NO. 46009-2-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

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

v.

Washington Utilities and Transportation Commission,
a Washington State Agency,
Respondent,

Public Counsel Division of The Washington
Attorney General's Office,
Intervenor-Respondent,

Packing Corporation of America,
f/k/a Boise White Paper, L.L.C.,
Intervenor/Respondents.

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I. INTRODUCTION

The Washington Utilities and Transportation Commission allowed PacifiCorp to increase its electricity rates for Washington customers, but rejected increases associated with certain costs, thus protecting Washington customers from excessive rate increases. The Commission's decision centered on standard utility ratemaking issues: (1) how costs should be allocated among states for a utility that covers multiple states, and (2) determining an overall rate of return, which factors heavily in determining the rates PacifiCorp can charge its Washington customers.

PacifiCorp proposed to increase its Washington customers' rates by including in its rate calculation the cost of contracts with Qualifying Facilities (QFs), small electricity generators, which are physically located out-of-state.[1] PacifiCorp's proposal would raise the net power costs for Washington customers by over $10 million. Under the Public Utility Regulatory Policies Act of 1978 (PURPA), the states are authorized to determine for the utilities they regulate the rate they must pay for QF power, if they comply with undisputed statutory limits. PacifiCorp did not meet its burden to show that the proposed changes were appropriate.

Further, the Commission's action did not violate the Commerce Clause because it did not affect interstate commerce, or favor a

[1] These small electricity generators are Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978 (PURPA).

Washington interest improperly over the interests of another state. The Commission's allocation of costs does not actually shift costs onto other states, and each state determines utility rates based on their laws and policies. Additionally, each state determines how it will implement PURPA for the utilities they regulate. The Commission's allocation of cost does not affect another state's implementation of PURPA, PacifiCorp's contracts with QFs, or the flow of electrons.

PacifiCorp also proposed that the Commission set the company's rates using a higher equity ratio than previously approved in its capital structure. Capital structure refers to the mix of debt and equity that a utility has used to fund its operations. A capital structure weighted too strongly towards equity – like the one PacifiCorp proposed – results in unreasonably high costs for the ratepayer. The Commission adopted a hypothetical capital structure to set PacifiCorp's rates after a multi-day evidentiary hearing. The Commission weighed the extensive evidence and explained that its adopted hypothetical capital structure appropriately balanced company and ratepayer interests. This Court should not re-weigh evidence the Commission considered.

The Commission exercised its expertise and discretion in determining the outcome of PacifiCorp's rate case. This Court should affirm the Commission's final order AR 824-932 (Order 05).

II. COUNTERSTATEMENT OF THE ISSUES

1. Under the Public Utility Regulatory Policies Act of 1978 (PURPA), did the Commission properly allocate PacifiCorp's power costs when it declined to include the cost of power purchase agreements with out-of-state Qualifying Facilities, states determine cost allocation and cost recovery of such contracts, and the Commission applied the Western Control Area cost allocation methodology?

2. Under the Commerce Clause of the United States Constitution, is the Commission authorized to treat the cost of power from out-of-state Qualifying Facilities pursuant to the Western Control Area cost allocation methodology when the Commission's action is consistent with PURPA, does not pose a barrier to interstate commerce, and does not advance a Washington interest improperly over that of another state?

3. Under regulatory principles, did the Commission appropriately set PacifiCorp's rates using a hypothetical capital structure when it weighed all of the evidence presented by the parties, it considered whether the proposed capital structures properly balanced safety and economy, and the capital structure proposed by PacifiCorp tipped too far in favor of shareholder interests?

III. COUNTERSTATEMENT OF THE CASE

In 2013, PacifiCorp filed its eighth general rate case in ten years seeking a rate increase from its Washington customers.[2] PacifiCorp requested a 12.1 percent rate increase, which would have raised the cost to

[2] Between 2003 and 2013, PacifiCorp filed eight general rate cases seeking to increase retail rates. The Commission docket number assigned to the 2013 general rate case, subject to the current appeal, was Docket UE-130043. The Commission docket numbers for the remaining seven cases were UE-032065, UE-050684, UE-061546, UE-080220, UE-090205, UE-100749, and UE-111190.

approximately 132,000 Washington customers by $36.9 million.[3] AR[4] 2344 (Exh. No. SRM-6T at 1:14-15); AR 2748 (Exh. No. RPR-1T at 2:16-17); AR 625 (PacifiCorp's Brief).

The Commission rejected PacifiCorp's request. AR 824 – 932 (Order 05). The proceeding below was robust and included an evidentiary hearing, two public comment hearings, and evidence submitted by the five parties. The record consists of testimony from 34 witnesses who collectively sponsored 286 exhibits. AR. 829 (Order 05 at ¶¶ 11-12).[5]

The parties before the Commission were (1) PacifiCorp, an investor-owned electric utility providing service to customers in south central Washington, (2) Commission Staff, who participates as a party in formal proceedings before the Commission,[6] (3) the Public Counsel Unit of the Washington Attorney General's Office (Public Counsel), who is the statutory representative of PacifiCorp's electric customers in Washington,[7]

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[3] PacifiCorp's initial request was for 14.1 percent increase, or $42.8 million. PacifiCorp later revised its request based on, in large part, changes in net power costs and certain tax credits. AR 625 (PacifiCorp's Brief at 1).

[4] AR refers to Agency Record.

[5] The evidentiary hearing produced a transcript consisting of 589 pages. Additionally, the Commission received oral comments from 12 individuals at the public comment hearings and numerous written comments, which are included in the formal record at AR. 1011-1013 (Exhibit B-1).

[6] The Commissioners, the presiding administrative law judge, and the Commissioners' policy and accounting advisors do not discuss the merits of proceedings with Commission Staff – or any other party – without giving notice and an opportunity for all parties to participate. *See* AR 829 (Order 05, n.6).

[7] RCW 80.01.100 and RCW 80.04.510. Public Counsel is a unit of the Attorney General's Office. Public Counsel is distinct functionally and administratively from the Utilities and Transportation Division, which represents the Commission in this appeal.

(4) Packing Corporation of America[8] (Packing Corp.), who is PacifiCorp's largest costumer in its Washington service territory, and (5) The Energy Project, who represents low income customer interests.[9]

The vast majority of PacifiCorp's Washington service territory is in Yakima and Walla Walla Counties. PacifiCorp's service territory also includes parts of Columbia, Garfield, and Kittitas Counties. AR 2748 (Exh. No. RPR-1T at 2:16-17). These counties continue to struggle to recover from the recent economic downturn, as indicated by U.S. Census data. For example, a disproportionately high number of people in Yakima and Walla Walla Counties live below the poverty level as compared to other areas in our state. The percentage of the total population in Washington living below the poverty level is 12.5 percent, whereas 18.2 percent in Walla Walla County and 21.4 percent in Yakima County lives below the poverty level. AR 3854 – 3855 (LD-1T at 8:13 – 9:3); AR 780 (Public Counsel Brief). Those in poverty in these counties would feel the effects of excessive rate increases especially acutely.

Public Counsel serves as the ratepayer advocate in utility company rate cases, representing residential and small business customer interests.

[8] Packing Corporation of America participated in Docket UE-130043 as Boise White Paper.

[9] The Energy Project is not participating in the review before this Court.

A. PacifiCorp Sought to Change its Cost Allocation Methodology to Include the Cost of Out-of-State Qualifying Facilities Contracts, Increasing the Cost of Power to Washington Ratepayers.

PacifiCorp serves customers in several western states, and it must allocate its costs among ratepayers in those states. AR 2748 (Exh. No. RPR-1T at 2:5-15); AR 2755 – 2757 (Exh. No. RPR-2); AR 832 (Order 05 at ¶ 19). It is important to allocate costs appropriately to ensure that ratepayers are paying only for costs associated with their service.

PacifiCorp's Washington multi-state cost allocation methodology, known as the Western Control Area cost allocation methodology, has been used since PacifiCorp proposed it in its 2006 general rate case. AR 857-860 (Order 05 at ¶¶ 79-82). This case is the fifth general rate case since the Western Control Area cost allocation was approved. *See* Fn. 1, supra; AR 859 (Order 05 at ¶ 82). In this case, PacifiCorp requested that the Commission change its cost allocation methodology to include in Washington rates costs associated with out-of-state QF power purchase agreements, regardless of the physical location of the generation facilities. AR 1225 (Exh. No. GND-1T at 5:9-12).

