

Table of Contents

I. Introduction and Background 1

II. Executive Summary 4

III. Current Economy..... 5

IV. Credit Ratings 8

V. Assessment of PGE’s Credit Ratings 14

VI. Operation of PGE’s PCAM Should be Fairly Balanced 15

VII. Conclusion 24

List of Exhibits 26

I. Introduction and Background

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

2 A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My
3 business address is 1489 W. Warm Springs Rd., Suite 110, Henderson, Nevada
4 89014.

5 **Q. On whose behalf are you testifying?**

6 A. I am testifying on behalf of Portland General Electric Company (“PGE” or the
7 “Company”).

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

9 A. I am President of Regulation UnFettered, a utility advisory firm I started in April
10 2002. Prior to that, I was employed by Fitch, Inc. (“Fitch”), a credit rating agency
11 based in New York and London. Prior to that, I served as Chairman of the Michigan
12 Public Service Commission (“Michigan PSC”).

13 **Q. What is your educational background?**

14 A. I graduated with high honors from the University of Michigan with an A.B. in
15 Communications in 1974. I graduated from the University of Michigan Law School
16 with a J.D. in 1979.

17 **Q. Please briefly describe your role as president of Regulation Unfettered.**

18 A. I formed a utility advisory firm to use my financial, regulatory, legislative, and legal
19 expertise to aid the deliberations of regulators, legislative bodies, and the courts, and
20 to assist them in evaluating regulatory issues. My clients include investor-owned
21 and municipal electric, natural gas and water utilities, state public utility

1 commissions and consumer advocates, non-utility energy suppliers, international
2 financial services and consulting firms, and investors.

3 **Q. What was your role during your employment with Fitch?**

4 A. I was Group Head and Managing Director of the Global Power Group within Fitch.
5 In that role, I served as group manager of the combined 18-person New York and
6 Chicago utility team. I was originally hired to interpret the impact of regulatory and
7 legislative developments on utility credit ratings, a responsibility I continued to have
8 throughout my tenure at the rating agency. In April 2002, I left Fitch to start
9 Regulation UnFettered.

10 **Q. How long were you employed by Fitch?**

11 A. I was employed by Fitch from October 1993 until April 2002. In addition, Fitch
12 retained me as a consultant for a period of approximately six months shortly after I
13 resigned.

14 **Q. How does your experience relate to your testimony in this proceeding?**

15 A. My experience as a Commissioner on the Michigan PSC and my subsequent
16 professional experience analyzing the U.S. electric and natural gas sectors – in
17 jurisdictions involved in restructuring activity as well as those still following a
18 traditional regulated path – have given me solid insight into the importance of a
19 regulator’s role in setting rates and also in determining appropriate terms and
20 conditions of service for regulated utilities. These are among the factors that enter
21 into the process of utility credit analysis and formulation of individual company
22 credit ratings. It is undeniable that a utility’s credit ratings significantly affect the
23 ability of a utility to raise capital on a timely basis and upon reasonable terms.

24 **Q. Have you previously given testimony before regulatory and legislative bodies?**

1 A. Yes. Since 1990, I have testified on numerous occasions before the U.S. Senate, the
2 U.S. House of Representatives, the Federal Energy Regulatory Commission, and
3 various state legislative and regulatory bodies on the subjects of credit risk within the
4 utility sector, electric and natural gas utility restructuring, fuel and other energy cost
5 adjustment mechanisms, construction work in progress and other interim rate
6 recovery structures, utility securitization bonds, and nuclear energy. With regard to
7 fuel and purchased power cost recovery mechanisms (“PCAMs”), I have previously
8 testified on that issue on behalf of PSI Energy in Cause No. 42200 before the Indiana
9 Utility Regulatory Commission, Arizona Public Service Company in Docket Nos.
10 E-01345A-03-0437 and E-01345A-06-0009 before the Arizona Corporation
11 Commission, Entergy Arkansas, Inc. in Docket No. 05-116-U/06-055-U before the
12 Arkansas Public Service Commission, Aquila, Inc. in Case No. ER-2007-0004
13 before the Missouri Public Service Commission, and Public Service Company of
14 New Mexico in Case No. 07-00077-UT before the New Mexico Public Regulation
15 Commission. I also testified before the Indiana Legislature in 2007 on the general
16 subject of adjustment or tracking mechanisms, not only PCAMs but also trackers
17 targeting costs related to environmental compliance, new clean coal generation,
18 DSM & energy efficiency, and renewable energy.

19 My full educational and professional background is presented in PGE Exhibit
20 1301.

II. Executive Summary

1 **Q. What is the purpose of your direct testimony?**

2 A. I believe that reinstatement of a PCAM for PGE by the Oregon Public Utility
3 Commission (“OPUC” or “Commission”) in 2007 represented a positive policy step.
4 However, based upon my background as a state regulator and bond rater, I do not
5 believe that the current framework of that PCAM achieves what I believe should be
6 the goal of utility regulation: timely recovery of all costs prudently expended by a
7 regulated utility in order to provide reliable service to customers at a reasonable cost.
8 Accordingly, I will provide testimony here on why the current framework of PGE’s
9 PCAM differs from mainstream regulatory practice, and thus places the Company at
10 a competitive disadvantage in attracting capital in the current economic environment.
11 When utility investors choose to take their funds to jurisdictions that provide greater
12 certainty of timely recovery of prudent expenditures, the cost of capital for regulated
13 utilities in Oregon goes up.

