Exhibit No.___(MPG-1T)
Docket No. UE-132027
Witness: Michael P. Gorman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of PUGET SOUND ENERGY, INC. For an Accounting Order Approving the Allocation of Proceeds of the Sale of Certain Assets to Public Utility District #1 of Jefferson County.	))))))))))	Docket No. UE-132027

RESPONSE TESTIMONY OF MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

March 28, 2014

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Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a managing principal of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exhibit No.___(MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will respond to Puget Sound Energy, Inc.'s ("PSE" or the "Company") proposed accounting order for allocation of the proceeds of the sale of certain assets to Public Utility District No. 1 of Jefferson County ("JPUD").

Summary

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS.

A. The Company proposes to retain the net book value of the assets and to recover transaction costs associated with the sale. It then proposes to keep 75% of the remaining proceeds and credit 25% to customers. Under this proposal, $44.9 million of the remaining proceeds would be allocated to shareholders and $14.9 million to ratepayers. Petition for Accounting Order ("Petition") ¶ 25. This proposal is not reasonable. PSE acknowledges that the Washington Utilities and Transportation Commission ("Commission") typically allocates gains based on risks and rewards, and benefits and burdens. Petition ¶ 7. However, as described below, PSE has not accurately assessed the risks and rewards, and the benefits and burdens produced by this transaction to both shareholders and customers.

Rather, PSE's position primarily focuses on shareholders, and is not a balanced assessment of consequences of the transaction. By recovering the net book value of the assets, as well as transaction costs, and reinvesting this capital in new assets, PSE bears little risk associated with the JPUD sale and will not be worse off as a result of the sale.

PSE's customers, on the other hand, assume significant risk of early retirements of regulated utility plant in-service. This risk relates to acceptable accounting mechanisms, regulatory treatment of plant that is retired early, or destroyed due to natural events. The JPUD forced asset sale is an instance of a utility retiring assets early. Customers typically assume significant risk of early asset retirement by providing utilities full cost recovery. In addition, PSE's customers have paid for, in their rates, a return of and a return on the capital assets that were sold to JPUD.

A more appropriate and balanced assessment that recognizes the risk/reward and benefit/burden consequences of this transaction supports my proposed allocation of the sale proceeds. I propose to allocate the sale proceeds by allowing PSE to fully recover its net plant balance and transaction costs, reimbursing customers for the accumulated depreciation paid to PSE (difference between gross plant and net plant), and allocating 90% of the remaining sale proceeds (above the gross plant amount) to customers and 10% to shareholders.

<u>JPUD Asset Gain and Sharing Allocation</u>

Q. DID PSE ESTIMATE THE AMOUNT OF TRANSACTION GAIN PRODUCED ON THE SALE OF THE JPUD ASSETS?

A. Yes. The Company estimates the gain from the JPUD sale to be $59.96 million.[1/] PSE derived the gain by the total sale price less the net book value of the assets and less the transaction costs. The method the Company uses to measure the gain essentially makes the Company whole for its net investment cost of the assets and transaction costs, and identifies the remaining amount as a gain on the transaction.

Q. DO YOU BELIEVE THE COMPANY'S METHOD OF IDENTIFYING THE AMOUNT OF SALE PROCEEDS TO SHARE BETWEEN CUSTOMERS AND INVESTORS IS REASONABLE?

A. No. Both the Company and customers made significant contributions to the gross plant value of the JPUD assets. Through annual depreciation expense recoveries paid via rates, PSE has recovered $29,938,735 of its original investment cost in the JPUD assets. PSE Exhibit No. ___(MRM-3). This amount represents the accumulation of annual depreciation expense on these assets. As such, the original investment funding of the JPUD assets has been shared between PSE and its customers. Hence, the sale proceeds should reimburse investors for their outstanding investment in the JPUD assets and customers for the payment of JPUD investment costs.

