BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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** **DPU Exhibit No. 5.0**

Direct Testimony of

Mark E. Garrett

REVENUE REQUIREMENT

For the Division of Public Utilities

Department of Commerce

State of Utah

February 12, 2009

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Direct Testimony of Mark E. Garrett

I. INTRODUCTION

Q. Please state your name and occupation.

A. My name is Mark E. Garrett. I am an independent consultant specializing in public utility regulatory issues.

Q. What is your business address?

A. My Business address is First National Center, Suite 1400 West, 120 North Robinson Avenue, Oklahoma City, Oklahoma 73102.

Q. On whose behalf are you appearing in these proceedings?

A. I am testifying on behalf of the Division of Public Utilities ("Division").

Q. Please describe your educational background and professional experience related to utility regulation.

A. I received my bachelor's degree from the University of Oklahoma and completed post graduate hours at the University of Texas and Stephen F. Austin State University. I received my juris doctorate degree from Oklahoma City University Law School and was admitted to the Oklahoma Bar in 1997. I am a Certified Public Accountant licensed in the States of Texas and Oklahoma with a background in public accounting, private industry, and utility regulation. In public accounting, as a staff auditor for a firm in Dallas, I primarily audited financial institutions in the State of Texas. In private industry, as controller for a mid-sized ($300 million) corporation in Dallas, I managed the company's accounting function, including general ledger, accounts payable, financial reporting, audits, tax returns, budgets, projections, and supervision of accounting personnel. In utility regulation, I served as an auditor in the Public Utility Division of the Oklahoma Corporation Commission from 1991 to 1995. In that position, I managed the audits of major gas and electric utility companies in Oklahoma. Since leaving the Oklahoma Corporation Commission, I have worked on various rate cases and other regulatory proceedings on behalf of industrial interveners, gas pipelines, and the Attorney General of Oklahoma. A more complete description of my qualifications and a list of the proceedings in which I have been involved are included at the end of this testimony in *Exhibit 5.1*.

Q. Have you previously testified before the Public Service Commission of Utah (Commission)?

A. Yes.

Q. Have you testified before other commissions and were your credentials accepted in those proceedings?

A. Yes. I have testified in regulatory and civil proceedings and my qualifications as an expert in utility ratemaking matters have been accepted. A more complete description of my qualifications and a list of the proceedings in which I have been involved are included (as Exhibit 5.1) at the end of my testimony.

II. PURPOSE AND RECOMMENDATION

Q. What is the purpose of your testimony that you are now filing?

A. My testimony presents the Division's position regarding several revenue requirement issues in this case. I address cash working capital, other working capital, payroll related expenses, incentive compensation, insurance expense, property tax expense, deferred income tax expense, and customer advances for construction. My testimony explains the basis for these positions and provides analysis and support for the proposed adjustments and recommendations.

III. CASH WORKING CAPITAL

Q. Please describe the Company's requested allowance for cash working capital?

A. The Company has requested a cash working capital allowance in this proceeding based on a 2007 lead-lag study.[1] Consistent with the Commission's current cash working capital policy[2], the Company excluded depreciation expense, interest expense on long-term debt, and dividends on both preferred stock and common stock from its lead-lag calculations.

Q. Were issues regarding the cash working capital methodology addressed in the prior rate case?

A. Yes. In the Company's last rate case, Docket No. 07-035-93, both the Division and the Committee were critical of the Company's cash working capital allowance request because it was based on a lead-lag study that was several years old at the time and was missing the underlying support data. The Committee further criticized the study because it excluded interest expense on long term debt in the cash working capital calculations. In its final Order, the Commission stated that it agreed with the Division and the Committee regarding the need to update the cash working capital study in the Company's next general rate case. In that order, the Commission did not adopt the Committee's recommendation to include interest expense in the study, but rather preserved the issue

[1] Supplemental Exhibit RMP (SRM-1S), tab 2.33.
[2] UPSC Docket No. 07-035-93, Order issued August 11, 2008.

for a determination in this proceeding. Specifically, the Commission quoted from its order in Docket No. 93-057-01 addressing the policy of excluding (1) depreciation, (2) interest expense, (3) preferred dividends, and (4) common dividends from the cash working capital calculations stating: "If this method is to be changed, a strong burden of persuasion will first have to be met which must include a comprehensive analysis of all four of the above mentioned items."

Q. What is the scope of your testimony on cash working capital in this proceeding?

A. My testimony in this proceeding provides a conceptual overview and discussion regarding the proper treatment within a lead-lag study for the four items set forth above: interest expense, preferred dividends, depreciation expense and common equity. The specific calculations of revenue and expense days in the lead-lag study and the resulting adjustments are addressed in the testimony of Division witness Mr. Matthew Croft.

Q. What is cash working capital?

A. Cash working capital is often defined as the net cash outlay that a utility must furnish to provide service before payment for that service is received from the customers.[3] However, it is common today for a major utility to receive payments from its customers before the various obligations of the company to its vendors and employees that relate to those services become due. This creates a situation where the customers are actually supplying the company with cost-free capital, and a reduction to rate base is appropriate in these situations. A utility company's ability to negotiate large contracts

[3] See *Accounting for Public Utilities*, § 5.04.

advantageously, coupled with its utilization of sound cash management techniques will, in most situations, produce a negative cash working capital requirement.