14 In explaining why I believe that modification of PGE’s PCAM by the
15 Commission would be consistent with the public interest, I will address my positive
16 experiences working with PCAMs as a regulator in Michigan. I will also discuss the
17 acceptance that the concept of recovery of actual prudent fuel and power supply
18 costs has received in a large majority of states across the United States.

III. Current Economy

1 **Q. Would you provide your thoughts about the recent economic recession faced by**
2 **the U.S. utility industry?**

3 A. Yes. With the capital markets having experienced a worldwide financial crisis and
4 subsequent severe economic recession, I believe it is important for regulators to
5 factor into their decision-making the particular negative stresses that a regulated
6 utility with credit ratings in the 'BBB' category currently faces. The U.S. stock
7 market experienced its third-worst year in more than a century in 2008, with the S&P
8 500 and the Dow Jones Industrial Average down 38.5% and 33.8%, respectively. No
9 fewer than fifteen U.S. banks failed in 2008, including the well-publicized
10 bankruptcy of Lehman Brothers on September 15, 2008, the largest bankruptcy in
11 U.S. history. While the capital markets have stabilized to a degree during the past
12 twelve months, substantial concerns remain due to continuing high unemployment, a
13 rapidly growing federal deficit, and fear that the bursting housing bubble has not yet
14 reached full collapse, with commercial real estate seemingly at risk as weakness in
15 the U.S. economy continues during the next couple of years. This uncertainty means
16 that there likely will be less capital available for companies seeking debt and equity
17 financing – and, unlike the broader corporate industrial sector which can delay
18 capital investment in times of duress, electric utilities have an obligation to serve and
19 thus carry a public responsibility to expend capital when needed to ensure safe and
20 reliable service to customers. As Moody's reported in a January 16, 2009, report
21 entitled, "Near-term Bank Credit Facility Renewals To Be More Challenging For
22 U.S. Investor-Owned Electric and Gas Utilities":

1 “Dramatic changes in the financial markets during 2008 have materially
2 changed the banking environment for utilities going forward, which will
3 make upcoming credit facility renewals significantly more challenging.
4 Those banks that do remain will be constrained in both their ability and
5 inclination to provide traditional credit, especially at the relatively low
6 pricing levels and on the liberal terms and conditions that prevailed prior
7 to mid-2008.”

8 **Q. Have other industry leaders offered similar cautions?**

9 A. Yes. During the January 13, 2009, Federal Energy Regulatory Commission
10 (“FERC”) Technical Conference on Credit and Capital Issues Affecting the Electric
11 Power Industry, regulators, industry representatives, and banks all agreed that the
12 financial crisis is having a more dramatic impact on lower rated utilities. W. Paul
13 Bowers, the Executive Vice President and Chief Financial Officer of Southern
14 Company, noted that although the financial crisis has led to increases in debt and
15 equity risk premiums for all utilities, these increases have been more consistently
16 applied to utilities that do not hold high credit ratings, resulting in significantly
17 higher cost of debt capital for ‘BBB’ category utilities as compared to ‘A’ rated
18 utilities.¹ Mr. Bowers’s views were corroborated by Anthony Ianno, Managing
19 Director and Head of Energy and Utilities Global Risk Capital Markets at Morgan
20 Stanley, with data that showed that investment in ‘BBB’ rated utilities dropped
21 approximately 13% in the period after the Lehman Brothers bankruptcy, while
22 investment in ‘A’ rated utilities rose by the same margin.² Such data clearly shows
23 that, in the wake of the financial crisis, investor interest has been increasingly
24 directed toward less risky ‘A’ rated utilities. As Chairman Garry Brown of the New
25 York Public Service Commission (“NYPS”) noted at the FERC conference, “there

¹ Statement of W. Paul Bowers at Federal Energy Regulatory Commission Technical Conference on Credit and Capital Issues Affecting the Electric Power Industry, Docket No. AD09-2-000, January 13, 2009.

² Statement of Anthony Ianno at Federal Energy Regulatory Commission Technical Conference on Credit and Capital Issues Affecting the Electric Power Industry, Docket No. AD09-2-000, January 13, 2009.