Qualifying Facilities, or QFs, are qualifying cogeneration facilities[10] and qualifying small power production facilities[11] under PURPA.[12] The out-of-state QF facilities at issue in this case are small run-of-river hydroelectric facilities, wind power generators, and biomass facilities located mostly in Oregon with some in California. AR 3792 (Exh. No. SC-1CT at p. 16:17-19; TR. 296:17-23; AR 1418 (Exh. No. GND-15CX, p.2).

Most of the QFs were small generators that most likely served the local markets in Oregon and California where they are located, and PacifiCorp did not provide evidence to the contrary. AR 3792 (Exh. No. SC-1CT at 16:14-16). Although PacifiCorp argued that power from the out-of-state QFs was used to balance the region's load and that power was physically delivered to meet Washington load, PacifiCorp did not have a power supply study to show the flow of power from the out-of-state QFs to Washington and could not quantify the benefit to Washington. AR 1225 – 1226 (Exh. No. GND-1CT, pp. 5-6); Duvall, TR. 296:22-23; AR 1418 (Exh. No. GND-15CX, p. 2, item (e)); AR 857, 867 (Order 05 at ¶ 79, 100).

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[10] Cogeneration involves the simultaneous production of both thermal energy, such as heat or steam, and electricity. This usually occurs on an industrial site.

[11] Small production facilities usually produce electricity from a renewable resource, such as wind, solar, or biomass.

[12] If a facility meets the requirements to be a QF, it may demand that a utility purchase its power and provide backup power to it. 16 U. S. C. § 824a-3(a).

The cost of power purchase agreements with out-of-state Qualifying Facilities (QFs) has never before been included in Washington rates at their contract rates under the Western Control Area cost allocation methodology. Duvall, TR. 295:5-18. Rather, the Western Control Area cost allocation methodology assigns the cost of QF contracts to the state in which the QF is physically located, which is also the state that establishes the price PacifiCorp pays the QF. Under the Western Control Area methodology, the practical effect is to replace the Oregon and California QFs with market purchases, which prevents Washington customers from being harmed by policies over which they have no control. AR 3973 – 3974 (Exh No. MCD-1CT at 6:17 - 7:9).

Due to policy decisions made by Washington, Oregon and California, each state calculates the cost of QF power differently. AR 3233 – 3237 (Exh. No. DCG-1CT at p. 9-13). QF contract pricing and contract terms are handled very differently in Washington than in Oregon or California. In particular, Oregon uses a fixed price while Washington does not. AR 3973 (Exh. No. MCD-1CT at 6:18-19). In addition, Washington requires smaller and shorter contracts than Oregon requires, which can insulate Washington from changes in avoided cost compared to the contract price. AR 3236 – 3237 (Exh. No. DCG-1CT at p. 12-13). For example, evidence shows that the nominal cost of a contract with the out-of-state QFs ($77 per megawatt hour) is substantially higher than PacifiCorp's avoided cost ($35 per megawatt hour). AR 3236 – 3237 (Exh. No. DCG-1CT at p. 12-13); *see also* AR 3793 (Exh. No. SC-1CT at 17:8-15); AR 3830 (Exh. No. SC-5C, p. 1).

PacifiCorp is not using out-of-state QF power to comply with renewable energy portfolio standards required under the Energy Independence Act (I-937), chapter 19.285 RCW. There are no Renewable Energy Credits associated with the power purchase agreements with the out-of-state QFs.[13] AR. 1353 – 1354 (Exh. No. GND-7CT, pp. 13:18 – 14:1); RCW 19.285.040(2).

B. PacifiCorp Requested That the Commission Use its Actual Capital Structure in Setting Rates.

PacifiCorp requested that the Commission use its actual capital structure for ratemaking purposes. Capital structure is the mix of debt and equity a utility uses to fund its operations. The Commission uses capital structure in calculating a utility's fair rate of return. Rate of return is calculated by first determining (1) the interest rate that the utility pays on debt and (2) the investor's required rate of return on equity, then multiplying the rates by the capital structure. AR 838 (Order 05, Table 5).

[13] To comply with I-937, a utility may produce electricity using renewable resources or it may purchase Renewable Energy Credits. RCW 19.285.040(2). The Commission reviews utility compliance with I-937 in a separate proceeding. For instance, the Commission reviewed PacifiCorp's compliance with I-937 in Docket UE-111880 (conservation) and Docket UE-131063 (renewable resources).

In this case, PacifiCorp presented a capital structure that consists of 52.2 percent equity and 47.5 percent debt.[14, 15] The Commission has historically used a hypothetical capital structure for PacifiCorp, most recently approving a hypothetical capital structure of 49.1 percent equity in PacifiCorp's 2010 general rate case.[16]

Packing Corp.'s witness Mr. Gorman recommended that the Commission continue to use the hypothetical capital structure with 49.1 percent equity because it supports PacifiCorp's bond rating and because the 52 percent PacifiCorp requested is "unnecessary and imposes unnecessarily high costs on Washington ratepayers." AR 4088 (Exh. No. MPG-1T at 24:12-19).

Commission Staff witness Mr. Elgin also testified that the Commission should use a hypothetical capital structure and rebutted PacifiCorp's argument that use of its actual capital structure was necessary

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[14] PacifiCorp also reflected approximately 0.3 percent of preferred stock in its capital structure. AR 3041 (Exh. No. BNW-14T, p.5)

[15] Mr. Williams for PacifiCorp initially testified that the equity ratio should be 52.5 percent, but adjusted the percentage in his rebuttal testimony to 52.2 percent. AR 3040 – 3041 (Exh. No. BNW-14T, p. 4 – 5). This is illustrative of how capital structure frequently shifts in its precise makeup.

[16] PacifiCorp's 2010 general rate case was heard by the Commission in Docket UE-100749. PacifiCorp sought judicial appeal of the Commission's final order in that case, after filing a Petition for Reconsideration with the Commission. PacifiCorp did not appeal the hypothetical capital structure. *PacifiCorp d/b/a Pacific Power & Light v. WUTC,* Thurston Cnty. Sup. Ct. No. 12-2-02667-7, Petition for Judicial Review (Dec. 28, 2012). PacifiCorp's 2011 general rate case was heard in Docket UE-111190 and was resolved by settlement that was silent on capital structure. *PacifiCorp d/b/a Pacific Power & Light,* Docket UE-111190, Order 07 (March 30, 2012)(hereinafter 2011 PacifiCorp).

to maintain the company's credit rating. Mr. Elgin recommended an equity ratio of 46.0 for setting PacifiCorp's rates. AR 3143 - 3144 (Exh. No. KLE-1T at 13:20-14:22). Mr. Elgin considered the proxy group of companies used in his return on equity calculation, and determined that the average equity ratio of those companies was 48.5 percent. AR 3141-3142 (Exh. No. KLE-1T at 11:19-12:2). Mr. Elgin concluded that PacifiCorp's proposed equity ratio of 52 percent was too high as compared to the proxy group average. AR 3142 (Exh. No. KLE-1T at 12:4-19). Mr. Elgin further analyzed the proxy group with respect to their operations. Some companies had substantial non-regulated operations, and those companies tended to have higher equity ratios. *Id.* Companies with more limited unregulated operations had equity ratios of "about 46 percent." *Id.* Mr. Elgin determined that the data "shows that a utility primarily with regulated operations and an equity ratio in the mid-40 percent range can achieve a solid investment grade rating that enables them to raise capital on reasonable terms." AR 3143 (Exh. No. KLE-1T at 13).

C. Procedural History.

The Commission issued its final order in PacifiCorp's 2013 general rate case, *WUTC v. PacifiCorp D/B/A Pacific Power & Light Company,* Docket UE-130043, Order 05, *Final Order Rejecting Tariff Sheets; Resolving Contested Issues; Authorizing and Requiring*

Compliance Filing (December 4, 2013). AR 824 – 932. The Commission allowed PacifiCorp to raise customer rates by 5.5 percent (or $16.7 million annually), but declined to include in rates the costs of out-of-state QF contracts or PacifiCorp's requested higher equity ratio. PacifiCorp timely filed a Petition for Judicial Review with the Thurston County Superior Court. PacifiCorp sought direct review, which this Court granted.

