~~Christine O. Gregoire~~ Rob McKenna
ATTORNEY GENERAL OF WASHINGTON
Utilities and Transportation Division
1400 S Evergreen Park Drive SW • PO Box 40128 • Olympia WA 98504-0128 • (360) 664-1183

January 27, 2005

Carole J. Washburn, Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Park Dr. SW
P. O. Box 47250
Olympia, Washington 98504-7250

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Re: *Puget Sound Energy*
Docket Nos. UG-040640, UE-040641, UE-031471 and UE-032043

Dear Ms. Washburn:

Enclosed please find the original and 19 copies of the Reply Brief of Commission Staff and Certificate of Service .

Very truly yours,

ROBERT D. CEDARBAUM
Senior Counsel

RDC:kll
Enclosures
cc: Parties

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STATE OF WASH.
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COMMISSION

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NOS. UE-040641 and UG-040640 (Consolidated)

REPLY BRIEF OF COMMISSION STAFF

January 27, 2005

ROB MCKENNA
Attorney General

ROBERT D. CEDARBAUM
Senior Counsel
Office of the Attorney General
PO Box 40128
1400 S Evergreen Park Drive SW
Olympia, WA 98504-0128
(360) 664-1188

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I. SUMMARY

1 On January 18, 2004, Staff submitted an Initial Post-Hearing Brief in support of its recommendation that the Commission allow Puget Sound Energy, Inc. (PSE or the Company) to increase revenues from electric and natural gas service by $15.8 million and $11.3 million, respectively. Staff addressed all of the arguments raised by the Company and other parties on contested issues. Thus, Staff's Reply Brief highlights the significant themes supporting its recommendation. Lack of argument on any contested issues should not be construed as agreement with another party on those matters.[1]

II. INTRODUCTION/GENERAL ARGUMENT

2 Staff noted previously the Company's unwillingness to accept the normal risks of doing business for both its regulated and unregulated operations.[2] The Company perpetuates this theme in its Initial Brief. It complains that shareholders must absorb the disallowance of an expense incurred to serve customers through a reduction in their actual earned rate of return.[3] Yet, PSE ignores that an expense is disallowed for ratemaking purposes because it is imprudently incurred. As a matter of law, the risk of an imprudent expense must be the sole responsibility of shareholders.[4] This result also

[1] The Staff Reply Brief is organized along the same outline that all parties used in their initial briefs.
[2] Staff Initial Br. at ¶ 204.
[3] PSE Initial Br. at ¶ 9.
[4] *POWER v. Utils. & Transp. Comm'n*, 104 Wn.2d 798, 810-11, 711 P.2d 319 (1985) ("Rather, the utility is not permitted to recover the expense in question in its rates to customers who purchase a regulated product or service."). PSE also mischaracterizes the impact on shareholders of disallowing an expense under WAC 480-07-510(3)(b)(i), such as an out-of period or non-recurring expense. The Commission's disallowance of such an expense from an historical test year has no impact on the Company's actual earned rate of return for the test year period.

Nor does disallowance of an excessive cost mean that the Company's future rate of return will be lower than its authorized rate of return. A Commission order disallowing an unreasonable expense places the company on notice to control that expense going forward in order to preserve its ability to earn its authorized rate of return.

holds true in unregulated markets, where competitive forces prevent companies from recovering excessive and imprudent expenses from their customers.

3 The Company observes that it is entitled to the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return commensurate with other enterprises of comparable risk.[5] Yet, it ignores that that opportunity presumes an "efficient and economical management."[6] The recent disallowance related to PSE's imprudent management of Tenaska fuel gas acquisition,[7] exemplifies a company's failure to commit to that fundamental responsibility. The Commission should also bear in mind the Company's out-of-control spending on rate case litigation, especially the hiring of numerous and expensive outside experts, when it considers PSE's allegations of not earning its authorized rate of return.[8]

4 Finally, the Company agrees that it bears the burden to prove that its proposed increase is just and reasonable.[9] That burden, however, is not one of merely going forward with the evidence. It is a burden of persuasion that extends to each element by which PSE seeks to justify an increase in rates.[10] The Company has not carried that burden here.

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[5] PSE Initial Br. at ¶ 8.
[6] *Bluefield Water Works Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679, 692 (1923).
[7] *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-031725, Order No. 14 (2003).
[8] The extent of Company spending on rate case litigation is well-documented. As of December 10, 2004, PSE had spent $2.3 million on the pending case. Of that amount, $1.5 million alone is for outside witnesses and other consultants. Ex. 249 at 1 and 3. There is no reason why a large portion of that work could not have been done in-house, especially given the Commission's prior admonitions for the Company to control its use of outside experts and legal counsel. *WUTC v. Puget Sound Power & Light Co.*, Docket Nos. UE-920433, *et al.*, 11th Supp. Order at 69 (1993).
[9] PSE Initial Br. at ¶ 8.
[10] Tegland, Karl B., *Washington Practice,* Vol. 3, § 301.2 (4th Ed. 1999).

