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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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| In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of its Proposed Electric Service Schedules and Electric Service Regulations | Docket No. 08-035-38 |
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PREFILED DIRECT TESTIMONY OF KEVIN C. HIGGINS

[TEST PERIOD]

The UAE Intervention Group (UAE) and Wal-Mart Stores, Inc. (“Wal-Mart”) hereby submit the Prefiled Direct Testimony of Kevin C. Higgins on cost of service/rate design issues.

DATED this 7th day of October, 2008.

/s/ _____
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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by email this 7th day of October, 2008, on the following:

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BEFORE
THE PUBLIC SERVICE COMMISSION OF UTAH

Direct Testimony of Kevin C. Higgins

on behalf of

UAE and Wal-Mart

Docket No. 08-035-38

[Test Period]

October 7, 2008

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DIRECT TESTIMONY OF KEVIN C. HIGGINS

Introduction

Q. Please state your name and business address.

A. My name is Kevin C. Higgins. My business address is 215 South State Street, Suite 200, Salt Lake City, Utah, 84111.

Q. By whom are you employed and in what capacity?

A. I am a Principal in the firm of Energy Strategies, LLC. Energy Strategies is a private consulting firm specializing in economic and policy analysis applicable to energy production, transportation, and consumption.

Q. On whose behalf are you testifying in this proceeding?

A. My testimony is being jointly sponsored by the Utah Association of Energy Users (“UAE”) Intervention Group and Wal-Mart Stores, Inc. Wal-Mart Stores, Inc. is a member of UAE that has intervened separately in this proceeding.

Q. Please describe your professional experience and qualifications.

A. My academic background is in economics, and I have completed all coursework and field examinations toward a Ph.D. in Economics at the University of Utah. In addition, I have served on the adjunct faculties of both the University of Utah and Westminster College, where I taught undergraduate and graduate courses in economics. I joined Energy Strategies in 1995, where I assist private and public sector clients in the

22 areas of energy-related economic and policy analysis, including evaluation of electric and
23 gas utility rate matters.

24 Prior to joining Energy Strategies, I held policy positions in state and local
25 government. From 1983 to 1990, I was economist, then assistant director, for the Utah
26 Energy Office, where I helped develop and implement state energy policy. From 1991 to
27 1994, I was chief of staff to the chairman of the Salt Lake County Commission, where I
28 was responsible for development and implementation of a broad spectrum of public
29 policy at the local government level.

30 **Q. Have you previously testified before this Commission?**

31 A. Yes. Since 1984, I have testified in twenty-two dockets before the Utah Public
32 Service Commission on electricity and natural gas matters.

33 **Q. Have you testified previously before any other state utility regulatory commissions?**

34 A. Yes. I have testified in approximately eighty other proceedings on the subjects of
35 utility rates and regulatory policy before state utility regulators in Alaska, Arkansas,
36 Arizona, Colorado, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Michigan,
37 Minnesota, Missouri, Montana, Nevada, New Mexico, New York, Ohio, Oklahoma,
38 Oregon, Pennsylvania, South Carolina, Virginia, Washington, West Virginia, and
39 Wyoming. I have also filed affidavits in proceedings at the Federal Energy Regulatory
40 Commission.

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42 A more detailed description of my qualifications is contained in Attachment A,
43 attached to my direct testimony.

44

45 **Overview and Conclusions**

46 **Q. What is the purpose of your testimony in this proceeding?**

47 A. My testimony addresses the matter of the most appropriate test period to be used
48 in this general rate proceeding.

49 **Q. What are your primary conclusions and recommendations?**

50 A. I offer the following conclusions and recommendations:

51 (1) I support RMP's proposal to use a fully-projected test period ending June 30,
52 2009. Such a test period best reflects the conditions RMP will encounter during the
53 period the rates will be in effect. I recommend that this test period be adopted by the
54 Commission in this proceeding.

