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. 11-035-200** **Exhibit No. DPU 1.0-R Revenue Requirement** **Rebuttal Testimony** **Charles E. Peterson**

FOR THE DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE
STATE OF UTAH

Rebuttal Testimony of

Charles E. Peterson

July 13, 2012

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I. INTRODUCTION AND SUMMARY

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

A. My name is Charles E. Peterson. My business address is 160 East 300 South, Salt Lake City, Utah 84114. I am a Technical Consultant in the Utah Division of Public Utilities (Division, or DPU).

Q. On whose behalf are you testifying?

A. The Division.

Q. Did you previously file testimony regarding cost of capital in this Docket?

A. Yes. I filed direct and rebuttal testimony in the cost of capital phase of this docket.

Q. What is the purpose of your testimony in this matter?

A. My testimony comments on certain issues raised by Mr. Kevin Higgins in pre-filed direct testimony in behalf of Utah Association of Energy Users (UAE) and by Mr. Greg Meyer who filed direct testimony in behalf of the Federal Executive Agencies (FEA).

Q. Specifically, which issues are you commenting on?

A. Both Mr. Higgins and Mr. Meyer recommend excluding from the revenue requirement all

(Meyer) or most (Higgins) of the Company's escalation adjustment for non-labor, non-NPC O&M expenses. While their reasoning differs, in both cases their arguments justifying the exclusion are flawed. Consequently I recommend that that Commission give little credence to their proposed adjustments.

II. DISCUSSION OF ESCALATION ADJUSTMENTS

Q. What was the Company's basis for this escalation?

A. The Company took a number of miscellaneous accounts and increased the amounts from the June 2011 base year by Global Insights' escalation factors to arrive at an overall escalation adjustment of $10,188,783.[1]

Q. Do you believe that an escalation of these costs is justified?

A. Generally, yes. Absent good evidence to the contrary, future costs of goods and services should properly be forecast to increase, in dollar terms, from some base historical cost.

Q. Why, generally, should the assumption of increasing costs be made?

A. There are at least two reasons. First and foremost is simply that the economy of the United States has consistently experienced inflation, i.e. the general increase in the cost of goods and services measured in dollar terms, for decades. Indeed, it is the policy of the Federal Reserve to maintain a level of "mild" inflation in the annual range of about 2 percent.[2] On the flip

[1] Direct Testimony of Steven R. McDougall, Exhibit RMP__(SRM-3) "Revenue Requirement Summary."
[2] http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm Accessed July 11, 2012.

side, the Federal Reserve, and economists generally, consider deflation, i.e the general decline in costs, as something to be avoided.[3]

Q. What is the escalation rate forecast for these expenses by the Company?

A. Accepting Mr. Meyer's calculation of the base amount of $258,987,000[4] the percent change is 3.93 percent from the base year July 1, 2010 to June 30, 2011 through the test year June 1, 2012 to May 31, 2013—slightly less than two years. Thus the annual "escalation" is about 2 percent.

Q. Earlier you said there were at least two reasons for assuming increasing costs, what is the second reason?

A. In this inflationary environment, there is no evidence that PacifiCorp/Rocky Mountain Power is anything but a price-taker for most of the goods and services subject to this adjustment. In other words, the Company pretty much has to accept the costs prevailing in the economy. In particular, Messrs. Higgins and Meyer do not present any evidence, or argument, that the Company can set its own prices for the goods and services in question.

Q. Is a two-percent growth rate reasonable?

A. Given the above, yes. I note too that the Division's auditors reviewed the Company's calculations and growth rates and did not recommend any changes to this escalation

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[3] For example see http://www.economist.com/blogs/buttonwood/2012/05/deflation
http://www.cnbc.com/id/39853052/Federal_Reserve_Terrified_of_Deflation_El_Erian
http://money.cnn.com/2010/07/20/news/economy/fed_deflation/index.htm
http://www.usnews.com/news/articles/2011/10/26/investors-and-economists-say-deflation-risk-is-real
all accessed July 11, 2012.

[4] Direct Testimony of Greg. R. Meyer, page 5, Table 2.

adjustment.

