BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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In the Matter of the Voluntary Request of	)	**Docket No. 14-035-147**
Rocky Mountain Power for Approval of	)	**DPU Exhibit 4.0 DIR**
Resource Decision and Request for	)	
Accounting Order	)	
	)	

REDACTED

DIRECT TESTIMONY

OF

ROBERT A. DAVIS

ON BEHALF OF THE

UTAH DIVISION OF PUBLIC UTILITIES

March 17, 2015

TABLE OF CONTENTS

Introduction

Q: Please state your name and occupation.

A: My name is Robert A. Davis. I am employed by the Division of Public Utilities (Division) of the Utah Department of Commerce as a Utility Analyst in the Energy Section.

Q: What is your business address?

A: My business address is 160 East 300 South, 4th Floor, Salt Lake City, Utah, 84114.

Q: On whose behalf are you testifying?

A: The Division.

Q: Do you have any exhibits that you are filing along with your testimony?

A: Yes I do. Exhibit DPU 4.1 is a confidential spreadsheet prepared by PacifiCorp, dba Rocky Mountain Power (Company) in response to the Division's data request DPU 1.1 on December 22, 2014.

Q: Please summarize your educational and professional experience.

A: I received a Master's in Business Administration with Master's Certificates in Finance and Economics from Westminster College in May of 2005. I am a Certified Valuation Analyst (CVA) by the National Association of Valuators and Analysts and an Accredited Senior Appraiser (ASA) by the American Society of Appraisers. In addition, I am a Certified General Appraiser in the State of Utah. I have been employed with the

Division since May of 2012 where I have worked on various telecommunications and energy related projects such as general rate cases, tariff adjustment requests, action requests from the Commission and other cases where auditing, financial and economic analysis is needed.

Prior to my present position, I was employed for seven years at the Utah State Tax Commission in the Centrally Assessed Property Tax Division-Utilities Section where I assessed telecommunication, energy and airline companies for property tax purposes.

Prior to working for the Property Tax Division, I was employed as an Electronic Engineering Technician at Fairchild Semiconductor for 22 years.

Q: Have you testified before the Commission on prior occasions?

A: Yes I have.

Purpose and Summary of Testimony

Q: What is the purpose of your testimony in this proceeding?

A: My testimony addresses two components of this proceeding. First, the Company's three Net Present Value (NPV) business plan scenarios: (1) keep the Deer Creek (Mine) open along with related Mine assets and continue to operate them until the Mine's estimated closure in 2019 ("Keep Case"); (2) close the Mine now and purchase coal on the open market ("Market Case"); or (3) close the Mine now, sell the mining assets and enter into a transaction with Bowie Resource Partners, LLC (Bowie) ("Transaction Case").

Second, I address the Company's subsidiary, Energy West Mining's (EW), withdrawal from the United Mine Workers of America (UMWA) multi-employer Pension Plan, which can only be accomplished by closing the Mine, thus eliminating the unionized employee expenses. Upon closure of the Mine and the elimination of unionized employee expenses, EW has three options: (1) EW can continue making annual payments until the last beneficiary drops off the plan, which will be determined at the time the Mine ceases operation; (2) EW can settle on a lump sum; or (3) EW can try to negotiate a lump sum payment based on the annual payments including the terminal value.

Background

Q: Will you provide a brief history of these two components for which you are testifying about in this proceeding?

A: Yes I will. The Company was prompted to begin investigating its options with the EW operated Mine located in Emery County, Utah as a result of several driving forces: the fact that the Mine is nearing depletion (estimated 2019), the resultant increasing costs associated with operating the Mine, and the forward risk associated with the UMWA pension liability.

The coal reserves and quality of coal from the Mine have been declining for the past few years, causing incremental cost increases from having to mix coal from other resources to meet the BTU and other quality demands [1] of the Huntington and Hunter power generating plants. To facilitate how to best proceed forward, the Company utilizes NPV scenario analysis to determine the best option with the lowest revenue requirement.