Q. How does one determine whether customers or investors actually supply the utility's cash working capital?

A. A lead-lag study is the most accurate method available to determine whether the company or the customer actually provides the cash that pays the bills for the day-to-day operations of the company. A lead-lag study compares the timing differences between the inflows of cash from revenues and the outflows of cash for operating expenses. The net difference is expressed as a positive cash requirement if the Company is supplying cash to pay its day-to-day operating expenses before payments for these services arrive from customers and as a negative cash requirement if payments from customers actually arrive before the Company is obligated to pay its various expenses. These differences are expressed in the number of days between the time the Company pays its bills and the time the customers remit their payments.

Q. How is depreciation expense generally treated in lead-lag studies?

A. A fundamental principle of the cash working capital allowance is that any non-cash cost items such as depreciation, deferred income tax, and return on common equity are excluded from the calculations. These items are excluded because lead-lag studies are intended to measure the timing differences in the collection and disbursement of cash. Noncash items have no impact on these timing differences. Depreciation is referred to as a "noncash" expense because there is no *cash outlay* required when a company records depreciation expense, as there are with "traditional cash" expense items such as payroll, operating expenses, interest and taxes. Moreover, depreciation expense is the mechanism for the "return of" capital to investors. Investors are aware of the timing differences associated with the return of their capital through depreciation recoveries and are compensated through the rate of return they charge for the use of their money. For these reasons, the Commission should continue its current policy of excluding Depreciation Expense from any lead-lag cash working capital study.

Q. How is common equity generally treated in a lead-lag study?

A. From time to time, a utility will seek to include the dividends on common stock, or other costs associated with common equity in the lead-lag calculations. These attempts are inappropriate and almost universally rejected, as is the case in this jurisdiction.[4] Common equity is generally excluded from the calculations because the return on common equity is a "noncash" item. In other words, there is not a current cash outlay requirement associated with common equity.

In addition, common equity is excluded from the calculations because when equity is returned to the company through rates, funds in the possession of the company are deemed in possession of the owners of the company. At that point, it is up to the owners of the company to decide when and how the funds are either reinvested in the company or dispersed among the owners. Ratepayers cannot be held accountable for timing differences associated with the return of common equity once the equity is in the control of the company, since the ultimate disposition of the equity at that time is completely up to the owners of the company and wholly outside the control of ratepayers.

[4] Oklahoma Corporation Commission, Cause No. PUD200500155, Order No. 516261.

Moreover, the capital markets are sufficiently aware of the timing differences associated with the return of capital to the company, and have included the cost of those timing differences in the return component required for common equity. In other words, the cost of equity required in the capital markets (i.e. the ROE) takes into account how capital is returned to the company, including any timing differences associated with its collection from ratepayers and its ultimate disbursement among the owners.

Q. How is Interest Expense on long-term debt generally treated in a lead-lag study?

A. In my experience, unlike depreciation expense and common equity, the interest expense on long-term debt is generally **<u>included</u>** in cash working capital calculations. There are a number of reasons for this treatment. First, money collected from customers to pay interest expense on long-term debt is not the Company's to keep. Instead, the Company is obligated to remit these funds to the creditors of the Company under a very specific timetable. During the period between when the money is collected from customers and when it is paid to the creditors, the Company has use of these funds to meet the day to day operating needs of the Company. Further, the Company actually uses these funds for this purpose, as evidenced by the fact that the Company does not segregate these funds in a separate account but rather commingles the funds in the operating accounts of the Company. Also, unlike "noncash" items such as depreciation, deferred taxes and return on common equity, interest expense is included because it is a "cash" item. In other words, there is a current cash outlay associated with this expense.

Q. How are Preferred Dividends generally treated in a lead-lag study?

A. The treatment of Preferred Dividends is generally not itself a major issue in cash working capital calculations because the cost amounts are often immaterial However, the treatment of preferred shares in a lead-lag study would depend in part on the characteristics of the shares. Preferred stock often has the characteristics of both debt and equity. While preferred shares generally have priority over common shares for dividend payments they typically have no voting rights. Without voting rights, preferred shareholders are often viewed more as creditors than owners of the company without any control over how and when earnings are distributed and/or reinvested. For this reason, dividends on preferred shares generally should receive the same treatment as interest on long-term debt and therefore should be included in the cash working capital calculations.

Q. Can you provide examples of other lead-lag studies where the cash working capital calculation excludes depreciation and common equity but includes interest expense on long-term debt as outlined above?

A. Yes. I am currently involved in two rate cases, one in Oklahoma and one in Nevada, where the treatment outlined above is being followed. In Oklahoma, in AEP-PSO's current rate case, both interest expense on long-term debt and preferred stock dividends were included in the lead-lag study, while depreciation expense and return on common equity were specifically excluded from the calculations.[5] This presentation is consistent with prior Oklahoma Corporation Commission orders where noncash expense items such as depreciation and return on common equity are excluded from the lead-lag

[5] See Schedule E-1 filed in American Electric Power – Public Service Company of Oklahoma's application in Cause No. PUD 200800144.

calculations.[6] In Nevada, Nevada Power Company filed a lead-lag study in its current rate case application that includes interest expense on long-term debt but does not include depreciation expense and return on common equity.[7] Preferred stock is included in the schedule, but with a zero balance. This presentation is consistent with the Nevada commission's treatment of these items in previous rate cases.

