BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of PUGET SOUND ENERGY, INC. and NW ENERGY COALITION For an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms	DOCKET NOS. UE-121697 and UG-121705 (Consolidated)
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NOS. UE-130137 and UG-130138 (Consolidated)

INITIAL BRIEF OF PUGET SOUND ENERGY, INC.

MARCH 6, 2015

PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

1. Puget Sound Energy, Inc. ("PSE") respectfully requests that the Commission issue an order authorizing a return on equity ("ROE") for PSE of 9.80 percent, and an overall rate of return of 7.77 percent. Substantial evidence in the record supports the ROE and rate of return that PSE requests.

2. This remand presents a very narrow issue for the Commission to decide: what is the appropriate ROE for PSE? There is substantial evidence in the record demonstrating that 9.80 percent ROE is within a range of reasonableness and is the appropriate ROE for PSE—that was true in 2013 when this case was originally before the Commission, and it remains true today based on the evidence in this case. Testimony from PSE and Commission Staff witnesses expressly supports the 9.80 percent ROE as within a range of reasonableness. PSE witness Dr. Morin testified that 9.80 percent ROE is at the low end of the range, while Commission Staff witness Mr. Parcell testified that 9.80 percent ROE lies at the higher end of a range that extends to 10.0 percent, consistent with the Commission's Order 07[1] in this case and now confirmed by the evidence. Although the Industrial Customers of Northwest Utilities ("ICNU") and Public Counsel argue for a lower ROE, evidence they presented in this case and in other cases support the appropriateness of a 9.80 percent ROE. As discussed in more detail herein, Mr. Gorman's risk premium cost of equity studies support an ROE in excess of 9.80 percent. Mr. Hill's prior testimony in 2013 endorsed a 10.0 percent ROE as consistent with *Hope*[2] and *Bluefield.*[3]

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[1] *WUTC v. Puget Sound Energy, Inc.*, Order 07 Final Order Granting Petition, Dockets UE-121697, *et al.* (consolidated) (June 25, 2013).

[2] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[3] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923).

3. The earnings sharing mechanism that currently applies to PSE must be considered when setting PSE's ROE. The mechanism, as modified by the Commission in Order 07, skews PSE's ability to earn its authorized ROE, on average, over time. In contrast, customers benefit from the earnings sharing mechanisms in a way that they have not benefitted in the past under traditional ratemaking. The Commission modified PSE's earnings sharing mechanisms when it approved the multi-year rate plan and decoupling, making it even more favorable for customers. Customers share immediately on a 50/50 basis on any earnings that exceed PSE's authorized rate of return. But there is no similar sharing by customers in the deficit when PSE fails to earn its authorized return, as has been the case for nearly a decade.

4. With respect to the issue of decoupling, there is substantial evidence in the record supporting the Commission's prior decision to wait until PSE's next general rate case to determine whether decoupling has an impact on cost of capital and whether a separate adjustment to cost of capital should be made because of decoupling. Empirical studies undertaken on the topic demonstrates that there is not reliable evidence that decoupling reduces cost of capital. ICNU and Public Counsel apparently view Washington state energy policy as not sufficiently important to justify waiting for highly reliable evidence on this topic. They ask the Commission to ignore traditional standards of statistical significance, intended to ensure reliable findings. The Commission should decline to do so.

5. Moreover, the Commission has not historically made separate adjustments to ROE to reflect every alternative rate making mechanism that is available to a utility, and decoupling should be treated no differently. The evidence in the record demonstrates that utilities around the country—and reflected in the proxy groups—have a wide variety of mechanisms available, and the particular mechanisms vary from jurisdiction to jurisdiction. Investors do not parse through

the mechanics of each mechanism available to a utility and make rating decisions based on a hierarchy of rate making tools. Rather, they look at the overall regulatory environment as a whole—whether it is generally a positive regulatory environment with mechanisms in place to allow a utility a reasonable opportunity for recovery of costs. The mechanisms available to PSE—even with decoupling—do not put it in a separate class that warrant lowering its ROE.

6. The nub of the argument from ICNU and Public Counsel is: what the Commission giveth with one hand, it should take away with the other. Decoupling, and PSE's one-time expedited rate filing, were implemented in response to identified deficiencies in traditional rate making. PSE had not earned its authorized rate of return for nearly a decade under traditional ratemaking, using a modified-historical test year. Decreases in load due to increased conservation mandates exacerbated the problem because much of PSE's fixed costs were recovered in volumetric rates, and with customer usage declining, PSE was not able to recover its fixed costs. The Commission recognized these problems and authorized a one-time expedited rate filing and a pilot decoupling program, in an effort to (i) provide an improved opportunity for PSE to recover its authorized revenue requirement and earn its authorized return, and (ii) more appropriately align all stakeholders interest with the state energy policy by removing the throughput incentive that requires a utility to sell more energy in order to recover its costs. Public Counsel and ICNU argue that PSE should be penalized for now coming closer to having a fair opportunity to recover its approved revenue requirement and earn its authorized return. The Commission should decline their invitation to compromise the important policy goals that decoupling is intended to achieve—aligning the interests of utilities and customers in an effort to promote energy efficiency while still maintaining financially sound utilities.

II. LEGAL STANDARD

A. The Scope of Review on Remand Is Narrow

7. This case is remanded to the Commission from the Thurston County Superior Court on a very narrow issue: what is the appropriate ROE for PSE, based on information that was or would have been available to the Commission when it considered PSE's decoupling mechanisms and expedited rate filing in the first half of 2013?

1. The Thurston County Superior Court order and letter decision

8. In its letter decision and order on judicial review of the Commission's Order 07, the court determined that the Commission followed improper procedure[4] with respect to setting the ROE in the context of a multi-year rate plan and remanded this case to the Commission to remedy this procedural error.[5] The court determined that the Commission's findings of fact with respect to the ROE component of PSE's cost of capital in the context of a multi-year rate plan was not supported by substantial evidence.[6] The court rejected challenges to Order 07 from Public Counsel and ICNU to (i) the Commission's decision not to adjust rates in a general rate case, and (ii) the attrition adjustment or K-factor rate plan.[7]

9. In its letter decision, the court specifically noted that the Commission set rates "without the evidence it deemed necessary and customarily relied on."[8] The court did not determine,

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[4] *Industrial Customers of Northwest Utils., et al. v. WUTC*, Thurston County Superior Court Case Nos. 13-2-01576-2 and 13-2-01582-7 (consolidated), Letter Decision at 5 (June 4, 2014) ("this court holds that the majority followed improper procedure.") ("Thurston County Superior Court Letter Decision").

[5] *Id.*

[6] *Industrial Customers of Northwest Utils., et al. v. WUTC*, Thurston County Superior Court Case Nos. 13-2-01576-2 and 13-2-01582-7 (consolidated), Order Granting in Part and Denying in Part Petitions for Judicial Review at 2 (July 25, 2014) ("Thurston County Superior Court Order").

[7] *Id.*

[8] Letter Decision at 5.

however, that the ROE or cost of capital currently in place was set at the wrong rate.[9] Rather, the court stated that "[t]he Commission has particular expertise in understanding the relevant evidence, determining which evidence and models are credible, and determining what is fair, reasonable, and sufficient means."[10] The court expressly stated that it "does not attempt to override the expertise on such matters, but focuses on the procedural requirements."[11] The court expressed concern that the Commission did not require PSE to present a sophisticated model or complex presentation or evidence regarding its current situation and from that determine its cost of capital for the multi-year rate plan.[12] Consistent with the court's limited function on judicial review, the court did not predecide how the Commission should remedy procedural errors or what the substantive outcome of the remand proceeding should be. *See* RCW 34.05.574(1). The court remanded the case to the Commission to take action consistent with the court's order.[13]

2. The Commission must consider evidence and determine the proper ROE

10. The Commission should reject arguments by ICNU that, on remand, the Commission is required to simply accept the evidence proffered by ICNU in the 2013 phase of the proceeding. This is counter to the express language of the Thurston County Superior Court order and letter decision and inconsistent with Washington law regarding remand to an agency. Here, the Thurston County Superior Court determined that the Commission followed improper procedure when it determined that evidence regarding ROE was not required in these dockets in the

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[9] *Id.* at 4 ("This court does not attempt to override the Commission's expertise on such matters, but focuses on the procedural requirements.").

[10] *Id.* at 4.

[11] *Id.*

[12] *Id.* at 5.

[13] *Id.*

2013 proceeding.[14] The court remanded the case to the Commission for further adjudication consistent with the court's opinion.[15] Thus, in this remand proceeding, the Commission properly heard evidence from PSE and other interested parties on the ROE component of PSE's cost of capital.

11. This approach is consistent with *Alpine Lakes Protection Society v. Washington State Department of Natural Resources.*[16] In that case the Forest Practices Appeal Board determined that there was no genuine issue of material fact and issued a modified determination of non-significance with respect to a watershed analysis prepared by the Plum Creek Timber Company. The Forest Practices Appeal Board granted summary judgment because it believed it unnecessary to consider future forest practices. The superior court disagreed and determined that, based on the evidence, an Environmental Impact Statement was required. The appellate court rejected the superior court's decision and determined that the appropriate procedure was for the case to be remanded to the Forest Practices Appeal Board for fact finding. The court rejected Plum Creek's invitation to pore over the factual evidence—a task better left to the Forest Practices Appeal Board in light of its expertise after taking those practices into account. The court ruled that the issue must be determined by the Board, following a remand and after a fact-finding hearing.[17]

12. Here, the Commission made a determination in the 2013 proceeding similar to the Forest Practices Appeal Board in *Alpine Lakes.* The Commission determined in the first phase of the proceeding that certain evidence was not required in the proceeding—evidence with respect to ROE to address current market conditions in the context of the expedited rate filing/decoupling

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[14] *Id.* at.4, 5.
[15] *Id.* at 5.
[16] 102 Wn. App. 1 (1999).
[17] *Id.* at 17.

proceeding.[18] The Thurston County Superior Court rejected this approach and ruled that the Commission followed improper procedure when it failed to require PSE to present evidence regarding updated market conditions and to follow its usual procedure in determining the ROE for PSE in the context of this multi-year rate plan. As in *Alpine Lakes,* the proper procedure on remand is for the Commission to require PSE to submit evidence on the appropriate cost of equity and allow other interested parties to submit such evidence—as the Commission has done. The Commission will determine, on remand, the appropriate ROE based on information available in 2013.

