

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

In the Matter of the Petition of )  
)  
PUGET SOUND ENERGY, INC., and )  
NW ENERGY COALITION ) DOCKET NOS. UE-121697/UG-121705  
) (Consolidated)  
For an Order Authorizing PSE to Implement )  
Electric and Natural Gas Decoupling ) and  
Mechanisms and to Record Accounting )  
Entries Associated with the Mechanisms )  
)  

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WASHINGTON UTILITIES AND ) DOCKET NOS. UE-130137/UG-130138  
TRANSPORTATION COMMISSION, ) (Consolidated)  
)  
Complainant, )  
)  
v. )  
)  
PUGET SOUND ENERGY, INC. )  
)  
Respondent. )  

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**REPLY BRIEF**

**OF**

**THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES**

**March 20, 2015**

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## I. INTRODUCTION

1 Every initial brief filed in this proceeding with the exception of Puget Sound Energy, Inc.'s ("PSE" or the "Company") recommends a reduction to the Company's return on equity ("ROE"). Additionally, none of these initial briefs, including the Company's, offers any legitimate criticism of the analyses of the Industrial Customers of Northwest Utilities' ("ICNU") expert, Michael Gorman, that would undermine his recommendation to set PSE's ROE at 9.3%. The Washington Utilities and Transportation Commission's ("WUTC" or "Commission") Staff does not discuss or challenge any of Mr. Gorman's conclusions. Meanwhile, PSE critiques only limited and ancillary portions of Mr. Gorman's analyses, and as discussed below, all of these critiques are either baseless or misleading.

2 Both Staff and PSE, in fact, spend very little time at all in their Initial Briefs discussing the evidence pertaining to the Company's ROE – the central issue in this case. PSE devotes 11 of its 45 pages to this issue; Staff uses only two.<sup>1/</sup> While PSE asserts that substantial evidence supports its recommended 9.8% ROE, because PSE bears the burden of proof in this case, it must persuade the Commission that its evidence more reliably establishes a reasonable equity return than the recommendations of other parties.<sup>2/</sup> As ICNU's Initial Brief showed, PSE's cost of equity studies are significantly flawed in a number of respects.<sup>3/</sup> Mr. Gorman's studies are far more transparent and reliable and show that a 9.3% ROE is commensurate with returns in enterprises having corresponding risk and is sufficient to maintain the Company's

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<sup>1/</sup> PSE Initial Br. ¶¶ 26-49; Staff Initial Br. ¶¶ 12-15.

<sup>2/</sup> ICNU Initial Br. ¶¶ 13-18; Fed. Signal Corp. v. Safety Factors, 125 Wn.2d 413, 433 (1994); Indus. Customers of NW Utils. v. WUTC, Thurston County Superior Court Case Nos. 13-2-01576-2 and 13-2-01582-7, Order Granting in Part and Denying in Part Petitions for Judicial Review at 2 (July 25, 2014); WUTC v. PacifiCorp, Docket No. UE-100749, Order 07 ¶ 26 (May 12, 2011).

<sup>3/</sup> ICNU Initial Br. ¶¶ 26-39.

financial integrity. This conclusion is supported by Mr. Parcell’s cost of equity studies and exceeds the ROE findings of Mr. Hill.<sup>4/</sup> An objective 2013 DCF analysis utilizing all of Dr. Morin’s and Mr. Gorman’s assumptions applied to a consistent proxy group further confirms Mr. Gorman’s recommendation.<sup>5/</sup> Finally, the evidence also shows that the upper end of Staff’s recommended range is unsupported based on Mr. Parcell’s analyses and that, therefore, Mr. Parcell’s recommended 9.5% ROE, far from being the midpoint of a reasonable range, lies, at best, at the high end of this range.<sup>6/</sup> Nothing in PSE’s or Staff’s Initial Briefs calls these conclusions into question.