1 is a clear relationship between a utility's bond rating and its ability to borrow at a
2 reasonable cost, particularly in times of economic distress as we are now facing."³

3 Given the Company's significant ongoing capital program and 'BBB' category
4 ratings status, sustained regulatory support is imperative for the Company to be able
5 to access adequate capital at reasonable costs for the ultimate benefit of its
6 customers. As I alluded to earlier, electric utilities do not possess the strategic option
7 of substantially cutting back their operations during difficult economic times.
8 Utilities must provide safe, efficient, and reliable service to their customers,
9 notwithstanding dysfunction within the financial markets. The electric utility sector
10 is one of the most capital-intensive sectors in the country, and utilities must continue
11 to make significant capital expenditures to maintain reliability, replace aging
12 infrastructure, and meet longer-term load growth requirements. As NYPS
13 Chairman Brown further noted at the FERC Conference, "Large capital programs
14 make it very important that electric utilities continue to have access to the financial
15 markets, and regulatory policies should support utilities' ability to raise capital."

³ Statement of Garry Brown at Federal Energy Regulatory Commission Technical Conference on Credit and Capital Issues Affecting the Electric Power Industry, Docket No. AD09-2-000, January 13, 2009.

IV. Credit Ratings

1 **Q. To place PGE’s current ratings status into perspective, could you provide a**
2 **brief overview of the credit rating process?**

3 A. Yes. Credit ratings reflect a credit rating agency’s independent judgment of the
4 general creditworthiness of an obligor or the creditworthiness of a specific debt
5 instrument. While credit ratings are important to both debt and equity investors for a
6 variety of reasons, their most important purpose is to communicate to investors the
7 financial strength of a company or the underlying credit quality of a particular debt
8 security issued by that company. Credit rating determinations are made through a
9 committee process involving individuals with knowledge of a company, its industry,
10 and its regulatory environment. Corporate rating designations of S&P and Fitch
11 basically have “AA”, “A” and “BBB” category ratings within the investment-grade
12 ratings sphere, with “BBB-” as the lowest investment-grade rating and “BB+” as the
13 highest non-investment-grade rating. Comparable rating designations of Moody’s at
14 the investment-grade dividing line are “Baa3” and “Ba1”, respectively.

15 Corporate credit ratings analysis considers both qualitative and quantitative
16 factors to assess the financial and business risks of fixed-income issuers. A credit
17 rating is an indication of an issuer’s ability to service its debt, both principal and
18 interest, on a timely basis. It also at times incorporates some consideration of
19 ultimate recovery of investment in case of default or insolvency. Ratings can also be
20 used by contractual counterparties to gauge both the short-term and longer-term
21 health and viability of a company.

1 **Q. Can you provide a brief discussion on why credit ratings are important for**
2 **regulated utilities and their customers?**

3 A. Yes. It is a well-established fact that a utility's credit ratings have a significant
4 impact as to whether that utility will be able to raise capital on a timely basis and
5 upon reasonable terms. As respected economist Charles F. Phillips stated in his
6 treatise on utility regulation:

7 Bond ratings are important for at least four reasons: (1) they are used by
8 investors in determining the quality of debt investment; (2) they are used
9 in determining the breadth of the market, since some large institutional
10 investors are prohibited from investing in the lower grades; (3) **they**
11 **determine, in part, the cost of new debt, since both the interest**
12 **charges on new debt and the degree of difficulty in marketing new**
13 **issues tend to rise as the rating decreases;** and (4) they have an
14 indirect bearing on the status of a utility's stock and on its acceptance in
15 the market.⁴ [Emphasis supplied.]

16 Thus, the lower a regulated utility's credit rating, the more the utility will have
17 to pay to raise funds from debt and equity investors to carry out its capital-intensive
18 operations. In turn, the ratemaking process factors the cost of capital for both debt
19 and equity into the rates that consumers are required to pay. Therefore, a utility with
20 strong credit ratings is not only able to access the capital markets on a timely basis at
21 reasonable rates, it also is able to share the benefit from those attractive interest rate
22 levels with customers through the rate-setting process. Access to the capital markets
23 is especially important for a company like PGE, which is planning to expend
24 significant levels of capital in order to take steps to ensure continuing reliability of
25 service to customers.

26 **Q. Please describe the qualitative factors used by the rating agencies.**

⁴ Phillips, Charles F., Jr., The Regulation of Public Utilities, Arlington, Virginia: Public Utilities Reports, Inc., 1993, at p. 250. See also Public Utilities Reports Guide: "Finance," Public Utilities Reports, Inc., 2004 at pp. 6-7 ("Generally, the higher the rating of the bond, the better the access to capital markets and the lower the interest to be paid.").

1 A. The most important qualitative factors include regulation, management and business
2 strategy, and access to energy, gas and fuel supply with recovery of associated
3 costs.⁵

4 **Q. Please explain your thoughts on the importance of regulation within the credit**
5 **ratings process.**

6 A. Regulation is a key factor in assessing the credit profile of a utility because a state
7 public utility commission determines rate levels (recoverable expenses including
8 depreciation and operations and maintenance, fuel cost recovery, and return on
9 investment) and the terms and conditions of service.

10 Since the announcement of California's restructuring plan in 1994, regulation
11 has become an even more important factor as the nature of a utility's responsibilities
12 in providing energy services to customers has undergone dramatic change. In some
13 states, industry restructuring was the result of plans formulated by the state
14 legislature. In other states, the regulators, rather than the legislators, have
15 determined the nature and pace of restructuring, or whether it would occur at all.