3. The Commission may reach the same result on remand

13. On remand, the Commission may reach the same result that it did in the first phase of this proceeding, provided its decision is supported by substantial evidence. Agencies are free to reach the same result on remand so long as they correct the errors identified by the court and follow applicable procedural requirements. As stated by the Ninth Circuit Court of Appeals, "It can hardly be doubted that an agency is free on remand to reach the same result by applying a different rationale."[19]

14. A recent case with very similar facts, *State of North Carolina ex rel. Utilities Commission v. Cooper,*[20] supports the Commission's ability to approve on remand the same ROE that it adopted in the underlying procedure, if it is supported by substantial evidence. In *Cooper,* the

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[18] Order 07 fn 72 ("The prevailing view, expressed in this Order, is that it is inappropriate to criticize PSE or claim that the Company has not carried its burden on cost of capital when the subject was not contemplated by PSE, Staff, or the Commission to be part of an ERF.").

[19] *Bowen v. Hood,* 202 F.3d 1211, 1219 (9th Cir. 2000) (internal quotation marks and citations omitted); *see also FEC v. Akins,* 524 U.S. 11, 25 (1998) ("If a reviewing court agrees that the agency misinterpreted the law, it will set aside the agency's action and remand the case—even though the agency (like a new jury after a mistrial) might later, in the exercise of its lawful discretion, reach the same result for a different reason.") (citing *SEC v. Chenery Corp.,* 318 U.S. 80 (1943)).

[20] *State ex rel Utils. Comm'n v. Cooper,* No. 268A12-2 (N.C. Dec. 19, 2014) (slip op.).

North Carolina Supreme Court upheld a decision by the North Carolina Utilities Commission ("NCUC") approving a 10.50 percent ROE (with 53 percent equity in the capital structure) on remand. The NCUC had previously approved the 10.50 percent ROE as part of a settlement agreement, but that earlier decision was appealed by the state Attorney General. The North Carolina Supreme Court agreed with the Attorney General on the first appeal and reversed and remanded the case to the NCUC with instructions to make an independent ROE determination based upon finding of facts that weigh all available information.[21] On remand, the NCUC reached the same result as it had in the earlier proceeding, authorizing a 10.50 percent ROE. "The Commission concluded that the ROE authorized in the rate order was 'justified and supported' by the evidence and was reasonable in light of the Stipulation as a whole."[22] The Attorney General appealed the remand order, but the North Carolina Supreme Court denied the Attorney General's appeal. The court determined that the NCUC's remand order approving the same 10.50 percent ROE was supported by substantial evidence. According to the court, "the requirement that the Commission reach an independent conclusion does not preclude the Commission from adopting an ROE recommended by a particular party or witness."[23] The court further stated:

> In conducting its analysis, the Commission was required to consider the Stipulation together with all the other evidence and was permitted to adopt the ROE contained therein. We hold that the Remand Order contains sufficient findings of fact explaining the weight given to the evidence and demonstrating that the Commission reached its own independent conclusion on ROE.[24]

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[21] *Cooper*, slip op. at 4.
[22] *Id.*
[23] *Id.* at 7.
[24] *Id.* at 9 (internal citations omitted).

15. The same principle applies in this case. The Commission must consider all the evidence and determine the appropriate ROE based on that evidence. Because substantial evidence supports the 9.80 percent ROE, as demonstrated by the record in this case, the Commission should authorize the 9.80 percent ROE for PSE.

B. Substantial Evidence Standard

16. The test of substantial evidence under RCW 34.05.570(3)(e) is whether there is "a sufficient quantity of evidence to persuade a fair-minded person of the truth or correctness of the order."[25] The fact that there is conflicting evidence does not mean there cannot be substantial evidence.[26] Rather, a court should overturn an agency's factual findings only if they are clearly erroneous and the court is "definitely and firmly convinced that a mistake has been made."[27] Moreover, the administrative decision must be viewed in light of the record as a whole when considering whether it is based on substantial evidence.[28]

17. The WUTC has broad generalized powers in rate setting matters.[29] The Washington legislature has delegated ratemaking power to the WUTC in "very broad terms" and "basically just direct[s the WUTC] to set those rates which [it] determine[s] to be just and reasonable."[30]

C. Standard For Setting ROE

18. As discussed above, this remand case requires the Commission to consider a very narrow issue: what is the appropriate ROE for PSE, based on information that would have been

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[25] *Callecod v. Wash. State Patrol*, 84 Wn. App. 663, 673 (1997); *King Cnty. v. Cent. Puget Sound Growth Mgmt. Hearings Bd.*, 142 Wn.2d 543, 553 (2000).

[26] *Callecod*, 84 Wn. App. at 676 ("A decision that is supported by substantial evidence is not arbitrary and capricious, however, even though the evidence before the trier of fact may, as here, be of a conflicting nature.").

[27] *Port of Seattle v. Pollution Controls Hearing Board*, 151 Wn.2d 568, 588 (2004) (citing *Schuh v. Department of Ecology*, 100 Wn.2d 180, 183 (1983); *Buechel v. Dep't of Ecology*, 125 Wn.2d 196, 202 (1994)).

[28] RCW 34.05.570(3)(e).

[29] *US West Communications, Inc. v. WUTC*, 134 Wn.2d 48, 56 (1997).

[30] *POWER v. WUTC*, 104 Wn.2d 798, 808 (1985).

available to the Commission when it considered PSE's decoupling mechanisms and expedited rate filing in the spring of 2013. In considering the appropriate ROE, the Commission is bound by the statutory and constitutional mandate that a regulated utility is entitled to (i) reasonable and sufficient compensation for the service it provides,[31] and (ii) the opportunity to earn "a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return comparable to other enterprises of corresponding risk."[32]

19. Unless a utility is given the opportunity to earn a reasonable return on its investment and recover its costs, customers as well as investors are harmed:

> It is just as important in the eye of the law that the rates shall yield reasonable compensation as it is that they shall be just and reasonable and non-discriminatory from the standpoint of the customer, because unless every rate does yield reasonable compensation, public service companies must resort to discrimination in order to live or must eventually be forced out of business.
>
> Every statutory element must be recognized in the fixing of rates, or the result will be to defeat the legislative purpose.[33]

20. Two landmark United States Supreme Court cases define the legal principles underlying the regulation of a public utility's rate of return and provide the foundations for the notion of a fair return. The *Bluefield* case set the standard against which just and reasonable rates of return are measured:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public *equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties* ... The *return should be reasonable*, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management,

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[31] *POWER*, 104 Wn.2d at 808; *Puget Sound Traction Light & Power Co. v. Pub. Serv. Comm'n*, 100 Wn. 329, 334 (1918) (en banc); RCW 80.28.010(1).

[32] *WUTC v. Avista Corp.*, Docket Nos. UE-991606, *et al.*, Third Supp. Order at ¶ 324 (Sept. 29, 2000).

[33] *Wash. ex rel. Puget Sound Power & Light Co. v. Dep't of Pub. Works of Wash.*, 179 Wn. 461, 466 (1934).

> to *maintain and support its credit* and *enable it to raise money* necessary for the proper discharge of its public duties.[34]

The *Hope* case expanded on the guidelines to be used to assess the reasonableness of the allowed return. The Court reemphasized its statements in the *Bluefield* case and recognized that revenues must cover "capital costs." The Court stated:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock ... By that standard *the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks*. That return, moreover, should be sufficient to *assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital*.[35]

In the *Permian Basin Rate Cases*, the Supreme Court stressed that a regulatory agency's rate of return order should:

> reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed.[36]

Therefore, the "end result" of this Commission's decision should be to allow PSE the opportunity to earn an ROE that is:

(i) commensurate with returns on investments in other firms having corresponding risks;

(ii) sufficient to assure confidence in PSE's financial integrity; and

(iii) sufficient to maintain PSE's creditworthiness and ability to attract capital on reasonable terms.

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[34] *Bluefield Water Works & Improvement Co.*, 262 U.S. at 692 (emphasis added).

[35] *Hope Natural Gas Co.*, 320 U.S. at 603 (emphasis added). The United States Supreme Court reiterated the criteria set forth in *Hope* in *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); in *Permian Basin Rate Cases*, 390 U.S. 747 (1968); and, most recently, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[36] *Permian Basin Rate Cases*, 390 U.S. at 792.

1. Timeframe for consideration of cost of equity

21. The appropriate time period for the cost of equity review in this remand proceeding is the first half of 2013. Expert witnesses for PSE, Public Counsel and Commission Staff all testified that they are able to review the information that was available, as of early 2013, and make a cost of equity determination in the same manner that they would have done in 2013.[37] The 2014 analyses performed by PSE provide additional support for the Commission to demonstrate the continued reasonableness of the ROE recommendation under current market conditions in 2014.

2. Only the ROE component of cost of capital is at issue

22. The court's order on remand expressly addressed the ROE component on cost of capital.[38] Therefore, the focus of the Commission should be on ROE only. Consistent with the court's order, parties have not challenged the other elements of cost of capital or PSE's capital structure, and these are outside the scope of this proceeding.

3. No separate determination regarding the effect of decoupling on cost of capital is required in this case

23. The court did not require the Commission to address on remand the issue of whether PSE's cost of capital should be lowered due to the adoption of decoupling. In the 2012-2013 phase of this proceeding, Mr. Cavanagh testified that there is no empirical evidence in any jurisdiction on the rate impacts of decoupling mechanisms and its specific correlation to the utility's cost of capital.[39] The Commission considered this evidence and determined that any reduction in the cost of debt would occur only prospectively and should be evaluated in PSE's next general rate case:

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[37] Morin, TR. 649:19-650:7; Hill, TR. 650:22-651:1; Parcell, TR. 651:23.
[38] Thurston County Superior Court Order at 2.
[39] Order 07 at ¶ 102, fn 161 (citing Cavanagh, TR. 173:24 to 174:15; Exh. No. RCC-2T at 22:2-17).