IV. STANDARD OF REVIEW

In reviewing agency decisions, this Court applies the standards of the Washington Administrative Procedures Act, chapter 34.05 RCW, directly to the record before the agency. *Brighton v. Dept. of Transportation*, 109 Wn. App. 855, 861-862, 38 P.3d 344 (2001). The Court will uphold an agency's decision when it is lawful, supported by substantial evidence, and not arbitrary and capricious. *Callecod v. Wash. State Patrol*, 84 Wn. App. 663, 670, 929 P.2d 510 (1997); RCW 34.05.570(3). The party challenging the agency decision bears the high burden of demonstrating that the decision is invalid. RCW 34.05.570(1)(a); *Brighton*, 109 Wn. App. at 862.

Under RCW 80.04.430, the Commission's findings are prima facie correct. The United States Supreme Court has noted that rate setting orders, like the one in this case, are "the product of expert judgment which [carry] a presumption of validity." *Federal Power Comm. v. Hope Nat. Gas Co.,* 320 U.S. 591, 602, 64 S.Ct. 281, 88 L. Ed. 33 (1944).

The Commission's findings of fact are reviewed under a substantial evidence standard. *US West Comm'n., Inc. v. Wash. Util. & Trans. Comm.*, 134 Wn.2d 48, 56, 949 P.2d 1321 (1997). Substantial evidence is evidence sufficient to persuade a fair-minded person of the truth or correctness of the order. *Brighton*, 109 Wn. App. at 862; *Callecod*, 84 Wn. App. at 673. Evidence is "viewed in light of the whole record before the court." RCW 34.04.570(3)(e).

A decision is arbitrary and capricious only if it is willful, unreasoning, and in disregard of the facts and circumstances. *Callecod*, Wn. App. at 676. A decision supported by substantial evidence is not arbitrary and capricious even when the agency record contains conflicting evidence. *Id.*

Courts neither weigh credibility nor substitute their judgment for that of the agency. *Brighton*, 109 Wn. App. at 862. Indeed, Courts "are not at liberty to substitute their judgment for that of the Commission in rate cases." *US West*, 134 Wn.2d at 56; *People's Organization for Washington Energy Resources (POWER) v. Wash. Util. & Trans. Comm'n.*, 104 Wn.2d 798, 812, 711 P.2d 319 (1985)(hereinafter *POWER*).

V. ARGUMENT

The Commission properly balanced company and consumer interests in its final order in PacifiCorp's 2013 general rate case. The Commission weighed the evidence and appropriately rejected PacifiCorp's request to include in rates the cost of power purchase agreements with out-of-state Qualifying Facilities, which would have unfairly inflated Washington's net power cost. Additionally, the Commission set PacifiCorp's rates using a capital structure that optimized levels of more expensive equity with less expensive debt, fairly balancing the cost to customers with the company's ability to access credit at reasonable rates.

A. The Commission Did Not Violate PURPA or the Commerce Clause, But Rather Set Fair, Just, Reasonable, and Sufficient Rates that Satisfy the End Results Test When it Rejected PacifiCorp's Request to Change Its Cost Allocation Methodology.

The Commission's decision regarding PacifiCorp's power purchase agreements with out-of-state QFs was proper under PURPA, the Commerce Clause, and regulatory principles. PacifiCorp is a multi-jurisdictional utility, and under PURPA, the states determine cost allocation and cost recovery for utilities in their jurisdiction. Thus, when the Commission set PacifiCorp's rates using a methodology that produced results that are just and reasonable, and therefore satisfied the end results test articulated in *Federal Power Comm. v. Hope Nat. Gas Co.*, 320 U.S.

591, 64 S.Ct. 281, 88 L. Ed. 333 (1944),[17] it acted well within its authority.

1. PacifiCorp originally proposed the Western Control Area cost allocation methodology it now seeks to reverse.

Inter-state cost allocation has been an issue for PacifiCorp since its 1988 merger that brought Pacific Power and Utah Power under one company. The primary concern was allocation of the Pacific Power states' lower cost resources to the higher cost Utah Power states.[18] *WUTC v. PacifiCorp d/b/a Pacific Power & Light Company,* Docket UE-050684, Order 04 at ¶¶ 22-24 (April 17, 2006)(hereinafter 2005 PacifiCorp).

Over the years, the Commission has reviewed various proposals regarding PacifiCorp's multi-state cost allocation.[19] The Commission has evaluated PacifiCorp's multi-state cost allocation proposals for whether they comply with Washington's statutory requirements and whether PacifiCorp demonstrated "a quantifiable benefit to Washington ratepayers." *2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶¶ 50-51.

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[17] The end results test requires rates to "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed." Commissions are not bound by any single formula or combination of formulae in setting rates. *Hope*, 320 U.S. at 601-605.

[18] Washington is a Pacific Power state.

[19] Before the Western Control Area allocation methodology, the Commission had not approved a multi-state cost allocation methodology for PacifiCorp. *2005 PacifiCorp,* Docket UE-050684, Order 04 at ¶ 25; *WUTC v. PacifiCorp d/b/a Pacific Power & Light,* Docket UE-061546, Order 08 at ¶¶ 43-58 (June 21, 2007)(hereinafter 2006 PacifiCorp).

In this case, PacifiCorp's proposal to allocate the cost of out-of-state QF contracts to Washington ratepayers is "tantamount to asking that [the Commission] abandon the [Western Control Area] methodology and adopt the Revised Protocol methodology." AR 871, Order 05 at ¶ 110. The Commission properly rejected the Revised Protocol in 2005, and PacifiCorp has not established that the Commission should reverse that decision made almost a decade ago.

In 2005, PacifiCorp sought approval of the Revised Protocol in Docket UE-050684, its general rate case. Although PacifiCorp uses the Revised Protocol in other states, the Commission rejected the Revised Protocol for use in Washington. *2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶¶ 48-63. Specifically, the Commission held that PacifiCorp did not meet its burden in establishing that the Revised Protocol assigned resources to Washington that were "used and useful," in Washington as required by statute. *2005 PacifiCorp,* Docket UE-050684, Order 04 at ¶ 1, 48-49; RCW 80.04.250. Put another way, PacifiCorp failed to demonstrate that all of the resources used in its six-state system were "joint" facilities or used and useful for service in Washington. *2005 PacifiCorp,* Docket UE-050684, Order 04 at ¶ 58. Because the Commission had no way to properly allocate costs to Washington, it had no choice but to reject PacifiCorp's rate filing. *Id.* at ¶ 64.

In 2006, PacifiCorp changed course and presented the Western Control Area cost allocation methodology in its general rate case. Under the Western Control Area cost allocation methodology, cost associated with purchase power agreements with QFs physically located in Washington are allocated to Washington ratepayers. Costs associated with QFs outside of Washington are not allocated for recovery from Washington ratepayers at their contract prices.

This "situs" allocation of costs was part of PacifiCorp's Western Control Area cost allocation methodology proposal. AR 866 (Order 05 at ¶ 98). The Western Control Area methodology essentially replaces the power costs from out-of-state QFs with the costs of market purchases. AR 866 – 867 (Order 05 at ¶ 98); AR 3973 – 3974 (Exh. No. MCD-1T at 6-7). AR 3233 – 3237 (Exh. No. DCG-1CT at 9-13).

The Commission determined that the Western Control Area cost allocation methodology presented a solid foundation for identifying the resources that actually serve Washington's load. *2006 PacifiCorp,* Docket UE-061546, Order 08 at ¶ 53. The methodology was straightforward and easy to understand, and it could allocate indirect benefits and costs when they are quantified and demonstrated. *2006 PacifiCorp,* Docket UE-061546, Order 08 at ¶ 56.

The Commission approved the Western Control Area methodology with limited modifications, and it has been in effect for PacifiCorp continually since that approval.[20] *2006 PacifiCorp*, Docket UE-061546, Order 08 at ¶¶ 43-58; AR 866 (Order 05 at ¶ 98). In the current case, the Commission correctly found that PacifiCorp failed to meet its burden is establishing that the cost allocation methodology in Washington should be modified.

2. The Commission's decision here does not violate PURPA because FERC has left cost determination and allocation to the states and the Commission properly allocated costs according to its regulations and policies.