16 This situation thus affects utility investors' decisions because, before major
17 investors will be willing to put forward substantial sums of money, they will want to
18 gain comfort that regulators understand the economic requirements and the financial
19 and operational risks of a rapidly changing industry and will make fair decisions that
20 are significantly predictable.

⁵ In their analysis, the rating agencies use quantitative factors hand-in-hand with the qualitative factors noted above. S&P has highlighted the three key ratios it most relies upon in its utility ratings assessments: Funds from Operations Interest Coverage; Funds from Operations / Total Debt; and Total Debt / Total Capital. (See S&P Research: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007.) Moody's tracks use of these measures and adds "Cash from Operations minus dividends / Debt" as a fourth key measure. (See Moody's Research: "Rating Methodology: Regulated Electric and Gas Utilities," August 2009.) With the subject of my testimony being PCAMs, I focus the bulk of my discussion on the qualitative factors of regulation and recovery of fuel and power supply costs.

1 For these reasons, rating agencies look for the consistent application of sound
2 economic regulatory principles by the commissions. If a regulatory body were to
3 encourage a company to make investments based upon an expectation of the
4 opportunity to earn a reasonable return – or, as discussed here, to receive full
5 recovery for prudently incurred expenditures – and then did not apply regulatory
6 principles in a manner consistent with such expectations, investor interest in
7 providing funds to such utility would decline, debt ratings would likely suffer, and
8 the utility’s cost of capital would increase.

9 **Q. Have the recent financial and operational challenges facing all utility**
10 **managements increased the focus on the actions of utility regulators by the**
11 **financial community?**

12 A. Yes, without a doubt. Events like the California restructuring debacle and Hurricanes
13 Katrina and Rita have tested the financial standing of the utility sector like never
14 before. With the extreme turmoil in the financial markets during the past year, we
15 appear to have come to another “never before” moment. Liquidity, or access to cash
16 when needed, has always been a major issue for regulated utilities, but it has leaped
17 to the forefront of utility financial and operational concerns and has driven structural
18 decisions on the part of utility executives.⁶

19 Thus, while “Regulation” has always garnered the attention of Wall Street, years
20 ago it seemed to be a focus only during the days leading up to a commission’s rate
21 case decision. This began to change around the time that Fitch hired me in 1993 to
22 serve in the role of regulatory analyst and to assess regulatory, legislative and

⁶ See, for example, “Utilities’ Plans Hit by Credit Markets,” Wall Street Journal, October 1, 2008 (“Disruptions in credit markets are jolting the capital-hungry utility sector, forcing companies to delay new borrowing or to come up with different – and often more costly – ways of raising cash.”).

1 political factors that could affect a utility's financial strength. When California
2 announced its ill-fated restructuring plan in 1994, the entire financial community
3 took much greater notice of regulators and how they carried out their responsibilities,
4 not only with regard to rate-setting, but even more importantly the manner in which
5 they undertook to change the way the entire utility industry had operated for over
6 100 years. And of course the recent stresses within the credit markets with their
7 huge financial repercussions have made regulatory decision-making and policies
8 even more important.

9 **Q. Do the rating agencies agree that utility regulators and their decision-making**
10 **have increased in importance?**

11 A. Yes. S&P highlighted the increasing importance of regulation to the financial
12 community in a November 26, 2008 report entitled "Key Credit Factors: Business
13 and Financial Risks in the Investor-Owned Utilities Industry":

14 Regulation is the most critical aspect that underlies regulated integrated
15 utilities' creditworthiness. Regulatory decisions can profoundly affect
16 financial performance. Our assessment of the regulatory environments
17 in which a utility operates is guided by certain principles, most
18 prominently consistency and predictability, as well as efficiency and
19 timeliness. For a regulatory process to be considered supportive of
20 credit quality, it must limit uncertainty in the recovery of a utility's
21 investment. They must also eliminate, or at least greatly reduce, the
22 issue of rate-case lag, especially when a utility engages in a sizable
23 capital expenditure program.

24 Consistent with these views, S&P recently explained how recovery mechanisms, like
25 PGE's PCAM, can play a key role in providing a regulated utility with timely
26 recovery of prudent expenditures, thereby helping to mitigate the negative effects
27 from regulatory lag:

28 ...there are ratemaking alternatives that can eliminate, or at least
29 greatly reduce, the issue of rate-case lag, especially when a utility
30 engages in an onerous construction program. Instead of significantly

1 large rate base increases or lengthy rate moderation or phase-in plans,
2 separate tariff provisions that allow for timely rate recognition during
3 construction, without requiring a utility to file a formal rate case
4 application, can gradually ease higher costs into rates, limiting the
5 accumulation of financing costs. ... the greater the percentage of a
6 utility's rates that it recovers through fixed charges rather than volume-
7 based charges, the greater the support for credit quality.⁷

