BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REPLY BRIEF OF PUBLIC COUNSEL

WASHINGTON STATE ATTORNEY GENERAL'S OFFICE

JANUARY 27, 2005

I. INTRODUCTION

1. In reviewing PSE's Initial Brief (PSE Brief), Public Counsel did not find many significant areas of dispute that had not been addressed in Public Counsel's Initial Brief (PC Brief). This brief, therefore, attempts to avoid as much as possible simply repeating arguments made in detail in the opening brief. Commission Staff (Staff) and the Industrial Customers of Northwest Utilities (ICNU) have also ably addressed many issues in their Initial Briefs. The attempt here is to highlight some main points and themes, and to respond to a few particulars.

2. To sum up the main points of this Reply Brief:

- Public Counsel's recommendations regarding capital structure and return on equity (ROE) are balanced, reasonable, and technically sound. The recommendations are not intended to, and do not in fact, disregard PSE's specific circumstances, or its legitimate capital requirements for resource acquisition, infrastructure, and risk management.
- There is an adequate record for the Commission to determine that PSE's rate case and PCORC expenses are excessive and should not be fully borne by ratepayers. The adoption of a normalized expense level for these costs will create an incentive for the Company to control these expenses.
- Approval of a revenue requirement that exceeds the tariffs actually on file, as requested by PSE here, is not permitted by Washington law.

II. COST OF CAPITAL AND CAPITAL STRUCTURE

3. The overall theme of PSE's cost of capital case and its critique of Public Counsel and Staff, is based on the premise that acceptance of PSE's ROE and capital structure is essential to permit the company to obtain capital to meet its resource acquisition, infrastructure, and risk management needs. PSE Brief, ¶¶ 1-4. Public Counsel and others are accused of indifference to these goals. PSE Brief, ¶¶ 5-7. The theme is based on dual faulty premises --- first, that

ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

ratemaking traditionally does not provide for these needs, and second, that PSE's situation is so unique that the Commission must accept its aggressive proposal for a hypothetical capital structure and an unorthodox ROE methodology. Dr. Wilson effectively dismissed the "uniqueness" premise at the hearing:

> Q: [Ms. Dodge]: Your return on equity recommendation for Puget Sound Energy does not take into account the company's plans for resource acquisitions or for infrastructure investments, does it?
>
> A: [Dr. Wilson]: That's completely wrong. I mean, I took the capital structure numbers off of Mr. Gaines' own exhibits. I have the resource acquisition plans, the spending plans of the company built into my analysis. I've compared the company's spending plans with the comparable companies that the company has identified, and frankly, this company's net plant additions are not particularly remarkable.
>
> There's only three companies out of that group of 12 that you've designated as most comparable that have smaller amounts of plant growth projected for future years. And there's a – most of those companies have more plant growth --- more plant investment projected than Puget does. Alliant, MDU, Sierra Pacific, Wisconsin Electric and Power, Wisconsin Power and Light all, according to their Value Line documents that are in the record, have substantially larger capital expansion plans than Puget. Tr. 546:19—547:16.

4. In a long colloquy with Chairwoman Showalter, Public Counsel witness Mr. Hill addresses the basic premise that if the Commission "knows" that PSE is planning plant additions and infrastructure investments it should allow recovery now on the basis of those projections by setting ROE and capital structure higher than otherwise warranted. *See, e.g.* Tr. 511:12--512:7. Mr. Hill pointed out that PSE already has a degree of certainty provided by the PCORC mechanism which allows it to "rate base plant additions sooner than a rate case." Tr. 512:13-16. This sort of mechanism is likely perceived as indicative of a supportive regulatory environment which understands the company's need to add plant and infrastructure. Tr. 514:21-25. Given that, Wall Street would be unlikely to assess undue risk to Company growth plans simply because PSE has not anticipated the growth by getting the capital structure in advance. As Mr. Hill put it:

> I think that's a positive thing, because after all, the way utilities grow their earnings and the way they make money is to build plant.
>
> It's the old fashioned way we used to do things when regulation was going along before people thought of taking things apart. If you want to grow your earnings, you build plant and you make more money on the billable plant. That's the way you do it. Tr. 514:25—Tr. 515:9.

