Exhibit No. __ (EJK-1T)
Docket UE-132027
Witness: Edward J. Keating

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 UE-132027**

TESTIMONY OF

Edward J. Keating

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

March 28, 2014

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I. INTRODUCTION AND SCOPE OF TESTIMONY

Q. Please state your name and business address.

A. My name is Edward J. Keating. My business address is the Richard Hemstad Building, 1300 S. Evergreen Park Drive S.W., Olympia, Washington 98504.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission ("Commission") as a regulatory analyst.

Q. How long have you been employed by the Commission?

A. I have been employed by the Commission since February 2010.

Q. Would you please state your educational and professional background?

A. I graduated from Saint Martin's University in Lacey, Washington with a Bachelor of Arts degree in Accounting. Before joining the Commission, my relevant professional experience consisted of 12 years in a variety of fields, including management, accounting/auditing, and the treasury side of banking.

During my employment at the Commission, I have performed accounting and financial analyses of regulated utility companies. I have attended the following regulatory courses: "Utility Ratemaking: The Fundamentals and the Frontier", "Essentials of Regulatory Finance", and "Regulatory Approaches to Accommodate Renewable Energy, Demand-Side Resources, and Energy Efficiency Programs". I also attended the 55th Annual National Association of Regulatory Utility

Commissioners Regulatory Studies Program held at Michigan State University in 2013.

I have presented testimony in Docket UE-101217 regarding the sale of Puget Sound Energy, Inc.'s ("PSE" or the "Company") property to Public Utility District #1 of Jefferson County ("JPUD Sale"); Avista Corporation's General Rate Case, Dockets UE-120436 and UG-120437; and PSE's Power Cost Only Rate Case ("PCORC"), Docket UE-130617. I have also presented Staff recommendations to the Commission in open public meetings.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present the Staff recommendation for the distribution between ratepayers and shareholders of the proceeds received by PSE from the JPUD Sale. The Commission expressly reserved this issue in its Declaratory Order in Docket U-101217.[1] Staff witness Christopher Mickelson presents the Staff proposal for reflecting the ratepayer allocation of proceeds in rates.

Q. What is the total amount of the proceeds from the JPUD Sale?

A. The total proceeds at issue from the JPUD Sale are $109,373,196.[2]

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[1] *In the Matter of the Petition of Puget Sound Energy, Inc., For a Declaratory Order Regarding the Transfer of Assets to Jefferson County Public Utility District*, Docket U-101217 at ¶ 26 (February 1, 2011).
[2] Company Petition at ¶ 32.

Q. Does Staff have any concerns with the final sale price?

A. No. PSE received adequate compensation for the sale of the assets, as the Commission determined in its Declaratory Order in Docket U-101217.[3]

Q. Did you prepare any exhibits in support of your testimony?

A. Yes. I prepared Exhibit No.___ (EJK-2), which defines relevant terms and how they are calculated. The clear meaning of each term is important for understanding the fundamental differences between PSE and Staff regarding the distribution of JPUD Sale proceeds each party proposes.

I also prepared the following additional exhibits:

- Exhibit No. ___ (EJK-3), PSE and Staff Proposed Allocation of Proceeds
- Exhibit No. ___ (EJK-4), Cumulative Harm of Fixed Production Plant Costs
- Exhibit No. ___ (EJK-5), Decoupling Impact
- Exhibit No. ___ (EJK-6), Summary of Harm to Ratepayers
- Exhibit No. ___ (EJK-7), Company Response to Public Counsel Data Request 31
- Exhibit No. ___ (EJK-8), Company Response to Staff Data Request 6

Q. Please summarize PSE's proposal for the disposition of the JPUD Sale proceeds.

A. PSE allocates to investors 100 percent of the Net Book Value ("NBV") of the sold assets and 75 percent of the gain on the sale of those assets. Only the remaining 25 percent of the gain is allocated to ratepayers. As I explain in more detail below, the "gain" that PSE proposes to allocate to shareholders includes accumulated depreciation paid by ratepayers located throughout the Company's service territory.

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[3] *In the Matter of the Petition of Puget Sound Energy, Inc., For a Declaratory Order Regarding the Transfer of Assets to Jefferson County Public Utility District*, Docket U-101217 at ¶ 24 (February 1, 2011).

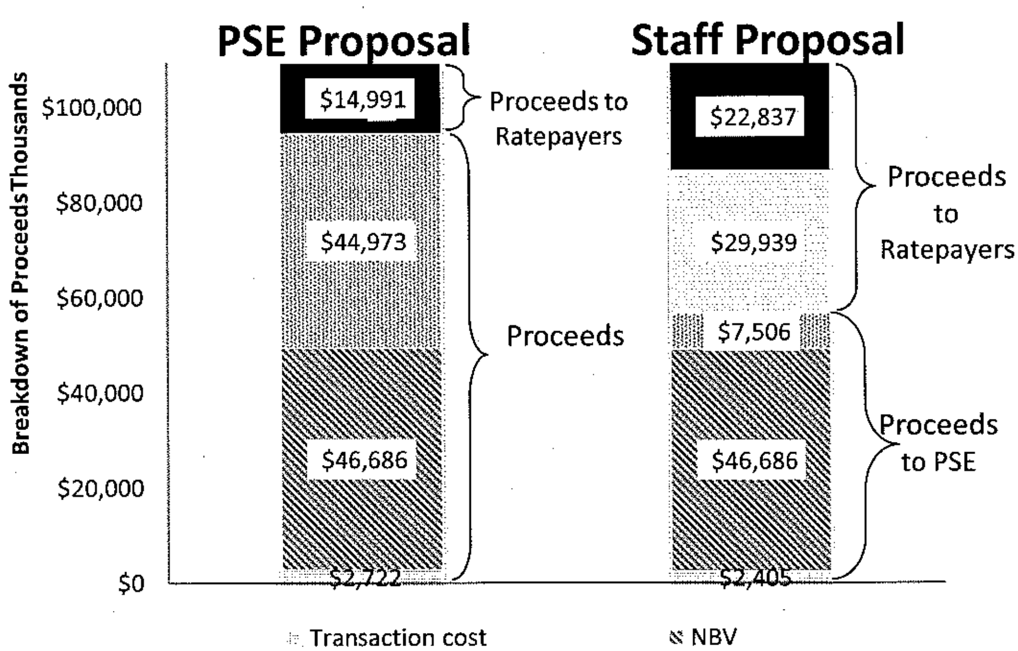
PSE's proposal allocates $94,382,118 to shareholders, including transaction costs of $2,722,448, and $14,991,078 to ratepayers, as shown on page 1 of Exhibit No.___ (EJK-3).