III. CAPITAL STRUCTURE AND COST OF CAPITAL

5 The Company's Initial Brief highlights several fundamental flaws in its analysis of the cost of capital. First and most important, in arriving at an 11.75% return on common equity, the Company, again, does not defend its threshold assumption that the dividend growth component in a Discounted Cash Flow (DCF) analysis should be determined solely by measuring a company's growth in stock price over the past year.

6 PSE does state that updating its approach to exclude three months when its stock price suffered from the Tenaska disallowance would produce a return on equity of 11.6%, rather than 8.7%, as Dr. Wilson calculated when he updated the Company's method.[11] The argument, of course, only proves Staff's point: estimating investors' expected dividend growth merely by calculating the change in a company's stock price over the past year is an extremely unreliable method given the inherent volatility of the stock market. It also ignores the far broader considerations that investors take into account when they formulate their expectations of dividend growth.[12]

7 The Company's only remaining defense to its DCF approach is that it accounts for the historic fact that PSE and some of the comparable companies have cut or eliminated their dividend.[13] Again, the criticism serves only to undermine PSE's own choice of companies that it identified as being most comparable to itself.[14]

8 Moreover, because investors purchase stocks for a combination of dividend yield and price appreciation expectations, expectation of *future* growth in dividends is the

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[11] PSE Initial Br. at ¶ 48.
[12] Staff Initial Br. at ¶¶ 50-51.
[13] PSE Initial Br. at ¶¶ 47, 49 and 51.
[14] Staff Initial Br. at ¶ 54.

relevant consideration in the DCF model. That expectation is precisely the focus of Dr. Wilson's analysis of investor return requirements.

9 The Company alleges that Staff presented "generic" cost of capital testimony that did not consider PSE's particular facts and circumstances, including its inability to earn its authorized rate of return, its resource acquisition and infrastructure investment activities, and the "unique" risks investors perceive in the Company and the utility industry in general.[15] As demonstrated previously, this criticism ignores that Dr. Wilson's DCF study used the same group of companies that PSE identified as being most comparable to itself.[16] It ignores that Staff's capital structure recommendation is based on the Company's own projected capital financing plans for infrastructure investments and resource acquisitions.[17] And, it ignores the healthy and sound financial condition actually experienced and projected for PSE's *utility* operations, as well as the numerous regulatory mechanisms currently in place that further reduce the low risk that investors already see in a vertically integrated utility, like PSE, that is regulated under traditional cost of service principles.[18]

10 The Company criticizes Staff's capital structure recommendation as being based on the consolidated common equity of PSE that includes the negative common equity of the Company's unregulated subsidiaries.[19] Even if that criticism is valid, Staff's equity ratio would increase from only 41.84% to 42.10%.[20]

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[15] PSE Initial Br. at ¶¶ 24, 27 and 37.
[16] Staff Initial Br. at ¶ 48.
[17] Staff Initial Br. at ¶ 77.
[18] Staff Initial Br. at ¶¶ 8-17 and 26-33.
[19] PSE Initial Br. at ¶ 14.
[20] Ex. 179C at 33: 18-20 (Gaines).

11 More important, the criticism highlights the confusion created by PSE between the reasonable financial performance of its regulated utility operations and the poor results of its unregulated subsidiary operations.[21] The Company's proposed capital structure adjusts common equity to reflect the negative equity ratio of its unregulated operations.[22] Thus, PSE *increases* the common equity ratio in order to compensate for losses attributable directly to its unregulated subsidiary finances.[23] Dr. Wilson corrects that approach that would otherwise unreasonably raise rates for utility customers.

12 The Company criticizes Dr. Wilson for using a 90-day Treasury bill in his Capital Asset Pricing Model (CAPM) study because it does not match the investment horizon of utility equity.[24] The evidence and academic literature, however, clearly support Dr. Wilson's use of the 90-day Treasury bill as the risk-less rate of return because the short maturity of the security protects investors from default and interest rate risk.[25] The same cannot be said for the long-term Treasury bonds used by PSE in its CAPM study.[26]

13 Even if a long-term Treasury security is used as a surrogate for the risk-less rate of return, Dr. Wilson's CAPM study still produces an equity return of 8.14%.[27] This

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[21] Staff Initial Br. at ¶¶ 13-17.
[22] Ex. 181C at 2, lines 27-29.
[23] Tr. 409: 11 to 410: 4 (Gaines).
[24] PSE Initial Br. at ¶ 62.
[25] Staff Initial Br. at ¶¶ 62-66.
[26] Staff Initial Br. at ¶ 66. For the same reason, the Company's risk premium study, which also relies upon 30-year Treasury bonds to represent the risk-free interest rate (Ex. 201 at 45: 8-9 (Cicchetti)), should be rejected.