## II. ARGUMENT

### A. The Commission Should Give More Weight to Mr. Gorman’s 2013 Results.

3 Both PSE and Staff argue in no uncertain terms that the “appropriate time period for the cost of equity review in this remand proceeding is the first half of 2013.”<sup>7/</sup> Mr. Gorman was the only cost-of-capital expert in this case that developed, and defended, a cost of equity analysis for PSE contemporaneously with this period. All other cost-of-capital witnesses had to perform equivalent studies retrospectively. Mr. Parcell testified that the need to perform a retrospective early 2013 analysis led him “to develop a broader range” than he otherwise would

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<sup>4/</sup> Parcell, Exh. No.\_\_(DCP-1T) at 17:13-16, 22:8-10, 25:8-13 (showing DCF and CAPM results significantly below 9.3% and Comparable Earnings results indicating a 9.3% ROE yields market-to-book ratios well above 100%); Hill, Exh. No.\_\_(SGH-2T) at 44:1-8 (recommending 9.0% ROE for PSE before accounting for decoupling).

<sup>5/</sup> ICNU Initial Br. ¶¶ 54-57.

<sup>6/</sup> Id. ¶¶ 40-53.

<sup>7/</sup> PSE Initial Br. ¶ 21; Staff Initial Br. ¶ 11 (“it is appropriate to authorize a return on equity that would have been applicable in the first quarter of 2013”).

have done.<sup>8/</sup> Accordingly, the other witnesses' early 2013 ROE analyses lack the precision of Mr. Gorman's, and therefore, should be afforded less evidentiary weight.

4 Mr. Gorman's recommended 9.3% ROE from this period was based on his highest results.<sup>9/</sup> Thus, they demonstrate that PSE's current 9.8% ROE is well above a range of reasonable returns from this period. They also show that 9.5%, far from being the mid-point of a reasonable range, as Mr. Parcell concludes, is, at most, the highest point of what could be determined to be a reasonable range based on the weight of the evidence.

5 Additionally, as ICNU demonstrated in its Initial Brief, it is possible to develop an objective early 2013 DCF analysis that uses a consistent proxy group and incorporates all of the data and assumptions in Mr. Gorman's and Dr. Morin's respective constant growth DCF studies.<sup>10/</sup> The results of that analysis indicate an ROE for PSE in early 2013 of 9.22%, which supports Mr. Gorman's 9.3% recommendation and provides further evidence that the 9.8% Dr. Morin recommends is unreasonable.<sup>11/</sup> The result of this analysis only decreases if the other cost-of-capital experts' data is considered.<sup>12/</sup> Accordingly, the substantial weight of the evidence from the early 2013 period supports Mr. Gorman's recommended 9.3% ROE and demonstrates that a 9.8% ROE is well above the range of reasonableness. Further, as discussed below and in ICNU's Initial Brief, this conclusion does not change when considering the 2014 analyses of Dr. Morin and Mr. Gorman.<sup>13/</sup>

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<sup>8/</sup> Parcell, Tr. 602:21-24.

<sup>9/</sup> Ex. No.\_\_(MPG-3) at 31 (table 3).

<sup>10/</sup> ICNU Initial Br. ¶¶ 54-57.

<sup>11/</sup> Id. ¶ 56.

<sup>12/</sup> Id.

<sup>13/</sup> Infra, ¶¶ 19-20; ICNU Initial Br. ¶¶ 24, 29-30, 33-35, 37-39.

## **B. Staff's Initial Brief Does Not Challenge Mr. Gorman's Recommendation**

6 Consistent with Mr. Parcell's recommendation, Staff's Initial Brief recommends a 9.5% ROE for PSE.<sup>14/</sup> Staff does not, however, discuss or challenge Mr. Gorman's cost of equity analyses and results. As ICNU's Initial Brief demonstrated, Mr. Parcell's models contain a number of flaws and his recommended range of reasonableness is based on highly questionable assumptions that are inconsistent with decisions he has made in other proceedings.<sup>15/</sup> The high end of Mr. Parcell's range in particular, which encompasses PSE's current 9.8% ROE, is not defensible based on Mr. Parcell's analyses.<sup>16/</sup> Rather, his studies far more strongly support Mr. Gorman's recommended 9.3%. This ROE far exceeds Mr. Parcell's CAPM results as well as the vast majority of his DCF results, and Mr. Parcell's Comparable Earnings analysis shows that a 9.3% ROE produces a market-to-book ratio well above the necessary 100%.<sup>17/</sup>

7 The remainder of Staff's Initial Brief is largely devoted to addressing whether decoupling's impact on the ROE is within the scope of this proceeding.<sup>18/</sup> As ICNU argued in its Initial Brief, PSE's decoupling mechanism bears on its overall level of risk, which is a primary consideration in establishing a regulated utility's ROE.<sup>19/</sup> Staff does not address this point.

