STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners: Robert M. Pickett, Chairman
Kate Giard
Paul F. Lisankie
T.W. Patch
Janis W. Wilson

In the Matter of the Revenue Requirement and Tariff Filings Designated as TA793-2, TA803-2, and TA804-2 Filed by ALASKA POWER COMPANY and Tariff Filing Designated as TA805-2	U-09-90 ORDER NO. 8

ORDER DETERMINING COST OF CAPITAL ISSUES, ESTABLISHING JUST AND REASONABLE RATES, AND REQUIRING FILINGS

BY THE COMMISSION:

Summary

We determine the capital structure and return on equity (ROE) to be used in determining the revenue requirement for Alaska Power Company (APC). We establish just and reasonable rates. We require filings.

Background

APC filed TA793-2[1] requesting across-the-board rate increases and review of its revenue requirement filing. We suspended TA793-2, granted interim and refundable rates, and invited participation by the Attorney General (AG).[2] We

[1]TA793-2, filed July 6, 2009.

[2]Order U-09-90(1), *Order Suspending Tariff Filing TA793-2, Granting Request for Interim and Refundable Rates, Approving Tariff Sheets, Establishing Interest Rate on Refunds, Requiring Filing, Inviting Participation by the Attorney General and Intervention, Scheduling Prehearing Conference, Addressing Timeline for Decision, Designating Commission Panel, and Appointing Administrative Law Judge*, dated August 20, 2009 (Order U-09-90(1)).

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established that an interest rate of 10.5 percent per annum will be payable on any amounts which are ultimately refunded, but allowed APC the option of placing the additional revenue received as a result of the interim rates into an escrow account and credit interest on the account to its customers.[3] APC opted to pay interest at 10.5 percent.[4]

The AG filed a notice of election to participate.[5] The Parties filed a Stipulation resolving all issues except for capital structure and ROE.[6] We held a hearing on capital structure and ROE issues on May 4, 2010.[7] We accepted the stipulation with modifications agreed to by the parties.[8]

We issued Order U-10-30(2)[9] establishing a new base amount for Power Cost Equalization (PCE) calculations, effective for bills rendered on or after July 1, 2010. TA805-2[10] was filed on behalf of APC by Commission Staff in order to make the proper base rate adjustment to the utility's PCE rate calculation. We suspended the permanent operation of TA805-2 into this docket.[11]

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[3]Order U-09-90(1) at 3-4.

[4]*Compliance Filing – Choice of Refund Options*, filed September 2, 2009, at 2.

[5]*Notice of Election to Participate*, filed September 2, 2009.

[6]*Stipulation Resolving Certain Issues and Statement of the Issues*, filed April 29, 2010 (Stipulation).

[7]Tr. 24.

[8]Order U-09-90(4), *Order Accepting Stipulation as Modified, Subject to Condition, and Designating Commission Panel*, dated May 26, 2010.

[9]Order U-10-30(2), *Order Establishing Base Amount for Power Cost Equalization Calculations and Closing Docket*, dated June 25, 2010 (Order U-10-30(2)).

[10]TA805-2, filed June 30, 2010.

[11]Order U-09-90(5), *Order Suspending Tariff Filing TA805-2, Approving Interim and Refundable Rates, Approving Tariff Sheet, and Amending Docket Title*, dated July 1, 2010.

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APC filed TA803-2 to revise its Cost of Power Adjustment (COPA), Non-Firm Power Purchase Rate (NFPPR), and PCE rates for its Haines/Skagway, and South Prince of Wales Island service areas.[12] We suspended TA803-2 into this proceeding.[13] APC filed TA804-2 to revise its COPA, NFPPR, and PCE rates for its North Prince of Wales Island, Tok/Dot Lake/Tetlin, and the Interior Villages service areas.[14] We suspended TA804-2 into this proceeding.[15]

Discussion

The Stipulation recites the resolution of all issues contested by the parties except for the issues of capital structure and ROE. At the prehearing conference we admitted all of the prefiled testimony and exhibits into the record.[16] APC presented the prefiled direct and prefiled reply testimony of Michael R. Garrett (Garrett),[17] the prefiled direct and prefiled reply testimony of Thomas M. Zepp (Zepp),[18] and the prefiled testimony of Robert C. Caprye (Caprye).[19] The AG presented the prefiled testimonies

[12]TA803-2 filed June 7, 2010 (TA803-2).