Q. WHAT IS A MORE APPROPRIATE CALCULATION OF THE GAIN FROM THE JPUD TRANSACTION?

A. The gain from the JPUD sale should be calculated after allocating net plant value and transaction costs to PSE and accumulated depreciation to customers. Using this allocation of original investment cost methodology, I propose to define the gain on the sale as a gross gain. This gross gain is computed by taking the difference between the

[1/] PSE Exhibit No.___(MRM-1T) at 7, and Exhibit No. ___(MRM-3).

sale price, removing a total gross plant investment of JPUD assets, and removing PSE's transaction costs. This produces a gross gain on the sale of around $30 million, which is computed by the sale proceeds of $109.4 million less the JPUD original asset cost of $76.6 million, and other transaction costs of $2.7 million.

Q. PSE ARGUES THAT REMAINING CUSTOMERS ARE NOT ENTITLED TO THE ACCUMULATED DEPRECIATION BECAUSE ITS FORMER JPUD CUSTOMERS PAID FOR THE FULL COST OF THE SOLD ASSETS. DO YOU AGREE?

A. No. By attempting to allocate the costs of supporting the JPUD assets to its former JPUD customers, PSE is assuming a precision in cost recovery that simply does not exist in ratemaking. Customers pay for the costs of PSE's service on a system-wide basis. As such, it is not clear which customers paid rates that provided PSE full cost recovery of its JPUD assets.

Further, PSE's allocation method does not recognize the cost recovery mitigation benefits created through allocating costs across all the customers on the system, and charging system-wide cost-based rates. Allocation of costs to customers over the entire system mitigates PSE's cost recovery risk. Cost recovery risk is impacted by weather, the economy, natural events, outages, and other factors which can limit PSE's ability to collect its revenue requirement from specific groups of customers. A broader and more diverse customer base mitigates this sales risk, or cost recovery risk, and improves PSE's ability to recover its cost of service. Hence, it is appropriate to conclude that PSE recovered the JPUD costs from system-wide cost recovery and not only from JPUD customers.

Q. WHAT IS YOUR RECOMMENDATION REGARDING AN EQUITABLE ALLOCATION BETWEEN CUSTOMERS AND SHAREHOLDERS OF THE GROSS GAIN AS YOU HAVE DEFINED IT?

A. Based on my analysis of the risks and rewards, and benefits and burdens to PSE and its customers resulting from the JPUD transaction, as described below, I believe customers should be entitled to the full amount of the gross gain. However, recognizing that PSE should have an incentive to get the best deal possible for its customers, I recommend that 90% of the gross gain be allocated to customers and 10% to the Company, as shown in Table 1 below.

TABLE 1

Proposed Sale Proceeds Allocation

Description	Amount (000)
Sale Proceeds	$109,373
Original Cost JPUD Assets	76,625
Other Costs	2,722
Total Costs	$79,347
Gross Gain	$30,026
Company Allocation:	
Net Plant	$46,686
Other Costs	2,722
10% Gross Gain	3,003
Total	$52,411
Customer Allocation:	
Accumulated Depreciation	$29,939
90% Gross Gain	27,023
Total	$56,962

Source: PSE Exhibit No. __ (MRM-3).

As also shown in Table 1 above, the total amount of the sale proceeds allocated to the Company would be $52.411 million, and the total amount of the sale proceeds allocated to customers would be $56.962 million. Customers' allocated share of the gain includes 100% of accumulated depreciation on the JPUD assets, plus 90% of the gross gain. When compared to PSE's proposal, which allocates $94.381 million of the total sale proceeds to the Company, and $14.991 million to customers, my proposal is a much more equitable division of the proceeds.

Risks/Rewards, and Benefits/Burdens to PSE

Q. PLEASE DESCRIBE THE COMPANY'S RATIONALE SUPPORTING ITS PROPOSED SHARING OF THE GAIN BETWEEN INVESTORS AND CUSTOMERS.

A. In its Petition, the Company recognizes that the Commission has applied the standard that reward should follow risk, and benefit should follow burden when allocating the gain in connection with utility asset sales. Petition ¶ 7.

