Q. Please state your name, occupation and business address.

A. My name is Jeffrey K. Larsen. My business address is One Utah Center, Suite 2300, 201 South Main Street, Salt Lake City, Utah, 84111.

Q. What is your position at PacifiCorp dba Utah Power (the Company) and your previous employment history with the Company?

A. I am currently employed as Managing Director of Regulatory Affairs. I joined the Company in 1985, and I have held various accounting, compliance and regulatory- related positions prior to my current position. I have testified on various matters in the states of Utah, Wyoming, California, Washington and Oregon.

QUALIFICATIONS

Q. Briefly describe your educational and professional background.

A. I received a Master of Business Administration degree from Utah State University in 1994 and a Bachelor of Science degree in Accounting from Brigham Young University in 1985. I have also participated in the Company's Business Leadership Program through the Wharton School and an Advanced Education Program through the J.L. Kellogg School of Management at Northwestern University. In addition to formal education, I have also attended various educational, professional and electric industry-related seminars during my career at the Company.

PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. Consistent with Utah statutes, the Company has proposed a forecast test year in this case that begins on October 1, 2006 and ends on September 30, 2007. The purpose of my testimony is to explain why this test period best reflects the conditions the Company expects to experience in the rate effective period. In so doing, I will: 1) discuss how matching principles and regulatory lag affect the choice of test year; 2) review the process of developing PacifiCorp's test year forecast and explain why the result is reasonable; and 3) discuss the advancement of forecasting issues in Utah

MATCHING PRINCIPLES AND REGULATORY LAG

Q. When will the rates likely become effective in this case?

A. Given their complexity, it is typical for orders in general rates cases to become effective near the end of the statutory 240-day period provided under section 54-7-12(3) of the Utah utility code. However, under the terms of the stipulation approved by the Commission in Docket No. 05-035-54 (the acquisition of PacifiCorp by MidAmerican Energy Holding Company), the rate effective date will be extended to December 11, 2006. This date could be extended further if other conditions specified in the stipulation are not met, but the likelihood is that the effective date of the rates in this case will fall within three months of the beginning of the forecast test year proposed by the Company. Thus, the commencement of the rate-effective period and the commencement of the test period will closely match each other in this case.

Q. Why is it important that the test period and the rate effective period closely match each other?

A. As the Commission has noted many times, one of the critical underlying principles that govern rate proceedings is the effort to match capital, expenses, and revenues in a test period. A similar matching concept also suggests that, to the extent possible, the rate-effective period and the test period should closely match each other, i.e., the new rates would ideally take effect with the commencement of the test year. Test periods that are historical in nature will never match these critical factors and, as I will discuss later, will cause a utility that is operating in a period of rapid expansion and rate base growth to chronically under-earn. A rate base, rate of return regulated utility like PacifiCorp must be given a reasonable opportunity to earn its cost of capital. In fact, by creating a statutory mandate that the type of forecast test period proposed by the Company in this case be given serious consideration, the Utah Legislature has expressed its clear intent that Utah utilities will be give a reasonable opportunity to earn their costs of capital.

Q. Why does PacifiCorp advocate the use of its forecast test year as the appropriate test period this proceeding?

A. As Mr. Mark Klein discusses in his testimony, PacifiCorp continues to experience significant load growth, especially in Utah. The need to serve this growing load has required the Company to acquire new generating resources, the cost of which is being reflected in rates for the first time in this case. This filing includes both Phase II of the Currant Creek facility, which adds 245 MW of generating capacity, and the Lakeside facility with 534 MW of additional production capacity. Significant new investments in transmission and distribution systems are required to integrate these new resources and ensure continued reliability. Net power costs continue to increase, driven by a combination of increasing fuel costs, purchased power and load growth. The Company continues to experience increases in the areas of employee pension and health care expenses, and the cost of maintaining the Company's low-cost but aging generation fleet is on the rise. Only a forecast test period can fully capture the ratemaking impacts of growing customer load, the dramatic increases in capital investment required to serve it, and the higher operation and maintenance costs required to maintain system safety and reliability. The forecast test year proposed by the Company, which closely matches the rate effective period, is the only test year capable of properly reflecting for rate setting purposes the costs the Company must incur in the rate effective period to provide the level of service it is planning for its customers.