Q. Please summarize Staff's proposal for the disposition of the JPUD Sale proceeds.

A. As shown on page 1 of Exhibit No. ___ (EJK-3), Staff allocates to the Company 100 percent of the NBV and 25 percent of the appreciation from the JPUD Sale. Staff allocates to ratepayers 100 percent of the accumulated depreciation and 75 percent of the appreciation. Staff's recommendation allocates $52,775,723 to ratepayers and $56,597,473 to PSE.

Q. Have you prepared a chart summarizing the Staff and Company proposals?

A. Yes. The Company and Staff proposals are compared as follows:



Q. Please summarize the basis for the Staff recommendation.

A. No single approach afforded a fully equitable split of the JPUD Sale proceeds between shareholders and ratepayers under the circumstances of this case. Therefore, Staff balanced the following six key factors:

- Rate Base Rate of Return Regulation;
- Risk-Reward / Benefit-Burden Analysis;
- Case Precedent;
- Impact of JPUD Sale on Ratepayers;
- Impact of JPUD Sale on Shareholders; and
- Incentives.

These six factors, when considered together, support Staff's proposal.

Q. How is the rest of your testimony organized?

A. Section II of my testimony provides the factual background of the JPUD Sale. Section III of my testimony discusses each of the six factors that guided Staff's recommendation on the division of sales proceeds between ratepayers and shareholders. Section IV of my testimony outlines Staff's proposal for transaction costs.

II. BACKGROUND

Q. Please explain the factual background of this case.

A. In November 2008, the citizens of Jefferson County voted to authorize JPUD to construct or acquire electrical facilities for the generation, transmission or distribution of electric power in Jefferson County. Prior to that vote, outside consultants were hired by both PSE and JPUD to conduct feasibility studies to determine the potential costs and risks associated with JPUD acquiring the assets of PSE in Jefferson County and providing electric service to the residents of East Jefferson County.

In June 2009, outside counsel was retained by JPUD to assist in the acquisition, by purchase or by condemnation, of PSE's assets in Jefferson County. In July 2009, settlement negotiations commenced between PSE and JPUD and additional appraisals were performed. PSE entered these negotiations as an "unwilling seller" under the threat of partial condemnation by JPUD. A partial condemnation occurs when less than a utility's assets throughout its service territory are taken.

On April 30, 2010 a tentative agreement was reached for the sale of PSE's Jefferson County assets. On June 11, 2010 an Asset Purchase Agreement ("APA") was entered by PSE and JPUD.[4] The agreed purchase price was $103 million. This purchase price constituted JPUD's last and best offer.

The APA contained provisions related to electrical services provided by PSE to JPUD prior to closing including additions or improvements to the assets, and for the depreciation of assets placed in service during the transition period. These

[4] The APA is contained in Osborne, Exhibit No. __ (SSO-3).

provisions, along with the provisions of a subsequent Customer Transition Agreement ("CTA"), increased the sales price to $109 million at closing.

Finally, as a condition precedent to closing, the APA required an order from the Commission confirming that: (a) the purchase price was sufficient to fully compensate PSE's customers for the sale of the assets; (b) the provisions of the APA pertaining to PSE's transition of its responsibilities to provide electrical service to its customers in the Service Territory were sufficient and consistent with PSE's public service obligations; and (c) the transfer of the assets did not require Commission approval under RCW 80.12.020(1).[5]

The Company sought to acquire these confirmations on July 15, 2010 by filing with the Commission a Petition for Declaratory Order Regarding the Transfer of Assets to Jefferson County Public Utility District. On February 1, 2011, following the filing of a full settlement, the Commission granted the Petition. The Commission also determined that the disposition of the proceeds from the JPUD Sale would be considered in an appropriate proceeding at a later date. The current docket is the proceeding reserved for that issue.

III. DISCUSSION

A. Rate Base Rate of Return Regulation

[5] Osborne, Exhibit No.___ (SSO-3) at 10 and 20.

Q. The first factor Staff considered for its recommendation is Rate Base Rate of Return Regulation. How does Staff define this factor in this proceeding?

A. Rate Base Rate of Return Regulation divides the initial shareholder investment (original cost of an asset) between NBV and accumulated depreciation. NBV represents the investment made by shareholders that has not already been recovered in rates. Therefore, when the asset is sold, 100 percent of the NBV should be returned to shareholders, as Staff proposes for the JPUD Sale proceeds.

Accumulated depreciation equals the sum of all prior years' depreciation expense already recovered through rates. Therefore, when the asset is sold, 100 percent of the accumulated depreciation should be returned to ratepayers, also as Staff proposes for the JPUD Sale proceeds.

The JPUD Sale proceeds include value beyond NBV and accumulated depreciation. Staff refers to this amount as "appreciation". Appreciation is not addressed strictly in the application of Rate Base Rate of Return Regulation. The other five factors Staff considered support its allocation of appreciation from the JPUD Sale, as I discuss later in my testimony.

Q. Has the Commission used these categories (NBV, accumulated depreciation and appreciation) in prior utility asset sale cases?

A. Yes. The Commission allocated the proceeds from the sale of the Centralia Power Plant using these same three categories.[6] I discuss this case further in the Case Precedent section of my testimony.

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[6] *WUTC v. Avista Corporation, et. al,* Dockets UE-991255, *et al.*, Order 08 (March 6, 2000).

Q. Does the Company's proposal reflect these three categories?

A. No. PSE divides the proceeds between only NBV and "gain" which is the difference between the sale price of the assets and the remaining NBV. The gain that PSE claims for shareholders includes investment that has already been returned to shareholders through accumulated depreciation paid previously by ratepayers. This leads to double recovery of shareholder investment at the expense of ratepayers.

Q. How does PSE attempt to justify this treatment?

A. PSE argues that its former customers in Jefferson County bore the financial burden of the accumulated depreciation of the sold assets.[7] Those customers have no interest in the JPUD Sales proceeds once they depart the Company's service territory. Therefore, the accumulated depreciation should be given to shareholders, rather than to ratepayers served elsewhere by PSE.