55 (2) I disagree with RMP's proposal to adjust the rate base for this test period to an
56 end-of-period value. The proposal violates the well-established ratemaking practice of
57 synchronizing revenues and costs, generally known as the "matching principle." It also
58 produces serious operational mismatches that are one-sided and disadvantageous to
59 customers. I recommend that the Company's end-of-period rate base adjustment be
60 rejected by the Commission. Instead, rates should be determined using average rate base.

61

62 **Test Period**

63 **Q. In the Company's direct testimony filed in this case, RMP witness A. Richard Walje**
64 **asserts that because of the Commission's decision on test period in the last rate case,**
65 **the Company is compelled to file more frequent rate cases in order to give it a**
66 **reasonable opportunity to earn its allowed return. Do you wish to comment on this**
67 **topic?**

68 A. Yes. As noted by Mr. Walje, the Commission has acknowledged that, in this time
69 of expanded utility investment, potentially increasing costs, and greater uncertainty of
70 economic conditions, more frequent rate cases may be necessary to ensure just and
71 reasonable rates. I agree with this conclusion of the Commission. However, as to RMP's
72 assertions that the Commission's test period decision is driving the frequency of rate
73 cases, I believe the Company's actions in Wyoming contradict this claim.

74 **Q. Please explain. What has transpired in Wyoming that is relevant to this discussion?**

75 On June 29, 2007, RMP filed a general rate case in Wyoming seeking an average
76 8.4 percent increase using a forward test period selected by the utility extending fourteen
77 months beyond the filing date. The Company proposed this test period based on a
78 stipulation in a 2005 case in which the settling parties had agreed to support a test period
79 extending up to twenty months beyond the historic period used as a baseline.

80 On April 28, 2008, the Wyoming Commission approved a stipulation in the 2007
81 general rate case granting RMP an increase equal to 64 percent of its requested revenue
82 requirement, effective May 1, 2008. Then, on July 24, 2008, less than three months after

83 this order was issued, and less than three months after the start of the rate-effective
84 period, RMP filed a new rate case in Wyoming seeking another 7.1 percent rate increase.

85 This sequence of events is revealing. Even with the adoption of a future test
86 period of the Company's own design, and even with approval of a stipulation granting the
87 Company 64 percent of its requested revenue requirement, RMP quickly filed a
88 subsequent rate case in Wyoming. The Wyoming experience suggests that irrespective of
89 test period decisions, RMP intends to file rate cases frequently. Blaming the
90 Commission's test period decision for the frequency of filings is misplaced, as it is
91 contradicted by the Company's own actions in Wyoming.

92 **Q. In his (initial) direct testimony, RMP witness Stephen R. McDougal states that at**
93 **the rates which were current at the time of the Company's filing, RMP will earn an**
94 **overall return on equity ("ROE") in Utah of 6.1 percent during the proposed test**
95 **period. Do you wish to comment on this statement?**

96 A. Yes. It is important to recognize several things about Mr. McDougal's ROE
97 calculation. First, as Mr. McDougal stated, his initial calculation was made prior to the
98 revenue increase approved by the Commission in its decision in Docket No. 07-035-93.
99 Updating his calculation to reflect the recent revenue requirement increase adds 100 basis
100 points, to 7.1 percent. Second, the ROE calculated by the Company is based on the end-
101 of-period rate base proposed by the Company – not the (more standard) average rate base
102 during the proposed test period. This causes the Company's ROE calculation to be
103 reduced by about 900 basis points than would be the case using average rate base. And

104 third, RMP calculates its Utah ROE based on the post-rate-cap revenues applied to the
105 pre-rate-cap rate base. This causes the ROE presented by RMP to be an additional 600
106 basis points lower than if it were calculated with respect to the revenues permitted by the
107 MSP rate cap.