Q. Please explain Exhibit UP&L___(JKL-1).

A. Exhibit UP&L___(JKL-1) is a graphical representation of the problem with regulatory lag. This Exhibit compares the base period (10/1/04 - 9/30/05), mid period (10/1/05 - 9/30/06) and forecast test period (10/1/06 - 9/30/07) and shows the mismatch in revenues recovered during the rate effective period when prices are based on lagging cost structures. Exhibit UP&L___(JKL-1) shows that regulatory lag ranges from 20 months based on the purely historical base period, to eight months based on the mixed historical and forecast mid period, and finally down to only two months in the forecast period where the revenues are matched with forecast cost to serve.

Q. Why is regulatory lag a problem in this rate case?

A. Regulatory lag becomes a serious problem when a steady upward trend in costs is expected for the foreseeable future. As Exhibit UP&L___(JKL-1) shows, there is an obvious disparity between costs in the historic base period and the mid-period, and the higher costs that the Company will incur in the rate effective period. PacifiCorp is in fact experiencing a period of rising utility industry and energy related costs that are coupled with substantial new investments being made by the Company to serve customer energy demands. As a result, basing rates on a test period that doesn't reflect the rate effective period puts PacifiCorp in an unachievable catch-up situation where the Company cannot make up for rising costs through efficiencies and cost savings measures. It would create a lag of many months that would effectively deny the Company a reasonable opportunity to earn the return authorized by the Commission.

Q. Are investment analysts concerned about the effects of regulatory lag on the electric utility industry and PacifiCorp in particular?

A. Yes, very much so. For example, in a report dated March 8, 2005 commenting on potential value erosion among electric utilities, Morgan Stanley stated:

> "Many utilities are facing more or less irresistible demands for higher levels of capital spending, along with rising operating costs similar to those affecting many other industries. In our view we are just entering a heavy investment cycle in which it is prudent for investors to stand aside from the big builders - who in effect may be entering a multi-year period of value erosion." (Page 4)

In an earlier report dated October 18, 2004, Citigroup offered a similar assessment of PacifiCorp:

> "There is a material risk that PacifiCorp's growth investment could be value destructive. To avoid this PacifiCorp will need to eliminate regulatory lag and achieve full recovery in future rate cases. (Page 26) Regulatory lag has been a significant issue for PacifiCorp. The rate setting process over the last decade has required PacifiCorp to file for rate increases after it has already incurred expenditure. Once a general rate case is filed, it can then take six to eight months for a decision. Overall, it can take 18-24 months before incurred capital expenditure can begin to earn a return. (Page 28)

Based on comments such as these, I think it is clear that the investment community will be watching this rate case very closely and that failure to address regulatory lag through the use of a forecast test year could have a negative impact on the Company's ability to attract needed capital investment.

Q. If you receive rate increases based on forecasted costs, how can the Commission be assured that this additional funding will be used for the benefit of customers?

A. During this period of rapid system growth, PacifiCorp will have an ongoing need to continue a high level of investment in the system in order to maintain and increase service reliability. System maintenance programs and initiatives, such as vegetation management, will require at least a stable level of funding going forward from the test year. Also, while there is hope that employee pension costs will stabilize and that the rate of growth in health care expenses will moderate, there is no expectation that these key cost drivers will fall below test-year levels in the near future.

Q. Would a test year other than the Company's forecast test year adequately capture the costs the Company will experience in servings its customers during the rate effective period?

A. No. Other test year options simply do not provide PacifiCorp with a reasonable opportunity to fully recover its cost of service. I have previously described the types of expected cost increases that necessitate the use of a forecast test year. However, it is important to recognize two additional facts about the Company's test year proposal. First, many of the expected costs increases are not manifested until well into the forecast test year. For example, the Lakeside Plant is scheduled to go into service in May of 2007. Second, the proposed test year already falls three months short of matching the rate effective period. Exhibit UP&L___(JKL-2) shows that the Company's expected revenue requirement increases by nearly $100 million between October 1, 2006 and September 30, 2007. This increase is driven in large part by plant additions, associated depreciation expense and other changes related to continued load growth. Exhibit UP&L___(JKL-2) demonstrates that any test year ending short of September 2007 will cause PacifiCorp to experience a proportional under-recovery of costs in the rate-effective period.

DEVELOPMENT OF TEST YEAR FORECAST

Q. Do you believe that in selecting the appropriate test year, the Commission should attempt to choose the approach that is based on the best evidence of the conditions in the rate-effective period?