Later in the discussion with the Chairwoman, Mr. Hill further explained the way in which ratemaking has always provided for the type of growth PSE has stated it plans to pursue:

> It's a normal course of events, when utilities are adding plant, for some of that --- some of those monies will be internally generated monies, they don't pay out as dividends, that they retain, some of those monies will come from there. Some will come from short-term debt, small amount. Some will come from preferred stock or debt and some will come from equity.
>
> When companies are expanding, they have to raise capital in the market place, and that's why you need to have an investment grade bond rating for a utility. That's important, and I've said that to you in previous Puget rate cases. I think that's important.
>
> But it's a normal course of events for the company to take their own destiny in their hands and determine how they're going to capitalize those operations. If they want a higher equity ratio, then they have to raise more equity from the capital market, and they're certainly in a position to do that. Their business position has improved from five to four, they have had a BBB bond rating with much worse common equity ratios and much lower coverages than we're recommending in this proceeding. So I think---that's why I hesitate to ask ratepayers once again to step up to the plate, or continue to step up to the plate for the company. Tr. 518:6 --- 519:7.

A. Capital Structure.

5. PSE's brief asserts that Public Counsel's proposals for capital structure and return on equity will erode the Company's financial position, undermining its ability to attract capital to fund resource acquisition and infrastructure, and to further support risk management activities. This assertion does not stand up to scrutiny under the facts of this case. PSE Initial Brief, ¶ 33. Public Counsel's recommendation for a 9.75% ROE is higher than any ROE the Company asserts it earned in the last three years. Earnings at the recommended level will improve the Company's financial position. The capital structure recommended by Public Counsel is

significantly higher than the capital structure actually employed by PSE over the last three years. During this time the Company has maintained its bond rating and successfully issued common equity.

6. PSE appears to argue at ¶ 28 of its brief that PSE is now in danger of losing its current bond rating, based on how it lines up with Standard & Poor's (S&P) benchmarks. Not only has PSE maintained its bond rating and issued common equity since 2001, there is clear evidence that its financial situation is improving, including its improved Standard & Poor's rating and the increased amount and term of its borrowing ability. Asserting that there is a strong downgrade risk now, when PSE is in the best financial condition of the past three years, does not square with the facts. PSE's financial condition compared much less favorably with the S&P benchmarks in the years after 2001 without negatively affecting the bond rating.

7. PSE asserts while "customers would pay a little more for the cost of a higher equity ratio" they will save due to lower debt costs over the next several decades. PSE Brief, ¶ 29. Public Counsel does not dispute the obvious point that an increase in PSE's credit rating will lower debt costs. That increase should be earned, however, through efficient management of operations, rather than by asking ratepayers to pay on equity that the Company does not have. Public Counsel also strongly disputes that savings on debt costs justify the equity ratio increase. Public Counsel witness Hill showed that the debt cost savings enabled by moving from BBB to BBB+ (first mortgage bonds) would be minimal, approximately $850,000 per year, compared with the additional $15.7 million per year cost of moving from 40% to 45% equity ratio. Ex. 357, p. 23:15-23 (Hill).[1]

[1] If the Company's requested ROE of 11.75% is used, instead of the actual ROE of 9.75%, the annual rate impact to PSE customers would be an additional $30 million. Ex. 351, p. 24:1-6 (Hill).

B. Return on Common Equity.

8. Even at an intuitive level, increasing PSE's ROE at a time when interest rates are down significantly and PSE is in a better position both financially and from a risk perspective, makes no sense on its face. Observable capital costs – as measured by bond yields, for example--- have declined more than 150 basis points since PSE accepted an 11% ROE in its 2001 rate settlement. Ex. 352, p. 8 (Hill). PSE argues that the investment community "expects the Commission will grant the Company rate relief that is supportive of [generation and infrastructure investments]." PSE Brief, ¶ 36. While this Commission does not look to Wall Street analysts to tell it how to set rates, PSE's statements should be compared with what the record actually shows about investment community expectations. The A.G. Edwards firm, for example, has observed that gas utility investments are expected to provide returns well below 10%. Ex. 351, p. 7:8-11 (Hill). Bond yields also reflect that capital costs are at historically low levels. Id., p. 7:17-8:18 (Hill). Lehman Brothers estimates an ROE outcome for PSE 125 basis points below their request with a 43% equity ratio. Ex. 160, p. 9.