108 **Q. Please explain further this last point.**

109 A. The MSP rate cap constrains the rate increase that can be imposed in Utah based
110 on a mark-up over what would have occurred under the Rolled-in methodology. The
111 MSP rate cap was negotiated by the Company with Utah parties in Docket No. 02-035-
112 04, including UAE. The rate cap has its origins in Company assurances to Utah parties
113 that within a few years of its adoption, the MSP Revised Protocol would produce smaller
114 rate increases in Utah than the Rolled-in methodology. The Utah parties to the MSP case
115 were skeptical about this prediction and insisted on the MSP cap as a means of mitigating
116 Utah's exposure to adopting the MSP Revised Protocol. And thus far, the Company's
117 forecast concerning the benefits to Utah from the MSP Revised Protocol is proving to be
118 incorrect – which is why the MPS cap continues to play a role in determining Utah's
119 revenue requirement.

120 In order to calculate the Company's Utah ROE, Utah cost of service must first be
121 determined. When RMP calculates its Utah ROE, the Company uses the costs allocated
122 to Utah per the MSP Revised Protocol – and not the reduced revenue requirement
123 determined by the MSP cap. This, of course, has the effect of understating the
124 Company's Utah ROE relative to the revenue requirements allowable under the MSP cap.

125 This exaggerates the degree to which the Company may be under-earning. Put another
126 way – even if RMP is granted every dollar of rate increase it seeks in Utah at the allowed
127 ROE it requests – the Company’s calculation of Utah ROE will still fall below the
128 authorized return as long as the MSP cap is in place – given the manner in which the
129 Company has chosen to calculate and present its Utah ROE. Although RMP has stood by
130 its commitment to apply the MSP rate cap in calculating revenue increases, the
131 Company’s approach to calculating its Utah ROE builds in an “MSP rate cap gap.” Yet,
132 Utah regulators and customers are not obligated to “make RMP whole” from the effects
133 of the agreed-to MSP rate cap.

134 **Q. How is this discussion related to the question of test period?**

135 A. The upshot here is that the test period determination should be made on its own
136 merits and not influenced by RMP’s claims about its Utah ROE, which given the method
137 the Company has chosen to calculate it, has a built-in gap that Utah is not obligated to
138 close.

139 **Q. Have you reviewed RMP’s test period proposal as presented in the direct testimony
140 of Mr. McDougal?**

141 A. Yes, I have.

142 **Q. What is your assessment of the Company’s test period proposal?**

143 A. I support the use of the test period July 1, 2008 through June 30, 2009 proposed
144 by RMP. However, I disagree with the Company’s proposal to adjust rate base to end-of-
145 period projected values. Therefore, I recommend that the Commission adopt the test

146 period July 1, 2008 through June 30, 2009, but maintain its longstanding practice of
147 setting rates based on average rate base.

148 **Q. Please explain your support for the test period July 1, 2008 through June 30, 2009.**

149 A. In its order approving the test period stipulation in a previous PacifiCorp general
150 rate case, issued October 20, 2004 in Docket No. 04-035-42, as well as in its recent test
151 period order in Docket 07-035-93, the Commission identified various factors that should
152 be considered in selecting a test period. The factors identified in the Commission's Order
153 include the general level of inflation; changes in the utility's investment, revenues or
154 expenses; changes in utility services; availability and accuracy of data to the parties;
155 ability to synchronize the utility's investment, revenues and expenses; whether the utility
156 is in a cost increasing or cost declining status; incentives to efficient management and
157 operation; and length of time the new rates are expected to be in effect.

158 In those same orders, the Commission also discussed several important policy
159 concerns implicated by future test periods. These concerns include diminished economic
160 examination and accountability, replacement of actual results of operations data with
161 difficult-to-analyze projections, ability of parties to effectively analyze the Company's
162 forecasts, dampening of the efficiency incentive of regulatory lag, playing to the
163 Company's strength from control of critical information, and shifting of the risks of the
164 future to ratepayers.

165 In my testimony in Docket No. 07-035-93, I addressed these factors and concerns
166 at length and concluded that a fully-projected test period with projections that were

167 relatively close in time best reflected the conditions RMP would encounter during the
168 period the rates will be in effect.