Q. Are you aware of other jurisdictions that follow this approach?

A. Yes. My understanding is that the Kansas Commission includes interest on long-term debt but not depreciation or common equity in the analysis of cash working capital.[8] I also know that the Arizona Corporation Commission addressed these specific issues in Decision No. 69663 in the recent APS rate case, Docket No. E-01345A-05-0816. In that case, APS included depreciation expense in its lead-lag study and excluded interest expense on long-term debt. Both Staff and the Residential Utility Consumer's Office ("RUCO") recommended the opposite treatment for both items. The Arizona Commission reviewed testimony and legal briefs on both issues and provided a thorough analysis in its final order to support its decision that the cash working capital allowance should include interest but not depreciation expense in the analysis. With respect to *depreciation expense* the Arizona Commission stated:

> There is no "cash expense" incurred by APS when it records depreciation. It does not have to find cash to pay itself one month and then pay itself back the next. As pointed out by RUCO, an allowance for cash working

[6] In Oklahoma, the larger gas and electric utilities, Oklahoma Gas & Electric, Public Service Co. of Oklahoma, and Oklahoma Natural Gas Co., all present lead-lag studies in their rate case applications to support either a positive or negative cash working capital allowance. In Oklahoma, interest expense on long-term debt is included in the cash working capital calculation while depreciation expense and return on common stock are excluded.
[7] See Schedule G-5, Page 1 of 1, Franklin, filed in Nevada Power's application in Docket No. 08-12002.
[8] See for example, Section 6, Schedule 6-H in the Kansas Gas Service's rate case Docket No. 06-KGSG-1209-RTS and Schedule 16 in the Kansas City Power and Light rate case, Docket No. 06-KCPE-828-R75.

> capital is to address cash flow timing problems, not "regulatory lag" issues related to earnings. . . . While it may be true that APS needs more cash, artificially increasing cash working capital to increase rate base and thereby operating income, is inappropriate.[9]

With respect to *interest expense* the Commission stated:

> Although interest expense is a non-operating expense, the ratemaking formula provides for the recovery of the periodic payments to debt holders, and the evidence shows that the Company has the use of these funds for an extended period of time before payments are required to be made. We will continue to include interest expense in the cash working capital calculation.[10]

Q. Do you know of jurisdictions where a different methodology is used?

A. Yes. In Texas, commission rules specifically exclude all "noncash" items from consideration. However, the list of "noncash" items includes depreciation, amortization, deferred taxes, prepaid items and return (including *interest on long-term debt and dividends on preferred stock*).[11] (Emphasis added). The problem with the Texas approach is the mischaracterization of interest expense as a noncash item. Clearly, interest expense is <u>not</u> a noncash expense, since there is a definite current cash outlay obligation associated with the expense. The other expense items in the Texas list, such as depreciation, amortization, deferred taxes and prepaid expenses are in fact noncash expenses. The error occurs by including interest expense in a list of noncash expenses, which results in an overstatement of cash working capital requirements.

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[9] Arizona Corporation Commission, Docket No. E-01345A-05-0816, Decision No. 69663, page 8.
[10] Arizona Corporation Commission, Docket No. E-01345A-05-0816, Decision No. 69663. page 10.
[11] §25.231(c)(2)(B)(iii)(IV) (-a-) The lead-lag study will use the cash method; all non-cash items, including but not limited to depreciation, amortization, deferred taxes, prepaid items, and return (including interest on long-term debt and dividends on preferred stock), will not be considered.

Q. What are your recommendations to the Commission regarding the cash working capital calculations to be used?

A. I recommend that the Commission continue its practice of excluding depreciation and common dividends from the cash working capital calculations. Both of these items represent the return of invested capital to the owners of the company. With respect to depreciation, the capital markets are aware of the regulatory lag involved with depreciation recoveries and have adjusted the cost of capital accordingly. With respect to common equity, decisions about how and when profits are distributed to the owners of the company are wholly within the purview of the owners themselves. They may choose to pay dividends or they may choose not to pay dividends. Ratepayers should not be held accountable for any acceleration or delay in the distribution of profits that result from those decisions. Even though including common dividends in the calculations would tend to lower the cash working capital allowance, I believe the Commission's policy of excluding common dividends from the cash working capital calculations is the correct approach.

With respect to interest expense on long-term debt, I recommend the Commission re-examine its treatment of this item. Clearly, interest is a cash expense. The ratemaking formula provides for the recovery of interest costs from the ratepayers through rates and the Company has the use of these funds for an extended period of time before payments are made to the debt holders. These debt payments are not discretionary payments but instead are binding contractual obligations of the company. As such, funds collected to pay interest expense provide a significant source of cash for use in the day to day operations of the Company that should be reflected in the lead–lag analysis.

IV. OTHER WORKING CAPITAL

Q. What items are included in other working capital?

A. Other working capital items include Fuel Stock, Prepayments and Materials and Supplies. These items are a part of the investment required to support utility operations. The balance of each of these accounts is subject to fluctuation throughout the year and it is common for regulatory commissions to use either a 12 month average or a 13 month average of these accounts in rate base. An exception can be made when a trend of increasing or decreasing balances is found and in those cases the ending balances may be included in rate base. I am recommending adjustments to each of these rate base components in the case of PacifiCorp because each of them are subject to seasonal fluctuations or changes in investment levels after the end of the base year.

Q. Please describe Fuel Stock and the basis for the amount the Company included in rate base.

A. Fuel Stock includes the inventory of coal, natural gas and fuel oil used for the generation of electricity. The largest part of this inventory is coal. The Company used a simple average of the projected balances for December of 2008 and December 2009 for the amount it included in rate base instead of the projected 13 month average balance used for Plant in Service.

