

BEFORE THE WASHINGTON STATE  
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

DOCKET NOS. UE-060266 and  
UG-060267 (Consolidated)

**INITIAL BRIEF  
OF THE FEDERAL EXECUTIVE AGENCIES**

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NORMAN FURUTA  
Associate Counsel  
(Regulatory Law)

Federal Executive Agencies  
333 Market ST, 10<sup>th</sup> Floor MS 1021A  
San Francisco, CA 94105-2195  
(415) 977-8808

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# INITIAL BRIEF OF THE FEDERAL EXECUTIVE AGENCIES

The Federal Executive Agencies (“FEA”) hereby files this Initial Brief concerning various matters arising out of the 2006 General Rate Case proceeding of Puget Sound Energy, Inc., (“PSE,” “Puget,” or “the company”).

## I. POWER COST ADJUSTMENT MECHANISM

1 Puget Sound Energy, Inc. (PSE or Company) is proposing revisions to the existing Power Cost Adjustment (PCA) Mechanism. PSE is proposing to revise the sharing mechanism that currently exists for power cost risks between the customers and shareholders. In addition, PSE is proposing to establish a separate credit line to support its wholesale energy market hedging transactions and pass the cost of the hedging credit line through the PCA Mechanism.

2 The current PCA Mechanism was negotiated in a power cost adjustment collaborative in 2002. The current PCA Mechanism sets forth an annual accounting process for sharing of costs and benefits between PSE and its customers over four graduated levels or bands of power cost variances on the first \$120 million of cost variations from a Power Cost Baseline. Under PSE’s proposed mechanism, greater risk is passed on to the ratepayers and removed from the shareholders.

3 The Federal Executive Agencies (FEA) opposes the Company’s proposed revisions to the PCA sharing mechanism. However, the FEA supports the hedging proposal and recovery of those costs through the PCA.

### **A. The Commission Should Reject Puget’s Proposed Revisions to the PCA Sharing Mechanism.**

4 Under the existing PCA Mechanism, there is a deadband of \$20 million. That is, for the first +/- \$20 million of cost variations from the Power Cost Baseline, the Company absorbs the

variations whether they are above or below the baseline. The Power Cost Baseline is the embedded cost in the tariffs that is paid by PSE customers. Beyond the \$20 million, and up to \$120 million, the current mechanism has three sharing bands where customers take an increasing share of any variation in the power costs over or under the Baseline.

5 PSE is proposing the annual sharing bands be revised so that the first \$25 million band is shared 50/50 between the customer and the shareholder. This proposal eliminates the current deadband. The second band, which would be from \$25 million to \$120 million, would be shared 90% with the customer and 10% with the shareholder. Finally, for any deviations greater than \$120 million, the customers' share would be 95% and the shareholders' share would be 5%.

6 Table 1 is a comparison of the existing and proposed cost adjustment sharing mechanism.

<u>Power Cost (\$ Millions)</u> <u>(Over or Under PCA Baseline)</u>	<u>Customer Share</u>	<u>PSE Share*</u>
<u>Existing Mechanism</u>		
\$0 - \$20 +/-	0%	100%
\$20 - \$40 +/-	50%	50%
\$40 - \$120 +/-	90%	10%
> \$120 +/-	95%	5%
<u>Proposed Mechanism</u>		
\$0 - \$25 +/-	50%	50%
\$25 - \$120 +/-	90%	10%
> \$120 +/-	95%	5%
* \$40 million cap on PSE's exposure over four-year period under existing mechanism; no cap under proposed mechanism.		

7 The FEA opposes the Company's proposed revisions to the sharing bands. FEA emphatically opposes the elimination of the deadband.

8 PSE has failed to show that the elimination of the deadbands results in a fair allocation of risks between the shareholders and customers. By eliminating the deadband, PSE is not eliminating wholesale market and natural gas price risk, but rather is transferring this risk to the ratepayer.