> Experience going forward with decoupling in place for PSE as various of its debt instruments mature over the next several years will provide valuable information to the Commission.[40]

24. Similarly, the Commission determined that parties could bring forth evidence in PSE's next general rate case on the issue of whether equity markets respond to the implementation of decoupling in the case of publicly traded companies.[41] This is consistent with decisions in other jurisdictions, for example, the Arizona Corporation Commission determined it appropriate to implement decoupling for a three-year period and conduct more detailed evaluations, including cost of capital implications, at the end of the three-year period.[42]

25. Because there is disagreement among the parties as to the scope of this proceeding with respect to whether decoupling has an effect on cost of capital, PSE has provided evidence to the Commission demonstrating that

(i) the evidence available at this point in time fails to demonstrate that decoupling lowers ROE;

(ii) the Commission should not lower the cost of equity as a result of decoupling, unless and until it has sufficiently reliable evidence demonstrating that decoupling lowers the cost of equity; and

(iii) any effect decoupling may have on cost of capital is already reflected in the proxy group, and therefore imposing a separate decrement to cost of equity due to decoupling would be inappropriate and constitute double counting.

However, it is PSE's position, consistent with the Thurston County Superior Court order, that the issue of a separate decrement to ROE due to decoupling is outside the scope of this proceeding.

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[40] Order 07 at ¶ 105.

[41] *Id.* at ¶ 106.

[42] Hill, Exh. No. SGH-23CX at 7 (Direct Testimony of David C. Parcell to Arizona Corporation Commission).

III. SUBSTANTIAL EVIDENCE SUPPORTS AN ROE OF 9.80 PERCENT AND A 7.77 PERCENT OVERALL RATE OF RETURN

A. Testimony of Expert Witnesses Supports a 9.80 Percent ROE and a 7.77 Percent Overall Rate of Return

26. The evidence presented to the Commission demonstrates that the appropriate ROE for PSE is 9.80 percent. This ROE was reasonable when the Commission issued Order 07 in this proceeding in June 2013, and it remains a reasonable and appropriate ROE for PSE. As discussed in more detail below, the cost of equity studies undertaken by Dr. Morin, Mr. Parcell and Mr. Gorman all support an ROE range that includes a 9.80 percent ROE. Dr. Morin testified that 9.80 percent ROE is at the low end of a range of reasonableness, while Mr. Parcell testified that it is at the high end of a range of reasonableness, and this is supported by Mr. Gorman's risk premium cost of equity studies as well. The evidence demonstrates that the average authorized ROE in 2013 was 10.0 percent, as both Dr. Morin[43] and Mr. Hill testified.[44]

27. The evidence in this case supports (i) an ROE in excess of 9.8 percent and (ii) a capital structure including an equity ratio in excess of 48 percent.[45] However, Mr. Doyle testified that although the evidence from the first half of 2013 supports a higher cost of capital than what PSE agreed to in the 2013 phase of this proceeding, PSE is committed to the terms it proposed to the Commission in its 2013 filings—a multi-year rate plan with decoupling based upon an authorized ROE of 9.8 percent and an authorized rate of return of 7.77 percent that includes an equity ratio of 48 percent.[46]

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[43] Morin, Exh. No. RAM-9 (10.17 percent average authorized ROE in 2012).

[44] Hill, Exh. No. SGH-25CX (testifying in Alabama that a 10.0 percent ROE is consistent with average return on equity allowed in the U.S. and thus a 10.0 percent ROE in 2013 is consistent with *Hope* and *Bluefield).*

[45] Doyle, Exh. No. DAD-4T at 16:5-20.

[46] *Id.*

28. When the Commission considers all factors, including (i) the Commission's adjustment to PSE's proposed earnings sharing mechanism, which now requires PSE to share 50/50 with customers any earnings in excess of PSE's authorized rate of return; and (ii) the limitations on PSE's ability to seek rate relief during the rate plan period, the 9.80 percent ROE is appropriate and reasonable.

1. Dr. Morin's cost of equity studies support a range of 9.80 percent to 10.7 percent in 2013

29. The ROE of 9.8 percent that PSE requests in this case is significantly below the cost of equity for both the first half of 2013 and the second half of 2014, based on the studies undertaken by Dr. Morin. Additionally, it is below the average allowed ROE authorized by Commissions throughout the country during these time periods.

30. Dr. Morin utilized a number of cost of equity methodologies. Based on his studies, he estimated the cost of equity for PSE to fall within a range of 9.8 percent to 10.7 percent for the first half of 2013. The midpoint of his estimates is 10.3 percent. The mean (median and truncated) are 10.0 percent. The results of Dr. Morin's studies for 2013 are shown below:

Summary of ROE Estimates for PSE for the First Half of 2013

Study[47]	ROE
Traditional CAPM	9.8%
Empirical CAPM	10.3%
Hist. Risk Premium Electric Utility Industry	9.8%
Allowed Risk Premium	10.7%
DCF Electric Utilities Value Line Growth	10.1%
DCF Electric Utilities Analyst Growth	9.8%

[47] *See* Morin, Exh. No. RAM-1T at 64:5-6. Note that the results of the Value Line and Utilities Analyst Growth DCF studies were transposed in Table 10 in Dr. Morin's testimony and have been corrected on this table. *See* Morin, Exh. No. RAM-1T at 26:1, 17; Exh. No. RAM-4 at 2; Exh. No. RAM-5 at 2.

31. Dr. Morin utilized these same methodologies to estimate the cost of equity for the second half of 2014. For this time period he estimated a range of 9.4 percent to 11.0 percent with a midpoint of 10.2 percent. The mean for this time period (average and truncated) is 10.3 percent. The results of Dr. Morin's studies for 2014 are shown below:

Summary of ROE Estimates for PSE for the Second Half of 2014

Study[48]	ROE
Traditional CAPM	10.3%
Empirical CAPM	10.8%
Hist. Risk Premium Electric Utility Industry	10.5%
Allowed Risk Premium	11.0%
DCF Electric Utilities Value Line Growth	9.4%
DCF Electric Utilities Analyst Growth	9.6%

32. Dr. Morin testified as to other benchmarks with respect to ROE that the Commission should take into account in assessing the reasonableness of his recommended ROE. The current AUS Utility Reports publishes the currently outstanding allowed returns on equity for the electric utilities in the peer group. The average authorized ROE for the companies in Dr. Morin's peer group is 10.2 percent, which is almost identical to the midpoint of his recommended range (10.3 percent) and exceeds PSE's currently authorized ROE of 9.8 percent.[49] Additionally, he testified that the current issue of Regulatory Research quarterly review of authorized ROE reports the decisions rendered to date in 2014. The average authorized returns on equity in recent decisions is 10.0 percent, which fell within Dr. Morin's recommended ROE range for PSE.[50]

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[48] Morin, Exh. No. RAM-1T at 64:12-13.
[49] Morin, Exh. No. RAM-1T at 66:1-67:2.
[50] Morin, Exh. No. RAM-1T at 67:3-7.

2. Evidence From Commission Staff Witness David Parcell Supports an ROE Range Between 9.0 and 10.0 Percent

33. Commission Staff's testimony and evidence supports a 9.80 percent ROE. Commission Staff's cost of capital witness Mr. David Parcell testified that an ROE of 9.80 percent is within a range of reasonableness.[51] Mr. Parcell performed three cost of equity studies. His Discounted Cash Flow ("DCF") study produced a range of 9.1 to 9.7 percent. His Capital Asset Pricing study ("CAPM") produced a range of 6.5 to 6.8 percent. And his Comparable Earnings methodology produced a range of 9.0 to 10.0 percent.[52] Based on these findings, Mr. Parcell concluded "that the cost of common equity for PSE, as of early 2013, was within a range of 9.0 percent to 10.0 percent."[53] Mr. Parcell recommended a midpoint of 9.5 percent ROE, but testified that 9.8 percent ROE fell within the range derived from his cost of equity studies.[54]

3. ICNU's cost of equity analyses contain irregularities but ultimately support an ROE range that exceeds 9.80 percent

a. ICNU's risk premium studies support a range above 9.80 percent

34. The risk premium cost of equity studies performed by ICNU witness, Michael Gorman, also support an ROE in excess of 9.80 percent. Mr. Gorman's 2013 Treasury bond risk premium estimate produced a cost of equity in the range of 8.11 to 9.88 percent.[55] His 2014 Treasury bond risk premium study produced a cost of equity in the range of 8.51 to 10.38 percent.[56] The risk premium cost of equity study is one of two separate risk premium studies performed by

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[51] Parcell, Exh. No. DCP-1T at 4:3-6.
[52] Parcell, Exh. No. DCP-1T at 3:22-23.
[53] Parcell, Exh. No. DCP-1T at 4:1-2.
[54] Parcell, Exh. No. DCP-1T at 4:3-6.
[55] Gorman, Exh. No. MPG-3 at 25:12-15. Mr. Gorman calculated the Treasury bond equity risk premium estimate using the difference between the average authorized return on utility common equity investments and U.S. Treasury bond yields each year. *See* Gorman, Exh. No. MPG-3 at 22:2-4; Exh. No. MPG-36; Exh. No. MPG-25T at 25:1-4.
[56] Gorman, Exh. No. MPG-25T at 28:15-16.

Mr. Gorman in both 2013 and 2014. The other separate risk premium study he performed was based on utility bond yields.[57] His overall risk premium estimate for 2014 produced a range of 9.24 percent to 9.91 percent.[58] Mr. Gorman conceded that more weight should be given to the high end of the range than the low end of the range.[59] Based on this testimony, a 9.80 percent ROE was in a range of reasonableness in 2013 and remained in a range of reasonableness in 2014.

35. Despite the undisputed fact that Mr. Gorman's Treasury bond equity risk premium analysis resulted in a cost of equity range reaching up to 9.88 in 2013 and 10.38 in 2014, Mr. Gorman attempts to lower these results by combining them with the results of his separate utility bond risk premium analysis, and giving only 75 percent weight to the high end of the estimates. Even with this arbitrary manipulation of the results, his 2014 risk premium estimate falls within a range of 9.24 percent to 9.91 percent.[60]

36. ICNU attempts to further lower the risk premium results by using only the midpoint of the range in 2013 and 2014, rather than the actual range. This allowed Mr. Gorman to recommend an equity risk premium estimate of 9.27 percent in 2013 and 9.60 percent in 2014[61] despite the fact that his studies produce a broader range that reaches beyond the 9.80 percent ROE requested by PSE.