169 The Commission agreed with this recommendation and ordered the adoption of a
170 Calendar Year 2008 test period, which corresponded to a period approximately 12½
171 months beyond the filing date of the Company's case. In this proceeding, RMP is
172 proposing a test period that is very similar to that approved by the Commission in the
173 preceding case, i.e., one that is approximately 11½ months beyond the initial filing date
174 of the Company's case.

175 My recent assessment of the nine factors identified by the Commission in its test
176 period orders, as well as the various concerns identified by the Commission in those
177 orders, are reflected in my test period testimony in Docket 07-035-93. I will not repeat
178 my testimony from that docket in great detail, but I incorporate that testimony here, as
179 well as the reasoning of the Commission's recent test period order. That analysis
180 continues to apply with full force in this case, which was initially filed only about five
181 months after the date of the test period order. For all of the reasons specified in my
182 testimony in the prior docket and in the Commission's test period orders, I continue to
183 support the adoption of a fully-projected test period with projections that are close in
184 time. Such a test period best reflects the conditions RMP will encounter during the period
185 the rates will be in effect. Therefore, I support the Company's proposed test period of
186 July 1, 2008 through June 30, 2009 and recommend that it be adopted by the
187 Commission.

188 **Q. Please explain your disagreement with RMP regarding the Company’s proposal to**
189 **adjust rate base to end-of-period values.**

190 A. As a threshold matter, I recognize that the issue of adjusting rate base to end-of-
191 period could be characterized as an adjustment “within” the test period, rather than a test
192 period issue *per se*. However, one could also view this issue as relating fundamentally to
193 the characterization of the test period. In the interest of timely disclosure, I will address
194 this topic at this juncture of the proceeding. Resolving this issue early in the case will
195 also better facilitate more meaningful evaluation of the company’s revenue requirement
196 and presentation of evidence.

197 The primary reason why the Company’s proposal to use an end-of-period rate
198 base should be rejected is that it violates the well-established ratemaking practice of
199 synchronizing revenues and costs, generally known as the “matching principle.” Under
200 RMP’s proposal, rates would be determined using a rate base that is set at its projected
201 end-of-period value during the test period, whereas all other values, e.g., revenues and
202 expenses, would be based on their projected pro-forma levels, i.e., they would not be
203 based on their projected end-of-period values, but on their projected levels during the
204 course of the year. Thus, while rate base would be measured in a way that takes into
205 account the cumulative effects of rate base growth, revenues would not reflect the
206 cumulative effect of growth in kilowatt-hour sales. This results in a classic mismatch
207 between revenues and costs. Permitting such a mismatch is generally ill-advised in
208 ratemaking.

209 **Q. Could the mismatch be corrected through conforming adjustments to revenues and**
210 **expenses to bring all costs and revenues to end-of-period?**

211 A. Theoretically, the mismatch between revenues and costs could be corrected by
212 bringing all revenue, expense, and rate base items to end-of-period values. However, this
213 would be a major undertaking as it would apply to all expense and revenue accounts.
214 Such an effort would introduce an entirely new set of adjustments to the proceeding, in
215 addition to the large number of adjustments that are normally presented in a general rate
216 proceeding. Moreover, although the revenue/cost mismatch would be addressed through
217 such a comprehensive set of adjustments, other operational mismatches would not be
218 corrected without further adjustments.

219 **Q. Please explain what you mean by “operational mismatches”?**

220 A. Five of the major facilities that RMP plans to bring on line during the test period
221 are power generation facilities. The end-of-period adjustment proposed by RMP would
222 treat these assets, for rate of return purposes, as having been in service during the entire
223 year. Yet, RMP’s calculation of net power costs does not treat these assets as being placed
224 throughout the full year, but rather incorporates them as they are scheduled to come on
225 line. Thus, while RMP’s approach would provide the Company with a full year’s return
226 on investment, the assets would not provide a full year’s worth of benefits to customers in
227 the determination of net power cost. This is the operational mismatch to which I refer.