PSE also provides articles in support of its risk premium study. PSE Initial Br. at ¶ 67, fn. 158 and Attachment Tabs U, V and W. These articles, which appear for the first time in these proceedings, are out of step with the extensive literature from the financial community that Dr. Wilson cites in his direct testimony. Ex. 481 at 20: 3 to 21: 19. *See also* Exs. 169 and 170. The Company's late-filed articles should not be given any weight by the Commission.
[27] Staff Initial Br. at ¶ 67.

further demonstrates that his 9% recommended return on equity is a reasonable estimate of the current low cost of capital.[28]

14 Finally, the Company alleges that Staff did not present a policy witness to address the overall impact of its proposal on the Company or its customers. According to PSE, Dr. Wilson presented only mechanistic calculations of financial theory and did not deny that his proposal will "utterly fail to strengthen the Company's financial position or flexibility."[29]

15 The Company's allegation could not be further from the truth. Dr. Wilson specifically addressed the interests of both the Company and its ratepayers. He formulated his cost of capital recommendation with the overriding goal that the Company should be allowed to recover no more, but no less, than its cost of capital.[30] Despite analyses that estimated the Company's cost of common equity as low as 8%, Dr. Wilson recommended that the Commission set rates based upon a 9% equity return in order to provide PSE a cushion for potential capital cost increases during the rate year and to enable the Company to continue to improve its balance sheet and credit rating.[31]

16 Dr. Wilson also expressly weighed the cost to ratepayers of Staff and Company capital structure recommendations. He demonstrated that the Company's proposal to include costs associated with more equity than actually exists on the Company's books unreasonably raises rates for customers.[32] In contrast, the capital structure he proposes

[28] Staff Initial Br. at ¶¶ 67-68.
[29] PSE Initial Br. at ¶¶ 5-6. PSE makes this allegation without any citation to Staff testimony. It refers only to the witness presented by Public Counsel. PSE Initial Br. at fn. 8.
[30] Tr. 562: 20-25 (Wilson).
[31] Ex. 481 at 6: 19 to 7: 6 (Wilson).
[32] Ex. 481 at 30: 12 to 34: 13 (Wilson); Tr. 564: 2-14 (Wilson). Indeed, the Company does not dispute the savings for ratepayers related to incremental long-term debt issues under a more leveraged capital structure. PSE Initial Br. at ¶ 31.

balances debt and equity on the bases of safety and economy by reflecting actual debt and actual equity at the present time and as reasonably foreseen through January 2006.[33]

17 In addition to his specific analyses, Dr. Wilson also considered whether to include in PSE's rates an allowance for common equity return equal to that experienced in recent years by other companies in other states. He convincingly rejected that notion because he believes the Commission should be guided not by what other state commissions have decided for certain firms at certain times, but rather by what the Commission believes is appropriate for PSE on a case by case basis.[34] Likewise, he advised the Commission not to set a return on equity based on where it believes a utility's stock price or market-to-book ratio should be driven.[35]

18 The Company had the opportunity to question Dr. Wilson on the technical and policy aspects of his recommendations. It elected not to do so.

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[33] Ex. 481 at 30: 16-18 (Wilson).
[34] Staff Initial Br. at ¶¶ 70-72.
[35] Tr. 542: 5-16 and 545: 10 to 546: 1 (Wilson). Dr. Wilson did state that market-to-book ratio is an important consideration in rate regulation because a market price of common stock equal to book value is a clear signal that investors' earnings expectations equal their required return or cost of capital. Thus, an equity return of 7.75% in this case is sufficient to sustain a stock price at book value. Ex. 481 at 23: to 26: 13 (Wilson).

The Company challenges this conclusion with the allegation that investors' return expectations are based only on what they expect to earn on their new investments, rather than on a utility's original rate base. PSE Initial Br. at ¶ 70. However, the earned return on rate base *is* the return that investors can expect to earn on their total investment in facilities dedicated to serving the public. The Company's balance sheet makes no distinction between "new" and "old" rate base.