37. Mr. Gorman employed several other arbitrary adjustments to his risk premium study that allow him to lower his recommendation to the Commission. While he conceded that more

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[57] Gorman, Exh. No. MPG-3 at 22:1; Exh. No. MPG-25T at 24:12-13. Mr. Gorman calculated the utility bond equity risk premium using the difference between the average authorized returns on utility common equity and A-rated utility bond yields by Moody's. *See* Gorman, Exh. No. MPG-3 at 22:9-11; Exh. No. MPG-25T at 25:6-10; Exh. No. MPG-37.

[58] Gorman, Exh. No. MPG-25T at 30:3-4.

[59] Gorman, Exh. No. MPG-3 at 25; Exh. No. MPG-25T at 29:19-22.

[60] Gorman, Exh. No. MPG-25T at 30:3-22.

[61] Gorman, Exh. No. MPG-3 at 25:15-17; Exh. No. MPG-25T at 30:3-4.

weight should be given to the high end of his range, he arbitrarily gave 75 percent weight to the high end and 25 percent weight to the low end. He provided no justification for this specific weighting. Additionally, Mr. Gorman limited the range of years from which to apply his "indicated risk premium." After choosing the years 1986 through 2012 for his 2013 study and 1986 through 2014 for his 2014 study, he then arbitrarily discarded six of the years in each study,[62] which included the most recent years in all four of his studies.[63] He gave no substantive justification for this selective use of years. Had his range included all of the years from 1986-2014, his cost of equity range for both utility bond yield and Treasury bond yield would have extended even higher.

b. The actual returns for ICNU's 2013 proxy group support a 9.80 percent ROE

38. The evidence proffered by ICNU in its 2013 cost of equity study supports the validity of an ROE in excess of 9.80 percent. PSE reviewed the authorized ROE for the regulated utilities within the holding companies in ICNU's proxy group in its 2013 study:

> According to the SNL Energy database, the average authorized return on equity for the operating utilities within ICNU's proposed proxy group is 10.08%, and the average capital structure for the operating utilities within ICNU's proposed proxy group contains 48.80% equity. . . . Thus, each of the average authorized return on equity and the average authorized capital structure of the operating utilities in ICNU's proposed proxy group is substantially higher than that advocated for PSE in this proceeding.[64]

39. Simple averages from Mr. Gorman's 2013 proxy group materially undermine the entire premise of his testimony and his proposed ROE. The ROE awarded to operating companies in

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[62] Gorman, Exh. No. MPG-3 at 22:20-22 (using 21 of the 27 observations to calculate ranges and excluding 2009, 2011 and 2012); Exh. No. MPG-25T at 25:19-20 (using 23 of the 29 observations to calculate range and excluding 2009, 2012, and 2013).

[63] *See e.g.*, Gorman, Exh. No. MPG-17 (excluding 2009, 2011 and 2012); Exh. No. MPG-37 (excluding 2009, 2011, and 2013). These recent, excluded years have a risk premium in excess of the top end of Mr. Gorman's arbitrarily established range.

[64] Doyle, Exh. No. DAD-1T at 7:1-6; Exh. No. DAD-3.

Mr. Gorman's proxy group for the third quarter of 2012 (after the Final Order in PSE's 2011 general rate case was entered) through the first quarter of 2013 average 10.08. The average for first quarter 2013 remained at 9.88—still above PSE's current authorized ROE.[65]

c. ICNU's manipulations of the 2014 proxy group lack a sound basis

40. Mr. Gorman's selectively discarded relevant data in his DCF studies, and particularly in the selection of his proxy group. As pointed out in cross examination, in establishing his proxy group, Mr. Gorman eliminated one of Dr. Morin's proxy group company's purportedly due to the size of acquisition program in which the proxy company was involved. But he did not consistently apply this criteria. He removed Duke Energy because it had an acquisition program of $4 billion, about 7.8 percent of its market capitalization; but he retained in his proxy group Northwestern Energy, which had an acquisition program of approximately $900 million, which is approximately 44 percent of its total market capitalization.[66] Mr. Gorman admitted he should have excluded NorthWestern Energy from his proxy group.[67] Such inconsistent applications call into question the methodologies used by Mr. Gorman.

d. ICNU's flawed credit metric analysis should be given no weight

41. The Commission should give no weight to the purported credit metric analysis that Mr. Gorman used in a failed attempt to justify his 9.30 percent ROE. Mr. Gorman asks the Commission to rely on this analysis as evidence that PSE's credit rating will not decrease if the Commission authorizes a 9.30 percent ROE. But, as pointed out on cross examination, Mr. Gorman's analysis is fatally flawed. There are numerous errors in his credit metric analysis shown in Exhibit No. MPG-42. Rather than using PSE's full rate base for the analysis,

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[65] *See* Doyle, Exh. No. DAD-3.
[66] Gorman, TR. 642:6-643:11.
[67] Gorman, TR. 695:16-18; 696:9-10.

Mr. Gorman selectively included only PSE's electric delivery rate base.[68] He failed to include PSE's electric generation rate base and PSE's gas rate base in his analysis—despite the fact that both Standard & Poor's and Moody's analyze PSE as a combined electric and gas utility when making credit rating decisions for the company. Thus, as shown on Exhibit No. MPG-42, Mr. Gorman's analysis assumes PSE's rate base is $2.6 billion when in actuality it is approximately $6.5 billion.[69] Other numbers in MPG-42 that flow from the rate base calculation are likewise compromised and cannot be used to support a 9.30 percent ROE.

4. Public Counsel's proposal for an 8.65 percent ROE is unreasonable, inconsistent with past testimony, and filled with discrepancies

42. Public Counsel's cost of equity methodologies and recommendations are unreasonable and inconsistent. The methodologies he uses in reaching his cost of equity recommendations are suspect, as Dr. Morin points out in his testimony. Moreover, one must question the reasonableness of Mr. Hill's recommendation that the Commission should precipitously decrease PSE's ROE by 115 basis points over a 13 month period— from the 9.80 percent ROE set by the commission in May 2012 to an 8.65 percent ROE as recommended by Mr. Hill effective June 2013.[70]

a. Public Counsel's Evidence Conflicts with Past Testimony

43. Public Counsel witness Stephen Hill's testimony recommending an 8.65 percent ROE for PSE lacks credibility for several reasons. Earlier in this case, in 2013, Mr. Hill recommended a 9.50 percent ROE based on market conditions; now, he recommends an ROE of 9.0 percent for

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[68] Gorman, TR. 646:12-19.

[69] ERF Docket, Barnard, Exh. No. KJB-3 at 2:36, column A (showing electric rate base of $4.962 billion for test year ending June 2012); Exh. No. KJB-4 at 2:34, column A (showing gas rate base of $1.592 billion for test year ending June 2012).

[70] Hill, TR. 620:2-8.

the same time period.[71] Additionally, Mr. Hill's testimony in this case conflicts with his testimony in other jurisdictions. Appearing before the Alabama Public Service Commission in a case involving Alabama Power Company in July, 2013, Mr. Hill's own client, AARP, found his cost of equity results to be too low. Mr. Hill recommended an ROE of 10.0 percent and testified that in 2013, a 10.0 percent ROE was reasonable and consistent with *Hope* and *Bluefield.*[72] He further testified that a 10.0 percent ROE was very similar to the average return on common equity currently being allowed regulated utilities in the U.S."[73]

b. Public Counsel's DCF studies contain discrepancies and irregularities

44. Dr. Morin enumerated multiple discrepancies and irregularities with Public Counsel's cost of equity studies.[74] Significantly, although Public Counsel witness Stephen Hill testified that 8.65 percent ROE was supported by his DCF studies, when the actual allowed ROE for his proxy group is reviewed, not one of his proxy companies has an allowed ROE below 10.0 percent as of May 2013. The average ROE for Mr. Hill's proxy group was 10.57 percent as of May 2013, and the average dipped only slightly lower in 2014, to 10.51 percent.[75] This inconsistency between Mr. Hill's cost of equity study using these proxy companies and the actual ROE authorized for these proxy companies, calls into question the reasonableness of Mr. Hill's cost of equity studies and recommendations.

45. Moreover, Mr. Hill unduly restricted his sample size to include only utilities with senior bond ratings between "BBB" and "A" (or "Baa2" and "A2"), with 70 percent or more of

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71 Hill, Exh. No. SGH-2T at 45:6-7, 12-16.
72 Hill, Exh. No. SGH-25CX at 41:3-13.
73 *Id.*
74 Morin, Exh. No. RAM-16T at 4:6–5:22.
75 Morin, Exh. No. RAM-16T at 7:11–9:3.

revenues generated by utility operations.[76] As Dr. Morin testified, the use of a handful of companies in a highly fluid and unstable industry produces fragile and statistically unreliable results. A far safer procedure is to employ large sample sizes representative of the industry as a whole and apply subsequent risk adjustments to the extent that the company's risk profile differs from that of the industry average.[77] As a result of Mr. Hill's restrictive selection of proxy companies, his dividend yield component of the DCF does not generate an accurate projection.[78]

46. Additionally, Mr. Hill's DCF benchmark growth rate forecast for his proxy companies is arbitrarily established and impossible to replicate. He selects growth estimates with little quantitative or academic empirical evidence.[79] Dr. Morin testified that Mr. Hill used a "shotgun approach to growth rates" which is unreliable and arbitrary rather than choosing an optimal growth rate proxy based on objective scientific research that is easily reproducible.[80]

47. Dr. Morin also testified regarding numerous defects in Public Counsel's sustainable growth methodology. The methodology employed by Public Counsel witness Mr. Hill is logically circular because it requires an estimate of the expected rate of ROE to estimate the cost of equity using the DCF model. Of particular note is that Mr. Hill's assumes returns on equity for these proxy groups that are significantly higher than the cost of equity he recommends for PSE. His assumptions include an average ROE for his proxy group of 9.7 percent in 2013, 9.9 percent in 2014, and 10.2 percent for 2016-2018, but he then recommends an ROE of 8.65 percent for PSE.[81] As Dr. Morin testified, "[t]his logical flaw compromises the integrity of

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[76] Morin, Exh. No. RAM-16T at 9:21–10:1; Hill Exh. No. SGH-2T at 20:20-22.
[77] Morin, Exh. No. RAM-16T at 10:19–11:2; Exh. No. RAM-1T at 21:14–24:9.
[78] Morin, Exh. No. RAM-16T at 11:17-19.
[79] Morin, Exh. No. RAM-16T at 13:7–16:4.
[80] Morin, Exh. No. RAM-16T at 15:19–16:4.
[81] Morin, Exh. No. RAM-16T at 17:14–19:16.