9. As it did at the hearing, PSE devotes substantial time to attacking Mr. Hill's list of ROE awards under 10%, contained in the introductory portion of his testimony. Ex. 351, p. 5, n.1. PSE Brief, ¶¶ 38-43**.** This is a straw man argument by PSE. Mr. Hill's testimony was simply that "capital costs have been low and several regulatory bodies have set the allowed equity return in the single digits," both indisputable points. The point of this compilation, clear from the hearing testimony quoted by PSE, was that "utilities generally have similar risk *compared to other investments in the marketplace*." Tr. 497:22-24. (emphasis added). Mr. Hill is merely addressing any general concern on the Commission's part that single digit rates of return are unheard of in the current era for utilities in the United States. This is not, as PSE well knows, the basis of Mr. Hill's ROE analysis. His own thorough cost of equity recommendation, including selection of a sample group of companies, appears later in his testimony and exhibits.

10. PSE asserts that Mr. Hill's recommendation "did not consider the Company's particular facts or circumstances." PSE Brief, ¶ 37. This not correct. Mr. Hill selected a similar-risk sample group. Among other factors, he reviewed: PSE's financial history, Ex. 351, pp. 18-19, 24-26, Ex. 357, pp. 1-2; present financial condition, Id.; its bond ratings, Ex. 351, p.23; its regulatory history, Id., p. 24; and its affiliate relationships in determining the cost of capital. Id., p. 19. *See also*, Ex. 351, pp. 33-34:8.

11. Contrary to PSE's claim, PSE Brief, ¶ 38, Public Counsel's cost of equity analysis quite specifically accounts for "the fact that the Company must compete in a national landscape that includes many other investment options" by relying on market prices in the Discounted Cash Flow (DCF) model. This directly shows the value investors are willing to put on the common equity of similar risk utility operations across the United States. Mr. Hill's analysis also takes into account the relative risk of an investment in Puget, compared to the broad stock market (i.e. "other investment options"), through the use of the beta coefficient in the Capital Asset Pricing Model (CAPM). This measures the relative risk of an investment in a vertically-integrated combination gas and electric utility versus that of the stock market as a whole. Ex. 355, p.1 (Hill).

1. DCF Methodology Issues.

12. PSE effectively concedes that Dr. Cicchetti's DCF analysis is unorthodox, arguing that " 'traditional' measures of the DCF component are inapplicable to the Company's facts." PSE Brief, ¶ 47. As discussed above, Public Counsel does not agree that PSE's situation is so radically new and different that well-accepted cost of capital analytical tools, understood and employed by this Commission in many cases, including PSE cases, is now to be discarded. It is more likely that Dr. Cicchetti, having discovered that the appropriate analysis does not reach the desired goal of an ROE increase above 11%, has sought to fashion a novel alternative that does.

13. PSE responds to Public Counsel's critique of Dr. Cicchetti's use of stock price growth for DCF by complaining that Public Counsel has simply chosen the wrong time period to measure growth – the period when stock price reacted to the Tenaska disallowance – and that this is "misleading." PSE Brief, ¶48. PSE's critique misses the point. Public Counsel readily agrees that this approach is misleading as a way of determining ROE – that is exactly the problem with this technique, whether employed by PSE or any other party. Dr. Cicchetti's selected period supports his proposed ROE. Public Counsel's selected period only four months later happens to match the traditionally derived DCF. The point is that Dr. Cicchetti's method is so dramatically volatile as to be unreliable.

14. PSE lists a number of ways in which Mr. Hill's sample companies are said not to be comparable to Puget because certain factors were not considered. PSE Brief, ¶¶ 54-59. However, the Standard & Poor's business position, used in compiling the sample group, takes into account all of the operating risks listed, including power purchases, infrastructure needs, regulatory factors, service territory, and economics. Ex. 345, pp. 6-7.

15. PSE's challenge to Mr. Hill's sample group screening is not well taken for other reasons. PSE Brief, ¶ 53. Each of the companies used by Mr. Hill had a BBB bond rating from at least one of the two major rating agencies. Mr. Hill accounted for the financial risk differences between his sample companies (average equity ration of 43.8%) and Puget (assuming a 40% equity ratio). Ex. 351, pp. 43-47 (Hill); Ex. 367. The minor differences in bond rating pointed to in the PSE brief are a red herring.