Costs associated with utility purchases of QF power are largely determined by states under PURPA. Congress enacted PURPA, 16 U.S.C. § 824a-3,[21] to remove obstacles preventing small power producers from interconnecting with a utility. Those obstacles were (1) utilities were not generally willing to purchase the small producers' power, or they were unwilling to pay an appropriate price for the power, (2) utilities generally charged unreasonable rates for back-up service to the small producers, and (3) the small producer ran the risk of being considered a public utility and

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[20] Approval of the Western Control Area cost allocation methodology was the result of a fully litigated case, not as a result of a settlement. A multi-party partial settlement was presented, but later withdrawn, and the case was determined on the merits. *2006 PacifiCorp,* Docket UE-061546, Order 08 at ¶¶ 11-58.

[21] PURPA has six Titles but only Section 210 of Title II, codified at 16 U.S.C. § 824a-3, is relevant here.

subject to state and federal regulation of utilities. *New PURPA Section 210(m)*[22] *Regulations Applicable to Small Power Production and Cogeneration Facilities*, 71 Fed. Reg. 64342, 64345 (November 1, 2006)(codified at 18 C.F.R. pt. 292)(hereinafter FERC Order 688).[23]

Under PURPA, Congress required utilities to purchase power from QFs. 16 U.S.C. § 824a-3(a). Rates for power from QFs must be just and reasonable to utility ratepayers, in the public interest, and not discriminatory against the QF. 16 U.S.C. § 824a-3(b). The rates also must not exceed avoided cost. 16 U.S.C. § 824a-3(b)(2); 18 C. F. R. § 292.101(a). Avoided cost is the incremental cost the utility would incur, either if it supplied the power itself or purchased it from another source, but for the purchase from the QF. 16 U.S.C. § 824a-3(b)(2); 18 C. F. R. § 292.101(a).

Each state regulatory authority was given the power to implement the rules prescribed by the Federal Energy Regulatory Commission (FERC) under PURPA. 16 U.S.C. § 824a-3(f). The state regulatory authorities, such as the Commission, were limited to implementing PURPA for electric utilities over which they have ratemaking authority. 16 U.S.C. § 824a-3(f)(1). Thus, the Commission may only implement

[22] Section 210 is codified at 16 U.S.C § 824a-3. The sections of Section 210 correspond with the sections of § 824a-3. For example, Section 210(m) is § 824a-3(m). Section 210(a) is § 824a-3(a), and so on.

[23] A copy of FERC Order 688 is attached hereto as Appendix 1.

PURPA with respect to the investor owned utilities providing electric service to customers in the State of Washington. RCW 80.01.040(3). Conversely, out-of-state regulatory authorities do not govern Washington's utilities' rates for utility service in Washington.

3. Recent FERC decisions affirm that states should decide their own cost allocation and cost recovery under PURPA.

In 2005, Congress added a new section to PURPA, changing the relationship between utilities and QFs. The primary purpose of the new section was to eliminate mandatory purchasing from QFs when certain market conditions exist, but it also briefly addressed utilities' recovery of the costs of purchasing power from QFs. *FERC Order 688*, 71 Fed. Reg. at 64342 and 64345; 16 U.S.C. § 824a-3(m).

16 U.S.C § 824a-3(m)(7) directed FERC to "issue and enforce such regulations as are necessary to ensure that an electric utility that purchases electric energy or capacity from a qualifying … facility … recovers all prudently incurred costs associated with the purchase." If FERC issued such a regulation, the regulation would be enforceable under the Federal Power Act (16 U.S.C. 791a et seq.).

FERC opened a rulemaking proceeding in 2006, to consider regulations to implement the provisions of 16 U.S.C. § 824a-3(m). After receiving extensive comments from stakeholders, including utilities and

QFs, FERC issued regulations to implement the new PURPA section.[24] Although FERC issued regulations implementing other subsections of 16 U.S.C. § 824a-3(m), it declined to issue a regulation implementing 16 U.S.C. § 824a-3(m)(7). FERC noted that its final rule "appropriately reflects Congressional intent in enacting section 210(m)," codified at 16 U.S.C. § 824a-3(m). *FERC Order 688*, 71 Fed. Reg. at 64342.

Utilities urged FERC to adopt rules implementing Section 210(m)(7), arguing that they face different methodologies for allocating costs across jurisdictions. *FERC Order 688*, 71 Fed. Reg. at 64369. FERC did not find the utilities' arguments persuasive because there was no evidence that the utilities were unable to recover their prudent costs. *Id.* FERC determined that there was no need to act, noting that it was "reluctant to review an issue that should be handled by the states in the first instance." *Id.* In other words, FERC concluded that the states should decide cost allocation and cost recovery under PURPA.

a. The Commission's treatment of QF costs is appropriate under PURPA.

When a utility such as PacifiCorp provides service in multiple states, it is subject to multiple regulatory jurisdictions. In PacifiCorp's case, it serves customers in Oregon, California, Utah, Wyoming, and

[24] PacifiCorp was one of the utility stakeholders who provided comments to FERC. *FERC Order 688*, 71 Fed. Reg. at 64375, Appendix A.

Idaho, in addition to Washington. PacifiCorp's operations in states other than Washington are outside of the Commission's jurisdiction and subject to the regulatory agencies in the other states.

Each state that regulates PacifiCorp is not bound by the determinations of the other. Each jurisdiction must regulate pursuant to its statutes, regulations, and policies. Those requirements may vary from state to state. For example, the Commission held that the statutory requirement that resources actually be "used and useful" in Washington effectively prohibited Washington's use of the Revised Protocol even though it was being used by other states in PacifiCorp's service territory. *2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶ 52-54; RCW 80.04.250. Indeed, the Commission recognized: "We cannot delegate our statutory responsibilities for determining prudence and protecting the interests of Washington ratepayers to other states." *2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶ 55.

Because states are not bound by the regulatory determinations of other states, and because each state has a duty to regulate the utilities in their jurisdictions pursuant to their statutes, regulations, and policies, it follows that the Commission properly evaluated PacifiCorp's request to alter its multi-state cost allocation methodology in light of Washington's statutes, regulations, and policies.

In this case, PacifiCorp attempted to allocate the cost of its power purchase agreements with QFs using the Revised Protocol methodology instead of the Western Control Area methodology. AR 871 (Order 05 at ¶ 110). This departure from the Western Control Area methodology would allocate a portion of all contracts with QFs located in Washington, Oregon, and California to Washington ratepayers. AR 1225 (Exh. No. GND-1CT at 5:9-12). Despite also allocating a portion of the Washington QF contracts to ratepayers in Oregon and California, the proposal would increase PacifiCorp's net power costs in Washington by $10.7 million.[25] AR 590 – 591 (Packing Corp. Brief at 22-23).

Additionally, the Commission rejected PacifiCorp's proposed changes to the Western Control Area cost allocation methodology because PacifiCorp failed to meet its burden to show that the proposed change was warranted. PacifiCorp failed to establish tangible, quantifiable benefits to Washington ratepayers that warrant a change in the multi-state allocation methodology used in Washington. AR 864, 865, 867 – 868, 871 (Order 05 at ¶¶ 92, 94, 100, 110). PacifiCorp failed to quantify direct benefits, such as flow of power from a resource to customers, or indirect benefits,

[25] It is important to note that the Western Control Area cost allocation methodology does not affect the rates paid by customers in any other jurisdiction. Allocating costs to a state other than Washington does not affect that state's rates. Rather, the cost allocation is a part of ratemaking, and the Commission is identifying costs that should be included in Washington rates. The other regulatory agencies in PacifiCorp's service territory make the same determinations about rates in their states.

such as system-wide benefits. AR 857, 867 (Order 05 at ¶ 79, 100); *See, 2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶¶ 50-53.

The Commission considered the policy differences regarding implementation of PURPA between Washington, Oregon, and California. TR. 500:9 – 505:15 (questioning from Chairman Danner regarding policy differences). Those policy differences have created differences in how avoided cost is calculated, resulting in higher avoided cost calculations in Oregon and California. TR. 505:10-14. "[As] a result of the policy choices that Oregon and California have made in implementing PURPA, the costs of these contracts results in net power costs that are significantly higher than would be the case were the same contracts re-priced at Washington's avoided cost rates." AR 867 (Order 05, ¶ 99).