## **C. PSE's Criticisms of Mr. Gorman Are Unpersuasive**

8 The Company criticizes four aspects of Mr. Gorman's ROE analyses from both this phase and the original phase of the proceeding.<sup>20/</sup> All of these criticisms are misleading or

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<sup>14/</sup> Staff Initial Br. ¶ 2.

<sup>15/</sup> ICNU Initial Br. ¶¶ 40-53.

<sup>16/</sup> Id. ¶¶ 41-48.

<sup>17/</sup> Id. ¶¶ 51-53; Parcell, Exh. No. \_\_ (DCP-1T) at 22:7-10, 17:13-16, 25:8-13, 26:21-27:1.

<sup>18/</sup> Staff Initial Br. ¶¶ 1, 6-8, 16-18.

<sup>19/</sup> ICNU Initial Br. ¶¶ 61-65.

<sup>20/</sup> PSE Initial Br. ¶¶ 34-41.

simply baseless. Moreover, PSE's Initial Brief does not challenge Mr. Gorman's CAPM studies or the substance of any of his DCF studies.

1. PSE's criticisms of Mr. Gorman's risk premium studies are without merit.

9 PSE argues that Mr. Gorman's risk premium ("RP") studies include a range of results that encompasses 9.8%, and that all of Mr. Gorman's decisions that support his ultimate RP recommendations of 9.27% in 2013 and 9.6% in 2014 are arbitrary.<sup>21/</sup> In fact, it is PSE's position that is arbitrary.

10 First, the Company criticizes Mr. Gorman for selecting a specific ROE – the mid-points of his ranges in 2013 and 2014 – rather than recommending the entire range.<sup>22/</sup> This is an odd criticism coming from the Company, given that its own cost-of-capital expert, Dr. Morin, did the same thing.<sup>23/</sup> In fact, Dr. Morin did not even attempt to develop a range, simply selecting the average of historical equity risk premiums and adding it to his risk-free rate.<sup>24/</sup> The point of the RP analysis is, as the name indicates, to estimate the premium investors require for assuming the additional risk embedded in an equity investment over a bond investment.<sup>25/</sup> That premium, as applied to a specific equity security, is a specific percentage, not a range of percentages. By selecting the mid-point of a range of the average of historical risk premiums, Mr. Gorman is choosing what he considers to be, in his expert judgment, the most likely risk premium applicable to PSE. The mid-point of historical averages can hardly be said to be arbitrary.

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<sup>21/</sup> Id. ¶¶ 34-37.

<sup>22/</sup> Id. ¶ 36.

<sup>23/</sup> Morin, Exh. No.\_\_(RAM-1T) at 55:1-6, 57:6-11.

<sup>24/</sup> Id.

<sup>25/</sup> Gorman, Exh No.\_\_(MPG-25T) at 24:5-11.



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Next, although not entirely clear, PSE appears to claim that, because Mr. Gorman testified that it was appropriate to give more weight to the high-end of his RP results, he should have given *all* weight to these results.<sup>26/</sup> Nothing supports PSE’s position on this issue. Mr. Gorman’s RP studies produced equity risk premiums as low as 8.11% that were developed from the same data as his high-end results.<sup>27/</sup> There is no reason his low-end results should not also be accounted for in developing an overall recommendation. Mr. Gorman testified in his 2013 study that he chose to give 75% weight to his high-end results “given the unusually large yield spreads between Treasury bond and utility bond yields.”<sup>28/</sup> He also testified in his 2014 study that “[p]roviding more weight to the high-end risk premium captures the greater market interest rate risk.”<sup>29/</sup> Thus, Mr. Gorman justifies his decision in his testimony. In essence, PSE’s faults Mr. Gorman for doing what an expert witness is supposed to do, which is use his or her judgment. That is precisely what Mr. Gorman did here, and by giving more weight to his high-end results, his judgment favors the Company.

