BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UG-040640** **Docket No. UE-040641** **(*consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For an Order Regarding the Accounting Treatment for Certain Costs of the Company's Power Cost Only Rate Filing.**	**Docket No. UE-031471 (*consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For an Accounting Order Authorizing Deferral and Recovery of the Investment and Costs Related to the White River Hydroelectric Project.**	**Docket No. UE-032043 (*consolidated*)**

REPLY BRIEF OF
PUGET SOUND ENERGY, INC.

JANUARY 27, 2005

[07771-0089/BA050270.017]

REDACTED VERSION

PUGET SOUND ENERGY, INC.

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I./II. SUMMARY / INTRODUCTION / GENERAL ARGUMENT

1. Puget Sound Energy, Inc. ("the Company") presented the Commission with the Company's strategic plan to acquire energy resources, expand risk management activities and pursue extensive infrastructure investments in order to help the Company provide service to its customers over the long term at low and stable rates.[1] A key element of this plan is to further strengthen the Company's financial position so the Company can attract the capital needed to implement its plan on reasonable terms. No other party has questioned this strategic direction, yet their proposals may make that vision impossible to realize.

2. One of the Company's critical objectives in requesting rate relief in this proceeding is to strengthen the Company's financial health to a level that supports improvement of the Company's corporate rating moderately, from its current level of "BBB-" to "BBB+". The "BBB-" corporate credit rating is just one notch above non-investment grade, places the Company in the bottom quartile of all utilities nationwide with respect to its credit rating,[2] and is significantly weaker than most of the Company's wholesale market counterparties.[3] The "BBB-" corporate credit rating constrains the Company's ability to engage in resource acquisition,[4] risk management[5] and infrastructure[6] initiatives on behalf of its customers.[7]

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[1] *See, e.g.*, Exh. No. 51 (Reynolds); Exh. No. 151 (Valdman).
[2] Exh. No. 201 25:21 – 26:2 (Cicchetti).
[3] Exh. No. 76C 1-3 (Ryan).
[4] *See* Exh. No. 51 8:3 – 12:8 (Reynolds); Exh. No. 61C 3:10 – 15:10 (Markell).
[5] *See* Exh. No. 51 8:3 – 12:8 (Reynolds); Exh. No. 71 16:18 – 24:21 (Ryan); Exh. No. 82C 3:1 – 9:4 (Ryan); Exh. No. 84C 2:5 – 15:9 (Ryan).
[6] *See* Exh. No. 51 8:3 – 12:8 (Reynolds); Exh. No. 131C 10:15 – 25:12 (McLain).
[7] The Company recognizes that some of its customers are on fixed incomes or are facing financial difficulties. The Company has taken steps to address the needs of such customers by dramatically increasing its energy-assistance program for low-income households. Exh. No. 53 2:17-20 (Reynolds). It would not be appropriate to limit the relief granted to the Company because of the financial circumstances of some of its customers. *See, e.g.* Exh. No. 311 3:8-13 (Heidell); *State ex rel. Puget Sound Power & Light Co. v. Dep't of Pub. Works*, 179 Wn. 461, 463-64, 467-68 (1934)

3. It is undisputed that the proposals advocated by Staff and Public Counsel would not improve the Company's credit rating, and the evidence shows that they would likely result in a downgrade to below investment grade status.[8] Neither Staff nor Public Counsel presents a credible alternative to the Company's strategic plan. Instead, both parties have presented proposals with the apparent (but unstated) policy goal of keeping the Company at the edge of non-investment grade status, at best. In defending this position, they ignore significant current and long-term benefits to customers associated with improvement of the Company's financial health,[9] as well as the potential costs to the Company and its customers of a downgrade.[10]

4. Both Staff and Public Counsel propose returns on equity (9.0% and 9.75%, respectively)[11] that would result in the Company having one of the lowest authorized returns on equity ("ROE") for vertically-integrated utilities in the nation.[12] Staff and Public Counsel argue that the Company does not need rate relief because it has not been denied access to capital markets in recent years[13] and because they believe that the Company is not in imminent danger of a corporate credit rating downgrade to non-investment grade status.[14]

5. An inability to access capital markets is not a prerequisite to, nor is it the legal basis for, granting general rate relief. Moreover, the relevant issue in this proceeding is not whether the Company is in a "much better financial condition now that [sic] it has been over the past five

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(holding that it is unlawful to fix rates based on the ability of the consumer to pay). Additionally, rates paid by customers since 2001 have *decreased* slightly. Exh. No. 58 1:29 & 3:27.

[8] *See* Exh. No. 179C 7:10-11 & 8:5-10 (Gaines).

[9] Initial Brief of Puget Sound Energy, Inc. ("Company Br.") ¶4; Exh. No. 51 8:3 – 12:8 (Reynolds); Exh. No. 61C 10:4 – 15:10 (Markell); Exh. No. 71 16:18 – 24:21 (Ryan); Exh. No. 82C 3:1 – 9:4 (Ryan); Exh. No. 84C 2:5 – 15:9 (Ryan); Exh. No. 179C 16:12 – 28:15 (Gaines).

[10] Exh. No. 82C 7:7 – 9:4 (Ryan); Exh. No. 179C 23:16 – 26:3 (Gaines).

[11] Initial Brief of Commission Staff ("Staff Br.") ¶2; Initial Brief of Public Counsel ("Public Counsel Br.") ¶2.

[12] *See, e.g.*, Exh. No. 182 (Gaines).

[13] Staff Br. ¶9.

years. . . ."[15] Despite the progress toward financial health made in the past several years, the Company's corporate credit rating remains "BBB-", even with the recent change in Standard & Poor's (S&P) assessment of the Company's business position ranking from 5 to 4.[16] As stated above, the Company requests relief in this case to *strengthen* its financial position, and the record demonstrates that the Company's request should be granted.

6. Further, the adjustments to the Company's requested revenue requirement that Staff, Public Counsel and ICNU propose would weaken the Company's financial position by: (i) setting an unrealistically low power cost baseline; (ii) increasing the amount of utility assets that are not earning a return; and (iii) reducing Company's ability to attract and retain a qualified workforce, and obtain the advice and representation it needs as a regulated company. Adoption of these parties' proposals would continue, and aggravate, the earnings drag that prevents the Company the opportunity to earn its authorized return on regulated utility investment. Adoption of the recommendations of other parties would also impose higher costs and significant risks on customers over time, contrary to the public interest.

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[14] Public Counsel Br. ¶2.
[15] *Id.* ¶38.
[16] TR. 478:2-11 (Gaines).

III. CAPITAL STRUCTURE AND COST OF CAPITAL

A. Debt

1. Long-Term Debt

7. All parties agree that the Company's cost rate for long-term debt is 6.88%.[17] The capital structure ratios for long-term debt, however, vary among their proposals for the reasons set forth in the Company's Initial Brief at ¶¶12-16.

2. Short-Term Debt

a. Short-Term Debt Cost Rate

8. Contrary to Staff's assertion,[18] the Company did not endorse Staff's short-term debt cost but only noted that the *weighted averages* were identical (0.15%).[19] The Company criticized Staff's proposed short-term debt cost, explaining that the differences in the respective proposals relate to the projected amount of short-term debt outstanding [REDACTED]. The Company's projected short-term debt balance [REDACTED] [REDACTED].[20] The Company's proposal then [REDACTED] [REDACTED].[21] By contrast, Staff divides short-term debt costs by the average of the projected short-term debt balances [REDACTED]

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[17] Company Br. ¶12 & App. A; Staff Br. ¶36 & App. A; Public Counsel Br. ¶20 & App. A; *see also* Exh. No. 179C 3:Tables 1-3 (Gaines); Exh. No. 181C 1:9 (Gaines); Exh. No. 490 1:2 (Wilson); Exh. No. 368 1:4 (Hill); Exh. No. 180 2:4 (Gaines). On brief, Public Counsel makes the unsupported assertion that "Puget's cost of debt issued during the 1990's was higher than it should have been, as we have discussed in the section of this brief on cost of capital." Public Counsel Br. ¶39. In fact, Public Counsel's Initial Brief neither discusses nor disputes the Company's cost rate for long-term debt.

[18] Staff Br. ¶39.

[19] Company Br. ¶17; Exh. No. 179C 35:6-- 36:15 (Gaines); Exh. No. 179C 3:Tables 1-3 (Gaines); Exh. No. 490 1:1 (Wilson); Exh. No. 368 1:5 (Hill); TR. 402:3-7 (Gaines).

[20] Exh. No. 179C 34:1 – 35:11 (Gaines).

[21] Exh. No. 171C 30:8-18 (Gaines); Exh. No. 178C 3-7 (Gaines); Exh. No. 181C 3-7 (Gaines).

[REDACTED].[22] The Commission should reject Staff's short-term debt cost because it disregards the Company's projected equity issuance.[23]

9. The Commission should also reject Public Counsel's proposed short-term debt cost of 4.0% because it is not based on *the Company's* short-term debt costs at all.[24] Rather, Mr. Hill estimated what he believes a generic "reasonable" short-term debt cost should be.[25]

b. Accounts Receivable as Collateral for Short-Term Debt

10. As discussed in the Company's Initial Brief, Rainier Receivables uses the Company's accounts receivable as collateral for the issuance of short-term debt, which lowers the Company's short-term borrowing rates for the benefit of customers.[26] Public Counsel suggests that impropriety *could* exist with regard to Rainier Receivables, but offers no evidence:

> there are other issues related to Puget's effective sale of its accounts receivable to Rainier Receivables *that Public Counsel has not been able to investigate thoroughly*, but which could have a significant impact on revenue requirements and deserve scrutiny.[27]

The Commission should not credit such innuendo.[28]

11. Public Counsel also questions the ability of the "Commission to tell by examining Puget's books of account how much short-term debt the Company is actually using."[29] Through

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[22] Exh. No. 481 35:1-13 (Wilson).

[23] Company Br. ¶17; Exh. No. 179C 3:Tables 1&3 (Gaines); Exh. No. 181C 1:7 (Gaines); Exh. No. 490 1:1 (Wilson).

[24] Company Br. ¶18.; Exh. No. 179C 3:Table 2 (Gaines); Exh. No. 368 1:5 (Hill).

[25] Exh. No. 179C 35:17 – 36:15 and n.20-23 (Gaines); Exh. No. 369 1 (Hill); Exh. No. 370 1 (Hill).

[26] Company Br. ¶20; *see also* Exh. No. 179C 37:4-22 & 42:20 – 45:21 (Gaines); TR. 453:22 – 454:6 & 466:23 – 468:3 (Gaines).

[27] Public Counsel Br. ¶29 (emphasis added).

[28] The Company responded to 227 data requests issued by Public Counsel, and Public Counsel received the Company's responses to the other 492 data requests issued by other parties. Of these, 20 data requests addressed Rainier Receivables. Public Counsel's assertion of inability to investigate thoroughly is unfounded.

[29] Public Counsel Br. ¶22. Public Counsel's statement that "the debt appearing on the books of Rainier Receivables averaged $184 Million" (Public Counsel Br. ¶24) inappropriately includes the subordinated notes payable to the Company, which is eliminated in consolidation. *See* Exh. No. 179C 40:12 – 41:2 (Gaines).

consolidation of Rainier Receivables' accounts into the Company's accounts, the Company's consolidated balance sheet is effectively unchanged by the establishment of Rainier Receivables.[30] All short-term debt associated with Rainier Receivables is transparent and presented within (i) the Company's consolidated balance sheet, (ii) the Company's quarterly and annual reports to the SEC[31] and (iii) the Company's evidence in this proceeding.[32]

12. Public Counsel also states that "the arrangement with Rainier Receivables may be distorting the cost rate of short-term debt."[33] Even including fixed costs, Rainier Receivables is the most cost-effective facility for the Company to procure short-term borrowings.[34]

13. Mr. Gaines refuted[35] Public Counsel's charge that "Puget calculated its short-term debt costs in one manner internally and in another manner for regulatory reporting purposes."[36]

B. Trust Preferred Stock

14. All parties agree that the Company's cost rate for trust preferred stock is 8.60%.[37] The capital structure ratios for trust preferred stock, however, vary among their proposals for the reasons set forth in the Company's Initial Brief at ¶ 22.

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[30] Exh. No. 179C 40:14 – 41:2 (Gaines). A consolidated financial statement is "[t]he financial report of a parent corporation and it's [sic] subsidiaries or affiliates which combines the assets, liabilities, revenues, and expenses of all of the entities." Black's Law Dictionary 308 (6th ed. 1990).

[31] *See* Exh. No. 187 4 ("At December 31, 2003, Rainier Receivables had sold $111.0 million in accounts receivable and the remaining receivables available for sale was $39.0 million."); *see also* Exh. No. 187 9 ("At December 31, 2002 there were no amounts outstanding under the accounts receivable securitization facility.")

[32] Exh. No. 181C 4:10 & 18 (Gaines).

[33] Public Counsel Br. ¶25.

[34] Company Br. ¶¶20-21; Exh. No. 179C 45:2-5 (Gaines); TR. 483:5 – 486:14 (Gaines).

[35] TR. 449:6-13 (Gaines). Public Counsel's Initial Brief also refers to "portions of the calculation simply being . . . electronically altered." Public Counsel Br. ¶28. As Mr. Gaines explained, the document in question was an Excel spreadsheet that was inadvertently missing a referential link. TR. 448:9-12 (Gaines). Had Public Counsel followed WAC 480-07-405(5) and requested clarification of the error symbols appearing in the spreadsheet when it received the data request response six months prior to the hearing, the Company would have corrected this oversight.

[36] Public Counsel Br. ¶26.

[37] Company Br. ¶22 & App. A; Staff Br. ¶39 & App. A; Public Counsel Br. ¶32 & App. A.