Q. Is the level of inventory investment requested by RMP reasonable?

A. This amount represents a significant increase over the levels of fuel stock maintained by the Company at any time during either 2007 or 2008. In fact, the Company's projected 2009 inventory represents an average 79-day supply. The comparable figures for 2007 and 2008 are 42 days and 52 days respectively. Data requests DPU 61.3 and 61.4 were issued requesting explanations and an economic justification for the coal inventory increases. While explanations for the increases were provided, the Company provided no economic analysis to support the increase in inventory. An acceptable analysis would compare the chances, duration, and cost of supply interruptions with the cost of maintaining the higher inventory levels. If the increase in inventory levels is not justified economically, then the excess cost should not be included in rate base.

Q. Is a 79-day supply typical?

A. In my experience, it is more typical to see lower inventory levels. In fact, I have observed lower inventory levels even in states located at much greater distances from the coal production areas. For example, in Oklahoma in a 2005 rate case, OG&E was allowed a 60-day supply even though the company maintained lower actual inventory levels during the test year.[12] AEP-PSO maintained a 54-day coal supply in its 2008 rate case.[13] In its current rate case, Nevada Power Company is requesting the equivalent of a 62-day supply of coal. Considering the more distant location of these other utilities from the primary coal production areas, and the fact that PacifCorp owns a significant portion of the coal supply used at its plants – which would tend to reduce potential interruptions or delays that other utilities might experience with third-party suppliers – the 52-day

[12] Oklahoma Corporation Commission, Cause No. PUD 200500151, Order No. 516261, page 88 2005.
[13] Oklahoma Corporation Commission, Cause No. PUD 200800144.

annual average supply maintained by the Company in 2008 appears to be reasonable. PacifiCorp did increase its actual inventory levels during 2008 and ended the year with a 57-day supply of coal. However, at no time in 2007 or 2008 did the Company come near the 79-day inventory level requested for the Test Year.

Q. Do you consider the Company's use of the average of the beginning and ending projected balance to be appropriate?

A. No. The use of a simple average of the beginning and ending balances for working capital items like fuel stock can provide a distorted picture of the actual average balance. This is because power generation is usually seasonal in nature. In states like Utah the electric utilities generally experience two peak production periods. One peak occurs in the summer with warmer weather and the use of air conditioning. The other peak occurs in winter with the use of electric heating. Coal stockpiles are normally increased in anticipation of these peak periods and then are allowed to decrease as the peak season progresses. To better reflect these naturally occurring changes in the inventory levels, I recommend a 12-month average of the inventory account balances to include both the high and low levels, so that neither the utility nor the ratepayer is penalized by the choice of test year dates. I recommend the 12-month average instead of the normal 13-month average because the 13-month average would begin and end on a peak month, and therefore, would overstate the inventory requirement.

Q. What is your recommendation regarding the fuel stock levels to be included in rate base?

A. I recommend that the coal fuel stock investment be adjusted to the 2008 levels at the 2009 average projected prices. This results in an adjustment to reduce Fuel Stock by $42,220,321 on a total company basis and by $16,862,796 for the Utah jurisdiction.

Q. Please explain your recommendation regarding Prepayments.

A. The balance of prepaid expenses tends to vary throughout the year. The balance of base year prepayments ranged from a low of $37,516,364 in July 2007 to a high of $46,434,467. The Company included the June 30, 2008 unadjusted balance of $40,665,612 in the 2009 test year rate base. While this amount appears reasonable because it is closer to the low end of the range, it is more appropriate to use a thirteen month average for this account to more accurately reflect the average amount of funds that must be provided by investors. In consideration of the need to better reflect test year conditions I recommend the thirteen month average balance for the calendar year 2008 in the amount of $39,207,305. This results in a total company adjustment to reduce Rate Base by $1,458,307 and a Utah jurisdictional Rate Base reduction of $628,607.

Q. Please explain your recommendations for the Materials and Supplies Inventory?

A. The Materials and Supplies Inventory balance increased throughout 2008. Specifically, the December 2008 balance was $4.9 million more than the June 2008 balance. When a balance sheet account is trending on one direction or the other, either up or down, the year-end balance is generally used in setting rates rather than a 12 or 13-month average.[14] Here, because the account balance appears to be trending slightly upward, I believe the December 2008 balance is more representative of test year levels than the June 30, 2008

[14] A 12 or 12-month average convention is used for inventory accounts that fluctuate throughout the year and the balance at the end of the year is not necessarily representative of the ongoing level.

balance used by the Company. This adjustment increases the total company rate base by $4,894,568 and the Utah rate base balance by $1,999,404.

V. PAYROLL AND RELATED EXPENSES

Q. Please describe the Company's payroll expenses and the adjustments related to these costs?

A. Employee costs are the second largest category of expenses in the revenue requirement after net power costs. Rocky Mountain Power is proposing to recover over $210 million from Utah ratepayers for labor expenses, benefits and payroll taxes. This includes a 3.5% salary increase from December 2008 levels. It also includes Company adjustments for scheduled collective bargaining labor increases and budgeted increases for non-bargaining labor as well as budgeted levels of incentive payments and benefit costs.

Q. Do you agree with the Company's proposed payroll adjustments?

A. No. While the Company contends that its projected pay increases are necessary to attract and retain good employees, the data upon which they rely to justify the rate of increase does not appear consistent with the current economic downturn.

Q. How does the Company's proposed payroll increase compare with other benchmarks?

A. PacifiCorp based its proposed salary increases on 2007 survey data, reflecting the rates of pay increase projected by other utility companies. These utility-specific benchmarks appear to yield inflated projections when compared with recent actual payroll increases among non-regulated companies. The U.S. Bureau of Labor Statistics reports that average wages and salaries for private industry increased at an annual rate of 2.4% in the third and fourth quarters of 2008. Companies in the competitive markets have recognized the impact of the economic downturn, and accordingly have shown restraint in awarding salary increases. The weakened U.S. economy and the resulting trends toward workforce reductions and salary decreases make it unlikely that payroll increases over and above the national average will be necessary to attract and retain good employees.