[13]Order U-09-90(6), *Order Suspending Tariff Filing TA803-2, Approving Interim and Refundable Rates, Approving Tariff Sheets, Addressing Timeline for Decision, and Amending Docket Title,* dated July 22, 2010.

[14]TA804-2 filed June 11, 2010 (TA804-2).

[15]Order U-09-90(7), *Order Suspending Tariff Filing TA804-2, Approving Interim and Refundable Rates, Approving Tariff Sheets, and Amending Docket Title,* dated July 28, 2010.

[16]Tr. 11-18. The prehearing conference was held May 3, 2010.

[17]*Prefiled Testimony of Michael R. Garrett (T-1)* with Exhibits MRG-1 through MRG-5, (T-1); *Prefiled Reply Testimony of Michael R. Garrett,* with Exhibits MRG-6 through MRG-10, (T-2).

[18]*Prefiled Testimony of Thomas M. Zepp (T-3)* with Exhibits TMZ-1 through TMZ-2, (T-3); *Prefiled Reply Testimony of Thomas M. Zepp* with Exhibits TMZ-3 through TMZ-4, (T-4).

[19]*Prefiled Testimony of Robert C. Caprye* with Exhibits RCC-1 through RCC-4, (T-6).

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of David C. Parcell (Parcell)[20] and Parker J. Nation, Jr. (Nation).[21] Upon agreement of the parties the prefiled testimonies of Caprye and Nation were admitted solely for the purpose of supporting the Stipulation.[22]

Capital Structure

APC is a subsidiary of Alaska Power & Telephone Company (APT).[23] Garrett testified that APT has been equity thin in the past and is currently working towards establishing a 40 percent equity position.[24] APC proposed a hypothetical capital structure consisting of 40 percent debt and 60 percent equity.[25] He asserted that the hypothetical capital structure should correlate with other elements in the weighted average cost of capital estimate.[26]

Garrett further asserted that the proposed 60 percent equity component recognizes that APC is a large portion of APT's entire operation, which includes non-regulated and regulated operations, power development companies, engineering project work, and project companies building with grant funding, all of which have differing levels of risk.[27] He asserted that using a 60 percent equity component for APC operations supports the higher risk profile of other APT subsidiaries which cannot

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[20]*Prefiled Direct Testimony of David C. Parcell on Behalf of Attorney General Regulatory Affairs and Public Advocacy,* with Exhibits DCP-1 through DCP-2 (T-5).

[21]*Prefiled Testimony of Parker J. Nation, Jr.*, with Exhibits PJN-1 through PJN-2 (T-7).

[22]Tr. 14-18.

[23]T-1 at 1.

[24]T-2 at 12.

[25]*Id.* at 13.

[26]*Id.*

[27]*Id.* at 12.

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support unduly high financial leverage.[28] He also stated that using the proposed 60 percent equity would result in a rate of return for this rate case "very close to the same rate of return level used in the last rate case for APC."[29]

The AG's witness Parcell observed that APT provides all of APC's capital.[30] He noted that since 2004 the common equity component of APT's capital structure has been under 30 percent, though it is striving to attain a goal of 40 percent equity.[31] He asserted that during the same time the average equity component of the capital structure of groups of electric or gas/electric utilities he identified was about 45 percent.[32] Using electric utility data from Value Line for the period from 2005-2008, Parcell identified group composite equity ratios of 44 to 49.5 percent and estimated group composite equity ratios of 46.5 percent in 2009, 47.5 percent in 2010, and 49.5 percent for 2012 to 2014.[33] Parcell recommended using a hypothetical equity component of 50 percent because it represented a suitable "target" capital structure for APC.[34] The 50 percent target for APC would exceed the electric group industry average, APT's actual equity ratios, and its 40 percent target.[35]

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[28]T-2 at 13.