Requiring Washington to adopt the avoided cost calculations of Oregon and California, as PacifiCorp requests, contradicts PURPA's delegation to states the ability to calculate avoided cost for the utilities in their jurisdiction. The reach of the Commission's authority stops at our state's borders because RCW 80.01.040(3) limits the Commission's jurisdiction to utility services provided in this state. Moreover, under PURPA, the Commission is prohibited from setting rates in excess of the avoided cost it determines. 16 U.S.C. § 824a-3(b) and (f); 18 C.F.R. § 292.304.

The North Carolina Supreme Court applied this reasoning in *State Utilities Commission v. North Carolina Power*, 450 S.E.2d 896 (1994), a case cited by PacifiCorp. In *North Carolina Power,* the North Carolina Utilities Commission disallowed $1.39 million in expenses associated with a contract with a cogeneration QF. *Id.* at 898. The contract had been entered into under the terms required by the Virginia State Corporation Commission. *Id.* The Court held that the North Carolina Utilities Commission did not violate PURPA when it excluded the costs determined by the Virginia Commission. *Id.* at 898-899.

As PacifiCorp does here, the utility in *North Carolina Power* contended that it was required to enter into the contract with the QF and that the Virginia Commission was implementing federal law. *Id.* The Court recognized that Virginia and North Carolina valued avoided cost differently and declined to force North Carolina to adopt Virginia's avoided cost calculation. *Id.* at 901.

In this case, the Commission excluded the contract price of the out-of-state QFs from PacifiCorp's rate calculation pursuant to Washington's adopted methodology, the Western Control Area cost allocation methodology. AR 866-867, 871-878 (Order 05 at ¶¶ 98, 110-114). The Western Control Area methodology assigns the costs of QF contracts based on the physical location of the generation facility. The practical effect of this "situs" assignment is to apply market rates to power produced by those out-of-state facilities when calculating Washington rates. AR 3973 – 3975 (Exh. No. MCD-1CT at 6:17-8:13). Just as North Carolina was not bound by Virginia's avoided cost determinations, the Commission is not bound by Oregon or California's avoided cost determinations, and the Commission's continued use of the Western Control Area methodology was appropriate.

PacifiCorp also argues that PURPA preempts the Commission's action and that state commission orders cannot contradict FERC decisions under PURPA, citing *Mississippi Power & Light v. Mississippi ex. Re. Moore,* 487 U.S. 354, 108 S. Ct. 2428, 101 L. Ed. 2d 322 (1988) and *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 106 S. Ct. 2349, 90 L. Ed. 2d 943 (1986). Neither case is applicable here because the Commission's action in this case does not contradict any FERC order.

Mississippi dealt with wholesale power rates and FERC power allocations that affect wholesale power rates. *Mississippi*, 487 U.S. at 355. This case is not about wholesale power rates, which are jurisdictional to FERC. The issue in this case is whether the Commission properly exercised its authority under PURPA, and it did.

Similarly, *Nantahala* dealt with FERC's allocation of so-called entitlement power from hydroelectric plants operated by the Tennessee

Valley Authority. Because FERC has exclusive jurisdiction over interstate wholesale power rates, the state commission was preempted from altering the allocation of entitlement power. *Nantahala*, 476 U.S. at 960-973. In this case, FERC does not set the avoided cost price that utilities must pay the QFs. States determine how avoided cost is calculated within certain guidelines provided by FERC. The Commission acted within those guidelines, and its action is not preempted in this case.

In sum, the Commission did not violate PURPA, but rather correctly set PacifiCorp's rates using the Western Control Area allocation methodology, protecting Washington customers from the higher avoided cost calculations of other states.

4. The Commission did not violate the Commerce Clause because it acted appropriately under PURPA, and it did not pose a barrier to the flow of commerce.

PacifiCorp argues that the Commission's actions violate the Commerce Clause of the United States Constitution. The Commission did not violate the Commerce Clause because it acted appropriately under PURPA, its actions do not pose a barrier to the flow of commerce, and its actions do not impede any other state's implementation of PURPA.

The Commerce Clause expressly empowers the U.S. Congress to "regulate Commerce….among the several states." U.S. CONST. art. I, § 8, cl. 3. The "dormant" Commerce Clause restricts states from unjustifiably discriminating against or burdening the interstate flow of commerce. This restriction applies to regulatory measures "designed to benefit in-state economic interests by burdening out-of-state competitors." *New Energy Co. of Indiana v. Limbaugh*, 486 U.S. 269, 273, 108 S.Ct. 1803, 1807, 100 L. Ed. 2d 302 (1988). For example, in *New Energy*, the U.S. Supreme Court invalidated certain tax credits given only to Ohio ethanol producers, or producers from states that granted reciprocal tax credits for Ohio-produced ethanol. The Commission's allocation of costs presents a very different scenario because the cost allocation decisions do not have an economic impact on customers or QFs in other jurisdictions.

The Commission did not burden an out-of-state competitor. Out-of-state QFs are not competitors to Washington-based QFs. Utilities are required to purchase power from QFs based on PURPA and state policies implementing PURPA. AR 868 (Order 05 at ¶ 102); 16 U.S.C. § 824a-3(b) and (f); 18 C.F.R. § 292.304. The states determine the amount and types of QF power that utilities subject to their jurisdiction must purchase. AR 868 (Order 05 at ¶ 102). PURPA does not allow one state to make these determinations for another state, and there is no competition among the states similar to the competition that is being protected by the Commerce Clause. Additionally, PacifiCorp would be required to purchase the QF power as determined by its regulator whether it operates in one state or multiple states.

The cost allocations under the Western Control Area methodology do not impact customers or QFs in other states. Any potential impact from any ' cost allocation decision is on the utility. This is because each state determines rates for the utilities providing service in their borders, and no state can set rates for another state. In this case, PacifiCorp has not demonstrated an impact on customers or QFs in other states, or on the company, and has not shown the economic protectionism that is prohibited by the Commerce Clause.

The cases cited by PacifiCorp are distinguishable. For example, in *New England Power Co., v. New Hampshire*, 445 U.S. 331, 102 S. Ct. 1096, 71 L. Ed. 2d 188 (1982), the regulatory agency prohibited the utility from selling is hydroelectric power outside of the state, requiring the electricity to be sold to customers within the state. In this case, the Western Control Area cost allocation methodology does not affect the flow of electrons; PacifiCorp is not prohibited from purchasing power from any power source. In *Middle South Energy, Inc., v. Arkansas Pub. Serv. Comm'n*, 772 F.2d 404 (1985), the regulatory authority planned to void certain contracts. In this case, the Commission's action has no effect on the power purchase agreements PacifiCorp has with out-of-state QFs.

Lastly, PacifiCorp cites to *Illinois Commerce Comm'n v. FERC*, 721 F.3d 764 (2013), for the proposition that states can not discriminate against out-of-state renewable energy. PacifiCorp fails to establish how Washington's use of the Western Control Area cost allocation methodology discriminates against any out-of-state renewable energy. Indeed, the Commission's use of the Western Control Area methodology has no effect on out-of-state QFs, as discussed above.

In *North Carolina Power*, the utility argued that the North Carolina regulatory commission's disallowance of expenses from a QF contract required by the Virginia regulatory commission violated the Commerce Clause. The Court held that North Carolina acted within its power under PURPA and thus did not violate the Commerce Clause. *North Carolina Power*, 450 S.E.2d at 902. The Court noted further that inconsistent state determinations of avoided cost by the North Carolina commission and the Virginia commission may burden the utility. The Court concluded that the burden was "a necessary consequence of doing business in more than one state." *Id.* This is precisely the situation PacifiCorp finds itself in.

Therefore, the Commission did not violate the Commerce Clause.

5. Maintaining the Western Control Area cost allocation methodology satisfies the end results test articulated in *Hope* because PacifiCorp is able to access capital markets at reasonable rates and is recovering its reasonable costs of service.

The Commission is the regulatory agency charged by statute with setting public utility rates in Washington. *US West*, 134 Wn.2d at 53. As an administrative agency, the Commission is a creature of the Legislature and has only the powers granted to it by statute. *Skagit Surveyors and Engineers, LLC v. Friends of Skagit County*, 135 Wn.2d 542, 558, 958 P.2d 962 (1998). The Commission is tasked with regulating in the public interest the rates, services, facilities and practices of all persons providing utility service in this state to the public for compensation. RCW 80.01.040(3).