PSE witness Matthew R. Marcelia identified risks/rewards and burdens/benefits[2/] which he used to support the Company's proposed allocation of the gain. Mr. Marcelia notes PSE's risks and burdens as follows:

1. Sale of the JPUD assets was a forced sale, and PSE was not a willing seller to the transaction;
2. Sale of the assets reflected PSE's entire utility operating system serving JPUD;
3. Sale of the JPUD assets resulted in a loss of revenue and investment return for PSE shareholders;
4. PSE lost its ability to conduct business in JPUD's established market, which PSE had been serving for approximately 96 years; and

[2/] PSE Exhibit No.__(MRM-1T) at 8-10.

5. Investors primarily bear the investment risk of utility investments while customers bear little or no transactional risk of a forced sale.

Mr. Marcelia also stated that he considered consequences to PSE's remaining customers associated with the JPUD sale, and the impact on those customers as measured by his colleague, Mr. Jon A. Piliaris.

Q. DO YOU BELIEVE THE COMPANY HAS ACCURATELY IDENTIFIED AND DESCRIBED THE REWARDS AND RISKS, AND BENEFITS AND BURDENS TO ALL THE STAKEHOLDERS OF THIS TRANSACTION?

A. No. With regard to his statements that the JPUD transaction was a forced sale that constituted all of PSE's Jefferson County system, Mr. Marcelia provides no indication as to why this should influence the allocation of the gain from the sale. Further, contrary to Mr. Marcelia's position, I disagree that investors bear all the investment risk of utility plant investments. Certainly, investors may bear financial and operating risk of plant investments, but asset cost recovery risk is transferred to customers in the event of early plant retirement or natural event destruction of plant. PSE's sale of its JPUD assets can essentially be viewed as an early plant retirement. PSE has failed to acknowledge that the ratemaking constructs, and accounting mechanisms, shift significant asset cost recovery risk to customers in these circumstances.

Q. PLEASE ADDRESS THE COMPANY'S ASSERTIONS REGARDING LOSS OF CUSTOMERS AND RATE BASE.

A. The Company's arguments regarding the risks and burdens with reductions in rate base and loss of sales are incomplete or inaccurate. Specifically, it is true the Company's rate base will shrink as a result of the sale of the JPUD assets. But the Company has already testified that JPUD was a high-cost service territory with limited growth potential. PSE Ex. No. __ (SSO-5) at 16:12-15. Moreover, what Company witness Marcelia fails to recognize is that the capital supporting that rate base investment will be returned to the Company. As a result, the returned capital is available for reinvestment by PSE, or it can be returned to shareholders.

PSE has already stated that it plans to reinvest the proceeds. Petition ¶ 42. PSE states that it will reinvest the proceeds in "investments PSE would otherwise be required to make in order to serve its remaining customers." Exhibit No.__(MPG-3) at 11 (Resp. to Staff Data Request ("DR") 11). This, however, does not change the fact that reinvestment of the capital will produce new earnings that offset lost earnings from the JPUD sale. Thus, the Company and its shareholders are made whole by this transaction. There is no burden to the Company or its shareholders from the smaller rate base produced by the JPUD sale since, according to PSE, all capital supporting the JPUD assets will be returned to PSE and reinvested.

Further, Mr. Marcelia's claim about a reduction in customers and sales is only partially accurate. Shrinking the customers and sales base is a negative impact on the Company because it can limit growth at current rates. However, as noted above, this impact will likely only be temporary as the proceeds from the JPUD sale are reinvested to produce new revenues and profits.

Additionally, the Commission recently authorized an automatic rate escalation plan for PSE in Docket Nos. UE-121697/UG-121705 and UE-130137/UG-130138. Order 07 ¶¶ 137-73. This plan was designed to alleviate earnings attrition the Company claimed it was experiencing. Order 07 ¶ 149. This earnings attrition regulatory mechanism will allow PSE to quickly reflect in its rates to remaining customers any capital reinvested in its system based on the proceeds of the JPUD asset sale. Therefore, PSE's rates and earnings will quickly be restored to offset any losses produced through this JPUD sale. There is no reason to believe PSE's rate escalation plan cannot compensate the Company for a temporary and relatively minor loss of earnings it may experience from its loss of the JPUD service territory. It is noteworthy, however, that in 2013, PSE's earnings exceeded its authorized rate of return.