8 Moody's agrees on the importance of regulation – and recovery of prudent
9 expenditures – in the determining of credit ratings:

10 For a regulated utility, the predictability and supportiveness of
11 the regulatory framework in which it operates is a key credit
12 consideration and the one that differentiates the industry from most
13 other corporate sectors. The most direct and obvious way that
14 regulation affects utility credit quality is through the establishment of
15 prices or rates for the electricity, gas and related services provided
16 (revenue requirements) and by determining a return on a utility's
17 investment, or shareholder return. ... However, in addition to rate
18 setting, there are numerous other less visible or more subtle ways that
19 regulatory decisions can affect a utility's business position. These can
20 include the regulators' ability to pre-approve recovery of investments
21 for new generation, transmission or distribution; to allow the inclusion
22 of generation asset purchases in utility rate bases; to oversee and
23 ultimately approve utility mergers and acquisitions; to approve fuel and
24 purchased power recovery; and to institute or increase ring-fencing
25 provisions. ...

26 The ability to recover prudently incurred costs in a timely
27 manner is perhaps the single most important credit consideration for
28 regulated utilities as the lack of timely recovery of such costs has caused
29 financial stress for utilities on several occasions. For example, in four of
30 the six major investor-owned utility bankruptcies in the United States
31 over the last 50 years, regulatory disputes culminated in insufficient or
32 delayed rate relief for the recovery of costs and/or capital investment in
33 utility plant.⁸

⁷ S&P Research: "Recovery Mechanisms Help Smooth Electric Utility Cash Flow and Support Ratings," March 9, 2009.

⁸ Moody's Research: "Rating Methodology: Regulated Electric and Gas Utilities," August 2009.

V. Assessment of PGE's Credit Ratings

1 **Q. What credit ratings does PGE currently hold?**

2 A. On January 29, 2010, S&P downgraded PGE's corporate credit rating to 'BBB' and
3 assigned a Stable Outlook. Moody's has maintained an equivalent 'Baa2' issuer
4 rating on PGE, assigning a Positive Outlook on that rating on November 21, 2008.

5 In downgrading PGE's rating, S&P highlighted the recessionary economic
6 environment in Oregon, and noted "a weak power cost mechanism and chronic
7 under-earning of authorized returns," a situation that is problematic for a utility that
8 relies "on power purchases for a significant portion of load [with] vulnerability to
9 hydro variability, which necessitates careful management of power requirements."⁹

10 In view of the difficulties that 'BBB'-rated companies faced during the recent
11 financial crisis, I believe it is even more important for the Commission to modify
12 PGE's PCAM to provide for timely recovery of actual fuel and purchased power
13 costs on a timely basis. My recommendation to both the Company and its regulators
14 is to target a return to the 'BBB+' rating level, with a longer term goal of achieving
15 an 'A' category rating, which should alleviate both access and cost pressures related
16 to ongoing financing needs. A key component of the agencies' analysis of the
17 decision in this case will be the manner in which the Commission sets the framework
18 for PGE's PCAM going forward.

⁹ S&P Research: "Portland General Electric Co. Corporate Credit Rating Lowered to 'BBB' on Weak Economy; Outlook Revised to Stable," January 29, 2010.

VI. Operation of PGE's PCAM Should be Fairly Balanced

1 **Q. You mentioned that you had experience with PCAMs during the time that you**
2 **served as chairman of the Michigan PSC. Can you explain how you viewed that**
3 **PCAMs should operate during that time?**

4 A. Yes. I served as chairman of a commission that utilized a form of PCAM – and, I
5 am glad to be able to say that while after-the-fact disallowances of fuel and power
6 supply costs were rare, they did serve to motivate appropriate behavior on the part of
7 utility managers.

8 Since the goal of the mechanism in Michigan was to only reimburse utilities for
9 their prudent expenditures, utilities communicated with commission staff to ensure
10 they were proceeding down the proper path. There was no need for forecasted levels
11 to be locked into base rates as the sole means of cost recovery, because under the
12 Michigan PCAM the companies knew they had an obligation to carry out their fuel
13 procurement and purchased power activities prudently – and when they didn't, they
14 knew they would be subject to a financial disallowance.

15 Based upon my time on the Michigan PSC, I view a key tenet of good regulation
16 to be that a utility's prudent expenses made in order to provide an appropriate level
17 of customer service and reliability are entitled to be fully and fairly recovered on a
18 timely basis – and customers should not be required to pay an amount greater than
19 those expenses. Price variations related to fuel and purchased power, as well as
20 amounts utilized by the utility, can vary greatly from year-to-year. Notwithstanding
21 the Annual Update Tariff that the Commission utilizes for PGE, it is very difficult to
22 accurately forecast variations in hydro and wind based power supply based upon

1 “normal” climatic factors. In the absence of a PCAM structured as I suggest, at any
2 particular moment in time, based upon then-existing circumstances, rates might be
3 set too low to allow the utility to recover all of its prudent expenditures or,
4 alternatively, rates might be too high to accurately pass through costs to customers.
5 The best way to avoid such a result is through use of a PCAM that affirmatively
6 seeks to tie timely expense recovery to the actual costs prudently expended. I do not
7 believe that PGE’s current PCAM can achieve that aim.