IV. REVENUE REQUIREMENT

A. Contested Adjustments- Electric

1. Adjustment 2.03 -- Power Costs

a. Gas Costs

19 The methodology recommended by Staff in this proceeding uses an average of three-month average forward prices for the period December 2003 to April 2004 to infer a "normal" spot price of $4.69/MMBtu for the rate year. The Company uses a three-month average of forward prices ending September 30, 2004 to forecast a gas price of $5.60/MMBtu. The Industrial Customers of Northwest Utilities (ICNU) bases its $4.25/MMBtu gas price on fundamentals-based forecasts that focus on the long-term period beyond July 1, 2006.

20 The differences among the parties can be succinctly explained. Staff's proposal is based upon sound statistical analyses of historical market data that show a high degree of correlation between spot and forward prices from December 2003 through April 2004. In contrast, forward and spot prices after April 2004 are abnormally distributed.[36] Neither PSE nor ICNU performed such analyses. In fact, the analysis the Company did perform includes data generated during the Western Power Crisis that clearly biases the results.[37]

21 Staff's proposal is also based upon an in-depth assessment of both non-market activities and current market trends that show sharp increases in forward prices after April 2004. These activities and increases are characteristic of an inefficient market that would bias the average gas price estimated for the rate year.[38] Again, neither the Company nor ICNU conducted the same assessment. Their forecasts rely upon the

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[36] Staff Initial Br. at ¶¶ 93 and 98.
[37] Staff Initial Br. at ¶ 96.
[38] Staff Initial Br. at ¶¶ 94-95, and 99.

necessary assumption that the gas market is efficient so that gas prices can be predicted through the rate year (PSE) and beyond (ICNU). Their assumption, however, is not supported by the record.[39]

b. Coal Costs

22 The Company states that Staff and PSE agree that the cost of coal for the rate year has increased.[40] As Staff stated previously, however, the amount of increase is contested because the production cost of coal relies upon the price of natural gas assumed in the power supply model.[41] Thus, this component of the power cost adjustment will be resolved when the Commission determines the appropriate gas price to be used for ratemaking purposes.

d. Hydro Normalization

23 Both Public Counsel and ICNU challenge the position of Staff and PSE to model power supply using a stream-flow study based on the 50-year period 1929-1978. Public Counsel and ICNU argue that a 40-year rolling average stream-flow is a requirement that Staff and the Company merely re-litigate using arguments that were rejected in prior cases.[42] Their criticism is unfounded.

24 First, while it is true that the Commission's order in PSE's 1992 rate case required "clear and convincing" evidence to change the 40-year rolling average methodology, it is not true, as Public Counsel would have the Commission believe, that the Commission established a "standard for the future [that would] put the debate to rest."[43] The 1992

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[39] Staff Initial Br. at ¶ 95. Likewise, the Company's reliance upon updated gas price information for periods ending December 15, 2004 is unjustified. *See* PSE Initial Br. at ¶ 79.
[40] PSE Initial Br. at ¶ 2.
[41] Staff Initial Br. at ¶ 103.
[42] Public Counsel Br. at ¶¶ 105-118; ICNU Initial Br. at ¶¶ 34-40.
[43] Public Counsel Initial Br. at 108.

case was neither a rulemaking nor a generic proceeding for all regulated companies. It was a rate case for one company. While such a proceeding certainly establishes precedent, and in that case strong precedent, it did not and could not eliminate the issue from re-examination in future proceedings.

25 Second, Staff's recommendation does not re-litigate previously rejected arguments. In the 1992 rate proceeding, Staff recommended use of the 40-year rolling average because it produced less cumulative error than other approaches.[44] Thus, Staff did not then analyze the statistical validity of the underlying stream-flow data. That additional examination was performed by Staff in the current case and it demonstrates conclusively that the 50-year stream-flow data is trend-less and normally distributed, and that there is a high degree of correlation between stream-flow and hydro generation.[45] In the prior case, the Commission simply was not presented with similar evidence that outweighs any prior justification for using a rolling average.[46]

26 Nor was the Commission in the prior case presented with evidence that takes into account the competing non-generation uses of the Columbia River System that restrict the use and flow of water for power generation. Such an analysis was presented in this case through Staff's use of estimated water run-off volumes, which capture the inherent variability of water use.[47]

27 ICNU argues that the Commission should use all available 120 years of available data if it elects not to use the 40-year rolling average.[48] However, the data for that 120-

[44] *WUTC v. Puget Sound Power & Light Co.*, Docket Nos. UE-921262, *et al.*, 11th Supp. Order at 43 (1993).
[45] Ex 451 at 21-22 (Mariam) and Ex. 454.
[46] Ex. 451 at 23: 17 to 25: 5 and 26: 5-9 (Mariam).
[47] Ex 451 at 13: 1-11 and 23: 6-16 (Mariam).
[48] ICNU Br. at ¶ 37.

year period are based on a "synthetic" regional stream-flow record,[49] which was not shown to match the many other inputs of the power supply model. ICNU also did not demonstrate that data for the period 1879 to 1928 was verified or verifiable. Nor do estimated run-offs exist for that early time period, as they do exist for the 50-year period used specifically by Staff to account for the non-generation uses of the river system.