Q. What is Staff's response to the Company's argument?

A. Staff strongly disagrees with PSE. The Commission sets rates on a system-wide basis rather than by individual sections of PSE's service territory. Therefore, accumulated depreciation on Jefferson County assets was recovered by PSE from *all* ratepayers, not just those customers that were located in Jefferson County. Consequently, ratepayers, not shareholders, are entitled to accumulated depreciation.

[7] Company Petition at ¶ 38-39.

Company witness Jon Piliaris appears to dispute this point, stating that "[t]he rate revenues paid by PSE's former customers covered their cost of distribution service . . ."[8] However, he contradicts this assertion by admitting that:

> The Company's rates are uniform throughout its service area. As such, all customers share in the recovery of PSE's overall depreciation expense. The amount paid by any given customer or group of customers is not tied to specific assets used to provide service within any particular city or county within PSE's service area.[9]

Prior Company testimony of Karl Karzmar also contradicts the assertion that former Jefferson County customers covered their costs:

> The high cost of serving Jefferson County in relation to the number of customers in its Service Territory limits its revenue potential.[10]

These statements demonstrate that Jefferson County was not a stand-alone system for ratemaking purposes. Nor did PSE's rates charged in Jefferson County cover all costs related to that geographical area. The assignment of more than NBV to shareholders simply because Jefferson County ratepayers have left the system is contrary to how rates are set by the Commission.

Q. Does PSE present any other argument in support of its proposal to allocate accumulated depreciation to shareholders?

A. Yes. PSE also argues that the loss of future potential income from former Jefferson County customers entitles shareholders to more than the NBV.[11] Mr. Karzmar's testimony quoted above belies the factual basis for this assertion. Moreover, the

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[8] Piliaris, Exhibit No. __ (JAP-1T) at 2:7-8.
[9] *Id.* at 14:14-17.
[10] Mr. Karzmar's testimony is contained in Osbourne, Exhibit No. __ (SSO-5) at 16:12-14.
[11] Company Petition at ¶¶ 33-34.

Company admits that this argument is invalid for valuing assets in a partial taking such as the JPUD Sale:

> The income approach is difficult and controversial to apply in the context of a partial taking (as is the case here). PSE was also advised that some courts have held that this method is not applicable in the case of a partial taking. Therefore, although PSE considered these numbers in arriving at a settlement, it did not place much weight on this methodology.[12]

In other words, if the income approach (loss of future income/going concern) is not valid in determining the value of the assets, it cannot and should not be used in determining the allocation of proceeds from the sale of those assets.

Q. Are there other Rate Base Rate of Return Regulation principles violated by PSE's argument?

A. Yes. Rate Base Rate of Return Regulation does not guarantee future income on assets that are no longer used to provide service. It does, however, provide a company the *opportunity* to earn a fair rate of "return on" its assets used to provide service. The Commission does this by determining an appropriate level of shareholder compensation through a rate of return applied to the NBV of utility assets, or rate base. Any risk associated with ownership of utility assets (such as future income) is included in the return on equity component of the overall cost of capital. In other words, the utility is compensated for risk in the "return on" portion of the revenue requirement. If at any time a utility believes it is not being compensated adequately for its risk, general rate cases, riders, trackers and other mechanisms are available for the utility to increase its revenues to adequately

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[12] Osborne, Exhibit No. ___ (SSO-5) at 10:22-11: 6.

compensate shareholders. Allocating the JPUD Sale proceeds to shareholders in the manner proposed by PSE is an inappropriate means to that end.

Q. Please continue.

A. Rate Base Rate of Return Regulation also provides a "return of" a utility's investment through rate recovery of depreciation expense. This represents payment by ratepayers to the utility of the actual dollars spent to purchase the asset. In other words, ratepayers pay back the utility for the nominal cost of its investments.

Thus, PSE's proposal has the effect of compensating shareholders twice for their initial investment: once through depreciation expense already included in rates, and again by the allocation of the accumulated depreciation to shareholders.

Q. Can you provide an analogy to the return on and return of concepts?

A. Yes. The concepts are similar to a home loan. The borrower is required to make monthly principal and interest payments to the bank. The principal payments are for the actual dollar cost of the loan ("return of"). The monthly interest payments compensate the bank for the use of its money and the risk of making the loan ("return on"). If the borrower sells the house prior to the loan being paid in full, he must pay the remaining loan balance. The bank receives the remaining balance on the loan (NBV) and has been compensated for the risk through interest payments. Ultimately, the borrower receives all of the funds from the sale of the asset, less the NBV of the loan owed to the bank and certain real estate transaction fees. PSE's proposal is analogous to the bank asking for more than what is owed on the loan.

Q. Please explain how Staff considered these regulatory principles in its proposal for allocating the proceeds from the JPUD Sale?

A. Rate Base Rate of Return Regulation allows the utility the opportunity to earn a fair rate of return on and a return of its investment, and nothing more. Therefore, Rate Base Rate of Return Regulation does not entitle shareholders to any appreciation on the sale of an asset.

Staff's proposal adheres to these principles in its allocation of all NBV to shareholders and all accumulated depreciation to ratepayers. Staff's proposal departs from Rate Base Rate of Return Regulation by allocating appreciation between ratepayers and shareholders based on the additional factors I discuss in my testimony.

B. Risk-Reward and Benefit-Burden Analysis

Q. Please explain the principles of Risk-Reward and Benefit-Burden.

A. The Risk-Reward principle states that reward should follow risk.[13] In other words, the reward should be provided to the entity that assumes the risk, where the risk is that of a capital loss. The Benefit-Burden principle states that those who bear the burden of the operation of utility assets should be entitled to the benefits associated with those assets.

[13] PSE agrees generally with this description. See Company Petition at ¶ 53.

Q. Do ratepayers or shareholders bear these risks and burdens?

A. Ratepayers. The decision in, *Democratic Central Committee v. Washington Metropolitan Transit Commission ("Democratic Central")*, supports this conclusion:

> One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom. The justice inherent in these principles is self-evident, and each already occupies a niche in the law of ratemaking; and their application, sometimes overlapping, to the problem at hand weighs the scale heavily in favor of consumers. For practice in the utility field has long imposed upon consumers substantial risks of loss and financial burden associated with the assets employed in the utility's business . . .
>
> [A]n investor can hardly muster any equitable support for a claim to appreciation in asset value where he has been shielded against the risk of loss on his investment, or has already been rewarded for taking on that risk.
>
> The proposition that capital gain rightly inures to the benefit of him who bore the risk of capital loss has been accepted in ratemaking law. Thus, as we have seen, investors have been denied capital gains realized on disposition of utility assets where they have not borne the risk of loss associated with the holding of such assets.[14] (footnotes omitted.)