Q. Is it a regulatory principle that a utility be allowed to recover its prudently-incurred operating costs?

A. Yes. This principle is at least implied in the well known U.S. Supreme Court decisions commonly referred to as the Bluefield and Hope cases.[5,6] Commenting on these as an economist and regulator, the Bluefield and Hope cases established economic and financial principles for proper regulation. These principles included (1) that the utility be allowed an opportunity to earn a return on its utility property generally equal to returns earned by other companies of similar risk; (2) this return should assure confidence in the financial soundness of the utility; (3) this allowed return should maintain and support the credit of the company and allow it to attract capital; (4) recognition that a return that is "right" at one time may become high or low by changes in the economy regarding alternative investments; and (5) particularly in Hope, what is important is that the "end result" of the rate order be just and reasonable; it is less important how that result is arrived at. While the above list reflects the rights of the utility, Hope and Bluefield balance those rights with the obligation that "just and reasonable" rates include fairness to the customers. By implication, Bluefield and Hope maintain that a regulated utility must recover its operating costs in order to be given the "opportunity" to earn a "fair" return or profit.

Q. Are there other recognized authorities that support the recovery of prudently incurred operating costs?

[5] Bluefield Water Works and Improvement Company v. Public Service Commission, 262 U.S. 679, (1923).
[6] Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, (1944).

A. Yes. For example, in his well-known book, Charles F. Phillips, Jr. in a general discussion of the factors that make up a utility's revenue requirement makes the following statement:

> The formula [for revenue requirement] indicates that determining the total revenue required (generally for a twelve-month period) involves three major steps. First, allowable operating costs must be ascertained. These include all types of operating expenses (wages, salaries, fuel, maintenance, advertising, research and charitable contributions) plus annual charges for depreciation and operating taxes. Operating costs represent the largest percentage of a utility's total revenue requirement. *Many of these costs are determined by normal competitive factors* (wages, salaries, fuel and maintenance) or by various levels of government (taxes). Others are determined by the individual firms (expenditures on advertising, research and development, and charitable contributions; purchases from affiliated subsidiaries) or by the regulatory commissions (annual depreciation rates). A public utility legally may spend any amount it chooses for such purposes, but a commission may not allow all expenditures made for rate-making purposes."[7] (Emphasis added).

Q. How does the Division understand the application of this principle in a rate case involving a forecasted test year?

A. The Division understands this principle to mean that the Company should be allowed the opportunity to recover its (prudent) operating costs as they are actually expected to occur in the test year, which would necessarily include expected price escalations. Otherwise, the principle is violated. Furthermore, by seeking to remove apparently reasonable price escalation factors from the revenue requirement forecast, Messrs. Higgins and Meyer are effectively reintroducing the regulatory lag problem that forecast test years are supposed to mitigate.

[7] Phillips, Charles F., Jr., *The Regulation of Public Utilities*, (Arlington, Virginia: Public Utilities Reports, Inc., 1993), page 177. See also pages 255-269 for a detailed discussion.

III. REVIEW OF MESSRS. HIGGINS' AND MEYER'S ARGUMENTS

Q. What is the argument for the exclusion made by Mr. Meyer?

A. Mr. Meyer's argument is basically that between 2010 and 2011 this set of PacifiCorp operating costs declined by $29 million; therefore there should be no increase in the test year over and above the level in the 2011 base year.[8] Mr. Meyer makes three additional arguments that (1) RMP is filing frequent rate cases so that "the need for an inflation adjustment is diminished;"[9] (2) "[a]n inflation adjustment cannot account for technological advances…and [it] also cannot reflect any increased productivity of the PacifiCorp workforce;"[10] and (3) the Global Insight indices increased between 2010 and 2011, but "Utah's (sic) actual expenses declined."[11]

Q. Do you have comments on Mr. Meyer's arguments?

A. Yes. With respect to the 2010 to 2011 change, the Company is applying its $10 million escalator to the 2011 amount, which is already $29 million lower than 2010. A one year change does not establish a trend. Mr. Meyer has not shown that there has been a long-term declining trend in these costs along with reasons why that decline cannot reverse in the test year. He argues that frequent rate cases "diminish" the need for an inflation adjustment, which I take to mean that the effects of regulatory lag are not significant enough to him to do anything about; that is, the Company isn't falling "too far behind." Similarly he refers to "technological advances" but makes no attempt to quantify their supposed impact on the test

[8] Meyer, Table 2, Op. Cit. See also his Exhibit FEA-1 (GRM-1).
[9] Meyer, page 7, line 119.
[10] Ibid. lines 121-123.
[11] Ibid. line 132.

year prices faced by the Company, nor does he show that Global Insights has not taken into account such productivity advances in its factors-- he merely makes an assertion. As for labor productivity gains, those should be accounted for in the labor cost increases that he has excluded.

In sum, the arguments made by Mr. Meyer amount to unsupported and unconvincing assertions.

Q. Earlier you stated that Mr. Higgins does not propose to adjust out all of the O&M escalator expense. What does he recommend?