A. Yes. The Commission's statutory charge is to select the test period that, in the exercise of its judgment based on the evidence, will best reflect the conditions in the rate effective period. In its analysis of what is fair for the Company and its customers, the Commission will want to select the test-year that reflects the unique costs and circumstances of the rate effective period.

Q. What evidence can you offer the Commission that the test year proposed by PacifiCorp in this case, the twelve months ending September 30, 2007, best reflects the conditions expected in the rate effective period?

A. It may be helpful to begin by examining the alternatives for selecting a test year that matches the rate effective period. A completely historic test year is not an option available under current statute. A historic test year with known and measurable adjustments creates serious mismatches between revenues and expenses within the test period. Likewise, a historic test period with known and measurable adjustments and a mid-period forecast offer no link to the rate effective period and does not adequately reflect the anticipated cost levels in the rate effective period. Only a forecast that most closely matches the rate effective period will adequately reflect the costs and circumstances that the Company will experience during that period.

Q. What is the advantage of the test period proposed by PacifiCorp?

A. PacifiCorp's proposed test year has the advantage of close proximity to the expected rate effective period on an actual calendar basis. Because the Company's test year forecast is reasonable, it will reflect the conditions that will be experienced when the new rates are in effect. The use of any other test period requires the assumption that the revenues and expenses developed for the test year will not change for an extended period of time until the rates become effective. Since this assumed stability creates a greater risk of mismatch with the rate effective period, there is no logical reason to choose a forecast period different from that proposed by the Company.

Q. Is PacifiCorp's forecast for its proposed test year reasonable?

A. Yes. PacifiCorp's forecast is: 1) grounded in actual data; 2) reflective of realistic and systematic cost and revenue projections; 3) developed and supported at the operating level; 4) consistent with actual performance; and 5) readily accessible for external review and analysis.

Grounded in Actual Data

Q. Please explain how PacifiCorp's test year forecast is grounded in actual data.

A. The test period was forecasted using the historical base year ending September 30, 2005. From that base year, each of the revenue requirement components was normalized or adjusted to remove any non-recurring items. The forecasted test period is then further developed by capturing known and measurable events and forecast data to properly match revenues and expenses and reflect conditions expected in the rate effective period.

<u>Realistic and Systematic Cost and Revenue Projections</u>

Q. Does the forecasted data relied upon in this application reflect realistic and systematic cost and revenue projections?

A. Yes. The projections relied upon in this application are integrally tied to the operations and management of the Company. It is based on the same information that management sees in carrying out its responsibilities. By providing this information through a public process, it is also providing information that may be reviewed by the financial community. The Company has every incentive to be as accurate as possible in the data that it presents.

Q. Please describe the process used to project test year costs and revenues.

A. Retail revenues were forecasted by applying the current tariffs to the test year load forecasts. Mr. Klein describes in detail the comprehensive approach used to forecast the loads used in this case. Wholesale sales forecasts (as well as all other components of net power costs) were developed using the GRID model which has been used extensively in prior rate cases and other regulatory proceedings in Utah. Normalized base year operation, maintenance, administrative and general (OMAG) expenses were split into labor and non-labor components. Non-labor costs were escalated using well-established, nationally-recognized inflation indices. The escalated amounts were compared to Company budgets and where significant differences existed, the escalated amounts were adjusted to reflect expected test period conditions. Labor costs were adjusted for expected increases through the end of the test period. These forecasting procedures are explained in greater detail in Mr. Ted Weston's testimony and exhibits.

Q. How does the use of budget comparisons improve the integrity of the forecasting process?

A. Cost indices are effective for projecting the future only to the extent that all future cost components are included in the base period. Since the Company will be bringing new generating resources on line and increasing OMAG expenses above historic levels, a forecast based entirely on indexed inflation changes would not capture all conditions expected in the rate effective period.

Q. Does PacifiCorp have a rigorous budgeting process that is capable of supporting a forecast test year?

A. Yes. The Company's operating and capital budgets are reviewed and approved by business unit management, PacifiCorp management, and the PacifiCorp Board.

Q. Can you summarize the budgeting process that supports the test year forecast?

A. Yes. Since new resource additions are a significant component of this case, my explanation will focus on the capital budget, although operating budgets follow a similar procedure. Initially, a long-term view of the Company's capital expenditure is developed at the business unit level by each unit's management. The business unit plans are then combined and the consolidated plan is reviewed by PacifiCorp's Chief Executive Committee and Board of Directors. This long-term view is then refined annually during the budget process to reflect the current needs of customers and the operating plans of the Company. At this stage, capital investment is allocated into discrete investment categories, not specific projects.