9 PSE's proposal to eliminate the deadband is inconsistent with recent Commission rulings. The Commission issued a decision in 2006 in Pacific Power and Light Company general rate proceeding, Docket No. UE-050684. In that proceeding, the Commission stated the following about PCA deadbands:

Deadbands and sharing bands are useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs.<sup>1</sup>

10 The WUTC has also recently approved changes to the Avista Utilities Energy (Avista) Recovery Mechanism in Docket No. UE-060181. In that case, the WUTC approved modifications and retained the deadband which Avista proposed to be eliminated. The approved settlement reduced the size of the deadband from the existing level.<sup>2</sup>

11 In the Joint Testimony of Staff of the WUTC, Public Counsel and the Industrial Customers of Northwest Utilities (Exhibit 599 or "Joint Testimony"), an analysis is presented that compares Avista's approved Energy Recovery Mechanism with PSE's current PCA mechanism. The Joint Testimony concludes the following regarding the comparison between PSE and Avista.

The current Puget PCA exposes Puget shareholders to a comparable level of risk to the recently updated Avista ERM. Measured on a revenue basis, it is somewhat

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<sup>1</sup> *WUTC v. PacifiCorp d/b/a Pacific Power and Light Company*, Docket No. UE-050684, Order No. 4, ¶ 96 (April 17, 2006)

<sup>2</sup> *In the Matter of the Petition of Avista Corporation, d/b/a/ Avista Utilities*, Docket No. UE-060181, Order No. 3, ¶ 9 (June 16, 2006)

smaller, while measured on an earnings basis, it is slightly higher. Exh. No. 599 at 16: 4-6 (Lazar, Schoenbeck, and Mariam)

12 It is clear that PSE's proposed change to eliminate the deadbands is at odds with the Commission's position on this issue. Since PSE's proposal in this case is inconsistent with recent Commission rulings on the appropriateness of deadbands in PCA mechanisms, the Commission should reject PSE's proposal.

13 PSE's proposed changes to the PCA mechanism significantly reduce PSE's exposure to earnings variations to power cost conditions by shifting the risk to ratepayers. The Joint Testimony states that under the current PCA, a power cost increase of \$200 million would cause a \$27.3 million reduction in net income, or about \$0.25 per share. However, under the Company's proposal, a \$200 million power cost increase would only cause an earning reduction of \$16.9 million, or \$0.15 per share. At this level, there would be a 40% reduction in the risk borne by shareholders under the Company's proposal. Exh. No. 599 at 19: 12-17 (Lazar, Schoenbeck, and Mariam). However, the Company has not proposed any reduction in its recommended earned rate of return relative to this change in the PCA mechanism.

14 In addition, the Joint Testimony presents the results of an analysis on the earnings per share under the current PCA structure and the proposed PCA mechanism for over 1,000 different combination of weather and power costs. These impacts of the modeling are described in Exh. No. 600C. The results of this modeling make it very clear that PSE's earnings per share risk is substantially reduced under the proposed structure. Exh. No. 599 at 20: 4-6 (Lazar, Schoenbeck, and Mariam).

15 Finally, in the Company's rebuttal testimony, PSE witness Salmon Aladin provided an analysis of PSE's proposed revisions to the current PCA sharing bands. The results of this

analysis indicated that if PSE's proposed PCA sharing bands had been in place during the past four years, customers would have shared more of the excess cost.

16 In PSE's rebuttal testimony, Mr. Aladin states that if the deadband is retained by the WUTC, it should be much smaller than \$20 million. Exh. No. 14 at 14: 12-13. However, as indicated earlier in this Brief, the analyses performed in the Joint Testimony do not support this contention.

### **B. The Commission Should Approve Puget's Hedging Proposal.**

17 The FEA supports PSE's proposal to establish a separate credit line dedicated to support its hedging activities and to pass the cost of this credit facility through the PCA Mechanism. The hedging program should reduce the amount of risk that the Company is exposed to and should also reduce anticipated variations in the power costs. This additional credit provides the Company with a means of reducing risk and supports a continuation of the current deadband and sharing mechanism.