28 Finally, Public Counsel argues that Staff's 50-year stream-flow study is inconsistent with weather normalization procedures that use multi-year rolling averages.[50] There is no inconsistency. Weather normalization addresses the impact of temperature on energy usage. Thus, a rolling average captures the effects of global climate changes on temperature, which meteorological organizations, such as NOAA, observe and estimate every ten years.[51]

29 In contrast, the greatest impacts on hydro-generation come not from changes in temperature, but from the timing, amount, and uses of stream-flow. The statistical and non-statistical evidence submitted by Staff demonstrate that there is no justification for eliminating data from the 50-year stream-flow study or for using a rolling average to normalize stream-flow conditions.

30 In sum, there has been no "dramatic change" in hydro normalization that Public Counsel believes must be present to warrant a change in policy.[52] There is, however, clear and convincing evidence to warrant that change.

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[49] *WUTC v. The Washington Water Power Co.*, Cause No. U-85-36, 3rd Supp. Order at 18 (1986).
[50] Public Counsel Initial Br. at ¶ 114.
[51] Ex. 451 at fn. 13 (Mariam).
[52] Public Counsel Initial Br. at ¶ 113.

e. **BPA Transmission Rate**

31 Staff recommends that the Commission not allow an increase in Bonneville Power Administration (BPA) wheeling charges because the increase is not known and measurable. PSE does not deny that the increase is not known and measurable. It alleges only that, if BPA or the Federal Energy Regulatory Commission (FERC) reject the Initial Proposal offered by the Transmission Business Line (TBL) for settlement of BPA's 2006-2007 transmission rate case, then the result would be higher, not lower rates.[53]

32 The argument, however, mischaracterizes the facts. If the Initial Proposal is rejected by BPA or FERC, the 2006-2007 transmission rate case would go into litigation mode. The TBL might propose higher transmission rates, but that proposal would be subject to challenge by other parties, and would not become effective in any event until approved by BPA and FERC. Until all such events play out, any increase in BPA wheeling charges remains unknown and un-measurable.

4. **Adjustment 2.10 – Miscellaneous Operating Expenses**

a. **Incentive/Merit Pay and Associated Payroll Taxes**

33 As noted in Staff's Initial Brief, the adjustment for incentive and merit pay has two components. First, Staff adjusted to the actual payout of $2.1 million made in 2004. The Company characterizes that as a normalization approach, which, if applied correctly would produce a higher amount than included by Staff.[54]

34 The Company mis-characterizes the Staff position. Staff's adjustment is not based on a normalized level of incentive payments. Rather, Staff includes the most recent actual payout as a reasonable amount because it more closely matches test period

[53] PSE Initial Br. at ¶ 87.
[54] PSE Initial Br. at ¶ 94.

performance, recognizes that the amount booked in the test year was abnormally high as compared to other recent years, and reflects that incentive plans have changed repeatedly and materially over the years.[55] Thus, PSE's allegation of 4-year or 6-year average amounts of incentive payments is irrelevant.[56]

35 The second component of Staff's adjustment eliminates 40% of the incentive payments made in 2004 because they are tied directly to Company earnings. PSE argues that no incentive payment is made if the earnings per share target is achieved, but not the service level targets.[57] Likewise, however, no incentive payment is made if the Company does not achieve the earnings per share target, but does achieve the service level targets. That symmetry supports a 50/50 sharing of incentive payments between ratepayers and shareholders. Staff's elimination of only 40% of the incentive payments, again, is generous to PSE.

b. Deloitte Fee for Income Tax Advice

36 The Company attempts to justify recovery of the Deloitte Fee by tying it to $10 million of deferred Federal Income Tax "benefits" to ratepayers.[58]

37 It is true that deferred taxes are treated as a rate base reduction, which reduces rates accordingly. However, the restatement of the tax basis of PSE's assets resulted in a large cash infusion from both the Federal Income Tax refund that PSE received and normalized, and the Montana Corporate Income Tax refund that was flowed through in the test period.[59] PSE removes this one-time Montana Corporate Income Tax refund in

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[55] Staff Initial Br. at ¶ 124.
[56] PSE Initial Br. at ¶ 93.
[57] PSE Initial Br. at ¶ 92.
[58] PSE Initial Br. at ¶ 96.
[59] We note that PSE did not even propose to include the deferred tax benefit until Staff included the item in its direct case.

total in its adjustment, to which Staff agreed, but, as an offset, Staff removes the associated costs.[60]

38 Staff continues to urge the Commission to remove this one-time fee from the test period as a nonrecurring cost. In the alternative, the Commission could spread the cost of the Deloitte Fee over the 20-year tax life of the benefits, as if the fee were a "financing fee" paid to get cash in hand.