228 The operational mismatch is particularly striking in the case of the High Plains
229 wind facility, which RMP projects as coming on line during the last month of the test

230 period.¹ While RMP is proposing to place the full value of the plant in rate base, the
231 Company's net power cost calculation only has this plant producing energy for one
232 month of the test period. As it is a wind facility, it produces energy at zero fuel cost; thus,
233 the operational mismatch – full cost of plant in rate base, but only one month's worth of
234 zero-cost energy reflected in net power cost – is significant, producing a very one-sided
235 result to the disadvantage of customers. It is a clear-cut example of the type of problem
236 introduced with an end-of-period rate base adjustment.

237 **Q. Has the Utah Commission previously addressed the issue of whether it is preferable**
238 **to use average-of-year or end-of-period rate base?**

239 A. Yes. The Commission expressly ordered the use of average-of-year rate base in its
240 February 14, 2008 test period order in Docket No. 07-035-93. Also, the Commission
241 directly addressed this issue in more detail in its Order issued in a Mountain Fuel case,
242 Docket No. 89-057-15, issued November 21, 1990. The Commission stated:

243 “The Commission finds an average rate base appropriate for the following reasons.
244 First, the Commission has relied on average rate base in recent US West Communications
245 and Utah Power and Light dockets. The present docket has produced no compelling
246 reason to depart from that practice. Second, an average-of-year rate base provides an
247 appropriate basis for matching the annual flows of revenue and expenses to the average
248 annual stock of plant and equipment employed by the utility and to the manner in which
249 the utility has been operated. An end-of-year rate base is a mere snapshot, a potentially
250 misleading picture of rate base at one point in time. Third, an end-of-year rate base
251 requires that substantial, difficult adjustments, fraught with policy implications, be made
252 to revenues and expenses.” [1990 WL 509865 at 4-5 (Utah P.S.C. 1990).

¹ Since the time of RMP's filing, the schedule for this facility has slipped to September 2009, beyond the test period. [RMP Response to DPU Data request 17.3.] However, the plant remains in RMP's proposed rate base at the time of this filing. In any case, this situation provides a good illustration of the operational mismatch problem.

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This finding by the Commission strikes to the heart of the matter. The defects inherent in an end-of-period rate base that were articulated by the Commission in 1990 remain defects today, as demonstrated in my testimony above.

Q. These defects notwithstanding, do you believe that an end-of-period rate base using a test period ending June 30, 2009 represents a sort of “compromise” between an average-of-year rate base for the same period and an average-of-year rate base using a more aggressive future test period such as Calendar Year 2009?

A. Not really. While RMP’s approach might have the appearance of a compromise, it is not a true compromise at all. The plant that is scheduled to come on line in the second half of 2008 is treated identically under both test periods, but the plant that is projected to come on line during the first half of 2009 is actually treated *more favorably* for RMP under its end-of-period proposal than it would be treated under a Calendar Year 2009 test period with average rate base. For example, a plant scheduled to come on line in June 2009 would be in rate base for 7 months using a Calendar Year 2009 test period with average rate base, but would be accorded a full year’s worth of rate base under RMP’s end-of-period rate base proposal in this case. Although plant coming on line in the second half of 2009 would be included in a Calendar Year 2009 test period, but excluded under the Company’s proposed test period, the advantage accorded to the Company’s plant coming on line during the first half of 2009 goes a long way toward dispelling any notion that the Company’s proposal represents a genuine “middle ground.”

274 **Q. What is your recommendation to the Commission on this issue?**

275 A. I recommend that the Company's end-of-period rate base adjustment be rejected
276 by the Commission. Instead, rates should continue to be determined using average rate
277 base.

278 **Q. Does this conclude your direct testimony?**

279 A. Yes, it does.