18 PSE is in the business of managing power costs that include the generating, buying, and selling of energy. The additional hedging should enhance the Company's position to manage its power costs. Most customers have limited power to manage their electric bills. For example, residential customers must rely on the Company to provide the lowest possible energy cost since they cannot hedge their power costs. Commercial customers' major concern is their primary line of business. In addition, many of these customers may also lack the expertise and resources to manage power costs in a cost-effective manner. Finally, PSE's industrial customers, for the most part, view electricity as an input to their production process over which they have limited



control. Exh. No. 491 at 6: 2-4 (Selecky). As a result, PSE is in a better position to manage variations in power costs, so the risk should not be shifted to the ratepayers.

19 The FEA recommends the Commission reject the Company's proposed changes to the existing PCA Mechanism. PSE's current PCA Mechanism is working as intended. The proposed mechanism is contrary to public interest because it shifts more risk to ratepayers. A properly designed PCA sharing mechanism should appropriately balance the risk between PSE and its customers. The current PCA mechanism accomplishes this task and should be maintained in its current form.

## **II. ELECTRIC ENERGY EFFICIENCY INCENTIVE MECHANISM**

20 PSE is proposing an Energy Efficiency Incentive Mechanism. The Company contends that it has no incentive to pursue energy efficiency more aggressively.

21 Under the terms of the current plan, the Company is assessed a penalty if it does not achieve a target savings. However, the Company does not receive a reward for meeting or exceeding the energy efficiency program goals. Furthermore, the Company contends that reductions in the energy sales due to energy efficiency programs result in lost revenue which can discourage expanded energy efficiency efforts. To correct for this deficiency, PSE is proposing an incentive mechanism.

22 Under PSE's original proposal, PSE would be awarded an incentive equal to the percentage of total electric program cost under the Conservation Rider. PSE proposed incentives that ranged from 10% to 20% of the annual electric program costs. Conversely, the Company would be assessed a penalty on a sliding scale for achieving savings below 80% of the baseline target. The Company's proposal is discussed in detail in the testimony of PSE witness Calvin E.

Shirley. In addition, Exh. No. 374 at 1, shows the energy saving thresholds and the incentive/penalty factors for achieving conservation levels as a percent of the baseline target.

23 In the rebuttal testimony of the NW Energy Coalition, Commission Staff and Public Counsel, alternative electric energy efficiency incentive mechanisms are supported and proposed. However, these parties take issue with PSE's proposal. PSE witness Shirley summarized each of the parties' proposals as follows in his rebuttal testimony:

Each of these parties proposes an alternative incentive mechanism. All three alternative mechanisms have similar structures, but differ in specific details. With respect to structure, each alternative proposal sets a base target with a 'deadband' where no incentive or penalty applies. Each party proposes a two-part incentive for energy savings beyond the deadband. The first part of the incentive is a dollar per MWh saved amount. The second incentive component is a share of the net value of the savings to ratepayers. The penalty is a dollar per MWh figure imposed for savings that fall below the deadband. Within this common structural framework, each party proposes different base targets, deadbands, and incentive and penalty levels. In addition, these parties agreed on a set of requirements that the Company would have to meet in order to be eligible for any incentive. (Exh. No. 379 at 3: 15 – 4: 4 (Shirley))

24 After consideration of the other parties' critiques of PSE's proposed initial program, the Company revised its proposal to be reflective of the criticisms that each party invoked. In the rebuttal testimony of PSE witness Calvin E. Shirley, PSE modified its sharing mechanism proposal. The Company's modified proposal sets a base target with a deadband where no incentive or penalty applies. This is consistent with the Company's initial proposal. However, the new mechanism would set a two-part incentive for energy savings beyond the deadband. The first part of the incentive is a dollar per MWh saved amount. The second incentive component is a share of the net value of savings to ratepayers. The penalty is a dollar per MWh figure imposed for savings that fall below the deadband. The Company contends that this is the same basic structure shared by the Commission Staff, Public Counsel and NWEA. Exh. No. 381 presents PSE's new mechanism and compares it to its original proposal. This also illustrates

what the total incentives and penalties would be at levels of energy savings equal to the start of each step in the incentive and penalty ranges. Exh. No. 379 at 8: 17-20 (Shirley).