8 **Q. What problems do you see with PGE’s current PCAM?**

9 A. Before discussing the problems I see, I would be remiss if I did not note the positive
10 nature of the step the OPUC took in 2007 to reinstate a PCAM for PGE. That action
11 placed the OPUC among the large majority of state utility commissions that utilize
12 some form of PCAM, and was very important for a utility that is facing substantial
13 capital needs over the next several years.¹⁰ Nonetheless, based upon my past
14 regulatory and credit rating experience, I see problems with the framework that the
15 Commission structured at that time. I firmly believe that the goal of a PCAM should
16 be the timely recovery of all prudent costs expended by a utility for fuel and power
17 supply in furtherance of providing reliable service to its customers. I do not believe
18 that PGE’s PCAM meets that standard.

19 **Q. Why is that?**

20 A. My difficulties with PGE’s current PCAM fall into two areas, both of which cut
21 against the goal of achieving utility recovery of actual prudent costs on a timely
22 basis, while only charging customers for actual prudent costs:

¹⁰ For a discussion of PGE’s significant capital investment needs within the current challenging economic climate in Oregon, *See* the Company’s Integrated Resource Plan Executive Summary.

- 1 1. the earnings test that the Commission has imposed; and
- 2 2. the asymmetric earnings deadband.

3 **Q. Please explain the problem with the earnings test.**

4 A. I view the earnings test, as structured, as an imperfect attempt to compel appropriate
5 utility behavior, at the expense of sacrificing the goal of recovery of actual prudent
6 costs with customers paying no more, no less. Such a framework ignores the
7 greatest hammer that a utility regulator holds – the authority to review the prudence
8 of a company’s resource procurement activities with the ability to disallow
9 imprudent expenditures. While that regulatory exercise may not pinpoint precisely
10 actual costs going into rates, from my experience, it comes pretty close.

11 The same cannot be said for a PCAM mechanism where PGE could be
12 underearning its authorized return on equity (“ROE”) by 100 basis points, and not be
13 reimbursed for actual prudent fuel expenses, notwithstanding the fact that the
14 Company does not receive any return or benefit for the funds it lays out or the risk it
15 is undertaking. The same situation holds on the customer side: PGE could be
16 overearning by 100 basis points, which positive result might partially be driven by
17 lower fuel costs, and the customer would still be paying more than the actual prudent
18 fuel costs of the Company.¹¹ Even the one state in which I have worked that
19 maintains an earnings test for PCAM recovery, Indiana, limits full recovery of fuel
20 and purchased energy costs only *if* the regulated utility is earning above its net
21 operating income authorized in the most recent rate case, and even then *only if* the

¹¹ Interestingly, under Senate Bill 408’s income tax reconciliation, the imprecision embodied within each of those unbalanced scenarios was multiplied further by the Oregon Legislature – a fact acknowledged by this Commission in Order No. 07-015.

1 "overearnings" are greater than any "underearnings" the utility has incurred over the
2 longer of the past five years or since the last rate case order.

3 **Q. How do you view the asymmetric deadbands?**

4 A. I believe the asymmetric deadbands exacerbate the problem. I have difficulty
5 understanding why PGE, or any regulated utility, should absorb some portion of
6 power costs, prudently incurred for the purpose of providing reliable customer
7 service, and upon which the Company receives no return, just reimbursement. To
8 make matters worse, that deadband is then skewed against the interest of the
9 Company and its investors. For example, PGE estimates that its actual fuel and
10 purchased power costs exceeded recovery by \$22 million in 2009, but because that
11 amount was within the asymmetric deadband, no additional recovery under the
12 PCAM occurs.

13 Not surprisingly, the financial community has expressed concerns over this
14 arrangement. In a report published on December 16, 2009, Bank of America Merrill
15 Lynch stated:

16 Unfortunatly, [the PCAM] has a wide deadband (\$45 million in 2009
17 or \$0.43 per share) in which [PGE] absorbs 100% of the costs/benefits.
18 Moreover, the deadband is weighted more heavily toward [PGE]
19 absorbing more costs than retaining benefits. Due to the company's
20 lack of control over hydro production and wind production, [PGE] has
21 historically had meaningful earnings swings due to the PCAM.

22 That said, Bank of America Merrill Lynch is hopeful, concluding that while the:

23 regulatory environment in Oregon historically has been challenging for
24 utilities, which is understandable given the previous parent company
25 [Enron,] ...recent developments in Oregon regulation have been
26 constructive. ...We would be much more constructive if the
27 Commission fixed the PCAM.¹²

¹² Bank of America Merrill Lynch Research: "Portland General Electric Company: Going Sideways – Initiate with Underperform," December 16, 2009.