Democratic Central overturned the decision of the Washington Metropolitan Area Transit Commission to allocate the gain on the sale of property to shareholders saying, "Our historical analysis of the interests of investors in value-appreciations of operating utility assets demonstrates beyond a doubt that the burden of safeguarding the utility's investment in all of the assets -- depreciable and nondepreciable -- is legally assigned in its entirety to consumers."[15]

[14] *Democratic Central Committee v. Washington Metropolitan Transit Commission,* 485 F.2d 786, 806-807 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 935 (1973).
[15] *Id.* at 821. (footnotes omitted.)

The approach that ratepayers throughout PSE's service territory bear the risk of capital loss and the burden of the operation of utility assets is applied by Staff's proposal in the present case.

Q. Can you provide an example of where all of PSE's ratepayers were at risk for the assets in Jefferson County?

A. Yes. Storm-related costs for the Jefferson County distribution system are embedded in rates together with the storm costs of PSE's other service areas. If a catastrophic natural disaster had resulted in the loss of the entire Jefferson County distribution system, the Company would have looked to its entire base of customers to contribute to the system's reconstruction. Ratepayers, not shareholders, bear the risk of that capital loss and the burden of associated operating and maintenance ("O&M") costs.

Annual depreciation expense along with other O&M expenses *not* associated with storm costs are also burdens borne by ratepayers. Allocating more than the NBV of the assets to shareholders compensates them for value beyond the scope of their original investment, and risks and burdens they did not bear. *Democratic Central* expands on this point:

> Ratepayers bear the expense of depreciation, including obsolescence and depletion, on operating utility assets through expense allowances to the utilities they patronize. It is well settled that utility investors are entitled to recoup from consumers the full amount of their investment in depreciable assets devoted to public service . . .
>
> In situations where consumers have shouldered these burdens on an asset which produces a gain, the equities clearly preponderate in their favor. This has been recognized in cases holding that rents received by a utility from the leasing of operating properties must be included in the utility's operating income. More directly in point, the cases, as we have seen, generally agree that consumers have the superior claim to capital gains achieved on depreciable assets while in operation and this, we believe, is as it should be.

> Investors who are afforded the opportunity of a fair return on a secure investment in utility assets are hardly in position to complain that they do not receive their just due from the traveling public. On the other hand, it is eminently just that consumers, whose payments for service reimburse investors for the ravages of wear and waste occurring in service, should benefit in instances where gain eventuates-to the full extent of the gain.[16] (footnote omitted.)

Q. Do you have another example of all ratepayers bearing the risk and burden of utility assets?

A. Yes. The example is the separate application by PSE in Docket UE-131099 for authorization to sell assets related to the Electron Hydroelectric Project.[17]

Q. What was the Company's proposal for the Electron Hydroelectric transaction?

A. The proposed sale of the Electron Hydroelectric Project resulted in a book loss of over $11 million that the Company proposed be paid for by ratepayers over a six year period at PSE's authorized rate of return. In other words, PSE asked ratepayers to not only cover the loss, but pay a return on that loss as well.[18]

This is the exact opposite position PSE takes for the JPUD Sale. The Company cannot expect ratepayers to cover any loss in the Electron asset sale, but then not benefit from appreciation in the JPUD Sale. This violates the Risk-Reward and Benefit-Burden principles.

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[16] *Id.* at 808 and 810-11.

[17] *In re the Application of Puget Sound Energy, Inc. for an Order Authorizing the Sale of the Water Rights and Associated Assets of the Electron Hydroelectric Project in Accordance with WAC 480-143 and RCW 80.12*, Docket UE-131099.

[18] The Commission approved PSE's application provided there were no material changes to the terms of the asset purchase agreement for the Electron Hydroelectric Project. *Id.* at Order 02 at ¶ 63 (October 23, 2013).

Q. Is there any risk associated with the loss of future revenue after the JPUD Sale, as PSE argues?

A. No. I have already established that the risk is one of capital loss, not loss of future revenue. However, even if the Commission determines that loss of future revenue is a risk, then returning the NBV to shareholders, as Staff proposes, allows one of two things to happen: 1) PSE refunds cash to shareholders equal to the NBV and they can decide how to invest it to earn their required return on capital; or 2) PSE reinvests the proceeds in other similar capital projects, as it plans,[19] thereby, enhancing future returns for shareholders. Both of these are acceptable outcomes that mitigate PSE's perceived risk of losing future revenue. Shareholders are still afforded an opportunity to earn future revenue.

Moreover, shareholders have already been compensated for the loss of future revenues in the equity component of the Company's overall rate of return. Accepting the Company's proposal would fundamentally alter PSE's risk profile.

Q. How does the Company's proposal affect its risk profile?

A. PSE's proposal essentially allows it to recover not only its initial investment and a portion of the investment already paid by all ratepayers through depreciation expense, but also the value associated with the future potential return on investment that is no longer used to serve ratepayers. PSE is, therefore, faced with virtually no risk of capital loss and severely diminished risk of earnings loss. From a business operations perspective, these two factors fundamentally alter PSE's risk profile and

[19] Company Petition at ¶ 42.

the rates at which PSE would be able to secure private equity. Approving the Company's petition should, therefore, require a reduction in the risk premium portion of the return on equity. Such a re-examination is only possible in a General Rate Case.

Q. Is there evidence that shareholders were already aware of the potential for future revenue loss from the JPUD Sale?

A. Yes. In its 2012 Securities and Exchange Commission 10K Report, Puget Energy advises its shareholders of the: "risks and uncertainties that could cause actual results or outcomes to differ materially from those expressed."[20] One of those risks and uncertainties includes:

> [T]he loss of significant customers, changes in the business of significant customers or the condemnation of PSE's facilities as a result of municipalization or other government action or negotiated settlement, which may result in changes in demand for PSE's services.[21]

Therefore, shareholders were aware of the risks and presumably demanded a commensurate degree of return. The return on equity authorized by the Commission and earned on the Jefferson County assets has compensated shareholders for the risk of condemnation and any lost revenue that may result.

Q. How did Staff use the Risk-Reward and Benefit-Burden factor to determine an appropriate allocation of appreciation to ratepayers?

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[20] Puget Energy, Inc., Annual Report (Form 10-K) at 5 (December 31, 2012)
[21] *Id.* at 6.