A. Mr. Higgins begins with the $10.2 million escalator amount and eliminates the escalation amounts for certain line items that reduces his adjustment by approximately $600 thousand to $9,613,343.[12]

Q. Please summarize your understanding of Mr. Higgins' justification for this adjustment to the Company's O&M costs.

A. Mr. Higgins states that he has two "serious concerns:"[13] First, that he believes that including projections of inflation into the prices set by regulators makes "inflation a self-fulfilling prophesy," which is, or should be, contrary to public policy.[14] Second, through these inflation mechanisms, the Company creates a "cost cushion" for future costs, and cites how the Company apparently has overstated its legal expenses in the test period by including extraordinary costs in its historical base periods to project its future costs as evidence that, by

[12] For details, see Direct Testimony of Kevin C. Higgins, UAE Exhibit RR 1.10.
[13] Ibid. page 25, line 495.
[14] Ibid. lines 495-503.

implication, this is going on in the O&M costs. Mr. Higgins appears to suggest that by eliminating the "cushion" of the inflationary increase, the Company has an incentive to improve its O&M efficiency that it otherwise does not have.[15]

Mr. Higgins also appears to suggest that if the Company were to make stand alone forecasts of the future costs of each line item in these accounts, rather than relying on Global Insights generic cost escalators, he might be willing to reduce—or perhaps eliminate—his adjustment.[16]

Q. Do you have comments on Mr. Higgins' arguments?

A. Yes. Mr. Higgins' concern about contributing to national actual and expected inflation through RMP's rate case is, at best, overstated. The size of Rocky Mountain Power, or PacifiCorp in its entirety, is completely dwarfed by the of U.S. economy whose GDP is approximately $15 trillion.[17] It should go without need for statement that the effect on actual and expected inflation of Federal fiscal and monetary policy is infinitely[18] greater than whatever the Utah Public Service Commission can contribute. Thus Mr. Higgins' policy concerns in this regard should be rejected. As I suggested earlier, the regulators' job is to allow for recovery of the Company's prudent costs.

Mr. Higgins next suggests that the Company may over-forecast costs in future test years to give itself a cushion; and that this cushion, in turn, can contribute to lax efforts on the part of

[15] Ibid. pages 25-27, lines 505-532.
[16] Ibid. pages 28-29, lines 557-581.
[17] http://www.bea.gov/newsreleases/national/gdp/2012/pdf/gdp1q12_3rd.pdf Accessed July 10, 2012.
[18] Metaphorically speaking.

management to continually improve efficiency. While I do not dispute that over-forecasting is a concern, Mr. Higgins does not demonstrate that these expenses are likely to have been over-forecasted. Instead he points to his evidence that legal expenses may have been over-forecasted to hint that O&M costs are as well. Raising the possibility that O&M costs may be over-forecast because some other cost may have been forecast too high is not sufficient evidence to justify an adjustment to the O&M costs. Again, the incentives for management to be lax are a justifiable concern, but a concern is not evidence justifying an adjustment.[19]

Finally, Mr. Higgins suggests that he is amenable to reducing his adjustment if the Company were to provide stand alone forecasts for each of the items forecasted using the Global Insights indices. The implication is that Mr. Higgins believes, *á priori*, that stand alone forecasts are worth the time and effort because they are necessarily more accurate for these items than the Global Insights factors. Unexplored by Mr. Higgins is the possibility that individual forecasts would only convey a certain aura of precision that, given the inevitable forecast error, is unjustified. As indicated above, the roughly 2 percent annual growth rate applied by the Company to these items appears to be within a reasonable range to the Division, consequently, without further evidence, the Division believes an adjustment is not warranted.

IV. CONCLUSIONS AND RECOMMENDATIONS

[19] Some evidence in the Company's favor are my analyses over the past few years in the cost of capital phases of recent rate cases that show that operating results of PacifiCorp consistently compares favorably with other utilities that I have selected as proxy companies. For example see the Operating Income as a Percent of Revenue columns on DPU Exhibit 1.16 included with my direct cost of capital testimony in this docket.

Q. Are you arguing in support of the specific escalation adjustment made by the Company to these O&M costs?

A. No. While the Division is not advocating an adjustment to this escalation, I am not endorsing and adopting it either. The purpose of my testimony is to show that the complete elimination of an escalation in a forecast test year costs requires more data analysis and better foundation in theory than has been offered. On the other hand, it is reasonable to present evidence that the rates of increase should be different than that projected by the Company. However, the testimony of neither intervenor witness presents such evidence.

Q. What is your recommendation?

A. I recommend that the Commission give little or no consideration to the proposed escalation adjustments of either Mr. Higgins or Mr. Meyer.

Q. Does this conclude your testimony?

A. Yes.