15. Public Counsel mischaracterizes trust preferred stock instrument as "effectively debt."[38] In fact, trust preferred stock is a hybrid instrument with equity-like characteristics, such as the ability to defer the dividend under certain circumstances,[39] yet the amount paid by the Company is deductible for federal income tax purposes.[40] This beneficial tax treatment is a feature that differentiates trust preferred stock from other preferred stock, and customers benefit from this advantageous tax treatment in terms of lower costs.[41]

C. Preferred Stock

16. The parties' capital structure ratios for preferred stock vary. All agree that the Company's cost rate for preferred stock is 8.51% and the weighted average cost for preferred stock is 0.0%.[42]

D. Common Equity

i. Impact of Staff and Public Counsel's Proposals on the Company's Credit Ratings

17. The Company needs to achieve the financial strength required to increase the Company's corporate credit rating from "BBB-" to "BBB+".[43] Staff and Public Counsel object that the short-

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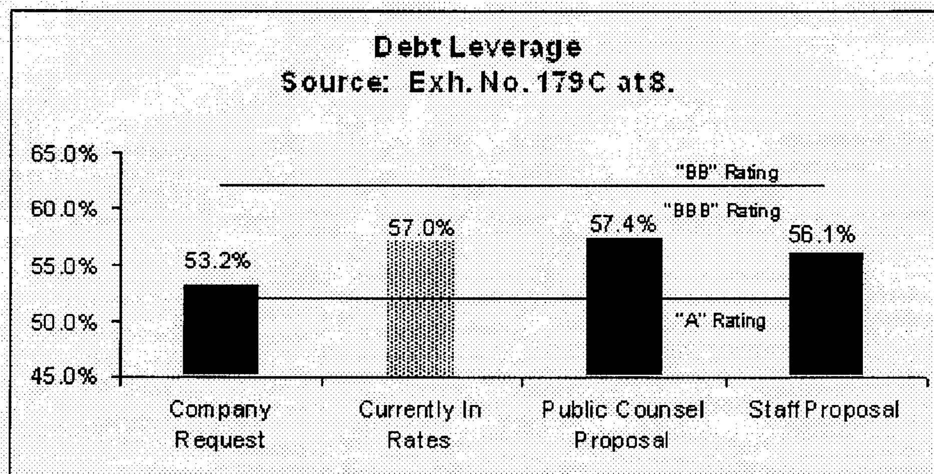
[38] Public Counsel Br. ¶32.
[39] Exh. No. 171C 31:11-20 (Gaines).
[40] *Id.* 31:2-20.
[41] *Id.*
[42] Company Br. ¶23 & App. A; Staff Br. ¶41 & App. A; Public Counsel Br. ¶33 & App. A; *see also* Exh. No. 179C 4:1-2 (Gaines); Exh. No. 179C 3:Tables 1-3 (Gaines); Exh. No. 181C 1:13 (Gaines); Exh. No. 490 1:4 (Wilson); Exh. No. 368 1:2 (Hill).
[43] Exh. No. 51 9:13-16 (Reynolds); Exh. No. 151 15:15 – 19:17 (Valdman); Exh. No. 171C 8:1 – 14:18 (Gaines). The credit rating that matters with respect to this case is the corporate credit rating for Puget Sound Energy, Inc. (the "Company"), which has a S&P corporate credit rating of "BBB-". This is the credit rating that counterparties and lenders look to as a proxy for the Company's financial condition. To the extent any of the Company's other credit ratings are relevant for particular debt issuances, these track the Company's corporate credit rating. Puget Sound Energy, Inc.'s parent corporation, the holding company Puget Energy, Inc., also has an S&P corporate credit rating of "BBB-". Unlike Puget Sound Energy, Inc.'s corporate credit rating, Puget Energy, Inc.'s corporate credit rating is impacted to some extent by the performance of Puget Energy, Inc.'s subsidiary InfrastruX. However, the impact of InfrastruX is relatively minor because it represents such a small percentage of Puget Energy, Inc.'s holdings. Company Br. p. 9, n. 46.

term costs paid by customers during the rate year will outweigh the resulting short-term interest cost savings.[44] Their myopic view of the benefits of an increased credit rating – limited to interest savings on a single type of debt – ignores the Company's evidence regarding customer benefits associated with the Company's generation acquisition, risk management and infrastructure initiatives.[45] Although Staff's case does not address risk management issues facing the Company, Staff admits that "a corporate credit rating upgrade all the way from BBB- to BBB+ may improve the Company's risk management opportunities."[46]

18. Staff and Public Counsel advocate ROEs of 9.0% and 9.75%, respectively,[47] and claim that these single-digit returns will not damage the Company's financial position or creditworthiness.[48] However, the following charts demonstrate that their proposals are not even supportive of the Company's present corporate credit rating:



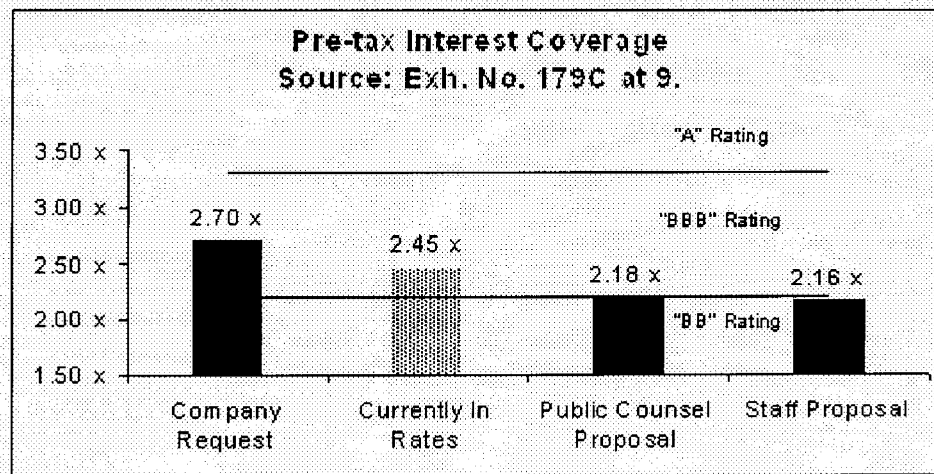
[44] *See, e.g.*, Staff Br. ¶¶6 & 18-25; Public Counsel Br. ¶19.

[45] The Company has presented the Commission with substantial evidence that the benefits of achieving a "BBB+" corporate credit rating will far outweigh the costs, particularly over time. Company Br. ¶4; Exh. No. 51 8:3 – 12:8 (Reynolds); Exh. No. 61C 10:4 – 15:10 (Markell); Exh. No. 71 16:18 – 24:21 (Ryan); Exh. No. 82C 3:1 – 9:4 (Ryan); Exh. No. 84C 2:5 – 15:9 (Ryan); Exh. No. 179C 16:12 – 28:15 (Gaines).

[46] Staff Br. ¶25.

[47] *Id.* ¶2; Public Counsel Br. ¶2.

[48] Staff Br. ¶4; Public Counsel Br. ¶18.



19. Staff's Initial Brief alleges that

> [t]he BBB- corporate credit rating . . . may not be the result of the Company's utility operations, but, rather, the poor earnings performance of PSE's unregulated subsidiaries and InfrastruX, its sister company within the holding company structure of Puget Energy.[49]

This statement is incorrect. First, the Company seeks to increase *the Company's—Puget Sound Energy, Inc.'s*—corporate credit rating to "BBB+".[50] InfrastruX is a subsidiary of the Company's holding company, Puget Energy, Inc.[51] As such, InfrastruX does not affect the Company's corporate credit rating. Second, *the Company's* unregulated activities, including *its* subsidiaries, make up a small fraction of the Company's total utility operations and only 1.43% of the Company's assets.[52] Thus, they cannot materially affect the Company's corporate credit rating. For this reason and the reasons discussed below, Staff is incorrect in positing that the Company's

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[49] Staff Br. ¶14.

[50] Exh. No. 51 9:13-16 (Reynolds); Exh. No. 151 15:15 – 19:17 (Valdman); Exh. No. 171C 8:1 – 14:18 (Gaines).

[51] Exh. No. 54 5 (Reynolds) ("Puget Energy operates in primarily two business segments: regulated utility operations, or PSE, and construction services, or InfrastruX. . . . InfrastruX specializes in construction services to other gas and electric utilities primarily in the south/Texas and the north-central and Eastern United States.")

[52] Divide the 2003 Total Assets of $75,196,000 in the "Other" column of Exh. No. 54 5 (Reynolds) by the 2003 Total Assets of $5,257,157,000 in the "Regulated utility" column of Exh. No. 54 (Reynolds).

"BBB-" corporate credit rating and 7.7% ROE[53] is attributable to its unregulated activities.

ii. The Regulatory Environment

20. Public Counsel cites to a November 2004 article in the *Public Utility Fortnightly*[54] for the proposition that "the *majority* of energy utility equity return awards over the past year . . . have fallen between 10% and 10.5%."[55] The average ROE granted during October 1, 2003, through September 15, 2004 was 10.67% for *all* the utilities cited in that article.[56]

21. Indeed, the four combination natural gas and electric utilities included in the cited article were awarded an average authorized ROE of 11.03%.[57] Madison Gas & Electric Company and Wisconsin Public Service Corporation each received authorized ROEs of 12.0% on both gas and electric operations.[58] Central Hudson Gas & Electric Corporation received an authorized ROE of 10.3% on both gas and electric operations,[59] but the order contained a revenue sharing plan covering ROEs up to 14.0%.[60] Finally, Rochester Gas & Electric Corporation received an

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[53] As demonstrated below, the Company's unregulated activities did not "dr[i]ve the Company's consolidated return down to 7.7%" for calendar year 2003. Staff Br. ¶15.

[54] Phillip S. Cross, "A Survey of Recent Rate Cases from State PUCs," *Public Utilities Fortnightly* at 49-51 & 57 (Nov. 2004) ("Survey of Recent Rate Cases"). For the Commission's convenience, the Company has included a copy of that article with its Excerpts of Non-Washington Authorities submitted with this Reply Brief.

[55] Public Counsel Br. ¶55 (emphasis added); TR. 507:13-18 (Hill).

[56] Survey of Recent Rate Cases at 49-51. Subsequent to publication of the article, the California Public Utilities Commission authorized ROEs for Pacific Gas & Electric Company and Southern California Edison Company of 11.22% on 52.00% equity and 11.40% on 48.00% equity, respectively. *Applications of S. Cal. Edison Co. and Pac. Gas & Elec. Co.*, Application Nos. 04-05-021 & 04-05-023, Opinion on Test Year 2005 Return on Equity and on Pacific Gas and Electric Company's True Up Year 2004, at 50-51 (Dec. 2004).

[57] *Id.* at 51. The four combination companies are Madison Gas & Electric Company, Wisconsin Public Service Corporation, Central Hudson Gas & Electric Corporation and Rochester Gas & Electric Corporation.

[58] According to Public Counsel witness Mr. Hill, authorized ROEs granted by the Wisconsin Public Service Commission "are outside of the mainstream of regulatory bodies in the United States." TR. 508:5-7 (Hill). Mr. Hill's recommendation that the Commission disregard the ROEs granted Wisconsin utilities is curious because those utilities are very similar to the Company. They serve in a jurisdiction that has not, nor plans to, restructure. Additionally, they are building significant base load generation. Despite these obvious similarities, Mr. Hill would exclude them from consideration because he has "a real problem with the awards that the Wisconsin Commission provides their companies." TR. 506:24 – 507:1 (Hill).

[59] Survey of Recent Rate Cases at 51.

[60] *Id.* at 51 n.19 and 57 n.19.

authorized ROE of 10.3% on electric operations and 9.6% on gas operations,[61] but the order contained a revenue sharing plan: "[e]lectric plan requires equal sharing with ratepayers on earnings above 12.25% threshold, while gas plan requires equal sharing above 12%."[62]

22. The cited article also echoes the Company's observations in its Initial Brief about significantly lower risks facing companies that have received single-digit ROE.[63]

23. The PGA, PCA and PCORC mechanisms do not reduce risk to the extent suggested by Staff,[64] particularly in comparison to utilities in other jurisdictions. Dr. Wilson acknowledged that "there are lots of jurisdictions that have those types of mechanisms."[65] The Company must compete for capital with utilities that have a broad array of pass-through mechanisms. These mechanisms are part of the status quo in the utility industry today and do not justify reducing the Company's authorized ROE to levels recommended by Staff and Public Counsel.

24. For example, the article discussed above and cited by Public Counsel describes a recent decision by the Indiana Utility Regulatory Commission involving PSI Energy's tracking mechanisms.[66] In that order,[67] the Indiana Utility Regulatory Commission approved three new cost and revenue adjustment mechanisms: (i) a Nitrogen Oxide Emission Allowance tracker; (ii) a

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[61] *Id.* at 51.

[62] *Id.* at 51 n.22 and 57 n.22. Mr. Hill's prefiled response testimony in this proceeding cited the Rochester Gas & Electric Corporation as one of the model orders with single-digit ROEs (Exh. No. 351 5 n.1 (Hill)), without referencing the fact that Rochester Gas & Electric Corporation had differing ROEs for its electric and gas operations and a revenue sharing plan that granted shareholders 100% of any ROE less than 12.25% for electric operations and 12.0% for gas operations. Instead, Mr. Hill averaged the authorized ROE for both electric and gas operations to manufacture an overall ROE under 10.0%. *See* Exh. No. 351 5 n.1 (Hill).

[63] *Compare* Survey of Recent Rate Cases at 51 (discussing the Connecticut Power & Light Co. order) *with* Company Br. ¶40 (discussing the same order).

[64] Staff Br. ¶¶30-31.

[65] TR. 568:3-4 (Wilson); *see also* TR. 331:6-20 (Cicchetti). The only mechanism unique to the Company identified by any witness was the PCORC. TR. 331:15-16 (Cicchetti); TR. 568:4-5 (Wilson). Although the PCORC mechanism is helpful in reducing the delay associated with including assets into rate base, the fact that over 11% of the Company's utility assets are not included in rate base attests to the fact that the PCORC does not eliminate earnings drag.

Midwest ISO Management Cost and Revenue Adjustment tracker; and (iii) a Purchased Power ("Summer Reliability") tracker.[68] These three new trackers complemented PSI Energy's four existing cost and revenue adjustment mechanisms: (i) a Fuel Cost Charge tracker; (ii) a Demand-Side Management tracker; (iii) a Construction Work In Progress (CWIP) tracker; and (iv) a Sulfur Dioxide Emission Allowance tracker.[69] Even with the reduced risk associated with these seven cost and revenue trackers, the Indiana Utility Regulatory Commission granted PSI Energy an authorized ROE of 10.5%,[70] 150 basis point higher than Staff's proposal and 75 basis points higher than Public Counsel's proposal.

25. Unlike cost pass-through mechanisms, the sharing bands in the Company's PCA subject it to tens of millions of dollars of excess power cost risk *each year*. Although 99% of such losses are capped at $40 million until June 30, 2006, financial markets are currently analyzing potential calendar year 2006 earnings.[71] Accordingly, the expiration of the PCA cumulative cap in mid-2006 is already influencing investors' decisions. The Company's PCA mechanism does not, in any way, justify reducing the Company's ROE below Dr. Cicchetti's recommendation, which reflects the relative risk reduction associated with the Company's mechanisms.