A. My testimony shows that ratepayers are at risk for any capital losses related to the value of utility assets. It, therefore, follows that ratepayers should receive all of the reward (*i.e.*, the appreciation) from the JPUD Sale. Nevertheless, as addressed later in my testimony, Staff acknowledges PSE's positive actions in negotiating the JPUD Sale and, therefore, proposes that 25 percent of the appreciation go to PSE.

Staff understands PSE's position as an "unwilling seller." However, the Company is not burdened with the risk of losing its investment – it is made whole if it receives the NBV, as Staff proposes.

C. Case Precedent

Q. Are there prior Commission cases addressing the allocation of proceeds from a sale of utility assets?

A. Yes. The Commission has considered that issue on numerous occasions, including the following:

- *WUTC vs. Avista Corporation, PacifiCorp and Puget Sound Energy, Inc.*, Second Supp. Order, Dockets UE-991255, UE-991262, UE-991409 (*Consolidated*) – Sale of the Coal-Fired Centralia Power Plant and Associated Transmission Facilities. The Commission allocated 100 percent of the NBV to shareholders, 100 percent of the accumulated depreciation to ratepayers, and ordered an equal sharing of the appreciation between ratepayers and shareholders.

- *Qwest Corporation d/b/a Century Link QC,* Order 01, Docket No. UT-120128. The Commission approved a sharing of the proceeds from the sale of land and a building by applying the same methodology employed in Docket UE-991255, *et al.,* including an equal sharing of the appreciation between the Company and ratepayers.

- *WUTC vs. Puget Sound Energy, Inc.,* Third Supplemental Order, Docket UE-990267 – Sale of the Colstrip Power Plant. The Commission allocated 100 percent of the NBV to shareholders and 100 percent of the net gain (accumulated depreciation and appreciation) to ratepayers. PSE did not complete the sale.

- *WUTC vs. Puget Sound Power & Light Company*, Second Supplemental Order, Cause No. U-85-53. The Commission allocated all of the gain from the sale of surplus (non-depreciable) property to ratepayers.
- *WUTC vs. Puget Sound Power & Light*, Third Supplemental Order, Dockets U-89-2688-T and U-89-2955-T. The Commission allocated to ratepayers 100 percent of the gain from the sale of non-depreciable property during the time the property was in rate base.
- *WUTC vs. Washington Water Power*, Order Granting Application, Docket U-87-1533-AT. The Commission allocated 100 percent of the after tax gain from the sale of a combustion turbine generator to ratepayers.

Q. Which of these decisions did Staff find most useful in this case?

A. The Commission's decision in Docket UE-991255 regarding the sale of Centralia provided valuable guidance. There, the Commission outlined an allocation methodology for the proceeds of an asset sale that used the same categories and regulatory principles I discussed previously in my testimony:

- Shareholders received an amount equal to NBV.
- Ratepayers received an amount equal to accumulated depreciation.
- Appreciation was allocated "[N]ot based on a preconceived formula, but on the equities of this distinctive case,"[22] which was determined for Centralia to be 50 percent to ratepayers and 50 percent to shareholders.

Further, the Commission stated, "If presented with a different asset sale that presents different circumstances, opportunities, risks and benefits, we would not necessarily

[22] *In re Application of Avista Corporation for Authority to Sell Its interest in the Coal-Fired Centralia Power Plant,* Dockets UE-991255, UE-991262, and UE-991409, Order 08 at ¶ 86 (March 6, 2000).

conclude that such a sharing of the gain is appropriate."[23] The JPUD Sale is an asset sale that presents different circumstances, risks and benefits, as outlined in my testimony.

The Commission applied this same approach in Century Link's sale of its Quest Plaza Building in Docket UT-120128.[24] Therefore, the only issue in the current case should be the sharing percentage between ratepayers and shareholders of the appreciation on the assets sold to JPUD. There should be no dispute that all NBV goes to shareholders and all accumulated depreciation goes to ratepayers.

Q. Are there cases outside Washington that provide guidance for allocating the proceeds from the JPUD Sale?

A. Yes. Staff sees merit in the Oregon PUC's treatment of PacifiCorp's sale of utility property to the City of Hermiston.[25] That case also involved the threat of partial condemnation against an unwilling seller. PacifiCorp and all other parties agreed to allocate 95 percent of the net gain to ratepayers and only 5 percent of the net gain to shareholders. The Oregon PUC adopted that agreement, stating that:

> [I]t is appropriate to allocate a share of the gain on a sale of utility property to the utility (its shareholders) when the utility has contributed significantly to the creation of value in the sale. The purpose of such an allocation is "to provide an incentive to the utility to enhance the value of the plant and to use an asset sale process that is most likely to obtain the best price.[26]

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[23] *Id.* at ¶ 97.

[24] Order 02, ¶ 8 ("The Company agrees to share the proceeds from the sale with the Washington ratepayers applying a methodology similar to that used by Avista, Puget Sound Energy and PacifiCorp to distribute the gain from the sale of the Centralia Power Plant in Dockets UE-991255, *et al.*")

[25] *In the Matter of the Application of PacifiCorp for Approval of the Sale and Transfer of Electric Properties and Transfer of Service Territory to the City of Hermiston*, Order No. 01-830, Docket UP-187 (September 26, 2001).

[26] *Id.* at 1- 2.

Thus, the Oregon PUC allocated to PacifiCorp a small portion of the gain (5 percent) as an incentive for the company to negotiate the best possible selling price. Staff also considered this incentive, as outlined in a later section of my testimony.

Moreover, the Oregon PUC stated:

> PacifiCorp provided a detailed, comparative revenue requirement analysis, before and after the Hermiston Properties sale. This analysis demonstrates to Staff that the company's remaining customers would not be harmed, but in fact, would benefit by the sale of the Hermiston Properties. In particular the analysis showed that without Hermiston, two major operating expenses, namely power supply and distribution were materially reduced.[27]

Thus, the Oregon PUC allocated to ratepayers 95 percent of the net gain even though ratepayers were not harmed by the sale. A similar conclusion cannot be drawn for the JPUD Sale, as discussed in the next section of my testimony

If the Hermiston sale was structured similar to Staff's proposal here, the Oregon PUC would have allocated to ratepayers 90 percent of the appreciation. Staff's proposal for the JPUD Sale allocates only 75 percent of the appreciation to ratepayers.