[29]*Id.* at 13.

[30]T-5 at 9.

[31]*Id.* at 10.

[32]*Id.*

[33]*Id.* at 11.

[34]*Id.*

[35]*Id.*

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Garrett asserted that the comparison companies used by Parcell were extremely large compared to APC and that studies show that smaller companies typically have higher equity ratios to keep financing costs low.[36]

The AG asserts that setting APC's hypothetical equity level at 50 percent is reasonable based upon Parcell's testimony concerning the current and estimated future average equity components in the capital structures of electric and combination gas/electric utilities, APT's actual equity ratios, and APT's targeted equity of 40 percent.[37] However, Parcell did not attempt to show that the capital structures of other utilities are optimal nor that they would be appropriate for a significantly smaller utility such as APC. Therefore we find his calculations standing alone inadequate to determine the appropriate capital structure for APC in this proceeding.

Neither of the parties recommends using APC's actual capital structure consisting of 100 percent equity for ratemaking purposes. We employ a hypothetical capital structure (1) when the actual capital structure is inefficient or unreasonable, (2) when the level of debt subjects the utility to excessive risks, or (3) when the utility is part of a holding company system in which the utility's book capitalization and capital costs are not a true reflection of the system's capital costs with respect to the utility.[38] APC's 100 percent equity component and status as a subsidiary whose capital is provided by APT, places APC within the first and third criteria we have used for employing a hypothetical capital structure. Using the 60 percent equity component in a hypothetical capital structure will result in a lower cost of capital for ratemaking purposes than using

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[36]T-2 at 13.

[37]T-5 at 10-11

[38]See Order U-83-53(32), *Order Deciding Substantive Revenue requirement Issues and Requiring Permanent Rate and Applicable Refund Determinations,* dated December 4, 1986, at 90.

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APC's actual capital structure while at the same time supporting the financial viability of APT. Therefore, for purposes of the revenue requirement in this proceeding, we adopt a hypothetical capital structure consisting of 60 percent equity and 40 percent debt.

Return On Equity

APC proposes an ROE of 15.3 percent based on studies conducted by Zepp.[39] Zepp's cost of equity studies use a group of 34 investment grade electric and combination gas/electric utilities.[40] Zepp asserted that the risks of electric utilities have been increasing and APC is riskier than his comparison group.[41] He stated that one reason APC is riskier than utilities in the comparison group is that APC is much smaller, which he believes supports a risk premium adjustment.[42] He also cited the parent company's liquidity risk and lack of financing flexibility, a perception of higher business risk in Alaska, the small size of the communities served by APC, Alaska's boom-bust history, and the possible perception of higher regulatory risks.[43] Zepp recommended that at least a 350 basis point risk adjustment be included in setting APC's ROE.[44]

Using his comparison group of 34 utilities, Zepp performed three different discounted cash flow (DCF) studies which consider three different ways investors determine future growth in dividends.[45] Before adding his risk adjustment, Zepp's studies indicated a cost of equity in the range of 11.3 to 12.6 percent.[46] Zepp stated

[39]T-3 at 7.

[40]*Id.* at 14 and Exhibit TMZ-2.

[41]T-3 at 15-16.

[42]*Id.* at 16-21.

[43]*Id.* at 21-24.

[44]*Id.* at 21, 24-25.

[45]*Id.* at 25-26. The studies are described in detail at 25-35.

[46]T-3 at 26-27.