7. Adjustment 2.18 – Rate Case Expense

39 Many of the parties in this case have expressed dismay with the continuing high litigation expenses incurred by the Company for outside services. PSE's only response is that rate case costs are legitimate expenses incurred for the Company to defend itself and, thus, they should never be shared with shareholders.[61] Surely, PSE cannot mean that it is legally entitled to recover any amount it spends on rate case litigation. Its rate case expenses are always subject to review and disallowance for imprudence or unreasonableness.

40 Moreover, while the Company does bear the burden of proof, it is also true that the level of costs PSE incurs for rate cases is tied directly to the positions it takes in its direct case and the decisions it makes on whom to hire to support those positions. It is also the Company's direct case that determines the issues that other parties will address. For Staff, the extent of those issues is equally as broad and complex as it is for PSE, and requires equally extensive testimony and discovery responsibilities, especially in light of Staff's audit function. The Company cannot justify its rate case expenses simply because those expenses are incurred.

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[60] PSE's treatment of the Montana Corporate Income Tax refund is also inconsistent with the methodology it proposes for the Oregon property tax assessment. Staff Initial Br. at ¶ 132.
[61] PSE Initial Br. at ¶ 104.

41 To remedy the current situation, Staff's proposal to normalize rate case expenses allows the Company to recover an appropriate amount of litigation expense, while also providing an appropriate incentive for PSE to control costs.[62] Staff's adjustment includes $650,000 for Power Cost Only Rate Case (PCORC) costs, and normalizes both that amount and 2004 rate case costs over three years, the period of time in which those costs were incurred. The $650,000 figure is one-half the amount PSE spent on the 2003 PCORC. Along with its recommendation to amortize currently deferred rate case costs, Staff's adjustment includes a total annual amount of $977,800 for rate case litigation.[63]

42 The Company adopts the $650,000 PCORC figure, but includes that amount in its entirety as if it will litigate a PCORC every year at the same cost, in addition to general rate cases. The total of PSE's rate case cost adjustments recovers $1,411,000 on an annual basis.[64]

43 The Company is unable to rebut the Staff position. PSE states that it did not discover until preparing its Initial Brief that Staff spread the normalized PCORC costs of $650,000 over three years.[65] However, the exhibits accompanying Staff's direct testimony indicate clearly that the allowed PCORC costs and estimated 2004 rate case costs were "expensed over 3 years."[66]

44 The Company's adjustment assumes that it will file a PCORC every year. That assumption does not reflect experience. The Company has filed only one PCORC and one general rate case in the past three years (2001-2004), which is the period of time that

[62] Ex. 421 at 21: 16-18 (Russell).
[63] Staff Initial Br. at Appendix A, Part 1 (Electric), page 25, line 12.
[64] PSE Initial Br. at Appendix B, page 2.18, lines 16 and 18.
[65] PSE Initial Br. at ¶ 139.
[66] Ex. 423 at 20, line 4 (Russell).

Staff used in its adjustment. If general rate cases or PCORCs come more or less often in the future, the normalization period may be adjusted to reflect those new circumstances.

45 The Company alleges that Staff's adjustment would only allow cost recovery for one PCORC every six years, if costs remained at the level of the 2003 case, or every three years, if costs were half of that amount.[67] This is a gross mischaracterization of the Staff position. The Company spent $1.3 million to litigate the 2003 PCORC.[68] That case was very controversial and resulted in a finding by the Commission that the Company was imprudent in managing Tenaska fuel gas acquisition.[69] PSE should not incur a similar level of expense for PCORC proceedings going forward.

46 Staff's adjustment allows PSE to recover almost $1 million every year for rate case litigation, whether the Company files a PCORC or a general rate case, or does not file any case at all. That amount should be more than sufficient to cover PSE's litigation costs going forward.

C. Contested Adjustments – Gas

1. Adjustment 2.01 – Revenue & Purchased Gas

47 In order to reflect the impact of temperature on gas usage, Staff uses the 30-year (1971-2000) normal temperature calculated by NOAA, while the Company calculates normal temperature using a 20-year rolling average. The Company challenges Staff's proposal as "premature and not sufficiently developed for adoption."[70]

48 The Company is wrong. First, as Staff noted previously, the pending collaborative on weather normalization neither bar the parties from promoting, nor the

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[67] PSE Initial Br. at ¶ 139.
[68] Ex. 421 at 19: 9 (Russell).
[69] *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-031725, Order No. 14 at ¶ 109 (May 2004).
[70] PSE Initial Br. at ¶ 116.