The Commission must set rates that are fair, just, reasonable, and sufficient, and is authorized to set rates after hearing by order. RCW 80.28.020. The Commission has defined fair, just, reasonable, and sufficient to mean "<u>fair</u> to customers and to the Company's owners; <u>just</u> in the sense of being based solely on the record developed in the proceeding following principles of due process of law, <u>reasonable</u> in light of the range of possible outcomes supported by the evidence, and <u>sufficient</u> to meet the needs of the Company to cover its expenses and attract necessary capital on reasonable terms." *WUTC v. Puget Sound Energy, Inc.*, Docket UE-

090704 and UG-090705, Order 11 at ¶ 18 (April 2, 2010)(footnotes omitted; emphasis added)(hereinafter 2009 Puget).

In setting rates, the Commission is not bound by any one ratemaking methodology, and the Commission has wide latitude in choosing methodologies used in ratemaking. *POWER*, 104 Wn.2d at 812. Rates must satisfy the "end result test" and "need only to enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed." *POWER*, 104 Wn.2d at 811 (internal quotations omitted)(citing *Hope Nat. Gas*, 320 U.S. at 605, 64 S.Ct. at 289).

Lastly, a regulatory agency's rate decision must fall within the "zone of reasonableness." *POWER*, 104 Wn.2d at 811 (citing *Permian Basin Area Rate Cases*, 390 U.S. 747, 797, 88 S.Ct. 1344, 1375, 20 L. Ed. 2d 312 (1968).

In evaluating the Commission's order, the reviewing court is to assure itself that the Commission's order is supported by substantial evidence, is within the Commission's authority, and properly balances shareholder and ratepayer interests. *POWER*, 104 Wn.2d at 811 – 812 (citing *Permian Basin*, 390 U.S. at 791-792). The reviewing court is not to supplant the Commission's decisions with one closer to the Court's liking, but rather the Court is tasked with determining whether the

Commission "gave reasoned consideration to each of the pertinent factors." *Permian Basin*, 390 U.S. at 792.

In this case, the Commission set rates that are fair, just, reasonable, and sufficient. The Commission gave due consideration to the parties' arguments and to the evidence. It considered its obligations under PURPA. TR. 299:9-17 (Commissioner Jones's question and witness answer regarding state authority under PURPA). It considered the different policies regarding implementing PURPA between Washington and Oregon. TR. 301:2 – 303:5; TR 500:9 – 505:14. The Commission considered how those different policies affect the avoided cost calculation and determined that the Western Control Area cost allocation methodology treated QF costs appropriately and fairly. AR 866-872 (Order 05 at ¶¶ 97-114). The rates satisfy the end results test because PacifiCorp has been able to access debt at reasonable costs. AR 840-841 (Order 05 at ¶ 39). Therefore, the rates adjudicated in this case meet the end results test and should be affirmed.

Although PacifiCorp complains that the states it serves use different multi-state allocation methodologies, causing theoretical gaps in cost recovery, PacifiCorp understood that there was a risk of under-recovery when its eastern operations merged with its western operations in 1988. *2005 PacifiCorp*, Docket UE-050684, Order 04 at ¶ 56. It understood that the states may adopt different cost allocation methodologies, which could lead to under-recovery of system costs. This risk, PacifiCorp understood, fell on its shareholders. *Id.* Any gap caused by the use of different cost allocation methodologies is not due to any error made by the Commission.[26]

B. The Commission Has the Authority to Use a Hypothetical Capital Structure for Ratemaking Purposes, Based its Decision on Substantial Evidence in the Record Before It, and Treated PacifiCorp Fairly.

The Commission's decision to apply a hypothetical capital structure in setting PacifiCorp's rates was well within its authority and discretion. The Commission based its decision on substantial evidence, and it treated PacifiCorp fairly in light of that evidence and the Commission's precedent.

1. Use of hypothetical capital structure is well-established in utility ratemaking, and the Commission has the authority to use a hypothetical capital structure.

[26] Although there is a theoretical gap when states implement different cost allocation methodologies, in PacifiCorp's case it appears that it may be recovering – or over-recovering – its costs. Packing Corp. noted this possibility in its brief before the Commission:

> Under Washington's WCA allocation methodology, the costs of QFs are situs assigned by state. This means that Washington ratepayers pay the full cost of these Washington resources. Despite this recovery, PacifiCorp is also allocating the costs of Washington's QFs to each of the other five states it serves. Thus, it appears PacifiCorp is already over-recovering some of the costs of Washington QFs. It now attempts to use its unique multi-jurisdictional status to seek to over-recover an additional $10.7 from Washington ratepayers related to Oregon and California QFs.

AR 592 (Packing Corp Opening Brief at p. 22 (internal citations omitted)).

A utility funds its operations using a combination of debt and equity. Debt generally consists of long or short term debt, and equity generally consists of preferred stock and common equity. AR 3139 (Exh. No. KLE-1T at 9:6-13). Capital structure refers to the mix of debt and equity that a utility has used to fund its operations. Debt and equity have different costs, so the funding decisions made by a utility can have a substantial impact on customer rates and investor returns. *WUTC v. Puget Sound Energy, Inc.,* Docket UE-111048, Order 08 at ¶ 35 (May 7, 2012)(hereinafter 2011 Puget); AR 3139-3140 (Exh. No. KLT-1T at 9:6-10:17).

A capital structure used for ratemaking purposes should present an optimal mix of equity and debt to balance capital costs with financial risk. *In re Zia Natural Gas Co.,* 128 N.M. 728, 731, 998 P.2d 564, 567 (2000). The Commission requires the capital structures of privately held utilities, such as PacifiCorp, to appropriately balance debt and equity. *2011 Puget,* Docket UE-111048, Order 08, ¶ 35; AR 3140-3141 (Exh. No. KLT-1T at 10:19-11:15)..

Although the regulator's authority is not to revise the composition of a utility's actual capital structure, which is fully within the prerogative of the utility's management, use of hypothetical capital structure is widely accepted. *Sekan Elec. Co-op. Ass'n, Inc. v. State Corp. Comm'n,* 4 Kan.

App. 2d 477, 480, 609 P.2d 188 (1980); *See* AR 3139 (Exh. No. KLE-1T at 8-9). "The authority of a commission to adopt a hypothetical equity ratio for rate of return purposes has been almost universally upheld in the courts." *Sekan,* 4 Kan. App. at 480; *see also, Petition of Otter Tail Power Co.*, 417 N.W.2d 677, 682 (Minn. Ct. App. 1988) (Minnesota court of appeals upheld the regulatory commission's use of a hypothetical capital structure, noting that it could not conclude that the commission's concerns regarding the "continuing upward trend in [the utility's] equity ratio" were unreasonable).[27]

a. The Commission uses hypothetical capital structure in ratemaking when doing so is necessary to balance "safety" and "economy."

The composition of PacifiCorp's capital structure used for ratemaking purposes materially impacts the price customers pay for service. *2011 Puget,* Docket UE-111048 and UG-111049, Order 08 at ¶ 35. A capital structure weighted too strongly towards equity can result in unreasonably high costs for the ratepayer. On the other hand, a capital

[27] Other examples include: *Zia Natural Gas Co.,* 128 N.M. at 732 (New Mexico Supreme Court upheld the regulatory commission's decision to impute 51.5 percent equity when the actual equity ratio was 100 percent); *Pine Tree Tel. & Tel. Co. v. Pub. Utilities Comm'n*, 631 A.2d 57, 68-69 (Me. 1993) (imputing a hypothetical equity ratio of 60% when the actual equity was nearly 100%); *Sekan Elec. Co-op*, 4 Kan. App. 2d at, 480 (Court upheld regulatory commission's decision to impute 35 percent equity when the actual equity ratio was 55 percent); *Petition of Mountain States Tel. & Tel. Co.,* 76 Idaho 474, 486, 284 P.2d 681, 687-688 (1955) (Court upheld the regulatory commission's decision to impute 55 percent equity when the utility had an actual equity ratio of 69.2 percent).

structure weighted too strongly towards debt can jeopardize the utility's access to capital markets and financial viability. *Pioneer Natural Res. USA, Inc. v. Pub. Util. Comm'n of Texas*, 303 S.W.3d 363, 373 (Tex. App. 2009). Consequently, it is important for the regulator to ensure that the utility's rates reflect an appropriate capital structure in arriving at just, fair, reasonable, and sufficient rates.