Q. DO YOU BELIEVE THAT THE COMPANY IS FAIRLY COMPENSATED FOR ITS RISK OF MAKING UTILITY PLANT INVESTMENTS?

A. Yes. The Company's investment risk is considered in each rate case in establishing a fair return on equity and overall rate of return. The return on equity reflects the level of compensation the market demands for assuming the level of risk in PSE. Thus, that return would include the known and long-standing risk that a public utility district such as JPUD may condemn a portion of PSE's service territory.

PSE's return also accounts for financial and operating risk of the utility. This financial and operating risk deals with the Company's ability to produce revenue to cover its cost of service and produce earnings and cash flow that are adequate to service its debt/financial obligations, and produce adequate earnings to pay dividends and reinvest retained earnings to allow for growth in dividends over time. As such, to the extent customers pay rates which provide the utility an opportunity to earn a fair rate of return, PSE is fairly rewarded for its investment risk. Allowing PSE to retain a portion of the gain on an asset sale will provide it compensation in excess of this fair rate of return or compensation level.

Q. PLEASE ELABORATE ON THE RISK OF CONDEMNATION PSE FACES.

A. PSE's witness, Mr. Marcelia, claims that one of the risks and burdens PSE faces from the sale of the JPUD assets is that JPUD's condemnation of PSE's service territory deprived it of its ability to operate in an established market it had served for many years. However, as noted above, PSE's competitive rate position is known to the market and to PSE. To the extent PSE's rates are so uncompetitive that there may be significant risk of additional condemnation of existing customer groups, that risk would be known to markets, and would be reflected in PSE's bond rating and stock price. Hence, this risk would be incorporated into its total investment risk and would be included in its risk-adjusted return awarded in rate proceedings. In fact, the JPUD sale was known to the Commission when it approved PSE's expedited rate filing and rate plan in 2013. Docket Nos. UE-121697/UG-121705, UE-130137/UG-130138, Order 07 ¶¶ 207-210.

PSE can help mitigate or offset this uncompetitive rate position risk by using every opportunity available to it to reduce its cost of service and make its rates and service reliability and quality more attractive to current and prospective new customers. Allocating a greater share of the gain produced by this asset sale to its customers is consistent with reducing PSE's rates and improving its competitive rate position. JPUD has stated that its decision to condemn PSE's service territory and receive power from the Bonneville Power Administration "substantially reduce[s] the cost of electricity to Jefferson County over the long-term." PSE Ex. No. __ (SSO-7) at 3. PSE's rates have increased significantly over the past decade, and, as discussed above, the Company was recently awarded an automatic rate escalator until at least 2016. Thus, by pricing its service in an uncompetitive manner, PSE increases the likelihood of condemnation by a public utility district. As I discuss more thoroughly below, this condemnation creates risks for remaining customers, but only PSE has any ability to avoid such a condemnation action.

Q. WHAT IS YOUR OVERALL ASSESSMENT OF PSE'S RISKS AND BURDENS ASSOCIATED WITH THE SALE OF THE JPUD ASSETS?

A. PSE faces negligible risks and burdens from the JPUD sale. The Company is fully compensated for the net plant value of the assets and will be able to reinvest this amount in new assets that will produce new revenue to make up for any lost revenue. The risks PSE faces from this transaction are nothing more than risks inherent in the utility business for which PSE is compensated through its return on equity and overall rate of return.

<u>Risks/Rewards, and Benefits/Burdens to Customers</u>

Q. PLEASE DESCRIBE THE CUSTOMERS' RISK AND REWARD OF UTILITY PLANT INVESTMENT.

A. Utility customers typically assume significant amounts of utility plant investment risk because they are obligated to pay cost-based rates based on the utility's cost of service including a fair rate of return. Utility plant in-service can become obsolete or not competitive (too expensive), and it may not produce optimal service. Nonetheless, customers have the risk of paying cost-based rates consistent with Commission regulatory practices for uncompetitively priced utility service.