The other driving factor mentioned above is the UMWA Pension Plan liability risk going forward. As a participant of the multi-employer pension pool, EW is exposed to substantial risk from annual payment increases as other participants in the pool withdraw for whatever reason. Even if this were not the case, the required payment per hour worked used to fund the pension is scheduled to increase significantly going forward as shown in confidential Exhibit DPU 4.1. This increase will likely become troublesome from a cost/benefit perspective as the pension payments will exacerbate the costs of operating the Mine beginning in June of 2015 and escalating thereafter. EW currently pays approximately [redacted] per year. If the deal does not conclude prior to June 1, 2015, this annual payment will likely increase significantly.

Business Plan Scenarios

Q: Will you briefly explain the Division's interpretation of the three NPV scenario analysis as presented by Ms. Crane in her Direct Testimony and Exhibit RMP (CAC-7)?

A: Yes I will. As mentioned above, the Company analyzed three NPV scenarios: Keep

1 See the Direct Testimony of Cindy A. Crane at lines 456-491. Concerns with high ash and sulfur coal content, incremental cost increases associated with the long-wall operation, inventory issues relating to the high ash and sulfur coal content to name a few.

Case, Market Case and the Transaction Case. The results of each of these scenarios are compared to each other to arrive at the scenario that produces the lowest revenue requirement based on the assumptions [2] used for the analysis.

The three scenarios utilize the same assumptions throughout with the exception of the costs associated with each scenario noted in Ms. Crane's Exhibit RMP (CAC-7). In addition to those assumptions listed in Ms. Crane's exhibit, the rate for the NPV analysis, time horizons (2029, 2036 and 2042), tax rate and pension annuity payments are held constant for each scenario.

Q: Will you explain the Division's position, as far as reasonableness, of the scenario analysis presented by the Company?

A: Yes. It is the Division's understanding that the Company utilizes the costs associated with each scenario based on the Company's best known forecasts of what the conditions will be going forward. As in any analysis, the analysis here is only as good as the assumptions used. If any of these costs were to change going forward, the analysis would likely produce different results possibly leading to a different conclusion. Without a certain depth of auditing the forecasted costs used for the scenarios, the Division can only assume that they are accurate and reasonable. The Division is not aware of any sensitivity analysis that was performed to arrive at the forecasted numbers as a result of these uncertainties. This additional probability forecasting step in the

2 See Cindy A. Crane Exhibit RMP (CAC-7).

Company's analysis likely would have provided a more convincing outcome.

Scenario analysis can be accomplished using many different methods, from simple to complex. The two most common methods used are Discounted Cash Flow (DCF) and NPV as used by the Company for this proceeding. The difference between DCF and NPV analysis is that in NPV analysis, the discounted cash flow stream is netted against a current period number, usually negative, signifying a cash outlay. Usually, if the net number is positive, then the outcome is a desirable option. If the outcome is negative, then it is a less desirable option. Using this number to compare different scenarios leads to the scenario of choice. In this proceeding, the Company's analysis identifies from among the scenarios the one that produces the lowest revenue requirement.

The cash flow stream to be discounted can be in any number of formats. [3] The important principle is that the rate used to discount the cash flows over the time horizon matches the cash flow stream (i.e., an after tax rate is used with an after tax cash flow stream). There is normally a terminal value at the end of the time horizon used to emulate what the cash flow stream would be into perpetuity, which is discounted back to the current period. Each cash flow stream can occur at the beginning of the period, at the end of the period or as in most cases, mid-year. This has an impact

3 The most typical cash flow stream is the after tax cash flow to invested capital which is developed by starting with Net Income, adding Non-Cash Charges plus Interest (Net of Tax Benefit) plus Dividends less Capital Expenditure less the Working Capital to support growth.

on the outcome, as NPV and DCF are based on the time value of money.