Q. Does the Company cite any Commission decisions in support of its proposal?

A. PSE cites the Centralia case but only for the general proposition that a gain on the sale of an asset results when the sales price exceeds NBV.[28]

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[27] *Id.* at 1-2
[28] Company Petition at ¶ 28.

Q. Does the Company cite any decisions from commissions in other states?

A. Yes. PSE relies heavily on, *In re Ratemaking Treatment of Capital Gains from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity Docket*, Decision 89-07-016 (CPUC 1989) ("*City of Redding II*").[29] *City of Redding II* allocated 100 percent of the proceeds of an asset sale to shareholders.

Q. Is the Company correct to rely on the City of Redding II decision?

A. No, the decision actually undermines PSE's position in several respects. First, the California PUC relied heavily on the principle that rewards and losses should accrue to the party taking or assigned the risk.[30] As I demonstrated previously, ratepayers were at risk for capital losses in Jefferson County and PSE has argued that ratepayers should also be responsible for losses from the sale of other utility assets (*i.e.*, the sale of the Electron Hydroelectric Project).

Second, the California PUC rested its decision on the findings that:

> At the time of sale, risk analysis should consider who has borne the risks during the investment lifetime. The gain on sale . . . should accrue to the utility, and thereby be made assignable to its shareholders, to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected . . .[31]

Thus, the California PUC's overriding concern was that ratepayers must not be harmed by the transaction before shareholders will be allocated any gain from the

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[29] *Id.* at ¶¶ 35-37, citing, *In re Ratemaking Treatment of Capital Gains from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity* Docket, 104 PUR4th 157 (CPUC 1989).
[30] *Id.* at 164-65.
[31] *Id.* at 167, Findings of Fact 6 and 7.

sale of utility assets. As demonstrated in the next section of my testimony, remaining ratepayers are harmed by the JPUD Sale.

Third, the California PUC qualified its decision by limiting gains to shareholders to the extent that "the remaining ratepayers have not contributed capital to the distribution system."[32] As I discussed earlier, remaining ratepayers of PSE have returned Jefferson County capital investment to shareholders through depreciation expense embedded in rates. The Company's reliance on *City of Redding II*, when taken to its illogical conclusion, would require that depreciation expense be removed from rates. PSE has never proposed such treatment in any rate case brought before the Commission.

Q. Please summarize how Staff relied on Case Precedent for its proposal?

A. Prior decisions of this Commission establish that NBV goes to shareholders, accumulated depreciation goes to ratepayers, and, depending on the particular facts and circumstances, the appreciation is distributed in a range of as much as 50 to 100 percent to ratepayers and 0 to 50 percent to shareholders. A neighboring commission (Oregon PUC), in circumstances similar to this case, shared the net gain by giving 95 percent to ratepayers and 5 percent to shareholders.

Staff's recommendation to split the JPUD Sale appreciation 75 percent to ratepayers and 25 percent to shareholders falls in the middle of the ranges previously used by this Commission. This was a good cross-check to determine the reasonableness of Staff's proposal.

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[32] *Id.*, Finding of Fact 7.

D. Impact of JPUD Sale on Remaining Ratepayers

Q. Does the JPUD Sale impact remaining ratepayers of PSE?

A. Yes. Staffs analysis shows a harm to remaining ratepayers of approximately $53 million over an initial period of five years as a result of the JPUD Sale. Staff's analysis relied upon Company exhibits and responses to data requests, and information from the most recent PCORC, Docket UE-130617.

There are three areas of impact on remaining ratepayers: 1) in the recovery of existing fixed production plant costs; 2) from revenues related to PSE's expedited rate filing ("ERF"); and 3) in determining the annual allowed delivery revenue per customer ("RPC") in PSE's decoupling mechanism ("Decoupling").

Q. Does Staff's discussion of items 2 and 3 regarding the ERF and Decoupling mean that those mechanisms should be revised by the Commission?

A. No. Those sections of my testimony are presented only as partial justification for Staff's recommendation to allocate to ratepayers 75 percent of the appreciation from the JPUD Sale. Staff does not intend my testimony to be reason to re-examine those two mechanisms.

1. Production Power Costs

Q. Please explain why remaining ratepayers are harmed in the recovery of existing fixed production plant costs as a result of the JPUD Sale?

A. Remaining customers are harmed because existing fixed production costs remain constant, while the number of ratepayers contributing to that fixed cost recovery has decreased with the departure of Jefferson County ratepayers from PSE's system. Exhibit No.___ (EJK-4) shows that the nominal harm to remaining ratepayers is approximately $39 million over the five-year period immediately after the JPUD Sale.[33] This harm is constant and will continue in perpetuity.

Q. Has PSE also addressed this issue?

A. Yes. Exhibit No. __ (JAP-7) shows a net present value *benefit* of $83,192,000 to remaining ratepayers over 20 years from avoided incremental power costs, using a 7.77 percent discount rate. Over the initial five years after the JPUD Sale, however, the Company shows a nominal cumulative *harm* to remaining ratepayers of approximately $46.5 million, which exceeds Staff's calculation.

Q. Why do the Company and Staff analyses differ?

A. The Staff analysis in Exhibit No.___ (EJK-4) shows only the harm that will occur over the initial five years due to the reduced number of ratepayers contributing to fixed cost recovery. Staff did not quantify any longer-term impacts arising from potential reduced power costs. Ultimately the effect on existing ratepayers of the loss of Jefferson County load will be quantified during PSE's next PCORC filing, anticipated in June 2014.

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[33] Exhibit No.___ (EJK-4) uses the load calculations provided by Company in Exhibit No. __ (JAP-7).

However, the Company's analysis in Exhibit No. __ (JAP-7) shows a large disparity between the cumulative harm that occurs during the first five years after the JPUD Sale and the time it takes for remaining ratepayers to benefit from any reduced incremental power costs. This is a concern for Staff.

Q. Why does Staff focus its analysis on ratepayer harm only for the initial five years following the JPUD Sale?

A. The nominal harm to ratepayers during the initial five years is substantial, has a higher probability of occurring, and is immediate. According to the Company, ratepayers will not receive any benefit from the JPUD Sale until 2018 at the earliest. This delay presents a significant risk that those benefits may not be realized.