16. The Company also argues that the debt capitalization "average for Mr. Hill's sample group *at the utility subsidiary level* is about 48.0%." PSE Brief, ¶ 56 (emphasis added). The key phrase here is "at the utility subsidiary level." Investors cannot buy stock at the utility subsidiary level. They can only buy stock in the publicly traded parent company. Therefore, the capital structure that impacts the risk faced by the investor, and thus the investor's required return, is that of the parent. As Mr. Hill notes in Ex. 367, the average debt ratio of the sample group is

56.17%, slightly below Public Counsel recommendation of 60%. Mr. Hill directly accounted for that difference in financial risk by raising his recommended return on equity 25 basis points – a generous upward adjustment given that the indicated increment was only 12 to 16 basis points. Ex. 367.

17. PSE also argues that some of the sample companies are located in states where restructuring is active and should have been excluded because "authorized returns" were lower in those states. PSE Brief, ¶ 58. The flaw in this argument is the Mr. Hill's analysis here was not tied to commission "authorized returns," but to investor-determined, market-required returns for similar risk utilities. If S&P concluded that, due to deregulation, the business risk of the sample group had been lowered, S&P would have recorded any such reduction. In fact, the business risk of the sample group is higher than that of Puget. Ex. 351, p. 33.

2. CAPM Issues.

18. PSE's brief mischaracterizes Mr. Hill's testimony regarding the market risk premium, referring to it as based on "77-year old financial market data going back to 1926," and failing to look at recent evidence. PSE Brief, ¶ 65. The evidence actually discussed by Mr. Hill was the 2004 edition of Ibbotson's *Stocks, Bonds, and Inflation* reviewing risk premium data from 1926 through 2003. Ex. 351, p. 56:1-2, n.22. Furthermore, Mr. Hill did in fact look at other recent information on this issue, noting that "recent research on the market risk premium indicates that the Ibbotson data may be overstated and that the actual market risk premium may range only from 2.5% to 4.3%." Id., p. 56:2-4. If the Ibbotson average of 6.6% overstates the expected market risk premium, the 12.91% derived by Dr. Cicchetti's use of a stock price growth DCF is shown to be *twice* the current expectation. Id., p. 56:18.

C. Short Term Debt.

19. PSE makes the assertion that "the Company has fully disclosed and accounted for Rainier Receivables in this case." PSE Brief, ¶ 19. In Public Counsel's view, this is only true because of

Public Counsel's efforts in discovery and in cross examination to explore this issue. Under the current arrangement, there is no way for the Commission to know how much short-term debt Puget has available for use or how much of Puget-secured short term debt is being used by the parent company.

20. Public Counsel does not agree that "in the absence of Rainier Receivables, the Company would have needed some other, more-expensive facility to provide liquidity and financial flexibility[.]" PSE Brief, ¶ 21. Public Counsel is not claiming that factoring receivables is bad policy, merely that the manner in which Puget has elected to structure the arrangement is harmful to ratepayers. Puget pays all Rainier Receivables fees, but no Rainer Receivables debt appears on PSE's books, therefore ratepayers do not get the advantage of all the short-term debt available to PSE. In addition, there has been no recognition in this case that selling receivables shortens revenue lag-time and should, if properly analyzed, reduce Puget's revenue requirement by lowering cash working capital requirements. Finally, the negative tax expense generated by Rainier Receivables should benefit PSE ratepayers because it is their consistent payment of bills that serves as the collateral for Rainier to issue debt. While Public Counsel acknowledges that the ultimate short term debt recommendations in this case do not differ dramatically among the parties, Public Counsel believes the rate case has provided an opportunity to examine these questions for their longer term significance. Public Counsel recommends that the Commission order: (1) that Rainier Receivables debt also be reflected on the books of PSE; (2) that the facilities costs associated with Rainier Receivables debt be attributed to all the Company's short term debt, not only that of PSE, and (3) that Staff conduct an investigation of the working capital and negative tax expense issues raised by Public Counsel.