26. Finally, Staff's Initial Brief claims that Dr. Cicchetti agrees that vertically-integrated utilities subject to traditional cost of service regulation are less risky than utilities in states that

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[66] Survey of Recent Rate Cases at 49.
[67] *Re PSI Energy*, 234 PUR 4th 1 (Ind. 2004).
[68] *Id.* at 26.
[69] *Id.* at 26.
[70] *Id.* at 51.
[71] TR. 212:12-24 (Valdman).

have restructured.[72] Staff's Initial Brief takes Dr. Cicchetti's hearing testimony out of context and ignores his written direct and rebuttal testimonies.[73] Moreover, Dr. Cicchetti testified that the investment community differentiates between utilities subject to traditional cost of service regulation in (i) jurisdictions that recognize "that cost of service traditional regulation requires a balancing of consumer and shareholder interest in a way that will get the cash needed to make the investments without trying to deny the imperative of cash when it comes to making investments"[74] from (ii) those jurisdictions that "don't seem to be looking for anything but an opportunity to lower rate of return in this current world of very low interest rates . . ."[75]

1. Capital Structure

27. As discussed in the Company's Initial Brief, the Commission enunciated the standard regarding capital structure in Puget Sound Power & Light Company's 1992 rate case:

> the Commission must establish an appropriate capital structure for the company. *This capital structure need not be the actual capital structure the company experienced during the test year.*
>
> The Commission determines an appropriate balance of debt and equity within the capital structure *on the bases of economy and safety.*[76]

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[72] Staff Br. ¶28. Staff refers to TR. 327:20 – 328:6 (Cicchetti). In that section of the hearing, Dr. Cicchetti continues a dialogue with Chairwoman Showalter regarding the lessons learned from the California power crisis and the relative risks of relying upon spot markets and supplier of last resort agreements:

> So I think California proved that you can't put everything in the spot market, and it also proved that the supplier of last resort agreement wouldn't hold up at the state level and certainly wasn't followed in a way that gave market stability at least in terms of dealing with the people who believed what FERC was saying during that period.

TR. 327:13-19 (Cicchetti). This does not support Staff's assertion that "the Company admits that this makes it less risky than utilities in states that have restructured." Elsewhere in the hearing, Dr. Cicchetti explained that disaggregated distribution systems present greater risks to consumers but that the "[t]he wires component, the delivery system and the return [in disaggregated jurisdictions] is probably less risky". TR. 321:10 – 322:13 (Cicchetti).

[73] Exh. No. 201 (Cicchetti); Exh. No. 206 (Cicchetti).

[74] TR. 328:11-16 (Cicchetti).

[75] *Id.* 328:17-21.

[76] *WUTC v. Puget Sound Power & Light Co.*, Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 25-26 (Sept. 1993) (emphasis added).

The Company is requesting a 45% equity ratio, which represents an appropriate balance of safety and economy given the current market environment and the issues facing the Company.[77] None of the other parties rejects a 45% equity ratio as unreasonable, per se.[78] In addition, the Company expects to have a capital structure with 45% equity in place [REDACTED].

28. Public Counsel's Initial Brief ignores the Commission's safety and economy standard. The Company's authorized capital structure need not mirror the capital structure experienced during the test year.[79] Thus, it is irrelevant that the Company's proposed equity component is higher than its actual equity component "over the most recent five quarters."[80]

29. To the extent the Company's actual capital structure is considered, Public Counsel would have the Commission impose upon the Company a capital structure that would not include financings projected [REDACTED] or even any of the increases in equity that Staff agrees will result from retained earnings and the Company's dividend reinvestment program.[81] The Company's equity will be increasing due to its need to fund resource acquisitions and infrastructure initiatives. Adoption of Public Counsel's backward-looking equity component at this time would force the Company to access equity markets on less favorable terms.[82] This would not benefit customers over the long-term.

30. Public Counsel's statement that the Company's projected capital structure contains

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[77] Company Br. ¶30; Exh. No. 171 7:4-8 (Gaines); TR. 159:23 – 161:2 & 162:12-15 (Reynolds); TR. 163:25 – 164:17 (Reynolds); TR. 197:16 – 198:8 (Valdman).

[78] Exh. No. 351 24:22-24 (Hill) ("[I]f, by the time of the next rate proceeding, the Company has achieved a common equity ratio of 45%, then it would be reasonable to consider it for ratemaking purposes."); Exh. No. 481 30:8-9 (Wilson) ("these percentages do not represent an unreasonable capital structure per se").

[79] *WUTC v. Puget Sound Power & Light Co.*, Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 25-26 (Sept. 1993) (emphasis added).

[80] Public Counsel Br. ¶24.

[81] TR. 487:22 – 488:12 (Gaines).

[82] TR. 164:8-13 (Reynolds); TR. 196:18 – 197:11 (Valdman); TR. 420:5-11 & 462:9 – 465:10 (Gaines).

"substantially more common equity and less debt capital than exists, on average, for similar-risk companies in the electric utility industry"[83] is incorrect. The average equity component authorized for utilities between January 1, 2003, through June 30, 2004, was 48.41%.[84] In fact, the "median common equity ratio in the near-term future for [parent] companies with investment-grade rated subsidiaries is in the range of 51 to 52 percent,"[85] and "in many instances individual operating companies have even higher common equity ratios."[86]

31. Public Counsel's allegation that the Company's proposed capital structure would "provide an inappropriate financial cross-subsidy to the parent Company's unregulated operations"[87] is unfounded and irrational. Access to the equity markets on reasonable terms is a key element in funding the Company's extensive resource acquisition and infrastructure investment initiatives. There is no evidence in the record that supports the allegations that InfrastruX is being subsidized by the Company or that the Company's proposals would result in cross-subsidization.

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[83] Public Counsel Br. ¶49. Mr. Hill presented an exhibit compiling equity ratios for August 2004, which posits that the average equity ratio for gas and electric combination companies is 38%. *See* Exh. No. 357 3 (Hill). Those equity ratios were for the operating utilities' holding company and not necessarily the equity ratios upon which rates were set. TR. 479:5 – 481:11 (Gaines). For example, Mr. Hill's exhibit shows an equity ratio for Unisource Energy of 21.0% equity (Exh. No. 357 3 (Hill)), but rates were recently set for the utility based upon 40.0% equity (Exh. No. 182 2 (Gaines)). Similarly, Mr. Hill's exhibit shows an equity ratio for Aquilla of 33.0% equity (Exh. No. 357 3 (Hill)) but rates were recently set for the utility based upon 47.5% equity (Exh. No. 182 2 (Gaines)).

[84] Exh. No. 182 3 (Gaines).

[85] Exh. No. 3 28 & 31 n.1.

[86] *Id.* 3 31 n.1.

[87] Public Counsel Br. ¶49.

32. Like Public Counsel, Staff would have the Commission completely ignore the Company's projected equity issuance [REDACTED].[88] The following statement from Staff's Initial Brief mischaracterizes the Company's testimony:

> PSE acknowledges, however, that stock issuance may or may not occur depending on a number of factors including the progress and extent of its resource acquisition plans. The Company's projection [REDACTED], therefore, "may go up or may go down."[89]

The Company has never stated that the stock issuance may not occur [REDACTED]. Indeed, the Company's testimony states that it will achieve a 45% equity ratio [REDACTED]:

> we believe that 45% is something that would be appropriate given the nature of our financial plan. We haven't stated when we would get there. We have stated that we would get there [REDACTED], but we didn't state how or when or during what time period.[90]

The record shows that the only uncertainty with respect to the timing of the Company's equity issuance is [REDACTED].

33. Staff's brief also erroneously asserts that

> Staff's recommended capital structure also produces a pre-tax interest coverage of 2.44X, again, treating trust-preferred as debt. This is sufficient for a BBB rating according to the Company's own testimony. The pre-tax interest coverage increases to 2.82X if trust-preferred is not treated as debt. This is sufficient for a high BBB rating.[91]

The only way that Staff's capital structure produces a pre-tax interest coverage of 2.44X is to exclude the additional debt imputed by S&P for payments under the Company's purchased power

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[88] Company Br. ¶¶13 & 32; Exh. No. 481 35:1-13 (Wilson); Exh. No. 171 7:4-8 (Gaines); Exh. No. 179C 34:13-35:5 (Gaines). If Staff had calculated a capital structure based on average of the monthly averages *for the rate year*, its proposal would have been 42.10%. Exh. No. 179C 38:18-20 (Gaines).

[89] Public Counsel Br. ¶78.

[90] TR. 197:16-21 (Valdman) (emphasis added).

contracts and by inappropriately including a hybrid security (trust preferred stock) as debt.[92] Apparently, Staff disagrees with the S&P methodology,[93] but this does not change the fact that S&P uses its methodology in rating the Company. The S&P methodology would result in a pre-tax interest coverage of 2.16X if Staff's proposal were adopted.[94] The reality is that only the Company's proposal supports a strengthening of the Company's credit position.

34. Finally, Staff criticizes the Company's capital structure proposal for containing "an adjustment to common equity to reflect negative retained earnings of its unregulated subsidiaries."[95] However, the Commission's Holding Company Order prohibits inclusion of unregulated activities' earnings (whether positive or negative) in the Company's regulated capital structure.[96] The Company's proposal complies with the Holding Company Order.

35. The Company's requested capital structure with a 45% equity ratio meets the Commission's safety and economy test. In fact, the Company's request is conservative given that the average of all authorized capital structures granted by public utility commissions throughout the country between January 1, 2003, and June 30, 2004, is almost 50%[97] and at a time when utilities are moving to 51% to 52% equity.[98]

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[91] Public Counsel Br. ¶83.
[92] Staff Br. ¶83.
[93] *Id.* ¶84.
[94] Company Br. p. 13 n.68; Exh. No. 179C 10:14-18 (Gaines).
[95] Staff Br. ¶85.
[96] *In the Matter of the Application of Puget Sound Energy, Inc.*, Docket No. UE-991779, Order Accepting Stipulation and Approving Corporate Reorganization to Create a Holding Company at ¶9 (Aug. 2000).
[97] Exh. No. 3 28 & 31 n.1.
[98] Exh. No. 182 3 (Gaines).

2. Return on Equity

36. Staff and Public Counsel propose ROEs that, like their proposed capital structures, are backward rather than forward-looking.[99] As stated by Mr. Valdman, the Company must be able to access capital markets on reasonable terms under all future market conditions.[100] While market conditions in the recent past have been favorable, with interest rates at forty-year lows, future market conditions are uncertain and interest rates are rising. The Company will be raising new, large amounts of capital to support needed investments in infrastructure and resource acquisitions. Staff and Public Counsel ignore these increased needs and market uncertainties, relying instead on rote application of theoretical financial formulas using erroneous assumptions.

37. The Company's Initial Brief[101] addresses in detail the Discounted Cash Flow (DCF), Capital Asset Pricing Model (CAPM), Comparable Earnings, Modified Earnings-Price Ratio, and Market-to-Book Ratio analyses presented in Dr. Wilson's and Mr. Hill's prefiled response testimony. To summarize, Dr. Wilson and Mr. Hill inappropriately rely on dividend growth rate estimates in performing a DCF analysis for the Company and its peers. Estimates on this basis are inappropriate for utilities, such as the Company, that have experienced negative dividend growth.[102] Whereas Dr. Wilson used the Company's list of comparable utilities for his analysis, Mr. Hill created his own sample group, a majority of which are not actually comparable to the Company.[103] Indeed, half the utilities in Mr. Hill's sample group are pipes and wires companies

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[99] ROR must be "forward-looking and not solely concerned with past conditions if new capital is to be attracted to a utility." Robert L. Hahne & Gregory E. Aliff, *Accounting for Public Utilities* at 9-5 (Release 21A 2004).

[100] Exh. No. 154 3:1-3 (Valdman).

[101] Company Br. ¶¶44-70.

[102] *Id.* ¶47; Exh. No. 206C 45:8-10 (Cicchetti); Exh. No. 484 1:4 (Wilson).

[103] Company Br. ¶¶52-58.

that operate in jurisdictions that have restructured or are pursuing restructuring.[104]

38. Both Dr. Wilson and Mr. Hill inappropriately use 90-day Treasury bills in performing their CAPM analyses.[105] Mr. Hill further errs by using unreasonably low market premiums in this analysis.[106] Finally, Dr. Wilson's and Mr. Hill's contentions rest heavily on the proposition that the Company's market-to-book ratio should be 1.0, despite evidence that (i) investors do not look to this measure, (ii) market-to-book ratios are driven by broader market events and investor expectations, and (iii) the approximate average market-to-book ratio in the industry is 1.60.[107]

i. New Arguments Advanced by Staff

39. Staff's Initial Brief erroneously alleges that "current rates for the utility operations of PSE provided shareholders a fair return on equity of 10.22% in 2003 . . . ."[108] Staff's argument confuses (i) ROE (Net Income divided by Equity) reported to the Securities and Exchange Commission (SEC) and used by investors with (ii) an ROE calculated from a rate of return ("ROR") derived by dividing net operating income by rate base, which does not reflect all funds that have been invested in the regulated utility.

40. Appendix C to the Initial Brief of Staff, which was presented for the first time in Staff's Initial Brief,[109] provides Staff's alleged support for the asserted 10.22% ROE. The last line of

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[104] *Id.* ¶58; Exh. No. 206C 33:17-21 (Cicchetti).
[105] Company Br. ¶62; Exh. No. 481 20:2 (Wilson).
[106] Company Br. ¶65; Exh. No. 355 5 (Hill).
[107] TR. 544:13-17 (Wilson). Indeed, the average market-to-book ratio for Mr. Hill's sample group (1.45) is higher than the Company's market-to-book ratio (1.28). Company Br. ¶69.
[108] Staff Br. ¶8.
[109] Dr. Wilson's prefiled testimony and exhibits do not contain any allegation that the Company actually earned a ROE of 10% or higher in calendar year 2003. TR. 573:12-14 (Wilson). At the hearing, Dr. Wilson stated that the Company earned "around a 10 percent return for the utility operations" for calendar year 2003. TR. 562:1-3 & 563:11-21 (Wilson). When asked if he had prepared any workpapers or calculations that formed the basis of this assertion, Dr. Wilson stated that "No, Staff has, and I think, in particular, Mr. Russell has, and I've seen them. I have not prepared them. I think Jim Russell has." TR. 573:15-20 (Wilson). Counsel for Staff offered that Mr. Russell could present

Appendix C posits that the Company earned a 10.22% return on $1,496,527,416 of equity. If correct, the product of those two numbers, $152.9 million, would equal the Company's net operating income for common stock in 2003. In fact, the Company reported net operating income of $114.7 million in 2003[110]—a financial result filed with the SEC. When this actual net operating income of $114.7 million is divided by Staffs $1,496,527,416 of equity, the actual return is 7.70%—the ROE publicly reported by the Company. Staff implies that the Company's unregulated activities caused it to underearn by approximately $38 million,[111] but this is impossible because these unregulated activities had positive net income of $438,000.[112]

41. The 10.22% cited by Staff is based on Commission basis report data that reflects the Company's net operating income (NOI) and rate base.[113] However, rate base is only a subset of the Company's regulated utility assets. The Company also has regulated utility assets that either (i) do not earn a return or (ii) earn a return significantly less than the Company's authorized ROE. At the hearing, Staff witness Mr. Russell acknowledged the existence of such assets:

> I think, looking at the working capital calculations that Mr. Parvinen did for both the gas and electric side, you could look at assets that are considered regulated and earning a return, regulated not earning a return, or totally nonregulated assets.[114]

Regulated utility assets that do not earn a return include assets in service but not yet in rate base:

> If a plant is under construction, it would be AFUDC. In other words, the Company would be reflecting in its income statement a return component

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evidence for Dr. Wilson's uncorroborated assertion (TR. 574:14-20 (Cedarbaum)), but Mr. Russell did not produce any such evidence on the stand and disavowed having any opinion with regard to issues related to financial issues. TR. 851:11 – 852:24 (Russell).