Also, certain accounting mechanisms shift cost recovery risk of obsolete equipment or early retirement of equipment to customers. For example, utilities will routinely retire plant before the plant operates over its expected useful life. Customers bear the cost recovery risk of plant that is retired early. Thus, as with the JPUD assets, customers assume the cost recovery risk of plant investment that does not operate for its expected useful economic life.

Customers also assume significant asset investment risk related to major damages caused by storms, earthquakes or other natural events. Indeed, PSE has fully recovered its restoration costs for these natural events, at significant cost to its ratepayers. As such, early asset destruction or impairment risk is shifted from shareholders to customers due to the regulatory treatment of major storms, or other natural events.

Q. PLEASE DESCRIBE THE ACCOUNTING TREATMENT FOR EARLY PLANT RETIREMENT.

A. PSE acknowledged that customers assume significant utility plant investment risk by responding to a hypothetical example in discovery requests. Exhibit No.___(MPG-3) at 1-2. In that hypothetical example, I ask them to describe the accounting treatment for a utility gross plant investment of $1 million, with $500,000 of accumulated depreciation, and a net plant balance of $500,000. PSE described the accounting treatment if this asset is retired early, i.e., before it completes its estimated useful life.

As shown on the attached Exhibit No.___(MPG-3), PSE described the accounting treatment that effectively would adjust its accumulated depreciation reserve to fully cover the net plant value of the retired asset. The accounting practice for early retirement of plant essentially adjusts accumulated depreciation to shift depreciation reserves to cover the balance of the undepreciated retired plant. This practice results in early plant being removed from cost of service, with no impact on the utility's remaining net plant balance.

As a result, the utility receives full cost recovery of plant that is retired early, even if the plant did not operate for its full expected useful life, and was not fully depreciated. The risk of this early plant retirement is transferred to customers as they pay rates that reflect net plant amounts adjusted to give investors full recovery of early retirement plant costs, even though the retired plant is no longer used and useful in providing service.

Through this accounting practice, utilities (including PSE) transfer cost recovery risk of early plant retirement to customers. The sale of the JPUD assets is similar to an early plant retirement in that PSE still has significant net plant value associated with these assets remaining on its books, and will remove these assets from its books upon sale completion. As PSE's response to ICNU DR 6.01 indicates, this is precisely the accounting treatment the Company has followed in the past when it has disposed of assets for significantly less than those assets' remaining net plant value. Exhibit. No.___(MPG-3) at 7-9. Customers have had to pay for the remaining difference.

Q. HOW DOES PSE SHIFT ASSET COST RECOVERY RISK TO CUSTOMERS WHEN PSE EXPERIENCES MAJOR ASSET DAMAGE CAUSED BY STORMS, EARTHQUAKES OR OTHER NATURAL EVENTS?

A. PSE described the regulatory treatment typically afforded to a utility in the event of major system investment destruction in the event of major storms, earthquakes, or other natural events. In response to ICNU DR 5.1, PSE outlined the authority for deferred accounting treatment, and full cost recovery of its expenses, and lost investment costs associated with natural disasters. Exhibit No.___(MPG-3) at 3-6. Customers assume the cost recovery obligations of restoring the Company's service in the event PSE is hit by these natural disasters that cause significant damage on its system. These costs can be significant, and the risk mitigation to PSE and its shareholders is meaningful. As such, customers take the risk of early asset retirement caused by natural events that destroy a part of the system. This is a material shift in risk of owning the assets and should be recognized in allocating the gross gain. Because customers may bear the cost recovery risks of early plant retirement and destruction, they should be awarded any gain accordingly. My testimony is not opining on the reasonableness of customers absorbing this risk, but noting it as a factual matter supports passing the gain to customers in this case.