<u>Developed and Supported at the Operating Level</u>

Q. Has the preparation of the Company's forecast test year forecast in this case been closely scrutinized?

A. Yes. For the reasons I have just described, there has been great attention to detail in the preparation of this forecast. Every effort has been made to provide an appropriate audit trail. Throughout the preparation of the forecast, we have used a "bottom-up" approach to ensure that the business units that will actually be spending the dollars to build, operate and maintain the system during the rate-effective period are in agreement with the projected levels of expenditure.

Q. Is it important that the test year forecast be reviewed and supported by those within the PacifiCorp organization who are responsible for actually constructing capital projects and operating and maintaining the system?

A. Yes, I believe it is very important to have this kind of reasonableness review applied to the forecast. It is all very well to apply the best forecasting techniques available, but there is no substitute for a final review by those who will be responsible for actually doing the work.

Q. What is the process for validating test year forecasts at the operating unit level?

A. As I have already explained, to the extent budgets are used in the forecast, they have already been built from the bottom up--being developed and reviewed at the business unit or operating level. The actual preparation of the test year forecast follows a similar approach. Early in the process meetings are held with each of the business units to review labor forecasts, escalation of non-labor costs, forecast capital additions, and all other components of test year cost. The overall forecast cannot be finalized until all of the business units have indicated their approval. This operating level review provides additional assurance that the test year amounts are in line with the Company's business plans and that the dollars will actually be spent for their intended purpose.

Consistent With Actual Performance

Q. How have previous PacifiCorp Utah test year forecasts compared to actual results for the same period?

A. That question cannot be fully answered at this point. The only fully forecasted test year in recent history was used in the Company's last Utah general rate case in Docket No. 04-035-42. That case was filed in August of 2004 and used a test year ending March 2006. Thus, at the time this filing was prepared we did not yet have actual data for the full forecast period. However, we do have a report required by the Stipulation in Docket No. 04-035-42, which is provided as Exhibit UP&L___(JKL-3).

Q. What does Exhibit UP&L___(JKL-3) show?

A. The exhibit shows that Utah OMAG expense for the 12-month actual plus forecast period exceeds the settlement results by over $25 million. Utah capital additions for the same period exceed settlement results by over $21 million.

Q. What conclusions can be drawn from this exhibit?

A. This exhibit indicates that both Utah OMAG expense and Utah capital additions will be higher than the corresponding amounts that are implicit in the settlement case for the rate effective period. In other words the Company will spend more money on OMAG and capital during the rate effective period than it will recover under the terms of the settlement. The fact that the Company spent more than it was able to recover in rates from the last general rate case, demonstrates PacifiCorp's commitment to providing reliable service to its Utah customers. I believe that this commitment sends a clear signal to the Commission that the Company is willing and able to spend all of the forecasted expense and capital dollars that it is requesting in this proceeding for the benefit of its customers.

<u>Accessible for External Review and Analysis</u>

Q. Are all of the Company's forecasting assumptions and calculations used in this rate case fully documented and available for review?

A. Yes. The development of the test year forecast is fully documented in this filing. In addition, subject to the terms of the "Stipulation on Filing Requirements, Discovery and Timing of Test Period Hearing" previously filed in this docket, PacifiCorp has included in this filing the data and information specified in Attachment A thereto ("Additional Revenue Requirement Filing Information"), the data and information specified in Attachment B thereto ("Additional Cost of Service Filing Information"), responses to the data requests included in Attachment C thereto ("Revenue Requirement Data Requests"), and responses to the data requests included in Attachment D thereto ("Cost of Service Data Requests"). Also, within 30 days after this filing, PacifiCorp will provide responses to the data requests included in Attachment E to the Stipulation ("Other Data Requests"). The Stipulation does not reflect an agreement to provide the data/information contained in Attachments A through E in any other general rate case. Rather, the data/information is being provided in this proceeding only to determine whether it will allow other parties to critically analyze PacifiCorp's proposed test year in a manner that is not unduly burdensome to the Company.

Q. By adopting the forecast test year approach proposed by PacifiCorp in this proceeding, would the Commission also be accepting all of the amounts reflected in the Company's filing?