[110] Exh. No. 54 1 (Reynolds).

[111] Staff Br. ¶15.

[112] Exh. No. 54 5 (column "Other") (Reynolds). Likewise, the Company's unregulated activities had net positive income of $4,384,000 for 2002. *Id.*

[113] Appendix C to Staff Br. (citing Exh. 56 3-4 (Story)).

[114] TR. 841:13-18 (Russell)

> of that, and that return component plus a debt component would be added to the construction work in progress. So during the construction phase, there's really no lag. But after the plant goes in service, and the time of the next rate case before the rates become effective, there may be some amount of what you might refer to as lag.[115]

Other examples presented were regulated utility assets, such as costs deferred under the PCA and PGA mechanisms, that earn a ROR far below the Company's authorized ROR.[116]

42. To understand the magnitude of regulated utility assets not earning a return, compare the Company's total average of the monthly averages (AMA) capital for calendar year 2003 on Appendix C ($3,995,526,072) to the rate base reported on Commission basis reports on Appendix C ($3,533,438,185). The Company has $462,087,887 (11.6%) of regulated utility assets that are not in rate base and do not earn a return. It is these type of regulated utility assets—not the Company's unregulated activities—that drive down the Company's earnings, which, in turn, results in an ROE (Net Income divided by Equity) of only 7.7% and not 10.22%.

43. Commission Staff's overstatement of the Company's earned ROE for calendar year 2003 is demonstrated as follows. First, Staff backs into an ROE by calculating an overall ROR by dividing net operating income ($295,659,351) by rate base ($3,533,438,185):

$$\text{Overall Rate of Return (ROR)} = \frac{\text{NOI}}{\text{Total Assets}} = \frac{\$295,659,351}{\$3,533,438,185} = 8.37\%$$

Second, Staff calculates the weighted average ROE (3.83%), by subtracting from the overall ROR the sum of the weighted averages for short-term debt, long-term debt, trust preferred stock and preferred stock:

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[115] *Id.* 841:23 – 842:8 (Russell); *see also Id.* 842:9-17 (Russell) (hydrolicensing costs).
[116] *Id.* 843:11-23 (Russell).

$$\text{Weighted-Average Return on Equity} = 8.37\% - 0.12\% - 3.68\% - 0.61\% - 0.14\% = 3.83\%$$

Finally, Staff divides the 3.83% weighted average ROE by the 37.46% equity component of capital structure results in a ROE of 10.22%:

$$\text{ROE} = \frac{\text{Weighted-Average Return on Equity}}{\text{Percentage of Equity in Capital Structure}} = \frac{3.83\%}{37.46\%} = 10.22\%$$

The methodology used in Appendix C, however, ignores $462,087,887 of the Company's regulated utility assets.

44. If Appendix C were modified to account for the $462,087,887 of regulated utility assets not in rate base, then Appendix C would also show a ROE of 7.61%. Dividing net operating income ($295,659,351) by total regulated utility assets ($3,995,526,072) arrives at an overall ROR of 7.40%:

$$\text{ROR} = \frac{\text{NOI}}{\text{Total Assets}} = \frac{\$295{,}659{,}351}{\$3{,}995{,}526{,}072} = 7.40\%$$

Subtracting the sum of the weighted averages for short-term debt, long-term debt, trust preferred stock and preferred stock from the 7.40% overall ROR yields a weighted average ROE of 2.85%:

$$\text{Weighted-Average ROE} = 7.40\% - 0.12\% - 3.68\% - 0.61\% - 0.14\% = 2.85\%$$

Dividing the 2.85% weighted average ROE by the 37.46% equity component of capital structure results in a ROE of 7.61%:

$$\text{ROE} = \frac{\text{Weighted-Average Return on Equity}}{\text{Percentage of Equity in Capital Structure}} = \frac{2.85\%}{37.46\%} = 7.61\%$$ [117]

This ROE is much closer to the Company's actual, reported ROE of 7.7% for calendar year

2003.[118] Investors rely upon these reported ROEs in making investment decisions—not an artificial calculation of "ROE" that ignores 11.6% of the Company's regulated utility assets. Indeed, Public Counsel witness Mr. Hill agrees that the Company's actual ROE at 7.7%, 7.2%, 7.0% and 7.5% for calendar years 2001, 2002, 2003 and 2004, respectively.[119]

45. The 10.22% ROE alleged in Appendix C to Staff's Brief does not support Staff's claim that the Company needs only limited rate relief or their claim that it is the unregulated subsidiaries that are causing the low consolidated return.[120] Instead, Appendix C illustrates the dramatic drag on the Company's regulated utility earnings.

46. Staff's Initial Brief also seeks to defend Staff's rejection of the 6% IBES projected dividend growth rate in Dr. Wilson's DCF analysis:

> using the retention ratio of 36% that Dr. Cicchetti shows for PSE for the rate year and beyond, PSE would have to earn almost 17% on book equity in order for investors to experience dividend growth, "g", of 6%.[121]

In making this assertion, Staff persists in the fundamental error of assuming for the Company that dividends per share, earnings per share, and cash per share all grow at the same rate:

> Sustainable growth depends upon the plow back or retention rate and ROE. Mr. Hill and Dr. Wilson make a third assumption concerning *g*. They assume that *g* is constant over time and that dividends per share, earnings per share (EPS), and cash per share all grow at the same rate "*g*". This assumption does not fit the facts for PSE.[122]

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[117] For 2002, the equivalent calculation for the ROE using the utility equity shown in Staff Initial Brief, Appendix C, of $1,339,577,881 would be a 7.17% rate of return, 2.25% weighted equity and 6.81% ROE.
[118] Exh. No. 54 2.
[119] Exh. No. 359 5 (Hill).
[120] Staff Br. ¶15.
[121] *Id.* ¶56.
[122] Exh. No. 206C 51:1-5 (Cicchetti).

ii. New Arguments Advanced by Public Counsel

47. Public Counsel's Initial Brief attempts to justify its single-digit ROE by arbitrarily adding (i) the Company's dividend yield to (ii) several long-term growth predictions selected from analyst reports.[123] Public Counsel has provided no rationale why the growth rates used in its Initial Brief are appropriate, in lieu of the dividend growth rate component of a traditional DCF that Mr. Hill advocated in his testimony.[124] Assuming *arguendo* that Public Counsel's simplistic analysis is viable, the correct long-term growth rate should be the average expected long-term growth among all analysts--6.5%.[125] That rate, combined with the 4.4% dividend yield, indicates a return of 10.9%.[126] Thus, just replacing the long-term growth rate of selected analysts with the average among analysts increases the return cited by Public Counsel by 150 basis points.

48. Public Counsel's Initial Brief attempts to impeach Dr. Cicchetti with testimony presented by Dr. Cicchetti on behalf of Western Resources in rate proceedings before the Kansas Corporation Commission.[127] Dr. Cicchetti's Kansas testimony involved a different company, a different regulatory environment, and different facts and issues completely unrelated to those before this Commission, as Dr. Cicchetti explained at the hearing.[128]

49. For example, Public Counsel criticizes Dr. Cicchetti for using growth in the Company's stock price as a proxy for the Company's dividend growth rate in this proceeding, while Dr. Cicchetti's DCF analysis before the Kansas Corporation Commission "was based on Value

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[123] Public Counsel Br. ¶¶35-36.
[124] Exh. No. 351 29:25 – 39:20 (Hill).
[125] *See* Exh. No. 501 1; *see also* TR. 237:22 – 239:7 (Valdman).
[126] TR. 237:22 – 239:7 (Valdman).
[127] Public Counsel Br. ¶¶78-82, 90.
[128] TR. 283:14 – 296:8 (Cicchetti).

Line projected earnings growth rates for his sample group."[129] As discussed in the Company's Initial Brief,[130] however, Dr. Cicchetti used the proxy of growth in stock prices in this case because the Company's dividend growth over the past decade has been *negative* 5.9%.[131] Thus, a "traditional" DCF analysis is inapplicable here, given the Company's particular circumstances.

50. With respect to CAPM analysis, Public Counsel's Initial Brief makes the unsupported assertion that "recent research in the field of financial economics indicates that even that long-term market risk premium overstates investors' current risk premium expectations."[132] Mr. Hill's prefiled response testimony and testimony at hearing did not refer to this research. Public Counsel's Initial Brief even fails to provide any citation in support of this statement to permit the Company or the Commission to review the purported research.

51. In an attempt to bolster their extraordinarily low proposed ROEs, both Staff and Public Counsel note that "[o]f ten investment firms that follow Puget Energy [the Company's parent], seven have 'hold' recommendations."[133] "Hold" recommendations are not particularly helpful in the Company's efforts to attract capital to support its generation acquisition or infrastructure development initiatives.[134] Moreover, these analyst reports were published in the Fall of 2004, when the Company's authorized ROE was 11.0% and analysts were "hopeful of a favorable

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[129] Public Counsel Br. ¶78-79.

[130] Company Br. ¶47.

[131] Exh. No. 206C 45:8-10 (Cicchetti); Exh. No. 484 1:4 (Wilson).

[132] Public Counsel Br. ¶87.

[133] Staff Br. ¶11; *see also* Public Counsel Br. ¶35 ("[t]he reports uniformly indicate that Puget is a stock that investors should "hold" or "buy;" there are no "sell" recommendations for the Company"). Please note that Public Counsel's Initial Brief refers to buy, sell and hold recommendations for the Company but instead means the Company's parent, Puget Energy, Inc. The Company is a wholly-owned subsidiary of Puget Energy, Inc. No equity analysts follow the Company.

[134] Exh. No. 160 22 (Valdman) ("BUY – Immediate purchase is recommended; the stock is expected to outperform the general market over the next 12-18 months; HOLD – Holding the stock is recommended. The stock has moved out

outcome to the . . . general rate case."[135] If the Company's authorized ROE were to be reduced from 11.0% to the levels advocated by Staff and Public Counsel, then these "hold" recommendations could quickly turn to "sell" recommendations.

iii. New Arguments Advanced by NWIGU

52. NWIGU did not present any evidence on the cost of capital issues in this case. On brief, NWIGU advances a novel and simplistic formula for setting the Company's ROE.[136] NWIGU argues that a number of the Commission's prior rate case orders have authorized ROEs that NWIGU calculates range from 22% to 60% higher than the long-term debt cost rates authorized for those companies in those orders.[137] NWIGU's approach ignores (i) the financial literature and precedent on setting ROEs for regulated companies; (ii) the constitutional and statutory standards for setting ROEs; (iii) the investment climate and (iv) specific financial and operational circumstances facing the Company. NWIGU presents no evidence or analysis regarding why the Company's ROE should be determined by its long-term debt cost rate. The Commission should reject NWIGU's arbitrary and unlawful ROE proposal.

E. Total Capital

53. The Commission should approve the Company's proposed overall ROR on rate base of 9.12% and capital structure, all as detailed in Appendix A to the Company's Initial Brief.

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of our preferred buying range, but there is further upside to the share price; or state objectives at the time of purchase have changed and share appreciation may take another 6-12 months.").

[135] Exh. No. 160 52 (Valdman).

[136] NWIGU Br. p. 9.

[137] *Id.* pp. 6-9.

IV. REVENUE REQUIREMENT

A. Contested Adjustments—Electric

1. Adjustment 2.03—Power Costs

i. "Normalization" and Projected Power Costs

54. This Commission has recognized that it is appropriate to set power costs in rates by using projections of what the Company's rate year costs are expected to be. "To develop normalized *pro forma* power supply costs, the company projects rate year power supply costs" in order "to look into the future to predict what rate year power costs will be at the rate year loads the company expects to serve and the resources the company expects to have."[138]

55. ICNU's Initial Brief quotes a Commission order that used the phrase "normal wholesale market price conditions" in support of ICNU's argument that the Commission should set power costs based on a "normalized" or "typical" level of costs instead of the costs the Company is expected to incur during the rate year.[139] The cited order concerned Avista's petition for emergency rate relief in July 2001, in which it requested an immediate surcharge due to circumstances then existing in western energy markets and historic low streamflows.[140] The reference to "normal wholesale market price conditions" was in the context of comparing those extraordinary circumstances to "the power costs assumed in the Company's current rates."[141]

56. ICNU also cites the Commission's statement in the 1999 Avista rate case that actual expenses may vary from year to year based on actual levels of hydro-conditions and the like.[142]

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[138] *WUTC v. Puget Sound Power & Light Co.,* Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 35 (Sept. 1993).
[139] Initial Brief of ICNU ("ICNU Br.") ¶10.
[140] *WUTC v. Avista Corp.*, Docket Nos. UE-010395, Sixth Supp. Order at ¶32-34 (Sept. 2001).
[141] *Id.* ¶35.
[142] ICNU Br. ¶10 (citing *WUTC v. Avista Corp.*, Docket Nos. UE-010395, Sixth Supp. Order at ¶35 (Sept. 2001)).

However, it is clear that even with the best estimates of expected rate year gas prices and "normal" hydro conditions, actual gas prices and hydro conditions may turn out to be different.[143] Moreover, in the same paragraph of the order ICNU cites, the Commission states that "[r]ates are set to recover the *expected level*" of power costs.[144] The Commission also described generally the types of adjustments to be made to the test year to "make it a *better predictor* of what the Company *can expect its operations to cost* in the rate year."[145]

57. These orders provide no support for ICNU's attempt to change the Commission's and the Company's historic practice of developing *pro forma* projected power costs. ICNU cites no order in which the Commission has rejected projected power costs in favor of some different, "typical" or "normal" cost.

ii. Re-running the AURORA Model.