Indeed, Company Exhibit No. ___ (JAP-7) uses the 2013 Integrated Resource Plan ("IRP") Portfolio Screening Model III ("PSM III") to estimate incremental power costs that are avoided due to the loss of Jefferson County load.[34] The Company's 2013 IRP recognizes that those projections are not used for investment decisions:

> It is important to recognize that the IRP does not make purchasing or investment decisions for the next two decades. The IRP process enables us to construct a portfolio that meets future challenges as we understand them today. Actual resource acquisitions and investment decisions are informed by the foresight developed in the IRP, but those acquisitions must respond to the market conditions that exist at the time when the decision is made.[35]

Moreover, the PSM III model and the associated analysis is less reliable the further into the future it projects. The model's projected immediate harm to

[34] Exhibit No. ___ (EJK-7) at 1.
[35] 2013 Integrated Resource Plan, Page 1-3.

ratepayers is much more likely to occur than are any future benefits. As discussed previously in my testimony, reward follows risk, and, here, ratepayers are at a clear risk of not realizing future benefits to offset current, much more certain, harm.

Q Does Staff have other concerns with the Company's model used to quantify avoided incremental power costs?

A. Yes. Exhibit No. __ (JAP-7) is based on assumptions that place into question the reliability of the results. These assumptions include:

- An abnormally high load growth rate for Jefferson County in the first year. Yet, testimony of Mr. Karzmar from Docket U-101217, states that "[t]here is no expectation of any significant load growth in the Service Territory within the foreseeable future."[36] This was confirmed in the Company's response to Staff Data Request 6 that I have included in Exhibit No. __ (EJK-8).
- A PSM III model run with 508,175 fewer MWh's than the load forecasted in Exhibit No. __ (JAP-7).[37]

The Company's model also starts one full year after the JPUD Sale and, therefore, excludes an entire year of net harm to ratepayers.

2. ERF-Related Revenues

Q. Please explain the genesis of the ERF.

[36] See Osbourne, Exhibit No. ___ (SSO-5), 16:14-15.
[37] Company Response to Public Counsel Data Request 31, Attachment A. See Exhibit No. __ (EJK-7).

A. In early 2013, PSE filed an Expedited Rate Filing in Docket UE-130137 to implement a rate increase within a shortend procedural schedule. The ERF accepted without debate certain aspects from PSE's prior rate case such as the rate of return, cost of service and rate design. The ERF also excluded power costs and production plant which are recovered in a PCORC. The remaining balance of costs were considered "delivery costs". The basis of these costs was a filing that mostly followed the constraints of the annual commission-basis report required by WAC 480-100-257 with minor adjustments. The Commission accepted the ERF in Order 07 granting an electric revenue increase of $31,138,511, or about 1.6 percent, effective July 1, 2013.

Q. Are remaining ratepayers harmed through ERF-related revenues after the JPUD Sale?

A. Yes. Remaining ratepayers are harmed $1,142,941 per year through the end of 2017 or until new rates become effective, as shown in Scenario 2 of Company Exhibit No. __ (JAP-3), page 2, column B, line 57.

Q. Please explain.

A. The ERF calculates a revenue deficiency based only on transmission-, distribution-, and general-plant and expenses. The revenue deficiency, in turn, sets the baseline RPC for Decoupling. Using the revenue deficiency, the Commission sets rates based on a single system pricing structure, or, as the Company states, "rates are uniform throughout its service area."[38] Exhibit No. ___ (JAP-3), Scenario 2 shows how the JPUD Sale affects the ERF.

Q. Exhibit No. __ (JAP-3), page 1 includes a Scenario 1, showing a benefit to remaining ratepayers as a result of the ERF. Please comment.

A. Scenario 1 shows a possible benefit up to $3.2 million per year. Exhibit No. __ (JAP-3), page 1, column B, line 57. However, Scenario 1 is unreliable because it uses a direct assignment-only method, rather than the uniform pricing method PSE admits the Commission uses to set rates.

In fact, the Company also admits that, "the results using only direct assigned costs are a bit less realistic *(i.e.* I would give slightly more weight to the results on page two of the exhibit)."[39] Page 2 of the exhibit refers to Scenario 2 of Exhibit No. __ (JAP-3) which is the scenario used by Staff to determine ERF-related harm.

3. Decoupling

Q. Please explain the genesis of PSE's Decoupling mechanism.

A. PSE filed for a Decoupling mechanism in late 2012 with revisions in March 2013. The Decoupling mechanism established a means to determine financial revenues based on the number of customers multiplied by a delivery cost per customer. However, customers will still pay bills on a cents per kilowatt-hour basis. The bill payments will diverge from the per customer revenues creating a balance to be trued up each year.

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[38] Piliaris, Exhibit No. ___ (JAP-1T) at 14:13.
[39] Piliaris, Exhibit No. ___ (JAP-1T) at 8:12-14.

Additionally, a rate plan was established to increase the delivery cost per customer by three percent per year for the next few years. The Commission accepted the Decoupling and rate plans in Order 07, effective July 1, 2013.

Q. Are remaining ratepayers harmed through Decoupling with the departure of Jefferson County customers?

A. Yes. The departure of the Jefferson County ratepayers reduces the total required residential RPC by $8,356,230 through the end of 2017, as shown on page 1 of my Exhibit No. __ (EJK-5).

Q. Please explain.

A. As shown in Scenario 2 of Exhibit No. __ (JAP-3), the initial revenue deficiency from the ERF filing is $1,142,941 less per year with the departure of the Jefferson County customers. This sets the baseline RPC for Decoupling. The Company's response to Staff Data Request 12, Attachment D shows the RPC under Decoupling using that revenue deficiency. The difference between the current annual RPC amounts versus the Company's response to Staff Data Request 12 results in the total residential RPC reduction of $8,356,230 through the end of 2017. I have included this data request response as pages 2-3 of my Exhibit No. __ (EJK-5).

Q. What is the total harm to remaining ratepayers calculated by Staff from issues related to fixed production plant cost recovery, ERF, and Decoupling?

A. The total harm through 2017 is approximately $53 million, as shown in Exhibit No.___ (EJK-6).

Q. How did Staff use this analysis to arrive at its overall position?

A. Staff acknowledges that it is not possible to quantify the full harm to ratepayers with complete accuracy. Staff's analysis was performed knowing that there would be numerous implicit assumptions of future operating characteristics, market conditions, and other generally unforeseeable events built into the models.

Nevertheless, there is evidence from both Staff and PSE of ratepayer harm in three areas during the initial five years following the JPUD Sale: existing production plant costs, ERF-related revenues, and Decoupling. This harm to, and the potential for no or insufficient long-term offsetting benefits for, remaining customers supports Staff's proposal that the majority of the appreciation (75 percent) should go to ratepayers.