Q. Did you analyze the actual impact the Company's budgeted pay raises on payroll expense?

A. Yes. I reviewed the Base Year payroll costs and the scheduled and budgeted pay raises for subsequent periods. I also reviewed the payroll information for the period ending January 11, 2009. I found that not all non-bargaining employees received raises during this period. When the entire group of non-bargaining employees is included, the effective rate of increase for the group is actually 3.12%, not the 3.5% included in the Company's payroll adjustment.

Q. Are there other problems associated with approving an increase in rates based solely on the Company's projected annual pay raises?

A: Yes. While it may seem reasonable that pay raises implemented after the base year would cause an increase in overall payroll expense, what may not be so apparent is that other events over the same period could decrease payroll levels by even greater amounts. For example, even with a stable workforce, employees are being added to, and taken off, the payroll registers on a fairly regular basis. Since retiring employees are generally paid much more than new hires, overall payroll expense levels can decrease significantly if a number of higher paid employees leaving the company are replaced with employees paid at lower levels or are not replaced at all.

Changes in a company's capitalization percentages during a period of higher construction can also reduce payroll expense levels, even with no reduction in overall payroll costs. Each of these potential reductions in payroll expense can more than offset the anticipated increase from an annual raise. As a consequence, even if the Commission were inclined to accept an adjustment to payroll levels, the Company's proposed adjustment is inappropriate because it fails to show that net payroll expense levels should and will actually increase by the amount of the estimated pay raises.

Q. What changes do you recommend to the Company's proposed payroll annualization?

A. I recommend that the Commission approve a rate of increase of 2.4% rather than the Company's requested 3.5% of December 2008 raises for the non-bargaining employees. The Division's proposed rate is based on the data collected by the U.S. Bureau of Labor Statistics for the 4th Quarter of 2008, which more accurately reflects current economic conditions. Moreover, by adopting a payroll rate increase at a 2.4% level, the Commission also reduces the potential for the Company over-earning, which exists as result of implementing an increase based solely on projected future pay raises without considering the offsetting decreases to overall payroll costs that may occur in that same time period. The adjustment reduces Test Year payroll for non-bargaining employees by 1.1%, and results in a reduction of Base Year payroll expenses of $1,505.297 on a total Company basis, and $609,278 for the Utah jurisdiction

Q. Have you proposed other adjustments to wage and employee benefit costs?

A. Yes. I am proposing adjustments to the Company's Supplemental Executive Retirement Plan (SERP) plan and to the projected medical expense.

Q. Please describe the Supplemental Executive Retirement Plan.

A. The Company provides supplemental retirement benefits to its officers and division presidents. Supplemental retirement plans for highly compensated individuals are provided because benefits under the general pension plans are subject to certain limitations under the Internal Revenue Code. Benefits payable under these supplemental plans are typically equivalent to the amounts that would have been paid but for the limitations imposed by the Code. In general, the limitations imposed by the Code allow for the computation of benefits on annual compensation levels of up to $245,000 for the year.[15] Retirement benefits on compensation levels in excess of the $245,000 limitation are paid through supplemental plans.

Q. What amounts were included in the pro forma operating expense for the executive pension plan?

A. The amount of Supplemental Executive Retirement Plan costs included in RMP's filed cost-of-service was $1,857,705[16] on a total company basis.

Q. What do you recommend with regard to the executive retirement benefit costs?

A. I recommend a sharing of the total executive benefits costs. The cost of all of the executive benefits included in the Company's regular pension plans should be included in rates, while the cost of the additional executive benefits included in the supplemental

[15] The limits are $225,000 for 2007, $230,000 for 2008 and $245,000 for 2009.
[16] See WP 4.11.2, 2,600,000 * 71.4502% = $1,857,705.

plan, should be excluded from rates and paid for by the shareholders of the Company. For ratemaking purposes, shareholders should bear the additional costs associated with supplemental benefits to highly compensated executives, since these costs are not necessary for the provision of utility service, but are instead discretionary costs of the shareholders designed to attract, retain and reward its highly-compensated employees. Because officers of any corporation have a duty of loyalty to the corporation, it is understood that these individuals will be motivated to put the interests of the company and its shareholders first. Because the interests of the shareholders are not always aligned with the interests of the ratepayers, the entire cost associated with compensation of corporate officers generally is not passed on to ratepayers. Many regulators are inclined to exclude executive bonuses, incentive compensation and supplemental benefits from utility rates, understanding that these costs would be more appropriately borne by the utility shareholders.[17] With regard to SERP costs, some utilities treat these costs as a below-the-line item even without a Commission order directing them to do. The adjustment I propose removes SERP costs in the amount of $1,857,705 on a total company basis and $751,917 for the Utah jurisdiction.

VI. INCENTIVE COMPENSATION

Q. Have you reviewed the level of incentive compensation expense the Company has included in the current rate case?

[17] The Garrett Group Incentive Survey of the western states revealed that most states exclude executive bonuses and incentive compensation. Here, the Company has voluntarily removed its executive stock bonus plan. With respect to SERP costs in particular, the Oklahoma Commission has consistently excluded SERP costs in AEP-PSO's and OG&E's rate cases. See for example, Cause Nos. PUD 200800144 and PUD 200600285.

A. Yes. The Company seeks to include $33,138,258 on a total company basis in the initial payroll projection, but reduces this to the 2009 target level of $21,250,000 in its 2009 O&M Target on Page 4.23.2.