A. No, of course not. There may be differences of opinion about the proper application of forecasting techniques and the calculation of individual inputs into the revenue requirement. Such differences are inevitable in a general rate case where the parties have different perspectives. PacifiCorp is not asking the Commission for a blanket validation of its forecast calculations. Rather, the Company is asking the Commission to accept the concept of a forecast test year as being the most appropriate way to provide timely recovery for the increased level of expenditures that are required to be made to serve the growing Utah load.

Q. Why is it so important that the Company's forecast has been documented?

A. I believe that the care that PacifiCorp has taken to document and explain its forecast along with its willingness to openly and voluntarily share information is the clearest indication that its approach to forecasting is reasonable. I have explained that the Company has applied a rational, systematic and comprehensive approach to the preparation of its forecasted test year revenue requirement. There are no secrets in this process. Based on all of the factors I have previously described, I believe that the forecast test year revenue requirement developed and proposed by the Company is fair and reasonable and is most likely to match the conditions in the rate effective period.

ADVANCEMENT OF FORECASTING ISSUES IN UTAH

Q. Please describe the work of the forecasting and discovery task forces created by the 2005 rate case stipulation.

A. Two task forces were created to examine rate case processes. A Forecasting Task Force was formed to "discuss methods for forecasting revenues, expenses, rate base, and customer loads and to discuss escalation factors and indices." Also, a Discovery Task Force was formed to "discuss ideas to improve the efficiency of the exchange of information and discovery in cases before the Commission." Both task forces met regularly during the last six months of 2005; and while neither produced a consensus report, they did provide an opportunity to gain a better understanding of the issues, positions and concerns of the participants. During the Forecasting Task Force meetings, PacifiCorp and Questar Gas made presentations covering budget processes and forecasting techniques for revenues, customer loads, expenses and rate base items. The Discovery Task Force focused on improving the efficiency of the discovery process in general rate cases, but also spent time discussing the exchange of data requests with information related to the test period determination. The work of both of these groups provided an important contribution to the Stipulation in this proceeding.

Q. Is it possible to devise a test period that is free from some element of prediction?

A. Of course not. The reality is that the Commission is charged with setting rates for a future, not a historical, period and that inevitably involves a certain amount of informed predictions of the future. In prior years, historic test periods with no out-of-period adjustments have been used in an effort to remove Company judgment and discretion from the calculation of the revenue requirement. However, given the dynamic nature of the world in general and the electric industry in particular, it is unlikely that a pure historic test year will ever "best reflect" the conditions in the rate-effective period; and, in fact, an unadjusted historic test year is not even an option that is available to the Commission under the current statute. All of the test year options require the Company to exercise informed judgment about how to best project future data or adjust historical data to reflect conditions in the rate effective period.

Q. Do you have any other general observations about the use of a forecast test year?

A. The Commission is required by statute to choose the test period that best reflects the conditions in the rate effective period. The Utah Legislature has explicitly made a forecast test year option available to the Commission. PacifiCorp now finds itself in a period where both capital and O&M costs are increasing significantly to meet growing customer demand for electricity and rising cost pressures. The Commission should require customers to pay a price today that matches the cost to serve that customer today. Any business that charges prices today that reflect two year old costs will always under-perform. I do not believe that the Legislature would have authorized the use of a forecast test year if it were not convinced that this option might be necessary to best reflect the conditions in the rate-effective period. In fact, I believe that PacifiCorp's current circumstances are a perfect example of the need for a forecast test year that was anticipated by the Legislature.

SUMMARY

Q. Please summarize your conclusions about the appropriate test year to be used by PacifiCorp in this proceeding.

A. The test period used in this proceeding must satisfy two objectives. It must best reflect the conditions in the rate-effective period as required by statute, and it must provide PacifiCorp with a reasonable chance of fully recovering the escalating costs of serving the growing electrical needs of its Utah customers. There is simply no way that a historical test year, even with selected adjustments, can recover the increased O&M expense and capital required to serve this growing load. These costs are only exacerbated by the fact that the load is growing faster on peak than it is overall. The fact is that in order to have an opportunity to recover its full cost of service and earn its authorized return on equity, PacifiCorp must employ a test year that is properly matched with the rate-effective period. My testimony has demonstrated that the Company has applied a rational, systematic, and comprehensive approach in forecasting its test year revenue requirement. I have explained that the resulting revenues and costs are fair and reasonable and are most likely to match the conditions in the rate effective period. Therefore, the Commission should approve for purposes of this proceeding, a forecast test year beginning October 1, 2006 and ending September 30, 2007.

Q. Does this conclude your direct testimony?

A. Yes.