E. Impact of JPUD Sale on Shareholders

Q. Are PSE's shareholders harmed by the JPUD Sale?

A. No. True financial harm occurs only if PSE's shareholders suffered a capital loss. This does not occur under Staff's proposal. Shareholders receive all of the remaining NBV, plus an equitable share of the appreciation on the sale. They come out ahead under Staff's proposal.

Q. Are shareholders harmed from the loss of potential future income, as PSE alleges?

A. No. In its petition the Company alleges that:

> This transaction was a forced sale of Assets that deprives PSE and its shareholders of future revenues from approximately 18,000 customers and the future growth of that customer base.[40]

Losing future revenue may be an opportunity cost, but it is *not* a risk of a capital loss. Receiving the full book value of the sold assets, as Staff proposes, makes shareholders whole. Therefore, shareholders are held harmless.

Moreover, PSE proposes to treat the gain as an involuntary conversion under 26 U.S.C. §1033. To avoid tax implications of the deferred income tax remaining on the assets sold to JPUD, the Company will reinvest in new utility plant an amount equivalent to the proceeds it receives. That new plant will receive a return equal to the plant retired due to the JPUD Sale. Therefore, any shareholder loss of future revenue is dependent on PSE's speed at re-deploying proceeds into new projects.

Q. The Company argues that it is entitled to the loss of potential future income as "going concern damages".[41] Does Staff agree with this assertion?

A. No. The Company describes going concern damages as "the investment value to the business owner of the components of an active, up-and-running business"[42] that "may be recovered, if proven, to compensate the utility for lost revenue potential."[43] This assertion might have some merit if the Company relied on going concern

[40] Company Petition at ¶ 33.
[41] Company Petition at ¶ 34.
[42] Company Petition at ¶ 34.
[43] Osborne, Exhibit No. ___ (SSO-5) at 15:9-10.

damages, then called the "Income Approach", in negotiating its settlement with JPUD. However, as explained in the Rate Base Rate of Return Regulation section of my testimony, that was not the case here.

F. Incentives

Q. Has the Commission previously authorized a sharing of appreciation from the sale of utility assets as an incentive?

A. Yes. The Commission in the Centralia case ordered the sharing of appreciation to encourage a utility to pursue the best possible sales price:

> We must be flexible enough to allow managers of regulated utilities to maximize the value of their entire systems, minimize rates, and best serve both rate payers and shareholders.[44]

The Commission also considers the equities of any particular facts and circumstances as a basis to allocate appreciation from a property sale.

Q. Are there other examples of commissions sharing gains from the sale of utility assets as an incentive?

A. Yes. As noted earlier, the Oregon PUC used the sharing of gains from asset sales to encourage companies to pursue the best possible sales price.

[44] Centralia Order at ¶ 85.

Q. Did Staff use the incentive factor in its allocation of JPUD Sales proceeds?

A. Yes. As an unwilling seller, PSE could have negotiated an amount equal only to the Jefferson County assets' NBV. It had little direct incentive to pursue the highest possible price.

That is not what happened. PSE's negotiating plan ultimately resulted in a sales price that included significant appreciation above NBV and the accumulated depreciation of the assets in Jefferson County. Such prowess should not be overlooked as the Company represented ratepayer's interests fairly throughout the settlement negotiations.

Staff's proposal to provide shareholders 25 percent of the appreciation from the JPUD Sale rewards that prowess and provides an incentive to PSE to pursue a vigorous negotiating plan in any other condemnation proceedings or asset sales.

Furthermore, 25 percent is approximately $7.5 million or about 7 percent of the gross proceeds from the JPUD Sale. This approximates the standard fee applied by brokerage firms in negotiating real property transactions between two parties. It is reasonable to use a similar benchmark for PSE in this case

IV. TRANSACTION COSTS

Q. Please explain Transaction Costs.

A. Transactions Costs were incurred as a result of the negotiations and execution of the APA and Customer Transition Agreement.[45] Pages 2-6 in Exhibit No. ___ (EJK-3)

[45] Company Petition at ¶ 31.

are Company responses to Staff data requests that show a breakdown of these Transaction Costs. The final amount of Transaction Costs is allocated to the Company as a reimbursement.

Q. Please describe the Company's allocation of Transaction Costs.

A. The Company allocates Transaction Costs of $2,722,448 to PSE.

Q. Please describe Staff's allocation of Transaction Costs.

A. Staff allocates $2,404,643 to the Company and $317,805 to ratepayers. The difference between PSE and Staff is due to an Internal Labor adjustment proposed by Staff.

Q. Please explain Staff's Internal Labor adjustment.

A. As demonstrated on pages 2-3 of Exhibit No.___ (EJK-3), Transaction Costs include Labor, and Outside labor and services. Staff determined that $317,805 of those labor expenses duplicated costs that are already included in rates from the ERF and most recent PCORC. Therefore, Staff's adjustment reimburses customers by removing $317,805 of labor expenses from Transaction Costs..

V. CONCLUSION

Q. Please summarize Staff's recommendation for allocating proceeds from the JPUD Sale.

A. Staff recommends that the Commission allocate all NBV to shareholders, all accumulated depreciation to ratepayers, and that the appreciation be split 75 percent to ratepayers and 25 percent to shareholders. In total, this results in $52,775,723 going to ratepayers and $56,597,473 going to shareholders.

Staff reached this recommendation by balancing six key factors given the facts and circumstances of this particular case. Each of these factors, taken on their own, could arrive at a different allocation of the appreciation. Given the broad discretion of the Commission to determine an equitable split of appreciation, Staff chose to balance all factors and the interests of all parties to arrive at its recommendation. This required the application of informed judgment rather than any precise mechanistic formula.

Q. Please provide the recommended accounting treatment to implement Staff's proposal.

A. The Commission should order the following accounting treatment:

- Remove $317,805 from the appropriate labor expense accounts and credit FERC Account 25300061.
- Debit FERC Account 25300061 by $7,506,394 and credit that amount to FERC Account 421.1, Gain on Disposition of Property.
- The result of these two entries leaves a credit balance in FERC Account 25300061 of $52,775,723.

- Amortize $52,775,723 plus interest from FERC Account 25300061 to FERC Account 407 over a period of 48 months via a rate credit to customers as described in Staff witness Mickelson's testimony.

Q. Does this conclude your testimony?

A. Yes.