Q. Please describe the Company's incentive compensation plan.

A. The Company provided a copy of its 2009 Annual Incentive Plan. The stated objectives of the plan are as follows:

> PacifiCorp's Annual Incentive Plan provides performance awards based on the following: achieving the goals of PacifiCorp, Pacific Power, Rocky Mountain Power and PacifiCorp Energy; individual performance; company management of risk and safety; and success in addressing new issues and opportunities that may arise during the course of the year. Awards will be made based upon measurable achievement of results. Achievement will be measured by senior management. This approach supports the philosophy of incentive compensation as pay at risk that is earned based on the company, business unit and individual performance."[18]

> The plan also sets forth the following four "Plan Components:"

> - Incentive awards are structured to achieve a target incentive payout. Target award percentages are based on job classification derived from competitive market data.
> - All participants will have an award opportunity based upon company, business unit and individual performance as measured and assessed by senior management.
> - Company and business unit performance will be evaluated based on meeting objectives established in operating and business plans and the organization's success in responding to unexpected events.
> - Any adjustments for individual performance will be reviewed by each president (business unit leader) and a final

[18] Response to DPU Data Request 58.9 b.

decision made in collaboration with senior management prior to final award determination.[19]

Q. From this information provided, are you able to determine how PacifiCorp's incentive plans are triggered?

A. Based upon this summary of the overarching incentive plan, incentive compensation payments appear to be based solely on the discretion of senior management, and the criteria that senior management will use to assess employee performance are not clearly defined. When incentive plans are designed in this manner, regulatory oversight of the actual performance rewarded by senior management is virtually impossible.

Q. Did the Company provide any other materials regarding the criteria that will be used to evaluate employees in implementing its incentive plan?

A: I reviewed several Company-provided statements outlining the goals for the 2008 and 2009 plan years. For example, I reviewed the PacifiCorp 2008 Goals and the 2008 Goals for the Division Presidents of Pacific Power, PacifiCorp Energy, and Rocky Mountain Power.[20] In addition to the 2008 plan year materials, I also reviewed the objectives from the 2009 Performance Management goals of specific employees within the Company. These plans outline a large range of goals, some of which are clearly financial goals for the benefit of shareholders, while other stated goals are designed to improve reliability and customer satisfaction. However, the plans provide no weighting of the various benchmarks, nor do they adequately explain the linkage between achieving one or more of the objectives and the amount of the incentive payment made.

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[19] See Response to DPU Data Request58.9 - PacifiCorp 2009 Annual Incentive Plan.
[20] CCS Data Request Attachment 6.11.1.

Q. Is it important for the Company to provide measurable benchmarks that show the linkage between the stated goals and the incentive payments?

A. Yes. When incentive payments are left exclusively to the discretion of management, it is impossible for the Commission to monitor what types of specific employee performance is being rewarded. As a result, it is impossible to ascertain whether the rewarded goals are furthering the goals of the Company's shareholders or its customers, or some combination of both.

Q. Did the Company's incentive plans in the past provide measurable benchmarks and formulas for determining the award and amount of incentive pay?

A. Yes. The Company has acknowledged that previous incentive programs did apply a formulaic approach that determined the award and amount of incentive pay. Once an employee met certain objectives, the employee was assured of a certain payment.[21] Under the Company's prior approach, the distinction between shareholder and customer goals was readily ascertainable. Now, however, the Company no longer uses this approach and instead leaves incentive payments totally to the discretion of management. Thus, it is impossible for the Commission to determine which portion of the incentive plan benefits shareholders, and which portion benefits the customers of the utility. This transition to a wholly discretionary plan without objective standards effectively thwarts implementation of the Commission's policy to exclude incentive payments tied to financial performance goals.

[21] See Rebuttal Testimony of PacifiCorp Witness Erich D. Wilson, Docket No. 07-035-93, p.17.

Q. From your review of the incentive plans, does it appear that financial goals make up an important part of the overall incentive compensation?

A. Yes. Several of the criteria within the plan encompass financial goals. In the "PacifiCorp 2008 Goals," the first objective is tied purely to financial performance. Because the various goals within the plan are not weighted in any way it is impossible to determine this financial goal's relative importance. However, I did note that it was the first goal listed. From a review of the other objectives listed within the PacifiCorp 2008 Plan, I noted many other specific objectives designed to increase financial performance. In reviewing Company-provided examples of 2009 Performance Management documents to evaluate the performance of specific employees, I noted these evaluation forms contained entire sections devoted to financial performance goals.

Q. Even though it is clear that some portion of the incentive plan is tied to financial performance, can the Commission determine the precise portion of the Company's incentive plan that should be excluded?

A. No. Because the Company fails to disclose how the various financial and operational goals are weighted, or how these objectives are evaluated by senior management, the Commission cannot make a precise determination of the amount that should be excluded for ratemaking purposes

Q. Is this a valid reason to allow the Company to include 100% of its incentive pay in rates?

A. No. The Company's decision to revise its incentive plans to eliminate objective measurements of the various goals does not mean that financial goals are no longer present within the plans. It is clear that financial performance goals are still included, and therefore the incentive plans are designed to benefit both the shareholders and the customers. In situations such as these, commissions often adopt an allocation methodology so that the costs of the incentive payments are shared between the customers and shareholders of the Company.

Q. The Company contends that incentive compensation payments are part of an overall compensation package, and are therefore necessary to provide a competitive level of compensation to attract and retain employees. Do you agree that this is sufficient rationale for including all of the incentive compensation for ratemaking purposes?