Mr. Hill's analysis and should be a sufficient basis for rejecting the results produced by this methodology."[82]

48. Mr. Hill inappropriately uses historical growth rates in arriving at proxies for the DCF growth forecast component, rather than using consensus analysts' growth forecasts. The latter are more reliable estimates. Historical growth rates are largely redundant and have little relevance as proxies for long-term growth forecasts due to structural changes in the electric industry.[83]

c. Public Counsel's CAPM results rely on erroneous data inputs

49. Public Counsel's CAPM results cannot be relied upon due to erroneous data inputs used in the analysis. First, Public Counsel witness Mr. Hill uses a risk-free rate estimate of 3.4 percent that is far too low—approximately 1.2 percent lower than projected. Mr. Hill fails to rely on projected long-term Treasury interest rates to take into account the forward-looking nature of the estimate.[84] Second, due to the small size of Public Counsel's sample group, the beta estimate of 0.67 is inaccurate and significantly below all the other cost of capital witnesses, as Dr. Morin points out in his rebuttal testimony. [85] Third, Public Counsel's CAPM analysis relies on a stale long-term market risk premium from 2011 Morningstar edition rather than using the then-current 2013 edition. Further, Public Counsel's analysis improperly uses total returns on government bonds, rather than income returns to estimate the market risk premium from historical data.

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[82] Morin, Exh. No. RAM-16T at 19:1-3. Dr. Morin also takes issue with Mr. Hill's exclusive reliance of Value Line forecasts for return on equity and retention ratios, and his use of end-of-period book equity rather than average book equity. *Id.* at 20:1-18.

[83] Morin, Exh. No. RAM-16T at 21:3–22:13.

[84] Morin, Exh. No. RAM-16T at 23:3-17.

[85] Morin, Exh. No. RAM-16T at 24:1-11.

Morningstar recommends use of the income return on government bonds as a more reliable estimate. This correction alone increases Public Counsel's CAPM estimate by 47 basis points.[86]

B. PSE's Earnings Sharing Mechanism Provides Protections To Customers and Provides a Counterbalance To Those Who Claim 9.80 Percent ROE Lies at the Upper End of a Range of Reasonableness

50. PSE's earnings sharing mechanism requires that PSE's ROE be set at the high end of the range of reasonableness. When the Commission approved PSE's decoupling mechanism and rate plan with an ROE of 9.80 percent, it modified the earnings sharing mechanism that PSE had proposed. Instead of including a 25 basis point buffer or dead band above the authorized rate of return of 7.77 percent, the Commission required PSE to share with customers on a 50/50 basis all earnings that exceed the 7.77 percent authorized rate of return. The Commission justified this change because the Commission determined that PSE's 9.80 percent ROE was at the higher end of the range of reasonableness in 2013.[87]

51. Mr. Doyle testified that the absence of a buffer or dead zone skews PSE's ability to earn its authorized ROE, on average, over time, and increases its financial risk. This is a factor the Commission must consider when setting PSE's ROE:

> Ultimately, beginning earnings sharing after 25 basis points does not significantly prevent PSE from earning the authorized ROE on average, however, earnings sharing beginning at the authorized rate of return clearly alters the upside and downside parity around the opportunity to earn the authorized ROE. This results in an asymmetrical earnings profile, biased to the downside, that, all else being equal, increases PSE's risk profile. [88]

Moreover, using PSE's electric results of operations for the twelve months ended December 31, 2013, Mr. Doyle demonstrated that even if PSE had earned its authorized allowed rate of return

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[86] Morin, Exh. No. RAM-16T at 24:14–25:19.
[87] Order 07 at ¶ 164.
[88] Doyle, Exh. No. DAD-4T at 21:1-6; Exh. No. DAD-5.

of 7.77 percent, it would have underearned its allowed ROE by 0.30 percent. The 50/50 sharing of earnings with customers that occurs above PSE's 7.77 percent authorized rate of return, negatively skews the distribution of PSE's opportunity to earn its allowed ROE, on average, over time.[89] This asymmetric risk means that PSE will not earn its authorized return on average. Assuming positive and negative earnings, which on average would balance out to the allowed ROE, sharing the upside but not the downside means that the balance is upset. PSE will underearn on average.

52. In sum, there are two important points for the Commission to consider with respect to the earnings sharing mechanism. First, customers benefit under PSE's decoupling mechanism and rate plan due to this earning sharing, in a way they did not benefit in the past under principles of traditional ratemaking. Although PSE has experienced nearly a decade in which it significantly earned below its authorized ROE due to aggressive capital spending to benefit customers,[90] customers did not share in the underearning scenario in those years. Now customers are able to reap the benefits if PSE operates efficiently and earns in excess of its authorized rate of return, but they are still not required to contribute on the downside if PSE fails to earn its authorized return.

53. Second, the earnings cap creates an asymmetrical earnings profile and increases PSE's financial risk. As Mr. Doyle testified, it results in a reduction to PSE's average ROE. The Commission would need to set the allowed ROE higher than the cost of capital so that PSE would again have a fair opportunity to earn its costs of capital.[91] The Commission should

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[89] Doyle, Exh. No. DAD-8T at 21:15–23:2; Exh. No. DAD-12.
[90] Schooley, Exh. No. TES-3; Doyle, Exh. No. DAD-4T at 18:1-2.
[91] Doyle, Exh. No. DAD-4T at 19:8 - 22:2; Exh. No. DAD-5.

recognize this increased risk profile when setting PSE's ROE.[92] Viewed from the opposite perspective, for those parties that argue that PSE's ROE is at the high end of the range of reasonableness, there is justification for PSE's to be set at the upper end of the range—whatever that range is determined to be. With the earnings sharing mechanism, PSE is taking on additional risk that it did not have under traditional ratemaking. The Commission recognized this tie between the earnings sharing mechanism and an ROE in the upper end of a range of reasonableness in Order 07.[93]

IV. THE COMMISSION SHOULD NOT DECREASE PSE'S ROE BASED ON ITS DECOUPLING MECHANISMS

54. The Commission properly determined in Order 07 that it should not prospectively adjust PSE's ROE due to decoupling, but should wait to fully evaluate the effects of decoupling in PSE's next general rate case, after the Commission has had an opportunity to view the effects of decoupling over a three-four year time period.[94] However, if the Commission determines that it is appropriate to make a determination with respect to the effect of decoupling on cost of capital

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[92] When compared to earnings caps and bands in other jurisdictions, PSE's is quite rigid. For example, the earnings sharing for Cascade Natural Gas in Oregon applied once the utility's earnings exceeded 175 basis points over its allowed ROE and only one-third was returned to customers. *See In the Matter of Cascade Natural Gas Corp. Request for Authorization to Establish a Decoupling Mechanism and Approval of Tariff Sheets No. 30 and No. 30-A*, Docket UG 167, Order 06-191(Apr. 14, 2006); *see also In the Matter of MDU Resources Group, Inc., Application for Authorization to Acquire Cascade Natural Gas Corp*, Docket UM 1283, Order No. 07-221 at 4 (June 5, 2007) (extending decoupling to September 2012); *see also In re Atmos Energy Corp's Georgia Rate Adjustment Mechanism ("GRAM") 2012 Petition*, Docket 34734, Order Adopting Atmos's Rate Adjustment Request at 2. (Jan. 31, 2013) (approving decoupling mechanism in which authorized revenues change annually according to a comparison of historic test year and a forward looking test year and the adjustments necessary to bring authorized revenues up to a 10.5 percent ROE or down to a 10.9 percent ROE—20 basis points to either side of the authorized 10.7 percent ROE); *Application of Wisconsin Power & Light Co. Regarding the 2015 Test Year Electric and Natural Gas Base Rates*, Docket 6680-UR-119, Final Decision (PSCW July 17, 2014) (authorizing rates for 2015 including an earnings sharing mechanism that allowed WPL to retain any earnings 25 basis points above its authorized return on equity of 10.40 percent, sharing evenly with customers any earnings between 10.65 and 11.40 percent, and refunding to customers any earnings in excess of 11.40 percent return on equity).

[93] Order 07 at ¶¶ 164-65 (determining that the 9.80 return on equity was at the higher end of the range of reasonableness and adjusting the earnings cap to remove the 25 basis point buffer and requiring earnings sharing if the authorized rate of return is exceeded).

[94] Order 07 at ¶¶ 104-106.

in this case, there is substantial evidence demonstrating that no separate decrement to PSE's ROE should be made due to decoupling. First, decoupling is an important state energy policy intended to break down barriers to aggressive pursuit of energy efficiency by removing a utility's incentive to sell more energy. The Commission should not penalize utilities for supporting this important state energy policy. Second, there is no statistically significant empirical evidence that decoupling reduces the cost of equity, as discussed in the testimonies of Dr. Vilbert and Dr. Dubin. Third, decoupling and other alternative ratemaking approaches have become much more prevalent over the past several years and are reflected in the proxy groups in cost of equity studies. The Commission should not impose a separate decrement to PSE's ROE when the impact of decoupling and other alternative rate making mechanisms are already reflected in the proxy group and the cost of equity study. No other single policy is used to adjust the ROE. The appropriate ROE is a function of all the risks to PSE. Attempting to determine the effect of individual policies is likely to be time consuming and contradictory.