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that the DCF studies tend to understate the cost of equity because investors generally purchase shares above book value.[47]

Zepp performed three risk premium (RP) studies which indicated a cost of equity for APC in the range of 14.6 to 15.6 percent and a capital asset pricing model (CAPM) study, which indicated a cost of equity for APC of 16.8 percent.[48] He stated that during times of relatively low interest rates, the required equity risk premium increases.[49] He also stated that under current market conditions the CAPM method's results may be less reliable, so he gave it minimal weight.[50]

In reaching his recommended ROE, Zepp first took the average result of his DCF studies, 11.9 percent, and added a 350 basis point risk premium based on his belief that APC is riskier than the comparison group.[51] Zepp stated his RP studies indicated a cost of equity for the comparison group of 11.1 to 12.1 percent, to which he also added a risk premium to arrive at a cost of equity for APC in the range of 14.6 to 15.6 percent.[52] Taking the mid-point of his results, he recommended an ROE for APC of 15.3 percent.[53]

Based on Parcell's recommendations, the AG proposed an ROE for APC of 11 percent.[54] For his DCF, CAPM, and Comparable Earnings Model (CEM) studies, Parcell used a group of seven publicly-traded electric utilities with market capitalizations

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[47]T-3 at 36.

[48]*Id.* at 37. These studies are described in detail at 41-54.

[49]*Id.* at 38-41.

[50]*Id.* at 54.

[51]*Id.* at 54-55.

[52]*Id.* at 55.

[53]*Id.* at 56.

[54]T-5 at 5-6.

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under $1 billion.[55] As a check on his results, he also performed analyses on the 34 larger utilities in Zepp's comparison group.[56]

Parcell's studies and analyses revealed DCF cost rates based upon mean or median growth rates ranging from 8.6 to 10.0 percent.[57] DCF cost rates based upon high growth rates ranged from 10.6 to 10.8 percent.[58] Parcell stated that he focused on the upper end of these results, 10.6 to 10.8 percent, to recognize APC's relative small size.[59] Parcell's CAPM studies and analyses demonstrated costs based upon new values ranging from 8.3 to 8.5 percent and costs based upon median values of 8.1.to 8.4 percent.[60] Parcell selected the upper end of the range, or 8.5 percent, as most representative of APC's cost of equity.[61] Parcell testified that his comparable earnings model (CEM) analyses indicated a cost of equity of no more than 10 to 11 percent.[62] Parcell testified that his studies taken together indicated a broad range of 8 to 11 percent, and he recommended we set APC's ROE at the upper end of the range.[63]

Parcell criticized Zepp's exclusive reliance on forecasted growth rates in his DCF analysis because investors also have historical growth rates available to them and because analyst forecasts are often too high.[64] Regarding Zepp's RP studies,

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[55]T-5 at 9.

[56]*Id.* at 9.

[57]T-5 at 28. These studies are described in detail at 23-27.

[58]*Id.*

[59]*Id.* at 28.

[60]*Id.* at 32. These studies are described in detail at 28-32.

[61]*Id.* at 32.

[62]*Id.* at 37-39. These studies are described in detail at 33-37.

[63]*Id.* at 39.

[64]*Id.* at 42-45.

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Parcell testified that the expected yield of 7.84 percent is excessive and that 6.5 percent is more appropriate.[65] Parcell also asserted that the three inputs into Zepp's CAPM analysis were dated and overstated.[66] Parcell testified that the results of Zepp's studies, even before adding the 350 basis point risk premium, are much higher than the cost of equity determinations by regulatory commissions during the last 11 years.[67]

Parcell disputed Zepp's 350 basis point risk premium adjustment, stating that bond ratings generally are not lower for small utilities.[68] Parcell also stated that the results of his various studies, when performed on his group of seven small utilities, were similar to the results for the 34 larger utilities in Zepp's comparison group.[69] Parcell also suggested that APT has not had difficulties accessing capital, and the higher cost of operating in Alaska is reflected in APC's operating expenses.[70] Parcell stated that his use of a relatively high 50 percent equity ratio along with recommending the upper end of his range of the cost of equity adequately compensates for any special risk factors faced by APC.[71]

Zepp offered several comments and corrections to Parcell's studies.[72] He adjusted Parcell's DCF studies by giving full weight to forecasted growth rates, which resulted in an average DCF cost of equity for Parcell's small utility group of 10.7

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[65] T-5 at 46.

[66] *Id.* at 47-50.

[67] *Id.* at 50-51.

[68] *Id.* at 52-53.

[69] *Id.* at 53.

[70] *Id.* at 53-54.