The Commission judges a utility's capital structure on how it balances economy and safety. "Safety" refers to the idea that a capital structure with more equity and less debt may result in higher overall costs and higher rates for customers, but enhanced financial integrity. "Economy" refers to the idea that a capital structure with more debt and less equity may result in lower overall costs and lower rates for customers. *2011 Puget,* Docket UE-111048 and UG-111049, Order 08 at ¶ 35. The Commission must address the "basic tension between economy and safety in determining the capital structure to use for setting a utility's rates." *2011 Puget,* Docket UE-111048 and UG-111049, Order 08 at ¶ 36.

The Commission uses hypothetical capital structure on a case-by-case basis when the Commission deems it appropriate, such as when the utility's capital structure does not optimally balance debt and equity. *2011 Puget,* Docket UE-111048, Order 08, p. 20, n.64;. In choosing a hypothetical capital structure, the Commission considers all of the evidence in the record. *2005 PacifiCorp*, UE-050684, Order 04 at ¶ 230.

While Washington appellate courts have not addressed the issue of hypothetical capital structure, the King County Superior Court affirmed the Commission's ability to use hypothetical capital structures in ratemaking in a 1972 ruling. In *Pacific NW Bell Tel. Co. v. Wash. Util. & Trans. Comm'n*, 98 P.U.R. 3d 16 (Wash.Super.)(1972)[28], the utility challenged the Commission's use of hypothetical capital structure that contained 50 percent debt and 50 percent equity. The utility's actual capital structure was 46 percent debt and 54 percent equity. *Id.*

The Court recognized that it was reasonable that a commission could conclude a different capital structure could lower capital costs, and the Commission could therefore set rates using a different capital structure. *Id.* "The owners and management of a utility have the right to determine what the debt-equity ratio should be[,] but they may not always make the ratepayers foot the bill resulting from their choice." *Id.* (citing *New England Teleph. & Teleg. Co. v. Massachusetts Dept. of Pub. Util.*, 92 P.U.R. 3d 113, 275 N.E.2d 493 (1971), abrogated on other grounds by *Boston Gas Co. v. Dept. of Pub. Util.*, 405 Mass. 115, 539 N.E.2d 1001 (1989)).

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[28] A copy of *Pacific NW Bell Tel. Co.* is attached hereto as Appendix 2.

Indeed, the Court held that a hypothetical capital structure may be used when the Commission finds that the existing capital structure is "unreasonable so as to impose an unfair burden on the consumer." *Pacific NW Bell*, 98 P.U.R.3d 16. This is consistent with the Commission's well-established standard that a utility's capital structure balance safety and economy. If a capital structure is too heavily capitalized with equity, as in this case, the costs are unfair to ratepayers, creating an unfair burden. AR 841-842 (Order 05 at ¶¶ 41-42).

b. The Commission's use of hypothetical capital structure in PacifiCorp's 2013 general rate case is consistent with its standards and precedent.

In using a hypothetical capital structure in PacifiCorp's 2013 general rate case, the Commission appropriately applied the standard of balancing equity and debt and acted consistently with its precedent.

Since at least 1958, the Commission has used hypothetical capital structure as a tool in ratemaking. In *Wash. Pub. Serv. Comm'n*[29] *v. Pac. Teleph. & Teleg. Co.,* 25 P.U.R.3d 18 (July 11, 1958)(Cause Nos. U-8971, U-9011), the Commission adopted an "appropriate" capital structure that reduced the company's equity ratio from 65 percent to 55 percent. The Commission defined an appropriate capital structure as one that balances

[29] The Washington Public Service Commission is a predecessor to today's Washington Utilities and Transportations Commission. See, http://www.utc.wa.gov/aboutUs/Pages/history.aspx.

the safety of equity and the economy (or low cost) of debt. The Commission determined that the actual capital structure was "not justified on the grounds of economy." *Id.* Using a hypothetical capital structure was done to incentivize the utility to move towards a more economical capital structure while still allowing the company to maintain its credit rating and induce further investment. *Id.*

The Commission has also increased the equity ratio for ratemaking purposes. The first known instance of this was in 1979, when a utility's equity ratio was increased so it could meet short-term financing requirements. *Wash. Util. & Transp. Comm'n v. Washington Natural Gas Co.,* 32 P.U.R.4th 530, 537 (Sept. 25, 1979). The Commission used a hypothetical capital structure with one percent more equity than in the company's actual capital structure. The Commission noted that hypothetical capital structures were a useful regulatory tool and that increasing the equity ratio in that case would appropriately incentivize the company to make capital structure adjustments. *Id.*

More recently, the Commission continues to use hypothetical capital structure, both increasing and decreasing equity ratios as circumstances merit. In PacifiCorp's 2005 general rate case, the Commission determined that a hypothetical capital structure was necessary to balance safety and economy, and it increased PacifiCorp's equity ratio. *2005 PacifiCorp,* Docket UE-050684, Order 04 at ¶¶ 230-233. The Commission applied a 46 percent equity ratio because it was higher than the company's historical equity ratio, reflected the infusion of capital recently made into the company, and was in line with the average equity ratios of comparable utility companies. *Id.* at ¶¶ 232-233.

In its 2010 general rate case, PacifiCorp requested that the Commission set rates using a 52.1 percent equity ratio. *WUTC v. PacifiCorp d/b/a Pacific Power & Light Company*, Docket UE-100749, Order 06, ¶ 23 (March 25, 2011)(hereinafter 2010 PacifiCorp). The Commission expressed concern about the remarkable growth in equity over a three year period. The Commission held that the capital structure held too much equity, tipping the balance too far in favor of investor interests over ratepayer interests. *Id.* at ¶ 39. The Commission recognized that the equity level should be raised from the prior level of 46.0 percent. The Commission followed the recommendation of one of the intervenor witnesses and applied an equity ratio of 49.1 percent. The Commission found that 49.1 percent equity properly balanced safety and economy.[30]

Further, the Commission has addressed PacifiCorp's capital structure outside of general rate cases. For example, when the

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[30] PacifiCorp appealed the final order in Docket UE-100749, but did not challenge the Commission's use of hypothetical capital structure. *PacifiCorp d/b/a Pacific Power & Light v. WUTC,* Thurston Cy. Sup. Crt. No. 12-2-02667-7, Petition for Judicial Review (Dec. 28, 2012).

Commission approved the merger that resulted in Scottish Power owning PacifiCorp, it approved a settlement that required the Commission to use a hypothetical capital structure in setting rates. *In the Matter of the Application of PacifiCorp and Scottish Power PLC, for an Order (1) Disclaiming Jurisdiction or, in the Alternative, Authorizing the Acquisition of Control of PacifiCorp by Scottish Power and (2) Affirming Compliance with RCW 80.09.40 for PacifiCorp's Issuance of Stock Connection with the Transaction,* Docket UE-981627, 5th Supplemental Order, 1999 WL 1295972 (Wash.U.T.C.) (October 14, 1999).

PacifiCorp's current owner, Mid-American Energy Holding Company,[31] should have been aware that the Commission may use hypothetical capital structure in setting rates. While the Commission did not specifically address hypothetical capital structure when it evaluated the MidAmerican Energy Holding Company acquisition, as it had in approving the Scottish Power acquisition, it expressly left all regulatory determinations to the Commission in future cases. *In the Matter of the Joint Application of MidAmerican Energy Holdings Company and PacifiCorp, d/b/a Pacific Power & Light Company for an Order Authorizing Proposed Transaction*, Docket UE-051090, Order 07, Final

[31] MidAmerican Energy Holdings Company is now known as Berkshire Hathaway Energy. The name changed occurred during 2014, and for ease of reference, this brief will use the former name.

Order Adopting Settlement Stipulation; Requiring Subsequent Filing at ¶ 18 (February 22, 2006). The merger stipulation did not pre-decide issues that would come before the Commission. After MidAmerican Energy Holdings Company's acquisition, the Commission continued to use hypothetical capital structure to set PacifiCorp's rates in its 2010 and 2013 general rate cases because capital structure was too heavily capitalized with equity, creating an unfair burden on ratepayers. AR 841-842 (Order 05 at ¶¶ 41-42).