III. REVENUE REQUIREMENT

A. Adjustment 2.03 – Power Costs (Hydro Normalization).

21. As stated in our opening brief, Public Counsel urges the Commission to retain the 40-year rolling average approach to hydro normalization. PSE argues on brief that its approach is "consistent with the direction" in the 1992 rate case because it retained an expert statistician to do an extensive analysis. PSE Brief, ¶ 84. While the brief now acknowledges the Commission's direction, the order was given little if any attention by Dr. Dubin. As both Public Counsel and ICNU argued in our initial briefs,[2] it is hardly consistent with the 1992 order for the company to simply reiterate the same arguments that were made in the earlier proceeding. PSE's brief does not even assert, much less explain how it has presented clear and convincing evidence of a superior alternative.

22. Staff's brief states that "the 40-year rolling average is not set in stone," citing a Washington Water Power decision from 1986. Staff Brief, ¶ 108. Given the language of the 1992 order, and the history of the issue between 1986 and 1992 discussed in that order, it is quite clear that the Commission did indeed intend to limit the circumstances under which it was willing to revisit this issue. The only real relevance of the 1986 language to the current case is that it previews the kind of careful "generic case" analysis that occurred in the 1992 case, leading to the Commission's decision to adopt a long-term resolution to the issue.

B. Adjustment 2.18 - Rate Case Expense.

23. Public Counsel supports the comments and recommendations of ICNU with regard to rate case and PCORC expense. Public Counsel agrees that normalization of rate case expense is a important tool in providing an incentive to PSE to control its rate case expense. Use of the

[2] CORRECTION: In Public Counsel's Initial Brief, there was an error in footnote 54 to the following sentence in ¶112: "Even in the prior PSE rate cases where the issue was litigated, it was known that streamflow data was available for at least 105 years." In addition to the Washington Water Power case, the footnote should have contained the citation to the PSE 1992 rate case. *WUTC v. Puget Sound Power & Light*, UE-921262, et al, Eleventh Supplemental Order, p. 42.

deferred accounting and regulatory asset mechanism simply provides PSE with a blank check to continue unfettered levels of expenditure which are borne entirely by its customers. Rate case expenses are not the type of unanticipated and extraordinary expenses appropriate for deferred accounting. Moreover, it does not appear that the Commission has ever specifically authorized PSE to defer rate case expenses. ICNU Brief, ¶ 48.

24. PSE's level of rate case expense is excessive and unreasonable. ICNU's Initial Brief persuasively reviews the evidence in the record regarding the reasonableness of the Company's expenditures. ICNU Initial Brief, ¶¶ 61-66. There is an ample record in this case upon which the Commission can determine a reasonable level of costs for inclusion in rates through normalized expense levels. The record includes: (1) the Commission's previous warning to PSE about expense levels, Id.; (2) the Company's own internal review of legal expenses, with data about national standard levels of cost and internal/external counsel ratios, Id.; (3) oral testimony regarding comparative levels of expenditure for experts by other parties and in other jurisdictions, Id.; (4) Staff's open meeting memorandum regarding PCORC expense, Ex. 385, pp. 3-5 (Exh. pagination); and (5) prefiled testimony and exhibits of Staff and ICNU witnesses.

25. While PSE has the right to a recover a reasonable level of expense for attorneys and experts, there is something fundamentally troubling about requiring ratepayers to carry the full burden of such a high level of expense incurred for the purpose of increasing the very amounts that customers will pay for energy from their family and business budgets. These expenditure levels also undermine the Company assertions about financial need in this docket.

IV. CATASTROPHIC EVENTS

26. Public Counsel supports the Staff position on this issue. Public Counsel has no objection to the change of the definition proposed. With respect to the annual cost threshold – the "second trigger," Public Counsel recommends the Commission adopt Staff's proposal as the more equitable from the ratepayer perspective for the reasons set out in the Staff Brief, ¶ 183. We also

agree strongly that an important component of the trigger should be making it subject to Commission review after December 2007, to allow for adjustment after there has been experience with the new metric. Finally, we join in Staff's recommendation that PSE's blanket authority not be extended beyond the electric system to include the gas system and non-storm events. Public Counsel is particularly concerned about the fact that this broader application would eliminate the availability of prudence review for expenses from such events.