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Finally, PSE criticizes Mr. Gorman for considering historical equity risk premiums going back to 1986, but excluding certain of those years in developing his ultimate RP recommendations.<sup>30/</sup> Again, there is no merit to this criticism. By excluding certain years, Mr. Gorman simply selected the range of equity risk premiums that was most commonly reflected in the historical data to eliminate outliers *on both ends*.<sup>31/</sup> Thus, while PSE argues that Mr.

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<sup>26/</sup> PSE Initial Br. ¶¶ 35, 37.

<sup>27/</sup> Exh. No. \_\_ (MPG-3) at 25:12-15.

<sup>28/</sup> Id. at 25:18-19.

<sup>29/</sup> Gorman, Exh. No. \_\_ (MPG-25T) at 29:21-22.

<sup>30/</sup> PSE Initial Br. ¶ 37.

<sup>31/</sup> Gorman, Exh. Nos. \_\_ (MPG-3) at 22:21-22, (MPG-25T) at 25:19-20, (MPG-17) and (MPG-36).

Gorman's range "would have extended even higher" if he had used all years,<sup>32/</sup> it is equally true that his range would have extended even lower as well. In his 2014 study, Mr. Gorman excluded six years, three of which had equity risk premiums above his range and three of which were below.<sup>33/</sup> The same is true for his 2013 study.<sup>34/</sup> PSE fails to explain how this is unfair or irrational. In fact, if one applied PSE's logic to Dr. Morin's historical risk premium studies, it would support ROEs as low as *negative* 50.82% in 2013 and *negative* 50.42% in 2014.<sup>35/</sup> These are patently absurd results.

13 PSE's position that a 9.8% ROE is justified simply because the highest data points in Mr. Gorman's RP studies may encompass this ROE is without merit. These studies also support far lower ROEs than the 9.27% and 9.6% Mr. Gorman recommends from these studies for 2013 and 2014, respectively. The purpose of the study, and what Mr. Gorman did, was to consider a range of possibilities and derive the most reasonable recommendation from the results.

2. PSE cannot justify its reliance on the average ROE from Mr. Gorman's 2013 proxy group.

14 PSE also asserts that the 2013 proxy group Mr. Gorman relies on supports a 9.8% ROE.<sup>36/</sup> PSE quotes Mr. Doyle's testimony that the average allowed ROE in Mr. Gorman's proxy group used in his 2013 DCF analysis is 10.08%, and thus, these "[s]imple averages ... materially undermine the entire premise of his testimony and his proposed ROE."<sup>37/</sup> To the

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<sup>32/</sup> PSE Initial Br. ¶ 37.

<sup>33/</sup> Gorman, Exh. No.\_\_(MPG-25T) at 25:19-20; Exh. No.\_\_(MPG-36).

<sup>34/</sup> Exh. No.\_\_(MPG-3) at 22:21-22; Exh. No.\_\_(MPG-17).

<sup>35/</sup> These results are derived by adding Dr. Morin's risk-free rates of 4.6% in 2013 and 5.0% in 2014 to the equity risk premium in 2008 of -55.42 shown in Exh. Nos.\_\_(RAM-8) and (RAM-14).

<sup>36/</sup> PSE Initial Br. ¶¶38-39.

<sup>37/</sup> Id. ¶ 38 (quoting Doyle, Exh. No.\_\_(DAD-1T) at 7:1-6.

contrary, ICNU submits that the Company's continued reliance on this simplistic analysis materially undermines its criticisms of Mr. Gorman's studies. If a reasonable ROE for a utility can be derived from simply averaging the allowed ROEs of other utilities, then ICNU, PSE, Staff, and Public Counsel would not need to hire experts to perform this task.

15                Surely, Dr. Morin himself would never approve of the Company's argument. In discussing the rationale for using several different methodologies for estimating a reasonable ROE, the Company's cost-of-capital expert testified that "[n]o one single method provides the necessary level of precision for determining a fair return .... Reliance on any single method or preset formula is inappropriate when dealing with investor expectations because of possible measurement difficulties and vagaries in individual companies' market data."<sup>38/</sup> PSE's method of averaging allowed ROEs in the proxy group dispenses entirely with such "vagaries in individual companies' market data." Furthermore, the other implication from PSE's position is that, ultimately, all utilities that were determined to be comparable to each other would have exactly the same ROEs that could never change because they would all be compared to each other based solely on that average ROE.