A. No. Requiring that the shareholders bear a portion of the employee incentive cost clearly does not prevent the Company from making the planned incentive payments, nor does it place PacifiCorp at a competitive disadvantage. Since most utility incentive plans are at least in part based upon achieving financial performance goals designed to maximize shareholder earnings, many regulatory agencies exclude part of the incentive from the revenue requirement.[22] Because this is the widely accepted regulatory treatment, PacifiCorp's overall compensation package would still be comparable with utility companies in numerous other jurisdictions if a portion of the plan costs were disallowed.

[22] In 2007 the Garrett Group, LLC surveyed the utility commissions in the western United States regarding the rate treatment of incentive compensation. The results of that survey showed that most states exclude utility incentive compensation associated with financial performance measures. Some states exclude incentive pay using other criteria, and a few states have no established policy with respect to incentive compensation, but virtually every state excludes incentive compensation in one manner or another. The following states closely observe the financial performance distinction: Oklahoma, Texas, Washington, Oregon, Idaho, Utah, North Dakota, South Dakota, Missouri, Kansas, and New Mexico. Arizona, Colorado, California and Minnesota exclude incentive costs using other criteria.

Q. What is the general rationale for excluding incentive compensation expense in other states?

A: Most jurisdictions limit the amount of incentive compensation to be recovered in rates. When costs associated with incentive compensation plans are excluded from rates, the rationale is generally based on one or more of the following reasons:

1) Payment is uncertain.

2) Many factors that impact earnings are outside the control of most company employees and have limited value to the customers of the company.

3) Incentive plans conditioned on earnings can discourage conservation of energy.

4) The utility and its stockholders assume none of the financial risks associated with incentive payments.

5) Incentive payments based on financial performance measures should be made out of increased earnings.

6) Incentives embedded in rates shelter the utility against the risk of earnings erosion.

Even though many states routinely exclude incentive compensation payments based on one or more of the reasons outlined above, this does not mean that the regulated companies in those states do not continue to offer incentive compensation packages. To the contrary, they do. However, because the utility retains all of the savings generated from any increased efficiencies between rate cases, payment to the employees achieving these efficiencies should be made from a portion of the savings these plans help achieve.

Q. What standard does Utah apply in determining the amount of incentive compensation recoverable through rates?

A. Typically, the Commission only allows in rates the portion of a company's incentive compensation plan that is shown to be based on goals that provide ratepayer benefits, such as measurable improvements in quality of service, while any portion of the incentive compensation plan that relates to earning or rate of return is generally excluded.[23]

Q. The Company maintains that its incentive plan is focused on operational goals instead of financial goals. Do you agree?

A. No. PacifiCorp's incentive plan states a number of very general goals, some of which are operational and others which are financial in nature. However, because the incentive payments are solely within the discretion of senior management, and there are no stated formulas or other objective bases defined, it is impossible to determine whether the incentive plan is designed to promote operational goals, financial goals or some combination of the two. There is certainly no showing that the Company is obligated to make any incentive payments based on achieving any specific identifiable operational goals that provide measurable benefits to ratepayers.

Q. How should the Company's incentive compensation plan be corrected?

A. In order for the Commission to evaluate the Company's objective measures of performance, a more structured plan should be provided. Each of the goals or objectives within the plan should be given a weighting and a formula so that the incentive value of each objective can be calculated. The plan should be designed in a manner that ensures that if the performance objectives and benchmarks are met, the company has a firm obligation to make incentive payments. Incentives related to "below the line" activities,

[23] *Garrett Group Incentive Survey* response, Utah PUC, Commission Utility Economist. See US West Communications Rate Case Docket 95-049-05. See also Missouri Corp. Rate Case Docket 97-035-01.

or specific financial performance goals which are intended to maximize shareholder earnings should be identified and excluded for ratemaking purposes. This was the approach used at the Company until recently.[24]

Q. Are you aware of other jurisdictions that require utility companies to structure incentive plans with clearly defined benchmarks that are objectively measured in order to be allowed as a recoverable expense for ratemaking purposes?

A: Yes. It is important for regulators to be able to assess the actual goals and incentives which cause the incentive payments to be triggered. Many jurisdictions focus on quantifiable goals such as measurable increases in reliability and quality of service to the customers. On the other hand, where the overriding goal of the incentive plan is to increase shareholder earnings, many jurisdictions disallow that portion of the incentive compensation plan which should be more appropriately funded out of the increased earnings that trigger the payments. In some states where a clear distinction between financial and customer-related goals can not be determined, the commission shares the cost of the incentive plan between the company and its customers on a 50/50 basis.[25]

Q. What are your recommendations regarding incentive compensation expenses?

A. My recommendations regarding incentive compensation are twofold. First, the Company included $31,721,407 in the wage and employee benefit adjustment at Page 4.11.2 of Mr. McDougal’s exhibit, but of this amount only $21,250,000 is included in the 2009 O&M Target on Page 4.23.2 for both bonuses and incentive payments. The first adjustment I propose is to limit the recovery of incentive cost and bonuses to the $21,250,000 included

[24] See Footnote No. 21.
[25] This treatment has been used in Arizona, Arkansas, California, Oklahoma, and Oregon.

on Page 4.23.3 of Mr. McDougal's exhibit. When the escalated bonuses are removed this adjustment reduces revenue requirement by $7,195,210 on a total company basis and by $2,912,304 in the Utah jurisdiction, net of capitalization and including the impact on payroll taxes.