Q. DID PSE OUTLINE THE POTENTIAL COST RECOVERY AND THE IMPACT ON EXISTING CUSTOMERS AS A RESULT OF THE SALE OF THE JPUD SERVICE TERRITORY?

A. Yes. PSE witness Piliaris estimated the impact on existing customers, at least on a short-term basis, in PSE Exhibit No.___(JAP-3). He provides two revenue requirements impacts excluding fuel costs. The first impact on page 1 under Scenario 1 compares the sale of the assets less avoided costs. In this analysis, Mr. Piliaris estimates a temporary increase in revenue requirement to remaining customers of around $3.25 million per year. In his second scenario, he considers lost revenue in comparison to changes in allocation of costs. However, this analysis is not useful for measuring the temporary cost impact on remaining customers because it does not compare lost revenue to avoided cost. Rather, he includes expenses as an offset to lost revenue which will not be avoided as a result of the sale of JPUD assets.

Further, in Mr. Piliaris's Exhibit No.___(JAP-7), he indicates a potential increase in PCA costs to remaining customers as a result of the sale of JPUD. Again, this may be a temporary cost, but it does indicate that customers may be burdened by increased cost of service, at least temporarily, as a result of the sale of JPUD. Mr. Piliaris indicates benefits to remaining customers starting in year 2018 as a result of the JPUD sale. However, these PCA cost projections at that point seem problematic because he assumes increases in PSE's incremental power costs of around

21% from 2017 to 2018, but an increase in JPUD-related PCA revenue of only 5%. Hence, starting in year 2018, Mr. Piliaris's assumptions seem to be based primarily on an assumption that JPUD customers would not pay the incremental increase in PSE's incremental power costs. Therefore, the accuracy and reliability of the net power cost benefit he calculates starting in year 5 (or 2018) is highly questionable.

Q. WHAT IS YOUR ASSESSMENT OF THE RISKS AND BURDENS OF THE JPUD TRANSACTION ON REMAINING CUSTOMERS?

A. Customers bear the vast majority of risks and burdens associated with PSE's sale of its JPUD assets. Even though this sale was involuntary, that does not modify PSE's accounting treatment of the sale, which transfers cost recovery risk of what can be characterized as early retired assets to PSE's remaining customers. Further, PSE's preliminary projections suggest that remaining customers may be burdened by higher costs, at least temporarily, as a result of the JPUD asset sale.

Q. PLEASE SUMMARIZE YOUR PROPOSED ALLOCATION OF THE SALE PROCEEDS BETWEEN CUSTOMERS AND PSE.

A. As outlined above, to properly reflect the risks/rewards and benefits/burdens the Company and customers assume from the JPUD sale, I recommend an allocation of the sale proceeds to provide PSE full recovery of its original investment cost of the JPUD assets as well as transaction costs, and to reimburse customers for payment of depreciation expense for the JPUD assets. The gross gain above the total original gross plant investment I recommend be allocated 90% to customers and 10% to shareholders.

Based on this analysis, I recommend that the $109.37 million of sale proceeds be allocated $52.411 million to the Company and $56.962 million to customers as outlined in Table 1 to this testimony.

Q. IN ADDITION TO YOUR RISK/REWARD FINDINGS, ARE THERE OTHER JUSTIFICATIONS TO SUPPORT YOUR 90/10 SPLIT BETWEEN PSE CUSTOMERS AND PSE SHAREHOLDERS?

A. Yes. First, my proposal simply attempts to make customers whole given their current level of investment in the JPUD territory that was transferred. Second, it is well known that PSE's high rates and poor customer service prompted the formation of JPUD, which customers had nothing to do with. PSE should not be permitted to profit from poor service. Third, the Commission should consider the totality of the circumstances when deciding the proper allocation, including how well PSE is currently earning. Fourth, the evidence in the case suggests 100% gain going to the customers. I have already made a 10% adjustment in favor of the Company in my proposed allocation.

Q. DOES THIS CONCLUDE YOUR RESPONSE TESTIMONY?

A. Yes, it does.