Commission from adopting, improvements in weather normalization procedures in this case.[71] The Commission should not adopt PSE's standard that asks only whether or not existing procedures are "sufficiently accurate."[72]

49 Second, NOAA's 30-year normal temperature will improve the weather normalization process. It eliminates the difficult task of verifying calendar month and billing cycle usage that exists under PSE's 20-year rolling average approach. It also results from a robust statistical analysis that removes the impacts of abnormalities in temperature and non-weather-related factors, such as errors in data collection and recording.[73]

50 The Company does not dispute these advantages. It states only a "concern" about "inconsistencies" between using statistical equations developed from test year usage and normal temperature developed from data that ends in 2000.[74]

51 PSE introduces a complication that simply does not exist. NOAA's 30-year normal temperature is applied only to determine what test year actual usage would have been had temperature been normal during the test year. It is irrelevant to that determination that test year usage is based on data from 2002 and 2003, while NOAA's normal temperature is based on data that ends in 2000.[75]

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[71] Staff Initial Br. at ¶ 161.
[72] PSE Initial Br. at ¶ 116.
[73] Staff Initial Br. at ¶¶ 158-59.
[74] PSE Initial Br. at ¶ 116.
[75] Staff Initial Br. at ¶ 161, fn. 253.

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

52 The dispute on this issue boils down to the meaning of a Commission order in the Company's last general rate case.[76] Staff and the Company have presented their opposing interpretations of that order.

53 The Company also argues that the Commission should adopt its position as a matter of policy, irrespective of the Company's commitments from that prior case.[77] As a matter of policy, we noted previously the following joint testimony presented in support of PSE's natural gas settlement in Docket No. UG-011571 in 2002:

> The test year level of depreciation on rental property is to be maintained over the next three years. This treatment is anticipated to result in a decrease or elimination of the depreciation deficiency on rental property *thus resulting in the rental revenues covering rental costs at the end of the three-year period contained in the stipulation* during which Company is not allowed to request an increase in the revenue requirement associated with the existing gas water heater and conversion burner rental programs.[78] (Emphasis added.)

Thus, through additional depreciation, the rental program was to be self-funded by September 2005 so that no subsidy from ratepayers would be necessary after that date. If the Company elected to file a general rate case before September 2005, then the subsidy provided by ratepayers would have to be eliminated. Staff's adjustment implements that expectation and public policy objective.

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

54 All parties agree that the Company's Accounting Petition in Docket No. UE-031471 should be denied in favor of allowing PSE to recover a normalized amount of

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[76] Staff Initial Br. at ¶ 173, citing *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-011570 and UG-011571, 13th Supp. Order, Settlement Stipulation For Remaining Natural Gas Issues and Application for Commission Approval of Settlement, Exhibit A, page 2, ¶ 5 (2002).
[77] PSE Initial Br. at ¶ 127.
[78] Ex. 323 at 4-5.

Power Cost Only Rate Case (PCORC) costs as an ongoing expense. However, as discussed in Section IV.A.7., the parties do not agree on the precise level of PCORC costs to be recovered.

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

55 Staff's Initial Brief demonstrated that the Commission does not have legal authority to approve an increase in rates that would produce more revenue than the tariff revisions currently under suspension.[79]

56 The Company ignored the merits of this issue, stating that it would respond to Staff in its reply brief. The Commission should not tolerate such tactics. This issue arose only when the Company, on cross-examination of its rebuttal case, indicated for the first time that it was requesting revenues above the amount produced by the filed tariff revisions.[80] Thus, Staff had no opportunity before its Initial Brief to address this issue.

57 Moreover, the issue of Commission legal authority was not invented by Staff. The issue arose directly from PSE's rebuttal case. The Company has the responsibility to address that issue in a timely manner, especially given its statutory burden of proof. The time for PSE to address the Commission's legal authority was in its Initial Brief.

58 In any event, the Company was made well aware during cross-examination,[81] as well as through the joint briefing outline, that this issue was ripe for argument. There is no excuse for the Company's delay in arguing its side of the issue, which has left Staff no opportunity to respond.[82]

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[79] Staff Initial Br. at ¶¶ 197-202.
[80] Tr. 131: 1-6 (Reynolds).
[81] Tr. 129-133 (Reynolds).
[82] The Company may rely on provisions of RCW 80.28.020 that give the Commission authority to determine whether existing rates are unjust and unreasonable and, if they are, to set just,

X. CONCLUSION

59 For the reasons set forth above and in Staff's Initial Post-Hearing Brief, the Commission should allow the Company to increase its rates for electric and gas service in accordance with the Staff recommendation.