A. Decoupling Is an Important State Policy Intended To Further Promote Energy Efficiency and the Commission Should Not Undermine this Important Policy by Penalizing Utilities that Adopt the Mechanisms

55. The State of Washington recognizes the importance of energy efficiency, reliability of electric service, and maintaining financially-strong utilities.[95] Decoupling is an important piece of the state energy policy. Traditionally utility rates are set such that a portion of the utility's fixed costs are recovered through volumetric rates. With the proliferation of energy efficiency, distributed generation and decreasing loads, utilities have not been able to fully recover their

[95] *See, e.g.*, RCW 19.285.020; RCW 80.28.260; *Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, To Encourage Utilities To Meet or Exceed Their Conservation Targets*, Docket U-100522 ("Decoupling Policy Statement"); Schooley, Exh. No. TES-2 (Letter from former Governor Gregoire emphasizing the importance of regulatory climate that encourages energy efficiency and recovery of utility costs).

allowed costs due to decreasing usage. Decoupling helps to address this problem. The purpose of decoupling is to reduce the throughput incentive for a regulated company that recovers a large portion of its fixed costs through a variable charge. It allows the promotion of energy efficiency, demand side management, and other policies to reduce greenhouse gas emissions and conserve energy. Decoupling better aligns the interest of utilities with other stakeholders on these key issues, because it allows the utilities a more fair opportunity to recovery their allowed revenue requirement while promoting energy efficient and conservation.[96]

56. Because decoupling is intended to align the interests of stakeholders to allow greater promotion of energy efficiency, it makes no sense to penalize utilities that are willing to adopt decoupling mechanisms. As Mr. Cavanagh testified "[t]his case . . . will help determine whether Washington State can achieve and surpass its demanding energy efficiency and pollution reduction targets while ensuring affordable and reliable electricity service."[97] Mr. Cavanagh further testified that the Commission should require demanding standards and solid evidence before deciding that "revenue decoupling should come packaged with an automatic upfront penalty for PSE, the state's largest utility and most important energy efficiency investor."[98]

B. The Commission Should Not Prospectively Adjust PSE's ROE

57. The Commission has a long history with decoupling as documented in the record in this proceeding[99] and in the Commission Decoupling Policy Statement.[100] The Commission's views on decoupling have evolved over time and continue to evolve. Most recently, the Commission has recognized that it should not prospectively adjust PSE's ROE based on supposition that

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96 Vilbert, Exh. No. MJV-1T at 7:4–8:2, 14:13–15:4; Exh. No. MJV-18T at 3:20–5:2.
97 Cavanagh, Exh. No. RCC-6T at 2:13-15.
98 Cavanagh, Exh. No. RCC-6T at 2:15-19.
99 Cavanagh, Exh. No RCC-1T at 2:17–5:5.
100 *See* Decoupling Policy Statement at App. 5.

decoupling reduces cost of capital. Instead, it should allow a reasonable time for decoupling mechanisms to be in place and evaluate their effect on cost of capital in PSE's next general rate case. This is a sound approach, which PSE has endorsed, along with the NW Energy Coalition and Commission Staff. However, if the Commission determines that it must consider the effects of decoupling on cost of capital in this proceeding, there is substantial evidence in the record to demonstrate that PSE's ROE should not be reduced.

1. Studies by The Brattle Group demonstrate that the Commission should not impose a separate decrement to ROE due to decoupling

58. Empirical studies on the effect of decoupling on cost of capital fail to demonstrate that decoupling reduces cost of capital. The evidence in The Brattle Group studies is consistent with decoupling having little impact, or even raising the cost of capital for regulated utilities [101] PSE witness Dr. Vilbert and his colleagues at The Brattle Group have studied this issue extensively over the past several years. The Brattle Group undertook a study of the gas local distribution company industry in 2011, and this study was referenced in the 2013 phase of this proceeding.[102] The Brattle Group updated and refined the gas decoupling study in 2013, and also conducted an electric decoupling study in March 2014 and updated in November 2014.[103] The basic conclusion that there is no statistically significant evidence that decoupling reduces cost of

[101] Dubin, Exh. No. JAD-1T at 3:7-10.
[102] Cavanagh, Exh. No. RCC-4T at fn 11; Exh. No. RCC-2 at 22.
[103] Vilbert, Exh. No. MJV-18T at 6:20-22.

capital[104] holds true over the course of the gas and electric studies and the updates of these studies.[105]

59. The Commission should reject invitations from Public Counsel and ICNU to cast aside the traditionally accepted statistical significance standard in this case, and impose a basis point reduction to PSE's ROE based on these studies—even though there is no statistically significant evidence supporting such a reduction in PSE's ROE. Public Counsel and ICNU take the position that the Commission's determination in this case is a mere policy issue and does not demand the rigorous standards of statistical significance that a scientific journal interested in "highly reliable knowledge" would require.[106] Thus, although the results of The Brattle Group studies do not meet the p-value of 0.05[107] or the 95 percent confidence level that is traditionally required for statistical hypothesis testing, Public Counsel and ICNU would have the Commission discard this standard and adopt a much lower level of confidence. In support of their position, Public Counsel and ICNU offer the testimony of Dr. Adolph, a political scientist who admittedly is not an expert in financial accounting, utility regulation, cost of capital, or the policy of decoupling.[108]

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[104] Vilbert, Exh. No. MJV-1T at 20:13-17, 28:2-6. Dr. Vilbert testified that the study results do not disprove the null hypothesis that decoupling has no impact on the cost of capital at the p-value of 0.05 or the 95 percent confidence level.

[105] Vilbert, Exh. No. MJV-18T at 8:1-8. Dr. Vilbert testified that the updated studies more accurately reflect the decoupling mechanisms of the sample group (i.e., recognizing that one of the electric sample companies had straight fixed variable rates during the study period) and they better control for companies that evolve over the course of the study due to mergers and acquisitions. *Id.* at 9:9-10:3. Further, Dr. Vilbert testified that the gas LDC study is likely to be more reliable than the electric study due to the fact that there is far more disruption in the electric utility industry—including mergers and acquisitions, struggles with distributed generation, renewable energy proliferation and integration, and demand side management—which may have effects on the electric studies that cannot be fully controlled. *Id.* at 10:13-11:5. Because true up decoupling and straight fixed variable ratemaking work similarly for the gas and electric industry, and in light of the significant changes going on in the electric industry, Dr. Vilbert testified that he believes the gas LDC results to be the most reliable *Id.* at 10:2-11:3.

[106] Adolph, Exh. No. CAA-1T at 20:17-19.

[107] The p-value, or observed significance level, is the probability of obtaining a more extreme estimate than the sample estimate, under the assumption that there is no effect. Dubin, Exh. No. JAD-1T at 7:19-21. Dr. Dubin explains the reason for use of a 95 percent confidence level in his testimony. Dubin, Exh. No. JAD-1T at 14:3-22.

[108] Adolph, Exh. No. CAA-1T at 3:4-6.

At various points in his testimony Dr. Adolph arbitrarily adopts confidence levels of 87 percent, 83 percent, and 63 percent simply to force the negative point estimates for the effect of decoupling on the cost of capital to pass the statistical significance test.[109] Mr. Cavanagh takes issue with Dr. Adolph's view—as should the Commission—that while scientific journals set high confidence levels (i.e. 95 percent) in order to encourage the production of highly reliable evidence, the Commission does not need to be concerned with highly reliable evidence for a mere policy issue.[110]

> In deciding whether revenue decoupling should come packaged with an automatic upfront penalty for PSE, the state's largest utility and most important energy efficiency investor, I believe that the Washington UTC should be no less demanding of the penalty's proponents than the editor of an academic journal when evaluating statistical data that bears directly on the point at issue. In considering witness Adolph's views here, the Commission also should note his acknowledgements that "I am not an expert in the areas of accounting, utility regulation, cost of capital or the policy of decoupling," and "I do not have an opinion on whether [PSE's cost of capital experts] have collected a representative sample of utilities, whether they have measured the cost of capital or degree of decoupling appropriately, or whether they have made reasonable decisions regarding which observations to exclude from these analyses." [111]

60. Contrary to testimony from ICNU and Public Counsel that The Brattle Group studies justify a decrease in the cost of capital, the results of these studies do not reach a level of confidence to justify lowering PSE's ROE. For example, with respect to the results of the November 2014 electric decoupling study, the evidence is consistent with decoupling raising, lowering, or having no effect on the cost of capital.[112] As Dr. Dubin testified, "[w]ith 95%

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[109] Dubin, Exh. No. JAD-1T at 16:19-17:2.
[110] Adolph Exh. No. CAA-1T at 20:17-19; 21: 4-6.
[111] Cavanagh, Exh. No. RCC-6T at 2:15-3:2 (quoting Adolph, Exh. No. CAA-1T at 3:4-6, 20-22).
[112] Vilbert, TR. 708:5-10.

confidence we can rule out decreases of more than 79 basis points or increases of more than 27 basis points.[113] Such evidence is not sufficiently reliable to justify a decrease in PSE's ROE:

> Relaxing the confidence levels (or raising the significance levels used to test hypotheses) fails to address the fundamental problem with weak evidence. If a confidence interval provides considerable support for two opposing positions, it has little evidentiary value. Dr Adolph's proposal to this Commission to raise the significance level reflects a "flawed understanding".[114]

61. The Commission should reject efforts by Public Counsel and ICNU to conflate the Commission's evidentiary standard and burden of proof with the research standard used to determine the significance to be placed on scientific research to determine whether it is reliable. As Dr. Dubin testifies, these are entirely different standards that serve different purposes, and previous efforts to combine these separate standards have been rejected by courts and scientific researchers in the past.[115] "The logical implication of Dr. Adolph's position is that the preponderance of the evidence standard should be based on 50 percent confidence levels, which is an absurd result, as Dr. Dubin testifies.[116]

62. Dr. Vilbert testified that decoupling is instituted as a policy response to support other regulatory goals, such as eliminating the throughput incentive. Effective energy efficiency programs and distributed generation generally result in decreasing sales, which, in conjunction with volumetric rates, frustrate utilities' ability to fully recover their fixed costs. The adoption of decoupling helps mitigate this impact and is an important factor in aligning utility and public policy objectives. This, in turn, is important as electric and gas utilities seek to provide safe and reliable service, while also being a change agent in society's move to ever greater efficiency,

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[113] Dubin, Exh. No. JAD-1T at 12:5-7.
[114] Dubin, Exh. No. JAD-1T at 20:12-16.
[115] Dubin, Exh. No. JAD-1T at 21:10-15.
[116] Dubin, Exh. No. JAD-1T at 17:11-13.

lower energy use, more renewable power, and remain financially sound in the process. In considering the lack of evidence to demonstrate that decoupling decreases cost of capital in spite of the intuitive argument, Dr. Vilbert hypothesizes that the decoupling is a response to other risk-increasing factors that utilities have faced over the past several years including increased energy efficiency mandates, integration of renewable energy, increasing distributed generation, and decreasing (or even negative) sales growth. Decoupling may be responding to and mitigating these increased risks that may otherwise increase the cost of capital rather than decreasing a utility's cost of capital.[117]