58. Calculation of the impact on the Company's revenue requirement of the gas price projections adopted in this proceeding may require a re-run of AURORA.[146] However, the Commission should be aware that this cannot be readily performed with a single gas price input. Because gas prices fluctuate during the course of a year, and because AURORA utilizes gas price data from eight market hubs, monthly gas prices for each hub is input into AURORA in order to obtain realistic cost projections.[147]

59. Re-running AURORA should not be problematic if the Commission's order in this

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[143] *See, e.g.*, TR. 653:18 – 654:11 (Dubin).

[144] *WUTC v. Avista Corp.*, Docket Nos. UE-991606, *et al.*, Third Supp. Order at ¶34 (Sept. 2000) (emphasis added).

[145] *Id.* at ¶26 (emphasis added); *see also id.* at ¶29.

[146] Staff Br. ¶89.

[147] *See, e.g.*, Exh. No. 79 27-28 (Ryan) (discussing "Areas" inputs in defining existing resources, including "fuel costs, hydro parameters, and load curtailment 'resource'").

proceeding specifies a forward market gas price methodology such as those proposed by Staff and the Company in this proceeding, along with the length and ending date of the underlying NYMEX strip. Both the Company and Staff calculated the power cost impact of their proposals by taking the NYMEX data for the strip length and ending date of their proposals and inputting into AURORA the monthly (rather than average) NYMEX data adjusted for Sumas and the other seven basin differentials. The Company could replicate this process for the ordered forward price strip methodology and dates, although that would likely add a day or two to the re-run process to gather and input the data into AURORA. By contrast, if the Commission's order contains only a single gas price, a methodology would have to be developed to shape this price to the various months and hubs. The Company and parties might be able to agree on such a methodology, or the Commission could decide that issue if the parties cannot agree.

60. The Company asks the Commission to take the issues described above into account when it "state[s] in its final order . . . the date by which the compliance filing must be made and the effective date that should appear on any tariff sheets that are required as part of a compliance filing,"[148] and in order to leave sufficient time between the issuance of the order and the end of the suspension period.[149] The Company also requests that the Commission schedule an order conference for a date shortly after the final order is issued to clarify inputs that the final order requires for the AURORA re-run, if necessary.[150]

a. Gas Costs

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[148] WAC 480-07-883(3)(a).

[149] In addition, it generally takes two to three days to rerun AURORA with new inputs and another day to recalculate power costs based on the AURORA results, plus another three days to spread the total revenue requirement to rates and generate the tariff sheets required for a compliance filing.

[150] WAC 480-07-840.

61. Staff and the Company agree on the methodology of using forward market prices, but do not agree on the months that should be used to determine gas prices. By contrast, ICNU proposes to use old price forecasts for years well beyond the rate year. The testimony of Staff witness Dr. Mariam supports the Company's evidence that forecasts based on industry fundamentals are not a good indicator of gas prices that will prevail during the rate year.

62. Staff's Initial Brief incorrectly states that the Company alleges only that Staff's analysis is not relevant to the Company's forecasting needs.[151] In fact, Dr. Dubin noted errors in Dr. Mariam's computer programming,[152] his misinterpretation of regression results,[153] and his exclusion of some months in 2004 from his average of three-month average prices based on the claim that prices for those months were "biased."[154]

63. Staff's stated concern on brief and at the hearing about forward gas market inefficiencies is confusing, at best, given that Dr. Mariam's prefiled direct testimony and analysis did not raise any such concerns[155] and, in fact: (1) concluded that "using up to three months of forward price strips to estimate forward spot prices is relatively efficient, or robust. . . .";[156] and (2) argued that "using rolling averages for about five months as a predictor of spot prices in the next six months is a sound assumption" based on arguments by some researchers that "forward prices of up to six

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[151] Staff Br. ¶93 (citing Exh. No. 125 2:18-23 (Dubin)).

[152] Dr. Mariam stated on the stand that correction of these errors did not materially change the results of Staff's recommendation, but he offered no errata testimony or workpapers to support that statement. TR. 724:15-19 (Mariam).

[153] Staff incorrectly states that the Company "admits . . . that it . . . misunderstands the results of Staff's regression analysis." Staff Br. ¶98. In fact, Dr. Dubin proactively volunteered on the stand that he had misunderstood a test of normality that was provided by Staff in workpapers without documentation, which led him to criticize that aspect of Staff's work in his rebuttal testimony. Dr. Dubin removed from his testimony the portion implicated by his error. The suggestion that Dr. Dubin's error impacts other aspects of his challenge to Staff's regression analysis or exclusion of post-April 2004 data is incorrect and not supported by the record. TR. 614:3-15 & 633:4 – 634:6 (Dubin); Exh. No. 125 3:3-4, 6:19-20, 12:2 – 22:6 & 23:3-6 (Dubin).

[154] Exh. No. 125 2:18 – 3:4, 6:1-20, 12:12 – 15:19, 17:10 – 22:6 & 23:3-6 (Dubin).

[155] Exh. No. 451 27:8 – 33:19 (Mariam).

months could be used as estimator of forward spot prices."[157] In support of its market inefficiency claim, Staff cites to a single research paper[158] that is contradicted by the weight of other research to date.[159]

64. Staff asserts that it is "not forecasting future gas prices" but rather merely "estimating an average price that will prevail during the rate year."[160] This is a distinction without a difference for purposes of this proceeding. A rate case requires some gas price input to forecast or estimate power costs during the rate year.[161]

65. Staff incorrectly claims that the Company "ignore[d]" evidence of the sharp increases in forward prices after April 2004.[162] Dr. Dubin and Ms. Ryan considered and analyzed Dr. Mariam's claim that the post-April 2004 data should be excluded. While Dr. Mariam merely examined a graph showing the price increases and inferred bias, Dr. Dubin tested the data and found no bias.[163] Similarly, Ms. Ryan concluded that there was no seasonal pattern to gas prices that would indicate that April through July prices should be excluded from a gas price forecast.[164]

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[156] Exh. No. 451 29:18 – 30:2 (Mariam).

[157] Exh. No. 451 30 n.1 (Mariam). Dr. Dubin analyzed Dr. Mariam's statistical analysis, then undertook his own analysis that looked directly at the correlation between forward price strips of varying length and subsequent spot market prices at various points in time after the forward market prices. Exh. No. 125 16:1 – 20:1 (Dubin). Dr. Dubin further studied the issue of gas market efficiency in response to a data request regarding his rebuttal testimony that was later provided to him as a cross examination exhibits. *See* Exh. No. 128 (Dubin); TR. 621:18 – 622:5, 647:4 – 654:24 (Dubin).

[158] Staff Br. ¶94 n.144 (citing Ex. 128 3-14).

[159] *See* TR. 649:4 – 652:2 (Dubin).

[160] Staff Br. ¶94.

[161] Staff's statement that "it is implausible to forecast gas prices for a future period of time," Staff Br. ¶95, is astonishing, given the numerous commodities traders, consulting companies, gas and power utilities, and other entities and persons that are engaged on a regular basis in exactly that task. The fact that such forecasts are not likely to be exactly correct does not make the task "implausible," particularly when forecasting rate case power costs, as the important point is to be as close as possible to correct on average, without any systematic bias in one direction or the other. *See, e.g.* TR. 653:18 – 654:11 (Dubin).

[162] Staff Br. ¶99.

[163] Exh. No. 451 30 n.1 (Mariam); Exh. No. 125 19:18 – 23:6 (Durbin); TR. 660:5 – 661:8 (Durbin).

[164] Exh. No. 82C 23:2 – 24:9 (Ryan).

66. Staff claims that the PCA mechanism will limit the Company's losses due to extreme price fluctuations, thus Staff's recommendation will not "reduce[] unnecessarily the Company's cash flow by setting gas prices too low . . .,"[165] yet Staff acknowledges the importance of "allow[ing] the Company to recoup sooner than later cash flow to purchase fuel."[166] Any implication that the PCA mechanism addresses the Company's cash flow concerns associated with purchasing fuel to serve its customers is incorrect and not supported by the record.[167]

67. Similarly, ICNU's description of the sharing bands under the PCA mechanism does not make clear that these bands operate on an *annual* basis.[168] Thus, if the power cost baseline is set too low, the Company would have to absorb $20 million or more in excess power costs *each year*. ICNU's claim that this sharing is "somewhat illusory" because of the $40 million cumulative cap disregards the significant financial impact on the Company of having to absorb that $40 million (and more, due to the Tenaska disallowance). It also ignores that the Company and its investors are already looking ahead to the increased excess power cost risks the Company will be facing as of expiration of this cap on June 30, 2006.[169]

68. Staff also speculates that "setting the base price too high also may motivate suppliers to refuse to negotiate contracts below the base price."[170] This proposition is not supported by any citation to the record, and Staff has not presented any witness in this proceeding to speak to the issues the Company is facing with respect to wholesale market counterparties.

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[165] Staff Br. ¶100 (citing Ex. 451 32:1-12 (Mariam)).
[166] *Id.* 32:15-16.
[167] Company Br. ¶75.
[168] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-011570, *et al.*, Twelfth Supp. Order, Exhibit A to Settlement Stipulation (June 2002) ("PCA Settlement") at ¶3.
[169] TR. 212:7-24 (Valdman); Exh. No. 154 21:6-16 (Valdman).
[170] Staff Br. ¶100.

69. ICNU advances a number of criticisms of the use of NYMEX forward market data to forecast rate year gas prices based on assertions that it supports only by citing two paragraphs from the Commission's Order No. 12 in the PCORC proceeding.[171] Review of the cited paragraphs shows that the Commission was merely reciting ICNU's allegations in the PCORC proceeding, not finding them to be true. This is not evidence.

70. ICNU also claims that NYMEX prices are not robust with respect to forecasting prices in the later months of the rate year.[172] Dr. Dubin analyzed this claim and concluded that ICNU's concerns were not supported by the data.[173] In any event, this concern further supports the Company's recommendation that the Commission utilize forward market data as close in time to the rate year as possible to forecast rate year gas prices.[174]

71. ICNU claims that the Company's gas price projections should be rejected because the power cost baseline set in this case may be in effect for longer than the rate year.[175] Again, ICNU ignores the importance of the Company recovering in rates its expected power costs during the rate year. Moreover, the Company's rate year projections are better indicators of prices that are likely to prevail in the 2006 time period than is ICNU's gas price projection based on stale fundamental forecasts for the 2006 through 2011 time period.[176]

72. ICNU also argues that if the Commission accepts the Company's gas price proposal, it should require the Company to update the gas price no later than the expiration of the cumulative

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[171] ICNU Br. ¶16.
[172] ICNU Br. ¶20.
[173] Exh. No. 125 23:18 – 25:8 (Dubin).
[174] Exh. No. 125 24:7-19 (Dubin); Exh. No. 82C 21:6-12 (Ryan).
[175] ICNU Br. ¶12.
[176] Initial Br. ¶¶80-81; Exh. No. 371HC 17:13 – 18:13 (Schoenbeck).

PCA cap on June 30, 2006.[177] The Company does not object conceptually to updating its gas price forecast, and believes in any event that the gas price forecast is likely to be updated before the expiration of the PCA cumulative cap.[178] However, it is possible that the Company's next rate proceeding will be a general rate case rather than a PCORC, and it is also possible that that proceeding could be underway but not yet completed by June 30, 2006. Absent a PCORC or general rate case, it is not clear how the gas price forecast could be updated. The Company does not believe it would be workable or appropriate to have its "gas price expire" as of June 30, 2006.

c. Oil Costs

73. ICNU first questioned oil costs for the Company's combustion turbines (CTs) in its cross-examination of Ms. Ryan at hearing.[179] ICNU's Initial Brief erroneously argues: (i) that AURORA already incorporates peaking temperatures such that the Company's proposal results in "double counting" these peaking costs; and (ii) that the oil expense issue in this proceeding presents the same questions as the power cost items that the Commission removed in prior rate cases. The Commission should accord no weight to ICNU's belated proposed adjustment.

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[177] ICNU Br. ¶¶12, 19.
[178] TR. 162:24 – 163:4 (Reynolds); TR. 762:5-24 (Story).
[179] TR. 883:12 – 884:4 (Dodge/Van Cleve).

i. The Company Is Not Double Counting Peaking Costs

74. AURORA is used to predict hourly variable costs of serving normalized load; however, other costs must be added to fully capture the Company's projected power costs.[180] The $12.75 million represents an allowance for costs during the months of November 2005 through February 2006 for either burning oil in its CTs or purchasing power in the wholesale market to serve peak loads or purchasing gas in the wholesale market to generate additional power.[181] Because the 200 hours of oil burn are a proxy for such costs, ICNU's table showing the actual amount of oil burned by the CTs over the past ten years[182] presents an incomplete picture of the historical costs that the Company has actually incurred for such peaking costs.[183]

75. ICNU is flatly incorrect that "the temperature extremes that PSE uses to justify the oil expenses are included in the normalized loads included in AURORA," and is also incorrect that "the cost of serving loads associated with the oil expense is already included in the AURORA results."[184] ICNU's statements contradict its earlier description of AURORA, which is that AURORA predicts the costs of "serving *normalized* loads."[185] As Ms. Ryan testified at hearing, the oil costs requested by the Company are *not* reflected in the output from AURORA.[186]

76. ICNU apparently reaches its erroneous conclusion by confusing two entirely different

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[180] TR. 871:24 – 872:15, 875:9-21 & 877:22 – 878:22 (Ryan); Exh. No. 101 (Ryan).

[181] TR. 874:7-15 & 954:18 – 955:15 (Ryan).

[182] ICNU Br. ¶¶31-32.

[183] TR. 886:21 – 887:17 (Ryan). If the Commission were to limit the Company's oil cost recovery to the historical burn amounts shown in ICNU's table, the megawatt hours the CTs ran multiplied by the Company's inventory costs for the oil in the CTs, would be $3.87 million based on the 1994-2003 data including the year 2000 and $2.15 million based on the 1994-2003 data excluding the year 2000.

[184] ICNU Br. ¶29.

[185] ICNU Br. ¶22 (emphasis added).

[186] TR. 876:10-14 (Ryan). Ms. Ryan's answer was provided subject to check, but, unlike some of the other "subject to checks" on which Ms. Ryan submitted an affidavit, this testimony needed no subsequent correction. Later in the

processes involved in developing proposed rates: (i) adjustments to test year loads in order to develop pro forma revenues for the rate year; and (ii) forecasts of normalized rate year loads in order to develop projections of power costs during the rate year. With respect to the former, the Company looks backward at temperatures and loads that have occurred (including extreme temperatures) to develop coefficients stating the relationship between temperature and load. The Company then applies those coefficients and data regarding "normal" weather to the revenues that the Company actually billed during the test year.