16                Notably, PSE made the same argument that it makes on brief here in the original phase of these proceedings in attempting to respond to Mr. Gorman's cost of equity analysis at that time.<sup>39/</sup> It is telling that, having gone through an entire proceeding dedicated solely to ROE, this is the only response the Company can muster to Mr. Gorman's 2013 DCF analysis.

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<sup>38/</sup> Morin, Exh. No.\_\_(RAM-1T) at 12:6-10.

<sup>39/</sup> Order 07 ¶ 56.

3. PSE's criticism of Mr. Gorman's treatment of the 2014 proxy group is unwarranted.

17 PSE claims that Mr. Gorman has “manipulat[ed]” and “selectively discarded relevant data” in the 2014 proxy group he adopted from Dr. Morin.<sup>40/</sup> The Company’s rationale for these accusations is that Mr. Gorman excluded Duke Energy from the proxy group due to its large acquisition program, but did not exclude Northwestern Energy, which also had a large acquisition program at the relevant time.<sup>41/</sup> PSE claims that Mr. Gorman’s “inconsistent applications call into question the methodologies” he used.<sup>42/</sup>

18 PSE’s attempt to discredit all of Mr. Gorman’s conclusions based on this one data point is, to say the least, a stretch. As the Company points out, Mr. Gorman testified on the stand that he was not aware of Northwestern’s acquisition program and that he would have excluded this company also from his 2014 DCF study had he known.<sup>43/</sup> Thus, Mr. Gorman did not “manipulat[e]” the data. The Company does not point out any other errors Mr. Gorman made and, of course, PSE itself filed a number of errata sheets correcting errors in its testimony before the hearing in this case, as often occurs in Commission proceedings.<sup>44/</sup>

19 Notably, while PSE makes much of Mr. Gorman’s “inconsisten[cy]” in not removing Northwestern Energy from the 2014 proxy group, it does not take the extra step to demonstrate the consequences of doing so. By removing Northwestern as well as the other companies Mr. Gorman eliminated from the 2014 proxy group, which neither Dr. Morin or PSE challenges, Dr. Morin’s 2014 DCF study based on *Value Line* growth rates increases from 9.43%

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<sup>40/</sup> PSE Initial Br. ¶ 40.

<sup>41/</sup> Id.

<sup>42/</sup> Id.

<sup>43/</sup> Id.; Gorman, Tr. 695:13-696:14.

<sup>44/</sup> See Docket Nos. UE-121697 *et al.*, PSE Revisions to Testimony and Exhibits (Feb. 5 & 10, 2015).

to 9.53%.<sup>45/</sup> Meanwhile, his 2014 DCF study based on consensus analysts' growth rates *decreases* from 9.57% to 9.35%.<sup>46/</sup> In other words, by removing inappropriate proxy companies, including Northwestern, from the 2014 proxy group, Dr. Morin's average ROE from his 2014 DCF studies *decreases* from 9.5% to 9.44%. Meanwhile, by removing Northwestern from Mr. Gorman's data, his 2014 constant growth DCF study using consensus analysts' growth rates increases from 9.36% to 9.48%,<sup>47/</sup> and his 2014 constant growth DCF study using sustainable growth rates increases from 9.05% to 9.14%.<sup>48/</sup> This means that the average of Mr. Gorman's 2014 constant growth DCF studies increases from 9.2% to 9.31%, which continues to support his 9.3% recommendation. It also means that the average of all of Dr. Morin's and Mr. Gorman's 2014 constant growth DCF analyses increases from 9.35% to 9.37%, a negligible amount and a result that continues to much more strongly support Mr. Gorman's recommended 9.3% ROE than Dr. Morin's recommended 9.8% ROE.

20                    Removing Northwestern from the proxy group, in other words, does not change the conclusion that a 9.3% ROE is reasonable for PSE. Given that none of Mr. Gorman's or Dr. Morin's 2014 constant growth DCF studies show an ROE above 9.53% with Northwestern removed, this also continues to support the conclusion that 9.5% is, at most, the upper bound of the range of reasonableness, and that 9.8% lies well above this range.

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<sup>45/</sup> Exh. No.\_\_(RAM-10) at 2.

<sup>46/</sup> Exh. No.\_\_(RAM-11) at 2.