2. Public Counsel's Revenue Volatility Analysis is riddled with errors and baseless assumptions; the Commission should reject it as other commissions have done

63. Public Counsel's attempt to calculate a decrement to PSE's ROE, based on decoupling, lacks merit, is built on baseless assumptions and uses inappropriate inputs. In their rebuttal testimony, Dr. Vilbert and Mr. Doyle dismantle, piece by piece, the "Revenue Volatility Analysis" presented by Public Counsel witness Mr. Hill, demonstrating the numerous defects in this analysis. This methodology has been expressly rejected in at least one jurisdiction, and the Commission should likewise place no weight on Public Counsel's faulty study.

a. Public Counsel's regression analysis, including the use of net revenues, is specious

64. A key deficiency in Public Counsel's revenue volatility analysis is the purported use of net revenues to measure the decrease in volatility and risk due to decoupling. First, Public Counsel's analysis uses a wholly incorrect net revenue value. Rather than using the delivery revenues affected by decoupling, Public Counsel uses a net revenue number that is approximately

[117] Vilbert, Exh. No. MJV-1T at 5:6-17, 32:14-33:9.

three times greater than the actual PSE delivery revenues subject to decoupling.[118] Public Counsel fails to remove all the fixed costs and other production costs that are not subject to PSE's decoupling mechanism. Thus, although PSE's electric delivery revenue subject to decoupling for the test year ended June 30, 2012 was approximately $500 million,[119] Public Counsel's analysis uses electric net revenues of approximately $1.6 billion for 2012.[120] Similarly, although PSE's combined gas and electric delivery revenues for 2013 rate year were forecasted at $787 million, Public Counsel uses a combined net revenue value of $2.23 billion for 2013 in its analysis.[121] At a minimum, a study that purports to measure the effect of decoupling on revenues should use the correct value of revenues subject to the decoupling mechanism in the study. Public Counsel's analysis failed this basic test.

65. Second, Public Counsel's approach uses an inappropriate metric for a cost of capital analysis. As Dr. Vilbert testified, net revenue is an accounting value, while cost of capital is measured in capital markets, not by accounting variables such as net revenue. Indeed, Public Counsel did not use net revenues or other accounting variables in its cost of equity studies; it measured expected returns in capital markets.[122] In contrast, in its Revenue Volatility Analysis which Public Counsel uses to argue for a decrease in PSE's ROE, Public Counsel rejects the use of net income or earnings for its analysis, choosing instead to use net revenues. His analysis is further compromised by his interchangeable use of the terms of "revenue," "net revenues",

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[118] *See* Hill, TR. 633:4-9.

[119] *See* JAP-18 at 2:6 (showing test year volumetric revenue of $280 million for residential and $214 million for nonresidential schedules); Hill TR. 632:11-25.

[120] *See* Hill, Exh. No. SGH-26CX at 1 (showing Electric Net Revenues in 2012 of $1.580 million).

[121] Vilbert, Exh. No. MJV-18T at 30:1-12 (citing Hill, Exh. No. SGH-19; Piliaris, Exh. No. JAP-18 at 1; Exh. No. JAP-19 at 1).

[122] Vilbert, Exh. No. MJV-18T at 32:12-18.

"income", "return" and "cash flow."[123] As Mr. Doyle testified, these concepts are distinguishable and net revenue is not the appropriate metric to use in this analysis:

> Although revenues, income, and cash flow are "related", most of the operating expenses (setting aside power cost and gas costs) of any utility, including PSE, that are deducted from revenues to arrive at income and residual cash flows are incurred and recognized independently of revenues. For example, operating expenses such as line clearance expense, depreciation expense, maintenance expense, current and deferred income tax expense, storm damage repair, bad debt expense, and interest expense are all recorded independently of accrued revenues.
>
> Because these expenses nearly always differ from what is included in the revenue requirement underlying the revenues for a given period of time, it logically follows that the volatility of revenues or net revenues is an *inappropriate* proxy for the volatility of income, returns or residual cash flows. Stated alternatively, volatility in operating expense recognition will create variability in net income, returns and residual cash flow that is different from and not present in the variability of revenues or net revenues.[124]

66. Third, Public Counsel's regression analysis comparing net revenues to heating degree days and gross state product cannot withstand scrutiny. Public Counsel claims that the analysis has an R-squared of 90 percent, meaning that economy and weather explain about 90 percent of the change in PSE's revenues.[125] When Public Counsel's regression analysis is calculated using net income, rather than net revenue, the purported R-square plunges from 0.90 to 0.28, demonstrating no predictive relevance or correlation between net income and the economy and weather.[126] Similarly, when net revenue is replaced with cash flow, weather and the economy

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[123] Doyle, Exh. No. DAD-8T at 7.
[124] Doyle, Exh. No. DAD-8T at 8:14–9:4.
[125] Hill, Exh. No. SGH-2T at 111:20-23.
[126] Doyle, Exh. No. DAD-8T at 11:9-14; Exh. No. DAD-10.

only explain 48 percent of the variability in cash flow—about the same effect as flipping a coin.[127]

67. Moreover, Public Counsel's R-squared of 90 percent is inflated because revenues and Washington's Gross State Product are both growing (i.e., trending together). As Dr. Vilbert testified, a time series regression, like that undertaken by Public Counsel, will bias upward if it does not treat the changes or first differences between years, rather than the absolute values in the years.[128] Public Counsel's study fails on this account as well.

b. Public Counsel's assumptions lack a reasoned basis and lead to nonsensical results

68. Dr. Vilbert catalogs several other baseless assumptions relied on by Public Counsel in the Revenue Volatility Analysis. Public Counsel builds a house of cards, piling one unsupported assumption on top of another. It collapses under scrutiny.

69. First, Public Counsel assumes decoupling will reduce the volatility of revenues by 50 percent. There is no basis for this assumption. Although Public Counsel claims that 90 percent of the change in PSE's revenues are explained by weather and the economy, rather than use the 90 percent correlation to explain revenue variability he uses "judgment" to lower the 90 percent reduction in revenue variability to about 50 percent reduction. He provides no basis for this decrease from 90 percent to 50 percent—other than questioning the use of linear regression and also recognizing that some risks are diversifiable.[129]

70. Second, Public Counsel assumes a further decrease in the alleged effect of decoupling on PSE's revenue volatility—from 50 percent to 35 percent. This reduction is purportedly based on

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[127] Doyle, Exh. No. DAD-8T at 12:1-6; Exh. No. DAD-11.
[128] Vilbert, Exh. No. MJV-18T at 36:8-12.
[129] Vilbert, Exh. No. MJV-18T at 37:6-9, 38:6-17 (citing Hill, Exh. No. SGH-2T at 112:14–113:13).

the number of jurisdictions with decoupling in Mr. Hill's cost of capital sample. Of course, as Dr. Vilbert points out, "decoupling in Mr. Hill's [cost of capital] sample has nothing to do with the reduction in the volatility of PSE's revenues in Washington due to decoupling."[130] The assumed 35 percent decrease in revenue volatility has no valid or rational basis.

71. Third, Public Counsel's Revenue Volatility Analysis, taken to its logical conclusion, would result in an absurd result, whereby the decrement for decoupling would decrease PSE's cost of equity below its cost of debt.[131] As Dr. Vilbert testified, assuming investors dislike all negative outcomes, not just those falling within the third standard deviation, the reduction in ROE would be 5.29 percent using Mr. Hill's methodology, and would decrease PSE's ROE from 9.80 percent to 4.51 percent, which is less than the cost of debt for PSE.[132] The assumptions in Public Counsel's analysis are baseless and, carried to their logical conclusion, lead to a nonsensical result.

72. Not surprisingly, this same revenue volatility analysis by Mr. Hill was soundly rejected by the Massachusetts Department of Public Utilities a few years ago. In that case Mr. Hill, testifying on behalf of the Massachusetts State Attorney General, used the same methodology to propose a 50 basis point reduction due to decoupling for Bay State Gas. The Massachusetts Department of Public Utilities rejected the analysis citing the numerous methodological deficiencies:

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[130] Vilbert, Exh. No. MJV-18T at 40:7-8.

[131] Mr. Hill assumes without support that net revenues are normally distributed both before and after decoupling. He then focuses on the third standard deviation of avoided negative revenue events, assuming—again without support—that these are the events that investors would be concerned about. Public Counsel ignores both the other negative events falling in the first and second standard deviation, as well as the proportional avoidance of positive revenue events that are reflected on the opposite side of the bell curves.

[132] Vilbert, Exh. No. MJV-18T at 44:18–45:14.

> Because of the many methodological deficiencies in the Attorney General's method for establishing the historical relationship between the variations in net revenues due to changes in weather and the economy, such as the quality of data used and statistical problems relating to auto-correlations, we cannot place any significant weight on the results of her analysis and recommendation.
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> . . . .
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> As stated above, we deny the Attorney General's 50-basis-point reduction because we are not persuaded that this is an accurate *quantification of the change in investors' risks perception* associated with Bay State's implementation of revenue decoupling.[133]

C. Decoupling Has Become Much More Prevalent and the Existence of Decoupling Mechanisms and Other Alternative Rate Making Mechanisms Are Already Reflected in Proxy Groups

73. The Commission should not apply a separate decrement to cost of capital because any effect decoupling may have on cost of capital is reflected in the proxy groups. Decoupling mechanisms have moved into the mainstream over the past few years. What once was an unusual and innovative regulatory approach, is now common. Moreover, it is not only decoupling mechanisms, but a wide variety of non-traditional ratemaking approaches that are being approved by commissions across the country. Investors look at the overall regulatory environment, not at mechanisms in isolation. They see these mechanisms as a response to the many challenges facing the regulated utility—increased mandated conservation, renewable portfolio standards, distributed generation and net metering, and other load reducing trends. There is substantial evidence in the record from Mr. Cavanagh, Dr. Vilbert, Dr. Morin and Mr. Doyle supporting this view.

74. Dr. Vilbert testified regarding the frequency of innovative rate policies in the proxy group used by Dr. Morin in his cost of equity studies. Numerous of the regulated utilities in

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[133] *In re Petition of Bay State Gas Co.*, Docket DPU 09-30, Order at 369, 372 (Oct. 30, 2009).