1 In December 2009, Wells Fargo Securities voiced similar concerns about PGE's
2 PCAM. While downgrading its expectations for the Company's future financial
3 performance, it did note that they "would view any improvement to the PCAM
4 deadbands ... and/or SB 408 positively."¹³

5 **Q. Do the views of the financial community surprise you?**

6 A. No. The inconsistencies within PGE's PCAM are of substantial concern to
7 investors, since the Company can do little to avoid either negative or positive
8 impacts. I strongly recommend modifying the PCAM so that it is fair to the
9 Company, its investors, and its customers: aligning actual prudent costs with what
10 customers have to pay.

11 **Q. The PCAM also includes a 90-10 sharing mechanism once the deadband is**
12 **passed, either up or down. Does that aspect trouble you as well?**

13 A. I am not sure the Company would agree with me, but while I would not add that
14 sharing aspect if I were regulating PGE, I can understand why this Commission
15 might. While the Michigan PSC did not inject such 90-10 sharing into the fuel
16 recovery equation, some states have added that policy in as an added motivation
17 toward proper utility attention to detail -- so I can accept that it might serve a
18 regulatory purpose and the OPUC might choose to use it.

19 **Q. Do you believe that, if the OPUC were to modify PGE's PCAM to reduce the**
20 **deadbands and eliminate the ROE asymmetry, such change should be reflected**
21 **in a authorized ROE?**

¹³ Wells Fargo Securities Research: "Regulated Electric Utilities – Downgrading POR," December 14, 2009.

1 A. No. I do not believe that providing actual prudent cost recovery on a timely basis
2 represents a reduction in risk that should be reflected in a lower authorized ROE. As
3 I allude to above, consideration of fuel costs in a manner that lowers uncertainty and
4 risk represents the mainstream position on this issue across the United States. Thus,
5 the financial community takes the presence of an effective PCAM as virtually a
6 given when comparing utilities across jurisdictions for possible investment.
7 Investors rely on the presence of such adjustment mechanisms to protect themselves
8 from the variability of fuel and purchased power costs that are substantially outside
9 the control of the affected utility, but which can have a substantial impact on the
10 financial profile of that utility, even when prudently managed. Of course, fuel and
11 power procurement is just one of a multitude of risks that a regulated electric
12 utilities' faces in its day-to-day operations. Thus, even with these mechanisms
13 mitigating a portion of the risk and uncertainty related to regulated utility's
14 operations (and I note PCAMs relate to activities upon which most utilities do not
15 receive a return), investors will still consider the business risks that remain and
16 compare them to utilities in other jurisdictions. Those utilities ordinarily operate
17 under recovery mechanisms more closely aligned with the modified PCAM I have
18 proposed for PGE. I have long argued that regulatory lag is not a burden that
19 regulated utilities should inherently be forced to bear.

20 **Q. Do the rating agencies concur with your opinion?**

21 A. I believe they do. S&P stated in November 2002 its opinion concerning the
22 importance of electric utilities having the opportunity to recover fuel and purchased
23 power expenses:

1 When assessing the importance of productive regulation to the credit
2 strength of an electric utility, something to consider is the means by
3 which the utility can expect to recover variable expenses, particularly
4 fuel and purchased-power expenses, which have highly erratic unit
5 costs. Recent, and in some cases, extreme volatility in the U.S.
6 wholesale electricity markets, as well as in the natural gas markets,
7 underscores this importance. It is no coincidence that utilities with
8 stronger fuel and power cost recovery mechanisms typically enjoy
9 loftier credit ratings.

10 S&P went on to comment upon the negative aspects of the absence of a PCAM:

11 In jurisdictions where [PCAMs] have been prohibited, electric utilities
12 have always been subject to the uncertainties surrounding the recovery
13 of incurred fuel and purchased-power expenses. With few exceptions,
14 companies operating exclusively in these jurisdictions have always had
15 ratings below the industry average.¹⁴

16 **Q. Do the other rating agencies share S&P's positive views with regard PCAMs?**

17 A. Yes they do. Moody's has commented upon the importance of PCAMs in mitigating
18 operating risk:

19 Cost Recovery Provisions: States have various policies with respect to
20 fuel and wholesale power cost recovery, and the recent volatility in
21 commodity prices have made these provisions important elements of a
22 utility's cost management capability. Such provisions make it possible
23 for utilities to quickly adjust rates in the event of an unexpected hike in
24 fuel costs. Although the number of states permitting such recovery has
25 declined, particularly in those that have transitioned to a competitive
26 market, they remain critical risk mitigants to those utilities still operating
27 in regulated environments.¹⁵

28 Fitch has discussed the credit implications of the presence of PCAMs:

29 Fitch factors risks related to commodity price volatility into stress cases
30 related to each company's individual circumstances and asset
31 portfolios.... Potential risks for regulated distribution and integrated
32 utilities: ... Utilities with frozen tariffs or those without the means to
33 recover their higher fuel expense are most at risk.¹⁶

¹⁴ S&P Research: "Constructive Regulation For U.S. Utilities Is More Important Than Ever," November 14, 2002.