Q. What is your second recommendation regarding the Company's incentive compensation plan?

A. In keeping with the Commission's policy of excluding the portion of incentive compensation costs attributable to achievement of the Company's financial performance goals, I recommend an allocation of the remaining $21,250,000 included in the 2009 O&M Target amount. Because PacifiCorp's employee evaluation forms and plan overview clearly indicate that financial performance goals are included within its plan, and because the Company elected to design an incentive compensation plan that is entirely within the discretion of senior management and provides no weighting criteria, I propose that the Commission exclude 50% of the costs of its plan in order to provide an appropriate sharing of these costs between PacifiCorp's customers and its shareholders. This adjustment reduces revenue requirement by $7,589,318 on a total Company basis and $3,071,821 in the Utah jurisdiction, net of capitalization and including payroll taxes.

VII. INSURANCE EXPENSE

Q. Please discuss your recommendation regarding Injuries and Damages Expense.

A. In its order in Docket No. 07-035-93, the Commission stated that it preferred to use a multiyear average of net cash paid for Injuries and Damages Expense. The Commission further stated that it did not have a preference as to whether the average should be a 3, 4, or 5 year average but based its decision on the 3-year average presented in that case. In this proceeding, I am proposing to use a 3-year average consistent with the Commission's decision in Docket No. 07-035-93. I use information through December 2008 which includes the latest information available.

Q. What adjustment do you recommend for Injuries and Damages Expense?

A. The 3-year average of cash payments made reduced by cash claim payments received from insurance companies as of December 31, 2008 results in an adjustment to increase test year Injuries and Damages Expense by $1,842,832 on a total company basis or $751,728 for the Utah jurisdiction.

VIII. PROPERTY TAX EXPENSE

Q. Please describe your review of Property Tax Expense?

A. The Commission, in its order on reconsideration in Docket No. 07-035-93 dated October 13, 2008, stated: "In future rate cases we request parties' comments on the Company's property tax estimation model and evaluation of its validity, assumptions, projections, and judgement contained therein." In response to this request from the Commission, I issued discovery, performed analysis and reviewed the Company's property tax expense projections in this docket and will provide testimony explicitly addressing these issues.

Q. Please describe the concerns expressed by the Commission in October 13, 2008 order?

A. The Commission was concerned that sufficient evidence had not been presented to support the Company's projected property tax expense levels. The Commission cited the lack of evidence related to special tax exemptions, the proper allocation of increased assessments to operations, state by state identification of estimated tax rates, and the possible impact of previous and future appeals of assessments. Generally speaking, the Commission was dissatisfied with the amount of evidence provided to support the Company's property tax expense adjustment.

Q. What discovery did you conduct related to the projected Property Tax Expense?

A. The Garrett Group discussed the Company's property tax budgeting and review procedures with Company personnel in Portland, Oregon and issued data requests to the Company. The DPU 35th set of discovery requests focused on the Company's projected and actual property taxes and the property tax projection model. We also discussed the projection model with a former Utah Tax Commission employee and performed analysis on the model and the projections.

Q. What were your findings from your review of this issue?

A. I found that the model used by the Company in the second supplemental filing reasonably approximated the Tax Commission's assessment methods. I also found that the property taxes for 2008 increased substantially over the 2007 levels and that the increase in the assessment and taxes was consistent with the increase in rate base between the two periods. I found that the Company's projected property tax expense is consistent with these models and the Company's projected rate base.

IX. DEFERRED INCOME TAX EXPENSE

Q. Has the Division proposed an adjustment related to Deferred Income Tax expense?

A. The Division has been working with the Company on the Deferred Income Tax Expense adjustment and the Company has indicated in response to the DPU data request number

58.11 that an adjustment is appropriate. The Company stated in that response that a processing error had occurred in the Second Supplemental Filing related to Avoided Cost and Contributions in Aid of Construction which should both be fully normalized. I accept this adjustment and recommend the Income Tax Expense be decreased by $11,384,497and Accumulated Deferred Income Taxes be decreased by $5,692,249.

X. CUSTOMER ADVANCES FOR CONSTRUCTION

Q. What do you recommend for Customer Advances for Construction?

A. The balances in this account have been increasing fairly consistently from $6,222,688 in January 2006 to $18,302,469 in June 2008 and then to $20,259,578 in December of 2008. The consistent growth in this account indicates that it is appropriate to use the most recent balance instead of the lower balance from June that was used by the Company. Because Customer Advances for Construction is used to reduce rate base, this adjustment decreases rate base by $1,496,311 on a total company basis and $777,043 in the Utah jurisdiction.

XI. CONCLUSION

Q. Please summarize your recommendations in this case?

A. I recommend that the Commission include interest on long term debt and preferred stock dividends in the cash working capital calculations but exclude depreciation and common dividends. I also recommend adjustments to the other working capital components of Fuel Stock, Prepayments, and Materials and Supplies. These adjustments reflect known and measurable changes through the end of 2008. In the case of Fuel Stock, I recommend a 12-month average balance based on 2008 inventory levels at the projected prices for 2009. For Prepayments I recommend a 13-month average for 2008. The Company did not escalate this item for the Test Year. I recommend the year end balance for Materials and Supplies because of the increases in this account over time. I recommend adjustments to payroll to decrease the January 2009 escalation proposed by the Company. I also recommend excluding the Supplemental Executive Retirement Plan and I recommend decreases to the proposed incentive pay. I propose an adjustment to update the three year average for insurance expense through December 2008. I recommend accepting the adjustment to income tax expense and accumulated deferred income taxes proposed by the Company. I also recommend updating Customer Advances for Construction through December 31, 2008.

Q. Does this complete your testimony?

A. Yes it does.