br. at 39.

[95] *WUTC v. Puget Sound Energy*, Dockets UE-121697, *et al.*, Order 07 ¶ 58 (June 25, 2013).

[96] *Industrial Customers of Northwest Utilities v. WUTC*, Thurston County Superior Case Nos. 12-2-01576-2 and 13-2-01582-7 (consolidated), Order Granting in Part and Denying in Part Petitions for Judicial Review, Appendix A at 5 (Jul. 25, 2014).

recovery is unsubstantiated because PacifiCorp will only under-recover "profit below the level its shareholders would like to reap."[97] This argument misconstrues one of the most basic and well-established tenets of utility ratemaking—that a utility's cost to serve customers includes both its operating and its capital costs.[98] Here, PacifiCorp's revenues were far below the cost to serve Washington.[99]

The Commission asserts that PacifiCorp's claim of under-recovery is based on the testimony of a single witness.[100] But PacifiCorp's evidence of historical earnings was based on annual reports filed with the Commission.[101] The Commission also claims that a staff witness testified that the Company's actual equity ratio resulted in "enhanced returns" for PacifiCorp's owner, BHE, which violated BHE's commitment when it acquired PacifiCorp that its acquisition would not result in higher capital costs.[102] In fact, staff's testimony did not address the Company's historical under-recovery and never disagreed that the Company had chronically under-recovered its costs since 2006.[103] The claim that the Company

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[97] Commission Br. at 23.

[98] *Bluefield Water Works & Imp. Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692, 43 S. Ct. 675, 679, 67 L. Ed. 1176 (1923); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S. Ct. 281, 288, 88 L. Ed. 333 (1944); *People's Org. for Washington Energy Res.*, 104 Wn.2d at 811; Bonbright, *Principles of Public Utility Rates*, at 111-12 ("cost must be given a broader definition than is customary in the language of accounting, since it must include allowance for a capital-attracting rate of return on investment").

[99] AR 1423, Ex. WRG-1T; AR 1250, Ex. GND-1CT.

[100] Commission Br. at 42-43.

[101] AR 1423, Ex. WRG-1T.

[102] Commission Br. at 35-36.

[103] AR 3176, Ex. KLE-1T.

earned "enhanced returns" is irreconcilable with this record. And the claim that the Company's actual capital structure violated an acquisition commitment is directly contradicted by the Commission's past orders finding that BHE's ownership has lowered PacifiCorp's cost of capital.[104]

**5. The Commission should have increased the cost of debt.**

The Company's actual debt costs correspond to the Company's actual credit rating, which is based on the actual capital structure.[105] The Commission's fictitious capital structure is riskier than the Company's actual capital structure and, if the Company were actually capitalized with 49.1 percent equity, it would result in higher debt costs due to a credit ratings downgrade.[106] It is well established that fictitious capital structures require corresponding adjustments: "[w]ith a deemed (fictitious) capital structure, [all cost of capital components] must be artificially adjusted so as to be synchronous with the fictitious capital structure adopted."[107] The Commission erred in not increasing the Company's debt costs to address the additional risks of the fictitious capital structure.

## IV. CONCLUSION

The Commission's refusal to include the Company's out-of-state QF PPA costs in Washington rates violates the WAPA, PURPA, and the U.S Constitution. The Commission's reliance on state cost allocation

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[104] *WUTC v. PacifiCorp*, Docket UE-100749, Order 06 ¶ 102 (Mar. 25, 2011).

[105] AR 2945, 2955, Ex. BNW-1T; Tr. 221:15-23 (Williams); Tr. 188:11-18 (Gorman); AR 3050, Ex. BNW-14T.

[106] *WUTC v. Puget Sound Energy*, Dockets UG-040640, *et al.*, Order 06 ¶ 27 (Feb. 18, 2005); AR 3049-50, Ex. BNW-14T; AR 2944-45, Ex. BNW-1T.

[107] Roger A. Morin, *New Regulatory Finance*, 485 (1st ed. Public Utilities Reports 2006).

policy to defend its order fails under PURPA and federal preemption principles. Order 05 is unconstitutional because it treats QFs differently based solely on their location, creates illegal preferences for Washington QFs and customers, and discourages the Company from engaging in interstate commerce. The Commission's ratemaking authority does not trump constitutional mandates or federal law.

There is no evidentiary support for the Commission's adoption of a fictitious capital structure. The Commission's failure to make corresponding and necessary adjustments to other elements of the Company's capital costs is one-sided and arbitrary. Order 05 must be reversed.

Respectfully submitted this 25th day of February, 2015.

By: ______________________

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## CERTIFICATE OF SERVICE

I hereby certify that on the 25th day February, 2015, I caused to be served the foregoing REPLY BRIEF OF APPELLANT on the following parties at the following addresses:

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