V. COMMISSION AUTHORITY TO APPROVE HIGHER RATES WITHOUT A TARIFF FILING

27. Public Counsel agrees with the position taken by Staff in its Initial Brief on this topic. Staff Brief, ¶199. PSE's request is not consistent with applicable statutory requirements. RCW Title 80, Chapter 28, sets out the general statutory provisions and procedures by which changes in customer rates are to be effected. RCW 80.28.050 requires that company tariffs be on file with the Commission and be open for public inspection. RCW 80.28.060 specifies the procedures for increasing and for decreasing tariffed rates. The statute provides that, unless otherwise ordered by the Commission, "no change shall be made in any rate, toll, rental, or charge" on file with the Commission, except after thirty days notice. The notice must "plainly state the changes proposed to be made in the schedule then in force, and the time when the changed rate, toll, or charge will go into effect, *and all proposed changes shall be shown by printing, filing and publishing new schedules, or shall be plainly indicated upon the schedules in force at the time and kept open to public inspection.*" (emphasis added). The statute goes on to provide that proposed changes may be suspended by the Commission prior to the effective date. RCW 80.04.130 sets out the procedures for suspension and hearing.

28. The Commission may allow rate changes on less than statutory notice, but only "for good cause shown" upon issuance of an "order specifying the changes so to be made and the time when it shall take effect." RCW 80.28.060.

29. A fundamental principle at the heart of Washington's rate making statutes and regulatory procedures is full, clear, and accurate notice to customers and the Commission of whether and how a company proposes to change its rates. Adequate and sufficient notice is not achieved by merely providing customer's notice of one rate proposal, and then pursuing a second one for a higher rate. The purpose of the statutes to require the Company to make a concrete and defined proposal for a rate change, so that the Commission and other parties will then know how to proceed. This enables customers, in particular, to determine if a rate case will affect them, what the maximum affect will be, and whether they wish to participate in the proceeding from the outset.

30. Both courts and commentators have recognized that tariff filing requirements protect consumers through notification and certainty. Professor Leonard Goodman's treatise, *The Process of Ratemaking*, observes that ratepayers are entitled to the notice and opportunity to be heard that occurs in a formal rate case when substantial rate increases are involved. Leonard Saul Goodman, *The Process of Ratemaking*, Vol. I, 58 (1998). Goodman also stresses the importance of specificity in rates when he points out that exceptions to filing requirements have been limited to those that are specifically exempted by administrative order. Id. at 46-47. The author cites multiple cases in which agencies rejected tariffs because they were improperly prepared pursuant to agency rules (for instance, lack of specificity in rates and improper filing form). Id. at 46 and 47.

31. Where the statutes prescribe a manner in which proceedings before a public utility commission are to be initiated, the procedure must be followed. *See, e.g., State ex rel. Laclede Gas Co. v. Public Service Commission of Missouri*, 535 S.W. 561, 568 (Mo. Ct. App 1976).[3] In *State ex rel. Utility Consumers' Council of Missouri v. Public Service Commission of Mo.*, 585

[3] Citing 73 CJS Public Utilities ¶ 47, p. 1114; *State ex rel. Landry v. Public Service Commission*, 327 Mo. 93, 34 S.W. 2d 37 (1931); *Florida Motor Lines Corporation v. Douglas, 150 Fla. 1, 7 So. 2d 843* (banc. 1942); Southern Bell Telephone & Tel Co. v. City of Louisville, 265 Ky 286, 96 S.W. 2d 695 (1936); City of Pittsburgh v. Pennsylvania Public Utility Commission, 157 Pa. Super. 595, 43 A.2d 348 (1954).

S.W. 2d 41, 49, 33 P.U.R.4th 273 (Mo. 1979), the Missouri Supreme Court elaborated on this principle, stating that "utility rates should be definite and published in order to insure stability and notice of rates to consumers…" Id. The court stressed that consumers must understand their rates and have the knowledge necessary to determine if a complaint is warranted. Id. The general rate case allows those opposed as well as those in sympathy with a proposed rate a forum to present their views. Id.

VI. CONCLUSION

32. For the foregoing reasons, and those set out in the Initial Brief, Public Counsel respectfully requests the Commission to adopt its recommendations on the contested issues in this case, and to approve the rate design/rate spread settlement supported by all parties.

DATED this 27th day of January, 2005.

ROB McKENNA
Attorney General

Simon J. ffitch
Assistant Attorney General
Public Counsel

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ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

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