<sup>47/</sup> Exh. No.\_\_(MPG-29).

<sup>48</sup> Exh. No.\_\_(MPG-32). Mr. Gorman's 2014 multi-stage DCF model increases from 8.64 to 8.69%. Exh. No.\_\_(MPG-34).

4. PSE’s criticism of Mr. Gorman’s credit metric analysis does not change the conclusion that a 9.3% ROE is sufficient to maintain the Company’s financial integrity.

21 Finally, PSE argues that the Commission should “give no weight” to Mr. Gorman’s credit metric analysis used to show that a 9.3% ROE will maintain the Company’s financial integrity.<sup>49/</sup> The Company states that this analysis contains “numerous errors,” though it discusses only one purported error.<sup>50/</sup> As PSE phrases it, “Mr. Gorman selectively included only PSE’s electric delivery rate base.”<sup>51/</sup> This, of course, was the rate base identified in the Company’s ERF filing that initiated this proceeding, so Mr. Gorman’s use of it was not “selective.”<sup>52/</sup>

22 Still, ICNU does not dispute PSE’s assertion 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.”<sup>53/</sup> The Company consequently argues that Mr. Gorman should have used \$6.5 billion as the rate base, rather than \$2.6 billion.<sup>54/</sup> The problem is that, again, the Company is content to rely on mere accusations against Mr. Gorman and does not take the extra step to demonstrate what impact this change actually has on the credit metric analysis.

23 By adjusting Mr. Gorman’s exhibit MPG-42 to apply a 9.3% ROE to PSE’s total rate base of \$6.5 billion, it shows debt-to-EBITDA of 3.7x and FFO-to-Total Debt of 17%.<sup>55/</sup> Both of these metrics are within S&P’s “significant” financial risk profile, which is the *same*

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<sup>49/</sup> PSE Initial Br. ¶ 41.

<sup>50/</sup> Id.

<sup>51/</sup> Id.

<sup>52/</sup> Exh. No.\_\_(MPG-42) (line 1).

<sup>53/</sup> PSE Initial Br. ¶ 41.

<sup>54/</sup> Id.

<sup>55/</sup> Exh. No.\_\_(MPG-42).

financial risk profile PSE has today.<sup>56/</sup> It is also higher than the “aggressive” financial risk profile of most utilities.<sup>57/</sup> Thus, while PSE may be able to claim that Mr. Gorman should have used total rate base rather than the rate base identified in the ERF filing, it cannot claim that doing so changes the conclusion that a 9.3% ROE is sufficient to maintain the Company’s financial integrity.

**D. PSE’s Position on its Earnings Sharing Mechanism is One-Sided and Lacks Evidentiary Support.**

24 PSE argues that its earnings sharing mechanism “requires that PSE’s ROE be set at the high end of the range of reasonableness” because it “creates an asymmetrical earnings profile and increases PSE’s financial risk.”<sup>58/</sup> As a threshold matter, ICNU finds PSE’s position that its financial risk is increased because its investors are not allowed to over-earn dollar-for-dollar to be rather cynical. At most, this mechanism dampens the potential upside for the Company’s investors. Furthermore, even if the Commission accepted PSE’s position that its ROE should be set at the high end of the range of reasonableness due to the earnings sharing mechanism, this brief and ICNU’s Initial Brief show that the evidence in this case demonstrates that this upper bound is, at most, 9.5%, not 9.8%.

25 In fact, however, there is no evidence in this case that would warrant increasing the ROE to account for the earnings sharing mechanism. Indeed, given the Company’s position on its decoupling mechanism in this case, PSE’s arguments with respect to the earnings sharing mechanism appear inconsistent.

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<sup>56/</sup> Id.; Gorman, Exh. No.\_\_(MPG-25T) at 37:10-13.

<sup>57/</sup> Gorman, Exh. No.\_\_(MPG-25T) at 37:10-13.

<sup>58/</sup> PSE Initial Br. ¶¶ 50, 53.

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First, the Company states that decoupling is part of a “wide variety of non-traditional ratemaking approaches” and that “[i]nvestors look at the overall regulatory environment, not at mechanisms in isolation.”<sup>59/</sup> Thus, the Company submits that the risk-mitigating effects of decoupling are already embedded in the market-derived cost of equity for PSE.<sup>60/</sup> Of course, investors are just as aware of PSE’s earnings sharing mechanism as they are of decoupling and the rate plan.<sup>61/</sup> One would think that if the Company’s risk-reducing mechanisms are embedded in market data used to derive the cost of equity, any mechanisms PSE has that may increase its risk would be similarly recognized.