2. The Commission's decision in this case was supported by substantial evidence and should be affirmed.

In this case, the Commission appropriately applied its standard that PacifiCorp's capital structure balance safety and economy. The Commission reviewed testimony and evidence from each of the three cost of capital witnesses who addressed capital structure. AR 2941 – 3078 (Williams); AR 3128 – 3208 (Elgin); AR 4073 – 4211 (Gorman). Each cost of capital witness was presented for the parties to cross individually, and then all three witnesses sat as a panel to field questions from the Commissioners.[32] TR. 150:9 – 174:10 (Williams); TR 175:1 – 202:2 (Gorman); TR 203:3 – 217:6 (Elgin); TR. 217:7 – 272:9 (panel).

[32] A fourth witness, Mr. Samuel C. Hadaway, was also seated on the panel. Mr. Hadaway testified on behalf of PacifiCorp on cost of capital, but not on the capital structure.

The Commission found that PacifiCorp's proposed capital structure did not properly balance safety and economy, but that it tipped too far towards safety, favoring shareholder interests over customer interests. AR 840-842 (Order 05 at ¶¶ 39 – 42). The Commission considered PacifiCorp's credit ratings and its ability to access credit at reasonable costs. AR 840-841 (Order 05 at ¶ 39); TR. 259:21 – 261:21. Thus, the Commission carefully considered each of the pertinent factors, as required by *Permian Basin*. The Commission weighed the evidence in favor of reducing the amount of equity to better balance safety and economy, while still providing PacifiCorp with the opportunity to earn a fair return and access credit markets as reasonable rates.

The Commission's decision is based on sufficient evidence and should be affirmed. PacifiCorp's dissatisfaction regarding the Commission's weighing of evidence does not support a different result.

3. PacifiCorp is asking this Court to re-weigh evidence the Commission considered not because the Commission erred, but because PacifiCorp is dissatisfied with the outcome.

The Commission fulfilled its duty to regulate in the public interest when it addressed PacifiCorp's capital structure. RCW 80.01.040(3). The Commission's ruling is consistent with its established standards of weighing safety and economy. It is harmonious with both the King

County Superior Court's 1972 decision and with other states' rulings. The Commission acted appropriately in using a hypothetical capital structure to set PacifiCorp's rates, which protected ratepayers from paying excessively high rates.

PacifiCorp argues that the Commission relied on the record of a prior case in determining the outcome of the current case, relying on the recent superior court decision in *Industrial Customers of NW Utilities v. WUTC* and *Washington State Attorney General's Office, Public Counsel Division v. WUTC*, Thurston Cy. Sup. Crt. Nos. 13-2-01576-2, 13-2-01582-7 (consolidated)(hereinafter Puget Appeal).[33] The Puget Appeal presented completely different circumstances than PacifiCorp's 2013 general rate case. In the Puget Appeal, the Commission set rates for a new multi-year rate plan, with automatic increases throughout the plan, using outdated cost of capital data from the utility's last rate case. Moreover, the utility did not present evidence regarding the appropriate cost of capital. As the Court noted, "Rather than putting on its own evidence, [the company] merely attempted to rebut the respondents' evidence." *Puget Appeal,* Thurston Cy. Sup. Crt. Nos. 13-2-01576-2, 13-2-01582-7 (consolidated), Order Granting in Part and Denying in Part Petitions for

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[33] Public Counsel and the Industrial Customers of NW Utilities sought judicial review of the Commission's final order from *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-121697 and UG-121705 and UE-130137 and UG-130138 (not consolidated).

Judicial Review, Appendix A, p. 5.[34] The Court reversed the rate plan and remanded for further proceedings because it found that the Commission lacked sufficient evidence for its decision, having not conducted a full review of the issue and failing to require the utility to carry its burden of proof.

But here, the Commission considered fully developed evidence regarding capital structure and it conducted a full review. Most fundamentally, PacifiCorp and Commission Staff presented cost of capital evidence, including a review of capital structure. Packing Corp. also presented such evidence. AR 2941 – 3078 (Williams); AR 3128 – 3208 (Elgin); AR 4073 – 4211 (Gorman); TR. 150:9 – 174:10 (Williams); TR 175:1 – 202:2 (Gorman); TR 203:3 – 217:6 (Elgin); TR. 217:7 – 272:9 (panel). Furthermore, it is clear that the Commission based its decision on the evidence presented to it in this case. That the Commission made a reference to PacifiCorp's prior rate case noting similarities in the two cases does not indicate that the Commission relied on the former case in deciding this case.

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[34] A true and accurate copy of the Court's order in Thurston Cy. Sup. Crt. Nos. 13-2-01576-2, 13-2-01582-7 (consolidated) is attached hereto as Appendix 3.

4. The Commission addressed PacifiCorp's concerns regarding regulatory lag.

PacifiCorp complains that the Commission should have increased its equity ratio to address under-earning. PacifiCorp Br. at 45-46. Moreover, PacifiCorp argues that failure to increase its equity ratio to address under-earning was arbitrary and capricious because the Commission has used this tool in the past to address utility under-earning.

PacifiCorp's arguments are without merit. First, PacifiCorp did not ask the Commission to specifically address any alleged chronic under-earning. It was only in its rebuttal testimony and at hearing that PacifiCorp stated that its filed rate case was its attrition study.[35] AR 1427-1428 (Exh. No. WRG-1T, pp.7-8.); TR. 111:3-7.

PacifiCorp requested that the Commission set rates based on the value of its rate base (infrastructure that is used and useful in providing electric service in Washington) at the end of the test year.[36] The usual method of valuing a utility's rate base during the test year is to calculate an average of monthly averages of rate base values. Calculating the value

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[35] William Griffith's rebuttal testimony provided a list of the Company's adjustments in the case that were designed to address under-earning.

[36] In a general rate case, the utility presents its operational costs, rate base, and revenue based on a 12 month test year. The test year values are then adjusted for known and measurable changes, and the adjusted test year then becomes the basis for determining the appropriate amount of revenue that the utility should collect annually.

of rate base at the end of the test period generally results in a higher value, and thus higher rates and return for the utility.[37]

The Commission in this case approved PacifiCorp's request to use the end-of-test period value for rate base. AR 897-898 (Order 05 at ¶¶ 181-184). The Commission gave careful consideration to the impact of regulatory lag. It was not required to use the regulatory tool of increasing the equity ratio; the Commission is only required to give due consideration to the issues and to make a decision that is supported by the record with substantial evidence. Here, the Commission considered evidence presented by the parties. *See, e.g.,* AR 3869 – 3878 (Exh. No. JRD-1T at 5:3 – 14:2). Adjusting the equity ratio upward is only one tool in the Commission's regulatory tool box. The Commission is permitted to evaluate each utility it regulates based on the unique circumstances and characteristics they possess. AR 840 (Order 05 at ¶ 38.)

In granting PacifiCorp's request to use end-of-period rate base, but not adjusting PacifiCorp's equity ratio to address "under-earning," the Commission acted appropriately.

[37] In this case, using rate base calculated at the end of the test year resulted in a reduction in value. This result was unexpected. AR. 3869 – 3871 (Exh. No. JRD-1T at 5:3 – 7:20); AR 3873 (Exh. No. JRD-1T at 9:3-9).

VI. CONCLUSION

The Commission's action in setting PacifiCorp's rates in Order 05 satisfied the "end results test" because it was fair, just, reasonable, and sufficient. The Commission set rates that fell within the zone of reasonableness. The Commission acted within its authority in rejecting the modifications to the long-standing cost allocation methodology. The Commission's actions did not run afoul of PURPA or the Commerce Clause. Additionally, the Commission properly exercised its discretion in using an appropriate capital structure for ratemaking purposes. As a result, this Court should affirm the Commission's final order, Order 05, in WUTC Docket UE-130043.

RESPECTFULLY SUBMITTED this 24th day of December, 2014.

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PROOF OF SERVICE

I certify that I served a copy of this document on all parties or their counsel of record on the date below as follows:

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I certify under penalty of perjury under the laws of the state of Washington that the foregoing is true and correct.

DATED this 24th day of December, 2014, at Seattle, WA.

Carol Baker

Carol Baker
Legal Assistant