DATED this 27th day of January, 2005.

Respectfully submitted,

ROB MCKENNA
Attorney General

ROBERT D. CEDARBAUM
Senior Counsel
Counsel for Washington Utilities and Transportation Commission Staff

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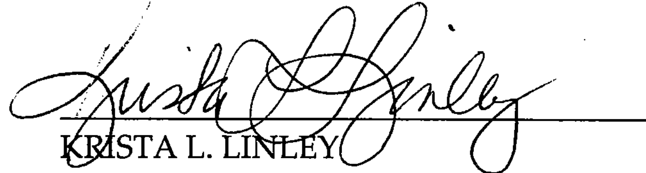
reasonable or sufficient rates. Such reliance is unjustified because it ignores the provisions of RCW 80.04.130(1) that further limit the extent of these proceedings to the tariff filings that are under suspension:

> . . . whenever any public service company shall file with the commission any schedule . . . the effect of which is to change any rate, charge, rental or toll theretofore charged, the commission shall have power, either upon its own motion or upon complaint, upon notice, to enter upon a hearing *concerning such proposed change and the reasonableness and justness thereof.* Pending hearing and the decision thereon, the commission may suspend the operation of *such* rate, charge, rental or toll for a period not exceeding ten months from the time the same would otherwise go into effect. After a full hearing, the commission may make such order *in reference thereto* as would be provided in a hearing initiated after the same had become effective. (Emphasis added.)

Docket Nos. UG-040640/UE-040641/UE-031471/UE-032043
CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing Reply Brief of Commission Staff upon the persons and entities listed on the Service List below via e-mail and by Federal Express, addressed as shown on said Service List.

DATED at Olympia, Washington this 27th day of January, 2005.



KRISTA L. LINLEY

All parties have signed Confidentiality Agreements

For PSE:
Kirstin Dodge
Jason Kuzma
Perkins Coie
The PSE Building
10885 NE Fourth St. #700
Bellevue, WA 98004-5579
Fax: 425-635-2407
E-mail: ksdodge@perkinscoie.com
E-mail: jkuzma@perkinscoie.com

For Kroger:
Mike Kurtz
Kurt Boehm
Boehm, Kurtz and Lowry
2110 CBLD Center
36 East Seventh St
Cincinnati, OH 45202
Fax: 513-421-2764
E-mail: mkurtzlaw@aol.com
E-mail: kboehmlaw@aol.com

For Seattle Steam:
Elaine Spencer
Graham & Dunn
Pier 70
2801 Alaskan Way, Suite 300
Seattle, WA 98121-1128
Fax: 206-340-9599
E-mail: espencer@grahamdunn.com

For ICNU:
S. Bradley Van Cleve
Matthew W. Perkins
Davison Van Cleve, P.C.
1000 SW Broadway, Ste. 2460
Portland, OR 97205
Fax: 503-241-8160
E-mail: mail@dvclaw.com

For Federal Executive Agencies:
Norman J. Furuta
Department of the Navy
2001 Junipero Serra Boulevard
Suite 600
Daly City, CA 94014
Fax: 650-746-7372
E-mail : norman.furuta@navy.mil

For Public Counsel :
Simon J. ffitch
Public Counsel Section
Office of Attorney General
900 Fourth Avenue, Suite 2000
Seattle, WA 98164-1012
Fax: 206-389-2058
E-mail: simonf@atg.wa.gov

For AT&T Wireless and Cost Management :
John A. Cameron
Davis Wright Tremaine LLP
1300 SW Fifth Avenue, Suite 2300
Portland, Oregon 97201
Fax: 503-778-5299
E-mail: johncameron@dwt.com

For NWIGU :
Edward A. Finklea
Chad M. Stokes
Cable Huston Benedict
Haagensen & Lloyd LLP
1001 SW 5th Avenue
Suite 2000
Portland, OR 97204-1136
Fax: 503-224-3176
E-mail: efinklea@chbh.com
E-mail: cstokes@chbh.com

For The Energy Project and WISH :
Ronald L. Roseman
Attorney At Law
2011 14th Avenue East
Seattle, Washington 98112
Fax : 206 568-0138
E-mail: ronaldroseman@comcast.net

For CUA :
John O'Rourke, Director
Citizens' Utility Alliance
212 W. 2nd Ave. Suite 100
Spokane, WA 99201
Fax: 509-744-3374
E-mail: orourke@snapwa.org

For NW Energy Coalition :
Danielle Dixon
NW Energy Coalition
219 First Ave. South
Suite 100
Seattle, WA 98104
Fax: 206-621-0097
E-mail: danielle@nwenergy.org