The Company did not perform its NPV analysis in the manner described above. Instead, it performed a Present Value (PV) calculation using the Company's after-tax Weighted Average Cost of Capital (WACC) [4] for each pre-tax cost line item over the time horizons mentioned above. The Company used a half-year convention in its analysis by multiplying a factor [5] to the current PV of the cost stream over the time horizon. The PV was not netted against a current period number, technically, making it a DCF rather than a NPV. Additionally, other than the possible pension annuity, there are no other costs that run for indeterminate periods, negating the need for a terminal value. The results of each of these line item PV costs are summed for each scenario, which are then used to weigh the scenarios against one another. This is how the Company determines the optimal scenario. The 2042 time horizon is used in the final analysis.

The Division finds the method and outcome to be reasonable given the assumed correctness of the assumptions used in the modeling.

Q: Does the Division have issues with the method in which the Company performed its analysis even though it finds it reasonable?

A: Yes. There are enough uncertainties in the assumptions that some level of

4 The Company used a rate that was representative of all the states in which it operates as opposed to the most current General Rate Case here in Utah. The difference is not significant.
5 The factor is 1+(Discount Rate/2)

probability forecasting should have been used. Given more time, the Division would have liked to ascertain some level of certainty to the correctness of the numbers used in the analysis. The method of analysis is somewhat unorthodox but effective in determining an optimum scenario in this proceeding. For example, changing any of the assumptions that are shared by all the scenarios does not change the overall outcome. In another context, the Division may have rejected this method as being fundamentally flawed. However, all things considered as presented in this proceeding, the analysis leads to the Transaction Case as the lowest cost choice among the options evaluated. The numbers used in the NPV analysis are not believed to be used in the accounting treatment of the transaction.

UMWA Pension Withdrawal

Q: Will you briefly explain the Division's interpretation of the UMWA Pension Plan withdrawal?

A: Yes. EW contributes to the 1974 Pension Trust based on the terms of the National Collective Bargaining Agreement between the UMWA and Bituminous Coal Operators' Association (BCOA). The Division is unaware of how much, if any, EW can negotiate the price per hour worked in this agreement. In this multi-employer pension plan, assets are pooled such that contributions may be used to provide benefits to employees of other employers participating in the plan. The pension covers the retired workers, disabled workers and spouses of workers for the rest of their lives. If an employer withdraws from the plan for whatever reason, the employer would be obligated to pay a withdrawal liability based on the entire participant's unfunded vested benefits in the plan. The Division understands this to mean that as more and more participants withdraw from the fund, the obligation to keep the fund fully vested falls to those remaining in the plan. This could have exponentially increasing liability risk factors to the employer participants remaining in the pension plan.

The financial condition of the 1974 Pension Trust has deteriorated dramatically since the start of the 2007 National Bituminous Coal Workers Agreement (NBCWA). As of June 30, 2006, the market value of the assets was [redacted] and the present value of the vested benefits was [redacted] or a deficit of [redacted]. Mr. Schwartz, in his Exhibit RMP (SS-4), now shows that deficit to be [redacted] as of June 2013. [6]

The Division has no reason to believe this deficit to be overstated or understated. EW's obligation to continue paying into the plan under the "Keep Case" or what the Company's withdrawal obligation will be under the proposed "Transaction Case" or "Market Case", where the Mine will be closed, is of concern. My Confidential Exhibit DPU 4.1 shows the current rates per hour worked as [redacted] through June of 2016. This rate increases to [redacted] beginning June of 2017, to [redacted] in June of 2018 and to [redacted] in June of 2019 during the year the Mine is scheduled to close. [7] This is the amount added per hour to the employee's normal wage and other benefits per hour.

6 See the Direct Testimony of Seth Schwartz at lines 192-198.
7 See Exhibit DPU 4.1, "Company Confidential UWMA Withdrawal Liability.xlsx".

This fact alone, demonstrates the potential payroll liability to the Company and its ratepayers if the Mine were to be kept open. The annual payment at that time would be EW's obligation until the plan is exhausted of beneficiaries in the future.