[71] *Id.* at 54-55.

[72] *Id.* at 2-5.

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percent.[73] Zepp corrected the growth rate forecast for one of the seven utilities, which further increased the Parcell study results to 13.8 percent.[74] Zepp also asserted that, another utility, Northwestern Corporation, should have been included in Parcell's small utility group.[75] Zepp asserted that Northwestern Corporation has a DCF-based cost of equity of 12.6 to 13.3 percent which also supports an ROE of at least 13.8 percent for APC.[76] Zepp contended that by merely making an ROE recommendation at the top of the range of study results, Parcell provided an inadequate adjustment to recognize the greater risks faced by APC compared to the proxy groups.[77]

Regarding Parcell's CAPM study, Zepp asserted that a risk free rate of only 4.27 percent is too low, and a rate of 5.2 percent is more appropriate.[78] Zepp disputed Parcell's calculation of a market risk premium of only 5.53 percent, which Zepp testified should be 6.7 percent.[79] Zepp revised Parcell's CAPM study to include an average size risk premium along with a revised risk free rate and market risk premium, resulting in an indicated cost of equity of 11.9 percent, to which he added a 350 basis point risk premium for APC's particular circumstances, yielding an ROE of 14.7 percent.[80]

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[73]T-4 at 5. Order U-08-157(10)/U-08-158(10), *Order Resolving Revenue Requirement Issues,* dated February 11, 2010, at 37.

[74]T-4 at 6-7.

[75]*Id.* at 8-9.

[76]*Id.*

[77]*Id.* at 9-11.

[78]*Id.* at 12-14.

[79]*Id.* at 14-20.

[80]*Id.* at 20-21, Rebuttal Table 5, Rebuttal Table 6.

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Zepp disputed that APC's company-specific risks are reflected in its cost of service because the cost of service does not reflect the risk that APC may not have adequate sales revenue in the future to maintain earnings.[81]

Determining the appropriate return on equity for any utility requires us to employ sound judgment because, unlike other elements of the revenue requirement, the cost of equity cannot be directly observed from the company's books and records or from any other document. Determining the cost of equity for APC is vexing because the publicly-traded utilities used in proxy studies are not directly comparable to APC. The proxy companies are significantly larger and do not operate electrically isolated generation and distribution systems. Zepp testified that all of the risk factors he identified, when taken together, merit at least a 350 basis point risk adjustment.[82] Parcell testified that he allowed for additional risk by advocating a 50 percent equity component in the capital structure and by recommending an ROE at the upper end of his range of 10 to 11 percent.[83]

Zepp's special risk factors include APC's relatively small size, financing risks, and a perceived risk related to investing in Alaska.[84] Parcell disputed Zepp's risk factor analyses.[85] Parcell testified that the so-called "Alaska" factor, to the extent it has

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[81]T-4 at 22.

[82]T-3 at 21, 24-25.

[83]T-5 at 54.

[84]T-3 at 16-17.

[85]T-5 at 52-54.

merit, is reflected in APC's cost of service.[86] Zepp presented no evidence that persuades us that investors generally perceive Alaska as a riskier place to invest than other states. Parcell, however, did not persuade us that all special risk factors faced by APC are reflected in its operating expenses or rate base. For example, APC operates small electrical systems in small communities that are not interconnected with any electric grid. If a generator malfunctions in one of these communities, a generator in another location cannot be used to supply the load and maintain APC's sales and revenues from that community. If a business in one of the small communities shuts down, that single event may have a significant negative impact on APC's sales and revenues. Risk factors like these are not faced by larger proxy group utilities where systems are interconnected with neighboring utilities, so some adjustment needs to be made to the proxy group study results to derive a reasonable cost of equity for APC.

Zepp and Parcell presented many DCF, CAPM, RP, and other studies to guide them in formulating a recommended ROE for APC. They also provided critiques of each other's studies. Significantly, neither witness relied solely on any one study or method. Likewise, we are not persuaded that any single study or method reliably portrays the cost of equity for APC to the exclusion of the other studies and methods. We note that the difference between Zepp's and Parcell's ROE recommendations is due more to their opinions regarding APC's special risk factors than the cost of equity for the proxy groups. As discussed above, we do not wholly agree with the way either witness factored the special risk factors into their final recommendations.