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Second, the Company is happy to sit back and “allow a reasonable time for decoupling mechanisms to be in place and evaluate their effect on cost of capital,”<sup>62/</sup> while simultaneously arguing that the Commission should consider the earnings sharing mechanism now in developing a reasonable ROE.<sup>63/</sup> Yet, in this proceeding, PSE has offered no “evidence actually demonstrating [the earnings sharing mechanism’s] effect in practice on either the debt or equity markets ....”<sup>64/</sup> If “empirical evidence” is required to demonstrate the impact of decoupling on the cost of equity,<sup>65/</sup> then the same requirement should apply to the earnings sharing mechanism.

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This is particularly the case when the evidence of decoupling’s impact on the ROE far outweighs such evidence relating to the earnings sharing mechanism. Every cost of

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<sup>59/</sup>

Id. ¶ 73.

<sup>60/</sup>

Id. ¶ 76.

<sup>61/</sup>

See Exh. No. \_\_ (MPG-45CX) at 2 (Moody’s report discussing the earnings sharing mechanism).

<sup>62/</sup>

PSE Initial Br. ¶ 57.

<sup>63/</sup>

Id. ¶ 50.

<sup>64/</sup>

Order 07 ¶ 104.

<sup>65/</sup>

Id. ¶ 103.



capital expert in this proceeding agrees that decoupling is a “risk-mitigating” mechanism,<sup>66/</sup> and thus, either testifies here, or has testified in the past, that a regulated utility’s ROE should be reduced to account for decoupling.<sup>67/</sup> The evidence also shows that the risk-mitigation PSE enjoys from decoupling and the rate plan is not present in the proxy group, and thus, is not reflected in the market-derived cost of equity that supports Dr. Morin’s recommended 9.8% ROE.<sup>68/</sup> The Brattle studies, proffered by PSE itself, further support the position that decoupling reduces the cost of equity.<sup>69/</sup> Notably, while Moody’s has stated that the Company’s decoupling mechanism is “credit supportive,” the agency’s discussion in the same report of the earnings sharing mechanism merely notes its existence and does not suggest that it increases the Company’s risk or is credit negative in any way.<sup>70/</sup> Thus, while there is substantial evidence in this case supporting the argument that PSE-specific risk-mitigating mechanisms reduce its cost of equity, no similar evidence supports the opposite conclusion with respect to the earnings sharing mechanism.

**E. The Rating Agency Reports PSE Relies on Support the Conclusion that a 9.3% ROE Will Continue to Maintain the Company’s Credit Rating.**

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In a final attempt to support the continued reasonableness of the ROE the Company was awarded in 2012, PSE warns the Commission that any reduction to its ROE could have negative credit rating consequences.<sup>71/</sup> The Company argues that rating agency reports make it “clear that it was the overall regulatory package approved by the Commission in June

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<sup>66/</sup> Morin, Exh. No.\_\_(RAM-16T) at 29:8-9; Morin, Tr. 686:8-12.

<sup>67/</sup> Gorman, Exh. No.\_\_(MPG-25T) at 4:1-5:6; Hill, Exh. No.\_\_(SGH-2T) at 83:17-123:17; Exh. Nos.\_\_(RAM-25CX) and (RAM-26CX); Exh. No.\_\_(SGH-23CX).

<sup>68/</sup> ICNU Initial Br. ¶¶ 66-74.

<sup>69/</sup> Id. ¶¶ 75-83.

<sup>70/</sup> Exh. No.\_\_(MPG-45CX) at 2.

<sup>71/</sup> PSE Initial Br. ¶¶ 79-81.