77. This is the process the Company described in response to ICNU's records requisition: "Identify where revenues associated with peaking events are located in PSE's pre-filed case":[187]

> The coefficients used for developing temperature normalized monthly *test year billed loads*, therefore, reflect the entire range of temperature extremes experienced during the historic period, and the temperature normalized loads developed using these coefficients, reflect this entire temperature range.[188]

With respect to the Company's prefiled case, if the temperature extremes:

> had not been included, the temperature normalized loads would have been lower, and the revenues resulting from those temperature extremes would not have been reflected. If the temperature extremes were to be removed, the months, on average, would be warmer and normalized billed loads would be lower resulting in lower proforma revenues.[189]

ICNU's assertion that this records requisition response "conclusively demonstrates that the Company is double counting" is a misrepresentation or misunderstanding of the Company's response. The process for normalizing actual, historic test-year loads to develop pro forma

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hearing, Ms. Ryan explained that peaking costs are projected outside the AURORA model because its monthly gas price input does not permit it to effectively model demand spikes associated with peaking. TR. 953:16 – 954:1 (Ryan).

[187] Exh. No. 108 1; TR. 956:10-14 (Van Cleve).

[188] Exh. No. 108 1 (emphasis added).

[189] *Id.*

revenues does not support the proposition that anything other than normal temperatures are used to project rate year power costs in AURORA.[190]

ii. These Costs Should Not Be Removed.

78. In its prefiled direct testimony regarding call options for peaking events, ICNU acknowledged that capacity costs are an appropriate cost to build into rates;[191] the question is what amount is appropriate.[192]

79. The Company utilized the same method in this case for determining its capacity costs associated with running the CTs (or obtaining substitute power) as it did in its 2001 rate case and 2003 PCORC case. For the 2001 general rate case, the result was a cost of $7.43 million and for the 2003 PCORC, the result was a cost of $10.85 million, as compared to the $12.75 million requested in this case.[193] The increase is due to the rising price of oil. In both the 2001 rate case and the 2003 PCORC, these costs were included in the approved power cost baseline rate.

80. The cases cited by ICNU present a very different situation. In the 1985 case, the cost item was not peaking power costs themselves, but rather the operation and maintenance costs associated with running the CTs. Staff argued that the CTs had not been used for peaking in

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[190] Indeed, ICNU's questions on cross examination appeared to posit a theory that there was a "mismatch" between the Company's pro forma revenues in the case such that the Company was not reflecting additional revenues it would receive from peaking while at the same time recovering these peaking costs. TR. 878:23 – 880:12 (Van Cleve). The Company's records requisition response, Exh. No. 108, should have put that allegation to rest. But instead, ICNU raises the entirely new theory on brief that AURORA actually includes the temperature peaks when the record shows that it does not.

[191] Exh. No. 82C 16:4 – 17:5 (Ryan).

[192] Exh. No. 371HC 19:16-19 (Schoenbeck). *See also id.* 25:13-15 (Schoenbeck) ("The last general rate case stipulation adopted $11.2 million of reservation costs for option purchases in 2002."); *id.* 25:23-27 (peak transmission exchanges "provide important system benefits"). On rebuttal, the Company provided further evidence to support its peaking call options and reduced its requested peaking costs in connection with revised projected volumetric needs for the rate year and the current status of ongoing resource analysis and planning. Exh. No. 82C 15:13 – 16:3 (Ryan); Exh. Nos. 94C, 95C, 96C (Ryan). ICNU does not object to the Company's revised costs for peaking call options and transmission exchanges. TR. 990:12 – 991:10 (Schoenbeck).

recent years, thus it was not reasonable or prudent to assume that they would be run for 200 hours each winter (or implicitly to incur the associated operation and maintenance costs based on such an assumption).[194] In the present case, the 200 hours of CT use is merely a proxy or placeholder for peaking costs during the rate year, regardless of whether the CTs actually run.

81. In addition, the Commission directed that the challenged costs should be recovered through Puget Sound Power & Light Company's Energy Cost Adjustment Clause (ECAC) mechanism. The suggestion by ICNU and Staff that this is the same as requiring the Company's CT oil peaking cost proxy to be recovered through the PCA mechanism is incorrect. The ECAC provided for true ups every four months of the company's actual net energy costs, with any over- or under-recovery rolled into a power cost rate rider.[195]

82. Similarly, the Commission's determination in the 1992 rate case that "the PRAM is the appropriate place to recover" the costs associated with a 358 MW capacity purchase agreement[196] was made in a far different context. Like the ECAC, the Periodic Rate Adjustment Mechanism (PRAM) provided for a pass through of variable power costs[197] to "insulate[] the company from fluctuations in earnings that would occur through variations in energy consumption that are beyond the company's control."[198] In other words, in both those earlier cases, Puget Sound Power & Light Company was allowed to recover its actual costs, dollar for dollar.

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[193] Exh. No. 102C (Ryan), Exh. No. 101 lines 547 (Ryan); Docket No. UE-031725 Exh. No. 47 (WAG-20) lines 547 (comparing power cost projections from 2001-02 rate case to 2003 PCORC power cost projections).

[194] *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-85-53, Second Supp. Order at 40-41 (May 1986).

[195] *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-81-41, Second Supp. Order at 17-18 (Mar. 1982); *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-81-41, Sixth Supp. Order at 2-3, 26-27 (Dec. 1988).

[196] *WUTC v. Puget Sound Power & Light Co.,* Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 39 (Sept. 1993).

[197] *WUTC v. Puget Sound Power & Light Co.*, Cause Nos. UE-901183-T, et al. Third Supp. Order at 6, 8, 11-12, 17 (Apr. 1991).

[198] *Id.* at 8.

83. By contrast, the sharing bands in the Company's existing PCA mechanism require that the Company absorb $20 million of excess power costs on an annual basis before there is any deferral of costs to be recovered from customers, and the Company must absorb 50% of the next $20 million of power costs on an annual basis.[199] Under these circumstances, there can be no anticipation that capacity costs for peaking will be recovered through the PCA mechanism.[200]

84. Finally, ICNU's and Staff's description of the impact of including the Company's requested costs on ratepayers is misleading. ICNU claims that the Company's proposal "comes at a cost of $12.75 million per year to ratepayers" and also claims that "if PSE actually experiences the temperatures and loads upon which this oil burn is premised, the cost of that oil will be flowed through the PCA."[201] These claims ignore the fact that the PCA is not like the ECAC or the PRAM—costs that "flow through" the PCA[202] are not necessarily recovered by the Company.

85. Staff makes the additional claim—unsupported by any record cite—that during a peaking event, the Company would "sell additional KWh and retain more revenues, which would more than offset the incremental cost of oil *and* any associated fuel cost deferral the Company would potentially absorb under the PCA mechanism."[203] Such revenues would be taken into account in the PCA true up through the adjustment to actual delivered load during the PCA year.[204]

86. The Company's $12.75 million in oil costs for peaking capacity does not represent "double counting" of costs, is appropriate for inclusion in general rates in establishing the power costs

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[199] PCA Settlement at ¶¶2-4.

[200] As described above and in the Company's Initial Brief, the current $40 million cumulative cap should not be invoked as a reason to treat the PCA mechanism as though it were a mechanism like the ECAC or PRAM.

[201] ICNU Br. ¶26.

[202] *Id.*; Staff Br. ¶105.

[203] Staff Br. ¶105.

[204] PCA Settlement, Exh. B, line 30.

baseline, and should not be removed from the Company's revenue requirement in this case.

d. Hydro Normalization

87. The Commission should adopt the 50-year dataset recommended by Staff and the Company for the reasons set forth in Staff's Initial Brief at ¶¶ 107-113 and in the Company's Initial Brief at ¶¶ 84-86.

88. The Commission's 1992 rate case order did not bar the Company from raising the hydro issue in future proceedings; rather it put the Company on notice that it must make a convincing presentation if it raised the issue again.[205] Similarly, in Avista's 1999 rate case, in which Avista proposed the use of the 60-year water record, the Commission approved a stipulation under which Avista and Staff agreed to use the 40-year rolling average only for that proceeding. The stipulation further provided that Avista could propose modification to the 40-year rolling average in a future proceeding, if Avista "provide[s] in its direct filing full documentation supporting its proposed change in methodology."[206] Thus, the Company retained an expert statistician to review the issue and submitted extensive evidence on the issue in its prefiled direct case.[207]

89. Public Counsel claims that "[n]either Dr. Dubin nor Dr. Mariam have explained away the fact that essentially all other normalization in the case is based on the use of multi-year rolling

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[205] *WUTC v. Puget Sound Power & Light Co.,* Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 43 (Sept. 1993).

[206] *WUTC v. Avista Corp.*, Docket Nos. UE-991606, *et al.*, Third Supp. Order at ¶148 (Sept. 2000). There was no requirement in the 1992 rate case or the Avista stipulation that the Company or Avista "convene a collaborative" in order to revisit the hydro issue. In the present case, the Company has properly requested relief from the Commission on an issue with significant financial implications through a rate case proceeding. Other companies were free to intervene, but are also entitled to expend their resources on issues or proceedings that might be of higher priority for them than the hydro issue.

[207] The requirement that the Company affirmatively present such evidence contributed in part to the costs of putting on this rate case, which ICNU and Public Counsel criticize for being excessive.

averages."[208] This claim reflects a fundamental misunderstanding of the testimonies of Dr. Dubin and Dr. Mariam, which noted the tendency of rolling averages to distort statistical analyses and criticized exclusion of a number of dry water years based on the erroneous conclusion that these years were abnormal.[209] The examples of normalization that Public Counsel cites do not involve statistical analyses.[210]

90. ICNU's proposed 120-year data set should be rejected for the reasons set forth in the Company's Initial Brief at ¶ 86.

e. BPA Transmission Rate

91. The Company discussed the reasons its proposed adjustment should be adopted in its Initial Brief at ¶¶ 87. Staff ignores evidence that if the proposed settlement is not approved, the result would be even higher transmission rates than those proposed by the Company.[211]

4. Adjustment 2.10—Miscellaneous Operating Expenses[212]

a. Incentive/Merit Pay and Associated Payroll Taxes

92. The Company addressed this issue at ¶¶ 90-94 of its Initial Brief. Staff incorrectly implies that the Company has proposed to include in rates the $6,647,172 amount booked during the test period rather than the Company's proposed prorated amount of $3,440,174.[213]

93. Staff argues that its removal of a portion of incentive payments tied to earnings is consistent with Commission precedent that "[p]lans which do not tie payments to goals that

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[208] Public Counsel Br. ¶114.
[209] Exh. No. 111 12:17 – 19:16 (Dubin); TR. 640:12 – 643:11 (Dubin).
[210] TR. 791:14 – 792:6 (Story).
[211] Staff Br. ¶118; TR. 963:16 – 964:10 (Schoenbeck).
[212] This adjustment mirrors Adjustment 2.07–Miscellaneous Operating Expenses on the gas side.
[213] *Compare* Staff Br. ¶124 *with* Company Br. 90 and TR. 809:19 – 810:8 (Parvinen).

clearly and directly benefit ratepayers will face disallowance in future proceedings."[214] This argument ignores the uncontested evidence that the Company's plan does in fact tie payments to customer service, service quality, safety, reliability and efficient operations.[215]

b. Deloitte Fee for Income Tax Advice

94. As discussed in the Company's Initial Brief at ¶¶ 95-96, the Deloitte fee is not a "non-recurring cost," but rather is indicative of ongoing costs incurred by the Company for engaging consultants to provide advice on tax issues.

95. Staff's alternative suggestion that the cost should be spread "over the 20-year tax life of the benefit"[216] is an entirely new argument on brief. Engaging consultants is a reasonable business practice to explore the potential availability of benefits or savings in a variety of areas regardless of whether work on a particular project results in an actual benefit or savings. Staff's treatment would create too great a tie between the fee for obtaining such services and the outcome of the inquiries, and would result in insufficient operating funds to support such efforts.

5. Adjustment 2.11—Property Taxes

96. The Commission should reject Staff's proposal to remove the Company's payment to the Oregon Department of Revenue for property taxes related to the 3rd AC transmission line.[217] Instead, the Commission should accept the compromise approach to which Staff has agreed in its Initial Brief, which is to net the one-time Oregon tax payment against the one-time Montana tax refund and permit the Company to recover the result in rates over three years. To accomplish this, the Commission should accept the Company's property tax adjustment and add one third of

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[214] Staff Br. ¶125.
[215] Company Br. ¶92.
[216] Staff Br. ¶129.

the Montana Corporate License Tax refund to the Miscellaneous Operating Expense, Adjustment 2.10, which will increase net operating income $409,933.[218]

7. Adjustment 2.18—Rate Case Expense[219]

a. Cost Treatment (deferral and amortization vs. expense)

97. As the Company pointed out in its Initial Brief, deferral and amortization of rate case costs has been this Commission's historic practice, and that practice is consistent with other jurisdictions' treatment of rate case costs.[220]

98. Staff claims that the Company "has been on both sides of this debate" because the Company deferred the costs for this general rate case, but also filed an accounting petition to defer the costs of the 2003 PCORC.[221] The Company's 2003 PCORC accounting petition demonstrates its intent to comply with the Twentieth Supplemental Order.[222] The Company affirmatively sought Commission authorization to defer costs associated with the 2003 PCORC proceeding, which was a new type of costs, whereas it understood that it already had Commission authorization to defer general rate case costs.[223] In addition, the Company's agreement with

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[217] Company Br. ¶¶97-98; Exh. No. 237C 17:12 – 19:1 (Story).

[218] Exhibit 237 20:21 (Story) ($1,892,000/3*.65).

[219] This adjustment mirrors Adjustment 2.10–Rate Case Expense on the gas side.

[220] Company Br. ¶¶100-101. ICNU cites two recent water utility cases. ICNU Br. ¶58. The Company notes that in one, the issue was whether costs for a prior case that the company had withdrawn should be added to the costs for the current case. *WUTC v. Rainier View Water Co.*, Docket No. UW-010877, Third Supp. Order at 23-24 (May 2002). It does not appear that in either case, particular attention was given to the question of what accounting treatment rate case costs ought to have.

[221] Staff Br. n.21; *see also* ICNU Br. ¶56.

[222] *WUTC v. Puget Sound Power & Light Co.,* Cause Nos. UE-920433, *et al.*, Twentieth Supp. Order at 20-21 (Dec. 1993). Staff, like ICNU, argues that "the Prudence Review was part of a general rate case and recovery of rate case costs was an issue the Commission cited expressly as recurring throughout the case." Staff Br. n.220. But the discussion in the Eleventh Supplemental Order in that docket on rate case costs had nothing to do with any concerns about deferral accounting for rate case costs. *WUTC v. Puget Sound Power & Light Co.,* Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order at 67-69 (Sept. 1993). Instead, the Commission's concern was that the Company had treated a variety of other expenses in this manner, such as self-insurance and storm damage.