¹⁵ Moody's Global Credit Research: "Rating Methodology: Global Regulated Electric Utilities," March 2005.

¹⁶ Fitch Special Report: "Electric Fuels Outlook: The Fuels Dilemma," November 11, 2004.

1 In February 2006, Fitch added these thoughts in a report discussing credit
2 implications of commodity cost recovery:

3 A utility's ability to weather a period of high and rising commodity
4 costs is influenced by many related factors, including the state's market
5 structure, rules regarding power procurement and the utility's obligation
6 to serve customers' energy needs, the utility's resource mix relative to
7 its load requirement, access to adequate liquidity and the state's
8 regulatory/political environment. Within this context, **effective and**
9 **timely commodity cost-adjustment mechanisms provide utilities**
10 **with greater assurance of ultimate recovery in a rising energy price**
11 **environment.** [Emphasis supplied.]¹⁷

12 Then in June 2006, Fitch re-emphasized the impact that timely recovery of fuel and
13 purchased energy expenses has on electric utility credit ratings:

14 Volatile and higher energy and fuel commodity prices represent a
15 challenge to electric utilities.... Given [the current] environment, Fitch
16 believes timely recovery of fuel costs is essential to an electric utility's
17 creditworthiness and that its response to high and volatile cost pressures
18 will be a key determinant to a utility's credit quality and rating in 2006
19 and beyond.¹⁸

20 **Q. With the U.S. utility sector experiencing significant volatility in fuel and**
21 **purchased power costs during the past few years, what are the implications for**
22 **PGE if the Commission were to leave the PCAM as is?**

23 A. The past decade is replete with examples of regulators attempting to artificially hold
24 the line on seemingly prudently incurred fuel and purchased power cost recovery
25 solely because those costs were growing at a rapid rate. Such flawed decision-
26 making can have very dire consequences for both utilities and their customers, as we
27 have seen in California, Nevada, Arizona, Illinois, and now potentially in Florida.
28 Properly structured PCAMs, with appropriate monitoring and decision-making tied

¹⁷ Fitch Special Report: "U.S. Electric Utilities: Credit Implications of Commodity Cost Recovery," February 13, 2006.

¹⁸ Fitch Special Report: "Cost Recovery and Public Power: Who Is at Risk?," June 1, 2006.

1 to prudence, are the best means to avoid negative financial consequences for
2 regulated utilities.

3 Uncertainty with regard to fuel cost volatility is the very reason that a majority
4 of states utilize a properly structured PCAM in the first place – so that a utility can
5 carry out its responsibilities to provide reliable service to customers at the best cost
6 available under then-existing circumstances, without having to be concerned that its
7 prudent expenditures in this regard might be found to be unrecoverable at a later
8 time. Because regulated utilities in most cases do not earn any profit or return on
9 their fuel and purchased power expenditures, barring unusual behavior on the part of
10 the utility, such expenses are presumed to be prudent, and rating agencies and
11 investors expect that utilities will recover them without undue delay.

VII. Conclusion

1 **Q. Do you have concluding thoughts?**

2 A. Yes. The concept of utility regulation is to provide a surrogate for the competitive
3 market that is not present when a company possesses monopoly or near-monopoly
4 status with regard to an essential good, such as utility service. PCAMs attempt to
5 align the costs that a utility expends for fuel and purchased power with its recovery
6 of those costs on a timely basis. Such costs 1) can vary widely from year-to-year; 2)
7 are substantially outside the control of the utility; and 3) represent a considerable
8 financial outlay by a utility, with no ability to receive a return on those expended
9 funds. By being able to recover prudently incurred costs expeditiously, a utility
10 lowers the risk of its operations and achieves consistency with the level of risk faced
11 by a wide majority of other utilities within the United States, all of which are chasing
12 the same investor funds. It is wholly consistent with rational utility economics for
13 customers to pay the actual costs of fuel and purchased power that are procured for
14 customers' benefit, whether those costs are in an escalating mode or actually going
15 down.

16 Finally, my advice to utility companies, investors and regulators alike is that
17 nothing should be taken for granted in the current investing environment. Investors
18 have choices, and a decision to take funds elsewhere leads to a higher cost of capital
19 for Oregon's regulated utilities including PGE. I believe both the Company and the
20 Commission should each undertake actions over which they have control so as to
21 create an environment which will encourage the ratings agencies to improve their
22 view of PGE so that the Company's ratings can return to the 'BBB+' level after

1 conclusion of this rate case. A constructive Commission decision that provides a
2 well-conceived modification to PGE's existing PCAM, so as to redirect the
3 mechanism to provide full recovery of all prudent fuel and power supply costs on a
4 timely basis, would represent an important step toward PGE stabilizing its financial
5 standing vis-à-vis the capital markets.

6 **Q. Does this conclude your testimony?**

7 A. Yes it does.

List of Exhibits

<u>PGE Exhibit</u>	<u>Description</u>
1301	Educational and Professional Background