Considering all of the testimony on the cost of equity for the proxy groups and the special risk factors faced by APC, we find that a return on equity of 12.8 percent most reasonably represents APC's cost of equity. Combining a 12.8 percent ROE with

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[86] T-5 at 54.

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the stipulated cost of debt of 5.24 percent and the hypothetical capital structure of 60 percent equity and 40 percent debt results in an overall weighted cost of capital for APC of 9.78 percent.

Rates

We now incorporate our capital structure and ROE determinations into the revenue requirement calculations resulting from the Stipulation. We have performed calculations which we believe accurately derive the new rates.

Based on our calculations, we establish a revenue requirement for APC's regulated operations of $11,020,433, which includes a stipulated rate base[87] of $29,422,968 and a weighted average cost of capital of 9.78 percent, to derive a return requirement of $2,876,389. Operating expenses, which were stipulated,[88] are $6,624,740. The income tax allowance contained components partially dependent upon our determination of ROE. Incorporating our ROE of 12.8 percent into the tax calculations yields a total income tax allowance of $1,519,304. Adding these components yields a revenue requirement of $11,020,433. This is a 6.83 percent decrease from the revenue requirement APC requested in TA793-2.

We calculate that the revenue requirement, when compared to total revenue from the test year, results in a gross deficiency of $506,736. Dividing the gross deficiency by stipulated revenues from rates of $10,052,795 results in an across-the-board increase to rates of 5.04 percent. Attached to and incorporated in this order is an appendix, containing schedules supporting these figures. Based upon the Stipulation and our decision in this order we find that both the interim rates and the permanent

[87]Order U-09-90(4), *Order Accepting Stipulation as Modified, Subject to Condition, and Designating Commission Panel*, dated May 26, 2010.

[88]*Id.*

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rates requested by APC in TA793-2, which exceed the rates established in this order, are unjust and unreasonable. The rates established in this order are just and reasonable rates to be collected by APC beginning September 30, 2010.

We require APC to file tariff sheets reflecting the new rates and new Power Cost Equalization (PCE) calculations, if necessary, and new Cost of Power Adjustment (COPA), if applicable, as a compliance filing in this docket.

The new rates, while higher than the permanent rates established in Docket U-04-73, are lower than the interim and refundable rates charged during the investigation in this docket. Accordingly, we require APC to file a refund plan to refund to each customer with interest at the rate of 10.5 percent per annum, the difference between amounts paid for electric service under the interim and refundable rates and the amounts each customer would have paid for electric service under the final rates determined by this order.

Final Order

This order constitutes the final decision in this proceeding. This decision may be appealed within thirty days of the date of this order in accordance with AS 22.10.020(d) and the Alaska Rules of Court, Rules of Appellate Procedure (Alaska R. App. P. 602(a)(2)). In addition to the appellate rights afforded by AS 22.10.020(d), a party may file a petition for reconsideration as permitted by 3 AAC 48.105. If such a petition is filed, the time period for filing an appeal is then calculated under Alaska R. App. P. 602(a)(2).

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ORDER

THE COMMISSION FURTHER ORDERS:

1. By 4 p.m., Friday, October 29, 2010, Alaska Power Company shall file revised tariff sheets, as a compliance filing, which reflect the rates as calculated in this order.

2. By 4 p.m., Friday, October 29, 2010, 2010, Alaska Power Company shall file a refund plan to refund to each customer with interest at the rate of 10.5 percent per annum the difference between amounts paid for electric service under the interim and refundable rates and the amounts each customer would have paid for electric service under the final rates determined by this order.

DATED AND EFFECTIVE at Anchorage, Alaska, this 29th day of September, 2010.

BY DIRECTION OF THE COMMISSION
(Commissioner Paul F. Lisankie, dissenting in part; Commissioners Robert M. Pickett and Kate Giard, not participating.)

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