[223] TR. 760:4-9 (Story).

Staff's recommendation to expense and normalize PCORC costs going forward does not mean that general rate case costs should be treated in the same matter. PCORCs are much more limited and shorter proceedings, while general rate cases are significantly more expensive, lengthy, and intermittent.[224]

99. Staff argues that normalizing and expensing rate case costs "reverses the perverse incentive under deferred accounting for PSE to ignore rate case cost control."[225] Deferred accounting does not mean that all costs so deferred will be approved for recovery in rates.[226] Due to the potential for disallowance, the Company has a significant incentive to control such costs.

b. Amount for Recovery

100. Staff proposes no disallowance to the costs the Company incurred for this case. If the Commission accepts Staff's proposal with respect to cost treatment, Staff's adjustment should be "revised for PSE's new estimate of 2004 rate case costs"[227] in the amount of $3,054,844.[228]

101. Staff does, however, join other parties in raising general concerns about the "high level" of costs incurred by the Company in rate cases.[229] Staff and ICNU both point to the Commission's *1992 rate case order* to support their allegation that litigation costs at the Company are "out of control" *in 2004*.[230] The record in this proceeding demonstrates that the Company has

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[224] TR. 760:23 – 762:24 (Story).

[225] Staff Br. ¶140; *see also* ICNU Br. ¶¶44, 57.

[226] *See, e.g.* ICNU Br. n.89. ICNU is incorrect that the Company earns a return on the deferred balance. ICNU Br. ¶46. The Company begins earning a return on rate case costs only after they are approved for recovery in rates. TR. 758:9-23 (Story). It is this post-approval return, during the period of time that the approved and amortized costs are being recovered, that Staff now seeks to prevent from earning any return.

[227] Staff Br. ¶136.

[228] Exh. No. 238C 23:8-12 (Story); Exh. No. 265 (2.10):9-12 (Luscier).

[229] Staff Br. ¶140.

[230] Staff Br. ¶141. Incredibly, Staff describes the block quote in this paragraph of its brief as "sharp criticism in a Company internal investigation." But the record cite, Exh. No. 240 56, shows that the quoted language was copied from

undertaken significant efforts since 1992 to control its legal expenses.[231]

102. For example, following the merger that created the Company, the Company added an internal Legal Department and has evaluated and implemented strategies for reducing legal costs, including diversifying the counsel that represent it, negotiating fixed fee agreements and handling more work in-house.[232] Remarkably, ICNU seeks to use these efforts to the Company's disadvantage by quoting isolated excerpts from a 2003 Legal Budget Analysis.[233] Review of that presentation in total confirms that the Company is managing its legal costs.[234] Moreover, a number of the recommendations made in 2003 have been implemented.[235]

103. Rate cases are precisely the type of case that are least likely to be brought in house because they require extensive, but intermittent, deployment of resources.[236] Although rate cases are outsourced, the Company works to control these costs.[237] The Company notes that it incurred $5.34 million for its 2001 general rate case, $2.28 million more than it is requesting here.[238] Furthermore, the $3 million in rate case costs the Company requests in this case are some $1.74 million less than the estimate filed in the Company's direct testimony in April 2004.[239]

104. ICNU criticizes the "$647,703 that PSE spent on testimony related to cost of capital and

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the Commission's order in the 1992 rate case and pasted into a power point slide used by the Company's General Counsel as part of a presentation on additional steps the Company could take to control its legal costs.

[231] Company Br. ¶105; Exh. No. 237C 31:7-23 (Story); Exh. No. 240C (Story).

[232] Exh. No. 240C (Story).

[233] ICNU Br. ¶62.

[234] Exh. No. 240C 25-49 (Story).

[235] *Compare* Exh. No. 240C 38, 41, 44 (Story) *with* 240C 2 (Story).

[236] Exh. No. 237C 30:21 – 31:6 (Story); Exh. No. 240C 47 (Story); *see also* Exh. No. 249 (Story) (variability of Perkins Coie attorney hours and invoice amounts for this case from 11/2003 through 11/2004); Exh. No. 247C 23-49, 63-83, Supp. Exh. No. 247C 12-16, 20-26 (Story).

[237] Exh. No. 237C 30:13-20 (Story); Exh. No. 240C 3 (Story).

[238] Exh. No. 244 (Story).

[239] Exh. No. 246C (Story). As of December 10, 2004, the Company had actually paid $2,318,413 for rate case costs, generally representing services received through November 2004. Given the subsequent hearing preparation,

other issues."[240] This total includes amounts paid by the Company as of December 10, 2004 for services performed by the teams of both Dr. Cicchetti ($475,047) and Dr. Dubin ($173,656).[241] Given the Commission's prior direction with respect to raising the hydro issue, it was appropriate for the Company to retain Dr. Dubin. Dr. Dubin's scope of services was expanded to the gas price issue only to rebut the statistical analysis and testimony of Staff witness Dr. Mariam.[242] With respect to Dr. Cicchetti, it is not reasonable to base the amount the Company is entitled to recover for its ROE expert by reference to the amounts that Staff and Public Counsel paid their experts. Dr. Cicchetti undertook and presented a careful and detailed analysis of the Company's unique circumstances and risks and its position within the industry. He also had to respond to both Staff's and Public Counsel's experts and extensive data requests regarding his analysis.

105. The other parties complain that they cannot devote this level of resources to the Company's rate cases. However, the intervenors can limit and focus their efforts to issues of specific importance to their constituents, and do not have the burden of proof. By contrast, the Company's entire operations and financial health are on the line when it files a rate case. The fact is that filing a general rate case for the Company's combined gas and electric operations and defending that case is a massive undertaking.[243]

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hearings, and briefing, the $3 million the Company requests is a reasonable estimate of the total costs it will incur for this case.

[240] ICNU Br. ¶61.

[241] Exh. No. 249 2 (Story) (PEG invoices for Dr. Dubin designated "Dubin" or "JAD"); *see also* Exh. No. 247C 13-22, 56-62, Supp. Exh. No. 247C 9-10 (Story); TR. 305:5 – 306:22 (Cicchetti).

[242] Exh. No. 249 2 (Story); TR. 694:1-7 (Dubin).

[243] That undertaking has become significantly more burdensome and expensive since Puget Sound Power & Light Company's 1992 rate case, due to factors including: (i) the need to present evidence on the gas and the electric operations; (ii) the greatly expanded role and complexity of risk management activities; and (iii) the concern that a failure to present sufficient evidence in its direct filing will lead to charges that the Company has failed to carry its burden to demonstrate the prudence of its costs. When questioned about his review of the Company's 2004 rate case

106. The Commission should reject calls to disallow a portion of the Company's requested rate case costs. It should also reject ICNU's proposal that the Commission further require the Company's shareholders to absorb 50% of rate case costs. As described in the Company's Initial Brief at ¶¶ 103-104, such an adjustment would be arbitrary and unlawful.

8. Adjustment 2.20—Property and Liability Insurance[244]

107. Staff agrees with the Company that test period and estimated insurance costs should be updated to actual.[245] In its rebuttal filing, the Company added $300,000 of costs related to a new policy and subtracted $4,389 of costs related to a cancelled policy.[246] The evidence Staff cites contradicts its claim that the Company "excluded a refund related to the associated canceled policy,"[247] because the Company included the refund.[248] There is also no basis in the record for Staff's argument that the Company's addition of a new insurance policy "may be offset by factors such as reduced risk or reduced levels of reserves."[249]

9. Adjustment 2.22—Wage Increase[250]

108. The Company agrees that Staff's calculation of slippage is correct, rather than the Company's.[251] However, as described below and in its Initial Brief at ¶¶ 107-108, the Company does not agree with removal of the pro forma 2005 wage increase for its non-union employees. Staff's claim that the pro forma 3% wage increase is not known and measurable is incorrect. Staff

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costs, Mr. Russell stated that rate case costs generally have "been in that range, million-dollar-plus range." TR. 829:20 – 830:8 (Russell).

[244] Electric Adjustment 2.20 mirrors Gas Adjustment 2.11.

[245] Staff Br. ¶146.

[246] Exh. No. 264 6:17-23 (Luscier); Company Br. ¶106.

[247] Staff. Br. ¶146.

[248] Exh. No. 264 6:21-22 (Luscier).

[249] Staff Br. ¶147.

[250] This adjustment mirrors Adjustment 2.13–Wage Increase on the gas side.

[251] Staff Br. ¶150.

refers only to the fact that wage increases for individual employees become effective in March 2005.[252] The evidence shows that while individual employees may receive differing percentage wage increases in approximately March of each year based upon performance reviews and calibration of performance to the overall merit pay budget, the Company's proposed overall 3% increase is consistent with its historic annual increases in non-union salaries, is at the low end of industry standards, and should be recovered in rates.[253]

109. Adoption of the Company's inclusion of its pro forma wage increase for non-union employees along with Staff's slippage calculation would result in a decrease to electric net operating income through Electric Adjustment 2.22 of $2,348,089, and a decrease to gas net operating income through the corresponding Gas Adjustment 2.13 of $1,218,086.[254]

10. Adjustment 2.23—Investment Plan[255]

110. Adjustment 2.23 should be revised consistent with the Company's agreement with the Staff's slippage calculation, described above.[256] The impact on Electric Adjustment 2.23 is to decrease electric net operating income by $98,366, and the impact on the corresponding Gas Adjustment 2.14 is to decrease gas net operating income by $54,995.

B. Rate Base, Deferred Taxes and Working Capital—Electric

111. The Company discussed this issue at ¶¶ 111-112 of its Initial Brief. Consistent with the

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[252] Staff Br. ¶149; TR. 601:6-8 (Hunt).

[253] Exh. No. 333 7:10 – 8:16 (Hunt). Exh. No. 267 2 (Luscier) does not precisely show the overall annual merit pay increase because its data on total non-union salaries is impacted by employees joining and leaving the Company. *See* TR. 601:5 – 603:12 (Hunt). Nevertheless, that exhibit further supports Mr. Hunt's testimony that the Company has in recent years consistently actually paid a merit increase in the range of the requested 3% adjustment for this case. Exh. No. 267 2 (Luscier) (Jan. 99 2.39%, Mar. 00 3.15%, Mar. 01 2.23%, Jul 02 1.66%/Aug 02 1.16%, Mar. 03 3.48%, Mar. 04 3.60%).

[254] *See* Exh. No. 443 14 (Parvinen), changing line 18 to 3% and line 1 to 4.83%.

[255] This adjustment mirrors Adjustment 2.14–Investment Plan on the gas side.

[256] Company Br. ¶109.

approach taken by Staff and ICNU in their Initial Briefs, the Company responds to their arguments on working capital issues associated with rate case costs in Section IV(A)(7), above.

112. With respect to the $72 million deduction for deferred Federal income taxes that Staff and the Company have removed from rate base, Staff argues that it would be "premature" to grant the Company's request to indicate the Commission's approval to restore the $72 million to rates if the Internal Revenue Service reverses the deduction.[257] It is not fair or reasonable to insist on taking the benefits of this deduction (which is still contingent)[258] while reserving for a future ruling – and presumably a potential disallowance argument – what should be a straightforward statement of the Commission's commitment to permit recovery of these funds if the Company is ultimately required to pay them to the Federal government.

C. Contested Adjustments—Gas

1. Adjustment 2.01—Revenue & Purchased Gas

113. The Commission should approve the Company's adjustment for the reasons stated in the Company's Initial Brief at ¶¶ 113-116. Staff's Initial Brief refers several times to the Company's 20-year data as a "rolling average," an implicit criticism given the discussion at hearing that use of rolling averages can produce cycles in data that do not actually exist.[259] This implicit criticism of the Company's data ignores that Staff's proposed 30-year NOAA dataset is also a rolling average.[260] Staff also incorrectly claims that the Company "has adopted NOAA's 30-year normal for its electric operations."[261] The cited evidence does not support Staff's proposition.

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[257] Staff Br. ¶¶154-155.
[258] Exh. No. 273C 5:19 – 7:1 (Story); TR. 777:13 – 779:9 (Story).
[259] TR. 641:24 – 643:11 (Dubin); TR. 718:3-23 (Mariam).
[260] TR. 710:20 – 711:4, 718:24 – 719:10 (Mariam). *See also* Company Br. ¶116.
[261] Staff Br. ¶160 (citing Ex. 451 39:1-3 (Mariam) and Ex. 453 4:5-13).

8. Adjustment 2.17—Gas Water Heater and Conversion Burner Rental Program

114. The Commission should reject Staff's proposed adjustments associated with the Company's gas water heater and conversion burner rental program, as stated in the Company's Initial Brief at ¶¶ 123-127. Staff argues that the Company's interpretation of paragraph 5 of the Water Heater Settlement[262] "defies logic and reason" because the first sentence refers to revenue requirement while the second sentence refers to revenues, operating expenses, and rate base related to rentals.[263] But it makes sense that the penalty for violating the bar on filing for additional revenue requirement associated with the program is more draconian than the bar itself. Otherwise, the other parties might be concerned that the Company would include such an increase in its filing and hope that the other parties would overlook it, with removal of the additional requested amount the only consequence of being discovered. By contrast, a penalty that requires removal of essentially the entire program from the Company's rates[264] would give the other parties confidence that the Company would not attempt to violate the settlement.

115. Staff's citation to the joint testimony presented in support of the Water Heater Settlement does not support its argument,[265] and instead supports the Company's position: that it agreed not to request an increase in the revenue requirement associated with the program. In fact, the

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[262] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-011570, *et al.*, Thirteenth Supp. Order, Exhibit A to Settlement Terms for Natural Gas Revenue Requirements, Including Common Cost Allocation, and Line Extension (Aug. 2002) ("Water Heater Settlement")

[263] Staff Br. ¶171-172.

[264] The Company notes that even if the Commission accepts Staff's arguments on this issue, Staff's proposed adjustment is flawed. Staff proposes to remove only $8,137,320 of revenues related to the rental program rather than the entire $14,438,632 of revenues associated with the rental program that were spread to rates in the 2001 rate case. *Compare* Exh. No. 443 18:3 (Parvinen) *with* Exh. No. 324 1 & 3:15-16 (Karzmar). If the entire amount were removed per Staff's arguments, the impact of Staff's proposed adjustment on the Company's revenue requirement deficiency in this case would be significantly less damaging.