2013 that signified to the ratings agencies an improved regulatory climate. Backtracking on these approvals, in any way, may be viewed negatively ....”<sup>72/</sup>

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The Company’s speculative statements are not supported by the rating agency reports on which it relies. While it quotes a Moody’s opinion that “unexpected regulatory developments or setbacks could cause us to revise the ratings outlooks for Puget and PSE downward,”<sup>73/</sup> one struggles to think of a utility – or any company for that matter – to which that statement would not apply. Additionally, PSE cites another Moody’s report indicating that this remand proceeding is a credit negative for the Company because “it introduces uncertainty into the ultimate revenue production of the company over the next two years.”<sup>74/</sup> PSE fails to note, however, that, in this same report, Moody’s voices an expectation “that the WUTC will maintain revenue and ROE levels sufficient for PSE to recover its prudently evidenced costs going forward and that PSE’s improved financial profile will remain intact.”<sup>75/</sup> The report also states that PSE’s “stable outlook reflects ... our view that Washington regulation will continue to provide for the adequate and timely recovery of prudently incurred costs, *despite* the potential revision to certain aspects of the company’s recent rate order.”<sup>76/</sup> Thus, to the extent this proceeding is “credit negative” for the Company, that is only insofar as it creates “uncertainty” that, theoretically, could result in “unexpected regulatory developments” that impair PSE’s ability to recover its prudently incurred costs. Moody’s, however, makes clear that it does not expect that to happen, even with a “potential revision” to the Company’s ROE.<sup>77/</sup>

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<sup>72/</sup> Id. ¶ 81 (emphasis in original).

<sup>73/</sup> Id. ¶ 80 (quoting Exh. No.\_\_(DCP-18CX)).

<sup>74/</sup> Id. (quoting Exh. No.\_\_(MPG-45CX)).

<sup>75/</sup> Exh. No.\_\_(MPG-45CX) at 3.

<sup>76/</sup> Id. at 4 (emphasis added).

<sup>77/</sup> Id.

31 To be clear, ICNU does not, and has not, proposed that the Commission establish an ROE for PSE that is so low as to prevent the Company from recovering its prudent and reasonable costs of providing service. Mr. Gorman’s multiple analyses demonstrate that a 9.3% ROE, far from being confiscatory, reflects the Company’s cost of equity, is commensurate with returns in enterprises having corresponding risk, and maintains its financial integrity. That is what an allowed ROE is supposed to do. Indeed, Public Counsel’s witness, Mr. Hill, recommends an ROE as low as 8.65%, while Staff’s witness, Mr. Parcell, has adopted an ROE range that extends down to 9.0%.<sup>78/</sup> These results indicate that Mr. Gorman’s recommended 9.3% ROE is more than sufficient for the Company.

32 As ICNU’s Initial Brief showed, a 9.3% ROE applied to the Company’s currently authorized capital structure would continue to generate the highest overall rate of return of any electric utility in the State – 7.53%.<sup>79/</sup> The Moody’s reports PSE cites indicate that such a result would be sufficient to maintain the Company’s credit rating and stable outlook.<sup>80/</sup> It is also sufficient to meet the statutory requirement that the Company’s rates be “just, fair, reasonable and sufficient.”<sup>81/</sup> That is all ICNU requests.

### III. CONCLUSION

33 For the foregoing reasons, and as stated in ICNU’s Initial Brief, PSE’s ROE should be reduced to 9.3% for the entirety of the rate plan, and in no circumstance should it be set higher than 9.5%. This should be accompanied by a corresponding reduction to the Company’s overall rate of return to 7.53%.

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<sup>78/</sup> Hill, Exh. No.\_\_(SGH-2T) at 44:3-8; Parcell, Exh. No.\_\_(DCP-1T) at 27:21-22.

<sup>79/</sup> ICNU Initial Br. ¶ 60; Exh. No.\_\_(MPG-26).

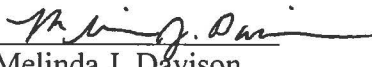
<sup>80/</sup> Exh. No.\_\_(MPG-45CX) at 4.

<sup>81/</sup> RCW § 80.28.010(1).

Dated in Portland, Oregon, this 20th day of March, 2015.

Respectfully submitted,

DAVISON VAN CLEVE, P.C.



Melinda J. Davison

Tyler C. Pepple

333 S.W. Taylor, Suite 400

Portland, Oregon 97204

(503) 241-7242 telephone

(503) 241-8160 facsimile

mjd@dvclaw.com

tcp@dvclaw.com

Of Attorneys for Industrial Customers  
of Northwest Utilities