Dr. Morin's sample had decoupling with revenue true up or fixed variable rates. Additionally, many of these companies have other innovative rate policies such as multi-year revenue caps with rate adjustment mechanisms, capital expenditure riders, formula rates, performance based ratemaking, and CWIP in rate base. Of the holding companies in Dr. Morin's sample, 61 percent of the holding companies had at least one decoupling mechanism/fixed variable rates, and 79 percent of the holding companies had at least one of the innovative rate policies. [134]

75. There are other innovative rate policies that are not fully reflected on these charts. Wisconsin, for example, has a forward test year,[135] electric fuel adjustment mechanism with deferred accounting,[136] securitization for environmental remediation costs,[137] decoupling[138] as well as other alternative rate making tools in its toolbox. Yet in 2013, Wisconsin utilities had authorized ROEs in excess of 10.0 percent.[139] At least two Wisconsin utilities are reflected in the proxy groups in this case.

76. Dr. Morin likewise testified to a sea change that has occurred in the electric utility industry over the past five years, with mechanisms such as decoupling and other innovative policies to reduce regulatory lag and address decreasing load becoming much more prevalent. [140] Dr. Morin testified that while these mechanisms had once been unusual, and some commissions had imposed decrements to ROE with the approval of these mechanisms, such treatment is no

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[134] Vilbert, Exh. No. MJV-14, Exh. No. MJV-15, Exh. No. MJV-16.

[135] *See, e.g., Application of Wisconsin Power and Light Company Regarding the 2015 Test Year Electric and Natural Gas Base Rates*, Public Service Commission of Wisconsin Docket 6680-UR-119, Final Decision (July 17, 2014), Attachments A–E (demonstrating future test years of 2015 and 2016).

[136] Wis. Admin. Code § PSC 116.

[137] Wis. Stat. § 196.027.

[138] Vilbert, Exh. No. MJV-11.

[139] Morin, Exh. No. RAM-16T 8, Table 1 (reflecting ROEs in excess of 10.0 for Alliant Energy and Wisconsin Energy)

[140] Morin TR. 569:15-23;

longer appropriate due to the prevalence of these mechanisms.[141] Such mechanisms are already embedded in the peer group.[142] Dr. Vilbert similarly testified to the infrequency of adjustment to ROE with the approval of decoupling; since 2011 there have been none.[143]

77. Mr. Ralph Cavanagh, a nationally-recognized expert in decoupling, testified that the vast majority of jurisdictions have not prospectively reduced a utility's ROE or equity ratio when implementing decoupling. In response to a question from Commissioner Jones regarding his experience testifying in decoupling proceedings, Mr. Cavanagh testified as follows:

> So just to reinforce the record, precisely because too often this gets discussed with commissions with either side cherry-picking the national record, I want to emphasize that you have in front of you an assessment of every ROE decision in a revenue decoupling case compiled by Pamela Morgan updated to March of 2013.
>
> And here are the numbers. 76 relevant decisions. 60 declining to make a prospective ROE adjustment. You will, of course, have an opportunity to look at the history, look at the experience, and decide if an adjustment is appropriate. But in 60 of 76 cases, there is no adjustment. In nine more there's a ten basis point adjustment, half of them as a result of settlement.
>
> What is proposed to you on ROE in the joint settlement is the mainstream of commission experience with this issue.[144]

78. As noted in the testimony above, Mr. Cavanagh presented an exhaustive study of decoupling decisions in the United States, performed by Pamela Morgan, which found that in 60 of 76 commission decisions, ROE was not reduced.[145] Decoupling deferrals may result in refunds to customers or surcharges, depending on customer usage, weather, the economy, and

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[141] *Id.*

[142] Morin TR. 572:11-13; 574:15-21 ("[I]nvestors look at the totality, the portfolio of supportive techniques by regulators when it comes down to risk mitigation. And variable rate design, formula rates, depreciation trackers, and the list goes on and on, are very similar in their impact on risk as revenue decoupling, so I felt pretty comfortable that my peer group reflects the impact of risk mitigators on the cost of capital.")

[143] Vilbert, Exh. No. MJV-1T at 8; Exh. No. MJV-3; Exh. No. MJV-5.

[144] Cavanagh, TR. 166:10-167:9.

[145] *See* Cavanagh, Exh. No. RCC-5 at 14. In the remaining 16 decisions, 9 of them involved ROE reductions of 10 basis points. Almost one-half of these were approvals of settlement agreements.

other factors that affect customers' use of energy. Further, the evidence in the record demonstrates that adjustments resulting from decoupling are minimal. Ms. Morgan points to two primary findings that shed light on the empirical questions involved in the ROE issue:

> First, it is clear that decoupling adjustments are both surcharges for under-collections of revenues for fixed costs and refunds of over-collections of such revenues. *In the refund situation, the utility has foregone the opportunity to collect more revenue (for fixed costs) than the amount authorized in its last general rate case.* While opponents of decoupling tend to testify extensively about the risk reduction associated with the possibility of surcharges, acknowledgements of lost opportunity associated with possible refunds are far more infrequent. Whether these changes in risk and opportunity affect income depends on whether those fixed costs are the same, less or more than the authorized amount. . . . Without looking at substantial amounts of empirical data, it is difficult to conclude that the risk of under-collecting fixed-cost revenue is greater than the lost opportunity of overcollecting fixed costs, assessed in consideration of changes between authorized and actual prudent fixed costs.
>
> Second, regardless whether refund or surcharge, decoupling adjustments are, by and large, small. It appears that neither the under-recovery risk reduction or over-recovery lost opportunity are very significant. Given the relatively small amounts of the decoupling adjustments, however, it is not apparent that this reductions is very significant.[146]

In other words, decoupling is symmetrical. It insures that customers pay no more than authorized revenues but also no less.

D. Credit Agency Reports Acknowledge Improved Regulatory Environment But View a Possible Change to ROE as a Credit Negative Event

79. The Commission should closely examine claims that credit agencies such as Standard & Poor's and Moody's have raised credit ratings or outlooks because of decoupling. First, the February 2014 upgrade to PSE's credit rating by Moody's was part of a general upgrade of nearly all electric and gas utilities, as expressly stated in that report:

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[146] Cavanagh, Exh. No. RCC-5 at 16 (emphasis added).

> The primary driver of today's rating action is Moody's more favorable view of the relative credit supportiveness of the US regulatory framework, as detailed in our September 23, 2013 Request for Comment: "Proposed Refinements to the Regulated Utilities Rating Methodology and our evolving View of US Utility Regulation." Factors supporting this view include better cost recovery provisions, reduced regulatory lag, and generally fair and open relationships between utilities and regulators. The US utility sector's low number of defaults, high recovery rates, and generally strong financial metrics from a global perspective provide additional corroboration for these upgrades.[147]

80. It is true that both Moody's and Standard & Poor's view positively the total package approved by the Commission in Order 07 in June 2013—the expedited rate filing, decoupling mechanism with a rate plan, *and an ROE of 9.80 percent.* It signals to the rating agencies a more positive regulatory environment. As various elements of that package were challenged by ICNU and Public Counsel, the rating agencies noted the uncertainty and potentially negative ratings that such challenges could bring. After acknowledging the supportive regulatory treatment by the Commission, Moody's opined that "unexpected regulatory developments or setbacks could cause us to revise the ratings outlooks for Puget and PSE downward."[148] Moody's elaborated even more on the fact that this remand proceeding—and a potential reversal of PSE's ROE—is viewed negatively by the ratings agency. In its July 31, 2014 report under a heading titled "Regulatory Environment and Cost Recovery Provisions Improving, But a Degree of Uncertainty Remains" Moody's states: "While still early in the process, the remand is a credit negative for PSE, as it

[147] Parcell, Exh. No. DCP-18CX at 1. *See also* Lohse, Exh. No. BJL-1T at 14:1-6 (explaining that PSE's upgrade in 2014 was part of a general upgrade to utilities by Moody's).

[148] Parcell, Exh. No. DCP-18CX at 1.

introduces uncertainty into the ultimate revenue production of the company over the next two years."[149]

81. When these rating agency reports are viewed in their entirety, it is clear that it was the overall regulatory package approved by the Commission in June 2013 that signified to the ratings agencies an improved regulatory climate. Backtracking on these approvals, in any way, may be viewed negatively by the ratings agencies as it may demonstrate a less supportive regulatory environment. In short, it is the overall supportive regulatory environment that has spurred more positive outlooks in the ratings reports—not merely decoupling. And, as Moody's January 2014 report indicates, this is not unique to PSE. Across the country, commissions are authorizing mechanisms and adopting regulatory approaches to help utilities better deal with the many challenges facing them in today's environment—"better cost recovery provisions, reduced regulatory lag, and generally fair and open relationships between utilities and regulators."[150]

V. CONCLUSION

82. Substantial evidence supports an ROE in excess of 9.80 percent. However, PSE agreed to an ROE of 9.80 percent and an overall rate of return of 7.77 percent in conjunction with its multi-year rate plan and decoupling mechanism, and PSE will stand by this agreement. A 9.80 percent ROE is below the average authorized ROE in the United States in 2013. The earnings sharing mechanisms, which the Commission modified when it approved the ROE of 9.80 percent in Order 07, skews PSE's ability to earn its authorized ROE, on average, over time,

[149] Gorman, Exh. No. MPG-45CX at 3. This report that was quoted extensively in Mr. Gorman's testimony but he omitted the discussion quoted above addressing the existing regulatory uncertainty and the credit negative effect of this remand and the potential change to PSE's return on equity.

[150] Parcell, Exh. No. DCP-18CX at 1; TR. 690:7-10.

and increases its financial risk. This justifies an ROE in the higher end of a range of reasonableness.

83. The evidence does not support a reduction to PSE's ROE based on decoupling. There is no reliable, statistically significant evidence on which to base such a reduction. The attempt by Public Counsel to quantify a decrease in risk and ROE due to decoupling should be rejected by this Commission as it was in Massachusetts. It is riddled with baseless assumptions and improper inputs. The Commission should recognize the important state energy policy that decoupling is intended to advance, and should not penalize PSE for stepping forward and proposing the mechanism.

84. For the reasons set forth above and in the evidence that is before the Commission, PSE respectfully requests that the Commission issue an order approving its requested relief.

DATED this 6th day of March, 2015.

Respectfully submitted

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