[265] Staff Br. ¶173.

specific joint testimony Staff cites was introduced into the record in this proceeding as an exhibit to the testimony of Company witness Mr. Karzmar.[266] Nowhere in the joint testimony does it state that the Company has agreed to a stay out period or penalty related to the program if it files for general rate relief prior to September 1, 2005 for reasons unrelated to the program.[267]

116. The reference in the joint testimony to depreciation related to the water heater and conversion burner rental program concerns an entirely different paragraph of the Water Heater Settlement, paragraph 6, which specifically addressed depreciation issues.[268] This paragraph reflects the parties' agreement to adopt the new depreciation rates proposed by the Company in Docket Nos. UE-011570 et al., but with establishment of a minimum depreciation expense for rentals until September 1, 2005.[269] The Company is complying with Paragraph No. 6 of the Water Heater Settlement,[270] and no party challenges its implementation of this aspect of the Water Heater Settlement.

117. Staff argues for the first time on brief that if the Commission adopts the Company's interpretation of the Water Heater Settlement, "the test year level of depreciation expense related to water heater and conversion burner rentals [should] be maintained until the next general rate case."[271] This recommendation would violate paragraph 6 of the Water Heater Settlement and has no support in the record.

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[266] Exh. No. 323 4-5 (Karzmar).
[267] *Id.*
[268] Water Heater Settlement at 2, ¶6.
[269] Exh. No. 321 4:22-23 (Karzmar).
[270] Exh. No. 321 5:5-7 (Karzmar).
[271] Staff Br. n.269.

V. CATASTROPHIC EVENTS

118. Staff states that the agreed change to the IEEE standard "alone is a significant benefit to PSE since the IEEE methodology captures more storm-related damage than the current definition of a catastrophic storm."[272] That statement is correct only if the cost threshold is set low enough to permit deferral of storm costs that are not being deferred under the current definition.[273] The Commission should adopt the Company's cost thresholds.[274]

119. Staff argues that in some years, its proposed threshold could "make[] the Company better off than existing practice," pointing out that in the year 1999, the Company would have deferred $2.3 million *more* under its proposed trigger.[275] However, taking the year 2003 as an example, Staff's proposed $7 million threshold would have resulted in the Company deferring $3.4 million *less* than it deferred under the current definition.[276] The Company proposed to revise the current mechanism precisely in order to make the Company better off than existing practice.[277] According to Staff's statistical analysis, there is a 95% chance that annual O&M storm damage costs will not reach a level sufficient to trigger the deferral mechanism.[278] Moreover, Staff's analysis excludes millions of dollars of storm costs that the Company incurred because Staff included only O&M costs in its calculations and excluded additional amounts that the Company was able to defer under the existing mechanism.[279]

120. Staff claims that its proposal "balances properly the interests of the Company and

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[272] Staff Br. n.273.
[273] Exh. No. 139 4:15 – 5:17 (McLain).
[274] Company Br. ¶133.
[275] Staff Br. ¶180.
[276] Exh. No. 142, line "12/4/2003" (McLain).
[277] Exh. No. 131C 27:15-19, 28:14 – 30:21 (McLain); Exh. No. 139 2:5-8, 4:15 – 6:12 (McLain).
[278] *See* Staff Br. ¶181.

ratepayers," comparing the $4.6 million in storm damage costs that are to be embedded in rates to a hypothetical in which the Company incurs only $1 million in such costs in a year.[280] However, the evidence in this case shows that during the six-year period from 1998 through 2003, the Company incurred less than $4 million in storm damage costs only in a single year: 1998.[281] Staff's unrealistic hypothetical does not support its claim that its cost threshold trigger is fair or balanced. By contrast, the Company's proposed $5 million annual cost trigger can be expected to require the Company to absorb nearly half a million dollars annually in costs above those set in rates (in addition to absorbing costs for electric events that do not meet the IEEE standard) before it can take advantage of its proposed new deferral mechanism definition.[282] Thus, the Company is unlikely to "keep" any amounts recovered in rates that it does not actually incur in storm costs.

121. The Company requests that the Commission expand the deferral mechanism authority to natural events other than storms and to man-made events, as well as to the Company's natural gas system, as discussed in its Initial Brief at ¶¶ 134-35.

VII. PCORC COSTS (DOCKET NO. UE-031471)

122. The Company agrees that the question whether to approve deferral of the costs for Docket No. UE-031471 is moot.[283] The Commission should approve the Company's proposal to recover a normalized amount of $650,000 per year in rates.[284]

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[279] *See* Exh. No. 142 (*compare* "Avg max O&M" table figures *with* "September Ended Rate Case Adjustment Data," "Total" column figures).

[280] Staff Br. ¶¶183-184.

[281] Exh. No. 142 ("December Ended . . . Data").

[282] Exh. No. 139 5:9-17 (McLain); Exh. No. 142.

[283] Staff Br. ¶193.

[284] Company Br. ¶¶138-140.

123. The Company notes that ICNU also understood Staff's prefiled testimony to propose an amortized amount of $650,000 per year,[285] not the $216,666 per year reflected in Staff's NOI adjustment. ICNU claims that recovery of $650,000 per year in rates would be excessive, given that PCORCs are supposed to be processed within four months of filing.[286] However, a month or two is required to prepare a PCORC for filing and extensive discovery and rebuttal testimony ends up being compressed into this time period such that a PCORC legal team would likely be entirely occupied with the case for five or six months. The evidence shows that the Company would likely incur in excess of $650,000 in legal costs alone to prepare and prosecute a future PCORC proceeding, not including any external experts or consultants.[287]

124. Finally, ICNU argues that customers should not bear the risk of paying for a future PCORC proceeding in which the Commission finds imprudence. But if a PCORC filing turns into a prudence case, the costs are likely to significantly exceed $650,000 -- as evidenced by the 2003 PCORC costs of over $1.3 million.

IX. COMMISSION AUTHORITY TO APPROVE REVENUES ABOVE AMOUNTS PRODUCED BY THE TARIFF SHEETS FILED ON APRIL 5, 2004

125. Staff argues that the Commission does not have the legal authority to grant an increase in revenues related to electric service above the $81.6 million reflected in the Company's proposed tariff revisions filed on April 5, 2004.

126. The increase from the Company's original request of $81.6 million to its rebuttal request of $99.8 is due almost entirely to the Company's update of its gas price projections in its rebuttal

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[285] ICNU Br. ¶¶67, 69-70.
[286] *Id.* ¶70.

testimony to reflect new information about forward gas prices that was not available at the time the Company filed its original case. The Company prefiled that updated information on November 3, 2004, nearly six weeks prior to hearings.[288]

127. Staff does not object to the Company's additional evidence regarding an increased electric revenue requirement *per se*. As Staff recognizes, the Company is entitled to support its proposed rate increase with such evidence. Staff argues that the Company ultimately "may not collect revenues above the tariffs that are under suspension and noticed to the public."[289] Thus, Staff's legal objection is moot unless the Commission determines that the evidence before it supports an award granting an increase in electric revenues to the Company in excess of $81.6 million.

128. If the Commission reaches this issue, it should conclude that it is authorized to grant the requested increase. The Company provided appropriate notice when it filed its proposed tariff sheets for this general rate case with the Commission on April 5, 2004, 31 days prior to the proposed effective date of May 6, 2004.[290] Pursuant to RCW 80.28.060, such tariff sheets become effective as filed unless suspended prior to the proposed effective date.[291]

129. If the Company had wished to change any aspect of the tariff sheets prior to their proposed effective date without withdrawing and refiling its case, it would have had to file a transmittal letter and substitute tariff sheets, and would have been restricted from making a change that increased the rates proposed in the pending tariff sheets.[292]

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[287] Exh. No. 247C 31-36, Supp. Exh. No. 247C 12-16 (Story); Exh. No. 249 2 (Story) (Perkins Coie 4/30/2004 and 11/30/2004 invoices for preparation of general rate case direct and rebuttal filings).

[288] Exh. No. 237C 13:7-13 (Story); Exh. No. 80 11:9 – 12:2 (Ryan); Exh. No. 92 (Ryan); Exh. No. 93 (Ryan).

[289] Staff Br. ¶202.

[290] RCW 80.28.060, WAC 480-80-121, WAC 480-100-194 and WAC 480-07-510(2).

[291] *State v. Pub. Serv. Comm'n of Wash.,* 76 Wn. 492, 497-98 (1913).

[292] WAC 480-80-111.

130. However, the Commission suspended the proposed tariff revisions on April 28, 2004, for investigation and hearing.[293] At that point, the filing became an adjudicative proceeding, and entirely different statutory provisions and rules apply. An electric utility is not required to accomplish the publication referenced in RCW 80.28.060 and WAC 480-100-194 if its tariff filing is suspended and the utility provides notice instead under WAC 480-100-197, entitled "Adjudicative proceedings where public testimony will be taken."[294] WAC 480-100-197 provides that "the timing, location, and amount of notice to the public or to customers will be addressed in the prehearing conference order."[295]

131. Customer notice was addressed at the prehearing conference and was accomplished through direct mailings of notices to customers containing language to which the Company, Staff and Public Counsel agreed.[296] Pursuant to WAC 480-100-197, the notice contained information set forth in WAC 480-100-194(4),[297] including:

> A statement that *the commission has the authority* to set final rates *that may vary from the utility's request*, which may be either *higher* or lower depending on the results of the investigation.[298]

The prehearing conference order set forth notice requirements with respect to participants in the proceedings, by establishing a schedule for the prefiling of written testimonies and hearings.[299]

132. The statement in WAC 480-100-194(4) that the Commission may ultimately set rates at levels higher than initially requested is consistent with Washington statutes. Once the

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[293] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 01 (Apr. 2004).
[294] WAC 480-100-194.
[295] WAC 480-100-197(1).
[296] *See* TR. 47-48 (ffitch/Dodge).
[297] WAC 480-100-197(2).
[298] WAC 480-100-194(4) (emphasis added).

Commission suspends proposed tariff changes, "[t]he commission may prescribe a *different* rate . . . after its investigation, if it concludes *based on the record* that the originally filed and effective rate is unjust, unfair or unreasonable."[300] Similarly, when the Commission conducts a hearing on the question of an electric company's rates and finds that

> such rates or charges are *insufficient to yield a reasonable compensation for the service rendered*, the commission shall determine the just, reasonable, or sufficient rates, charges, regulations, practices or contracts to be thereafter observed and in force, and shall fix the same by order.[301]

This is consistent with the proposition stated by Goodman that "[a]n agency . . . possesses the discretion to authorize a higher rate than the company requested."[302]

133. Contrary to Staff's assertion, the Commission's ultimate order in this case is not limited to "the pleadings" consisting of "the filed tariff revisions."[303] Rather, the Commission's decision must be based on the record that is developed before it through the adjudicative process. The *Bohn* case, cited by Staff, states the general proposition that the commission "is limited to the hearing and the determination of those issues only which are raised by the pleadings." However, the case goes on to rule that the suspension order in that case was sufficiently informative to put the affected carriers on notice that the question of minimum, as well as maximum, rates would be "presented and adjudicated in that hearing."[304] As the Court explained, once a proposed rate is filed and suspended, the Commission has the authority to issue an order setting the rate that is

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[299] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 03 at ¶11 and App. 1 (May 2004).
[300] RCW 80.04.130(2)(a)(ii) (emphasis added).
[301] RCW 80.28.020 (emphasis added).
[302] Leonard Saul Goodman, *The Process of Ratemaking* at 57 (1998).
[303] Staff Br. ¶200 (citing *State ex rel. Bohn v. Dept. of Pub. Serv.*, 6 Wn.2d 676, 682 (1940)).
[304] *Bohn*, 6 Wn.2d at 683.

determined through the hearing process to be reasonable.[305]

134. The cases Staff cites from other jurisdictions do not require a different result. Staff incorrectly quotes *Re Providence Water Supply Bd.*, 97 PUR 4th 317 (Rhode Island 1988), in support of its argument. In that case, the Rhode Island Commission declared the existence of a "general proposition" that a utility is bound by its filed proposed rate level, citing only two FERC decisions. Furthermore, the Rhode Island Commission did not state that an attempt to enhance the filing at "a *later* stage" of the process violates the fundamental administrative principle of adequate notice to the adverse parties.[306] Instead, the commission stated that an attempt to enhance a filing at "a *late* stage" of the process violated notice principles.[307] The commission criticized the utility's attempt to revise a proposed attrition allowance *after the cross examination hearings*. Moreover, the change would have doubled the allowance originally proposed.[308]

135. Staff also cites *Re Toledo Edison Co.*, 42 PUR 4th 568, 598 (Ohio 1981).[309] In that case, the Ohio commission based its decision on an Ohio statute requiring publication of application for rate increases and subsequent Ohio Supreme Court and commission cases interpreting that statute. No mention is made of notice requirements or commission authority specific to adjudicative proceedings after the proposed tariffs are suspended for investigation, such as exist in Washington.[310] The Ohio commission was also concerned about the possibility that a company could reduce interventions by understating its published request, then "spring a greatly increased

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[305] *Id.* at 683-84.
[306] Staff Br. ¶210 (emphasis added).
[307] *Id.* at 339.
[308] *Id.* at 338-339.
[309] Staff Br. ¶201.
[310] *Re Toledo Edison Co.*, 42 PUR 4th at 598.

rate request on the commission at hearing."[311] Such concerns need not result in a general prohibition barring all awards of rate increases that are higher than an original filing.

136. In this case, the Company's customers had notice of and the opportunity to contest the Company's requested revenue increase, and the Company has not sought to "spring" a rate increase on its customers to prevent their participation in this case. Staff and Public Counsel have been active participants on behalf of residential and small commercial customers from the beginning. The Company's original request of $81.6 million was also sufficiently large to attract the attention of ten additional entities or organizations representing the Company's large commercial and industrial as well as low income electric and gas customers, which petitioned for and were granted intervenor status at the first prehearing conference.[312] In addition, the Company prefiled its evidence supporting an increased revenue requirement well in advance of the hearing, in accordance with the procedural rules and prehearing conference order.

137. The policy concerns Staff expresses can be addressed as appropriate on a case-specific basis, but are not implicated in the present proceeding. As a legal matter, the Commission has authority under Washington statute and regulations to approve the Company's requested $99.8 million increase in electric revenues.

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[311] *Id.* at 599.

[312] *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 03 at ¶¶6-8 (May 2004).

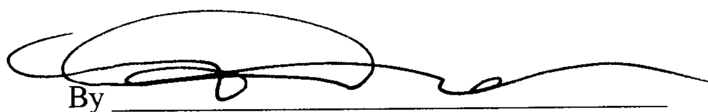
X. CONCLUSION

138. For the reasons set forth above, in the Company's Initial Brief, and in the evidence that is before the Commission in this case, the Company respectfully requests that the Commission issue an order approving its request for general rate relief.

DATED this 27th day of January, 2005.

Respectfully submitted

PERKINS COIE LLP



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