Q: Please explain how the current annual pension annuity payment is derived.

A: The current annual annuity payment is based on two parts. The first part is a three-year "running average of hours worked" beginning in June of 2005 from the prior three years. The second portion is determining the highest hours worked within the previous ten-year look back of the three year running averages. The next period forecast of the ten-year look back is then multiplied by the current contribution rate per hour to determine the annual payment going forward. Currently this is [redacted] times [redacted] hours or [redacted]. [8]

Q: Please explain how the current annual payment translates into the potential withdrawal obligation.

A: The [redacted] annual payment can be determined on a "today" amount by simply dividing the amount by a discount rate, which is usually predetermined such as the 30 year Treasury rate. At the time of the Company's filing, EW had used a Treasury rate of 3.0848 percent. This equates to a PV of [redacted] or [redacted] rounded.

Worth noting is that a slight change in the rate, either up or down, will lead to a significant change in the outcome of this calculation. For example, if the rate was 2.8848

8 Id.

percent, the PV would be [redacted] million. If the rate was 3.2848 percent, the PV would be [redacted] million. As demonstrated, the PV is very sensitive to changes in the rate given the same annual payment.

EW has three options to withdraw from the Pension Plan upon closure of the Mine. The first option is to keep paying the annual payments, which would be set at the time the last union employee is no longer on the payroll. The second option is to pay a lump sum, which would be determined by the Pension Trust and is currently unknown until toward the end of 2015. EW estimates the lump sum to be approximately [redacted] if it would have withdrawn from the Plan between June 2013 and July of 2014. The Division's understanding is that even if EW chooses this option, the Trust could, within three years, demand more payment. The third option is a negotiation between EW and the Trust to set a lump sum based on the annual payments and terminal value. If EW is successful in negotiating this option, EW would be totally withdrawn from the Pension Plan. This amount would become a fixed amount and could be amortized over a determined time horizon.

Q: Does the Division believe EW is proceeding in this component of this proceeding in a manner that is in the public best interest?

A: Yes. However, given the uncertainty of how the pension withdrawal payment amount will be determined, the Division cannot speculate what that number might be today. Therefore, the Division recommends that the Pension Plan withdrawal liability be addressed in the next general rate case and adjusted at that time, if it is known at that point. Currently, the [redacted] is already in rates as part of fuel expense. This expense should not be adjusted until the point in time where the actual liability is known.

The Division believes the Company is moving forward in the public interest given its assumptions of what the Pension Trust may determine EW's liability to be. Given the liability risk stated above, the Division does not believe that option two stated above, the [redacted] lump sum, is in the public interest and should be avoided. The Division believes the option to make a negotiated lump sum payment based on the annual payments would be optimal. In any event, the current [redacted] annual payment is known and in rates. Any changes in the annual payment up or down should be addressed in the next general rate case. [9]

Conclusions and Recommendations

Q: Please summarize the Division's recommendations.

A: The Division has concerns regarding the methods used in the construction of the NPV scenario analysis. However, by keeping shared assumptions between the scenarios constant, the results would generally point to the same conclusion as one based on the assumptions specific to each scenario. The Division believes, based on this component of the proceeding that the "Transaction Case" is the best choice. [10]

The uncertainties surrounding the withdrawal liability of the 1974 Pension Plan

9 See Utah Code Ann. § 54-17-402 (4) (b) and 54-17-403 (1) (b).
10 See Utah Code Ann. § 54-17-402 (3) (b) (i).

are too vague at this time. The only known amount is the current annual payment. Until the Trust determines EW's withdrawal liability toward the end of 2015, too much uncertainty surrounding the amount exists to recommend a pre-approval. Rather, the Division recommends that the Pension withdrawal liability be addressed in the next general rate case when the actual number is known.

Q: Does this conclude your direct testimony?

A: Yes it does.