**A. The Commission Should Not Approve the Company's Proposed Energy Efficiency Incentive Mechanism.**

25           The Commission should not artificially increase the program costs that PSE is passing on to ratepayers for providing energy efficiency programs. Under all of the proposals, the Company will receive revenues in excess of the actual program cost if it does indeed achieve its baseline energy efficiency target. Ratepayers should only be required to pay the prudently incurred program costs and no more. The current program that was established in 2001 has been performing satisfactorily and should not be adjusted to allow the utility to recover costs that it will never incur.

FEA contends that PSE should not be rewarded for exceeding its energy efficiency target. FEA witness James T. Selecky addresses this in his direct testimony.

As a protected monopoly, a utility has an obligation to provide the least cost service and should not be provided cost incentives to provide energy efficiency or conservation services. PSE's energy efficiency program is simply another service that the utility is providing. Also, to achieve the goals of least cost long-term energy supply, utilities evaluate and pursue a combination of supply side and demand side resources. It is a combination of these resources that is most likely to result in the lowest cost to ratepayers. Therefore, as I will discuss later, supply side and demand side or energy efficiency programs should be treated similarly. To the extent that the energy efficiency program provides the expected benefits, PSE should be allowed to recover its actual costs and no more. (Exh. No. 491 at 14: 6-15)

27           The costs that are associated with the energy efficiency program should be treated no differently than the cost associated with the installation of a supply side option. FEA is not aware of any incentive that the Company receives relative to any additional cost or investment it may incur relative to a supply side option. In addition, it is common regulatory practice for a

supply side option to be subject to a used and useful and/or prudency standards. Therefore, energy efficiency costs should be treated in a same fashion as supply-side costs.

28 Staff witness Joelle R. Steward states in her cross-answering testimony that the Company has considerable influence over setting the target because it controls most of the information used in setting the target. Exh. No. 569 at 3: 16-17. In addition, during cross-examination by FEA, Ms. Steward stated the following on that issue:

And I think with this incentive mechanism, you would see us becoming more active in trying to scrutinize what exactly is in that target. And with my mechanism, what I am trying to do is minimize some of the controversy that could arise from having it designed such that you create some perverse incentives for setting the target too low in order to achieve a higher incentive. Tr. 750: 3-10 (Steward).

29 The Commission should not establish an incentive mechanism until it is assured that the target for the incentive is realistic. It is clear from Ms. Steward's testimony and cross-examination that Staff has concerns regarding the Company's undue influence over establishing the target. If the targets are not properly set, the incentive mechanism proposal may be creating unjustified incentives.

**B. There Is No Regulatory Obligation to Provide PSE With an Incentive for Providing the Least-Cost Options to Ratepayers by Means of an Energy Efficiency Mechanism.**

30 Support for not providing an energy efficiency mechanism is indicated in the Washington Integrated Resource Planning Rule. Elizabeth C. Klump on behalf of Public Counsel states the following:

Fundamentally, each investor-owned electric utility in Washington, under WAC 480-100-238, the Integrated Resource Planning Rule, "has the responsibility to meet its system demand with a least cost mix of energy supply resources and conservation" whether or not it is awarded an incentive. Exh. No. 510 at 6: 8-11 (Klump)

It is clear that there is no regulatory obligation to provide PSE with an incentive for providing the least-cost options to ratepayers via the energy efficiency mechanism.

31 Finally, the Company has indicated in its 2005 least-cost plan, that an accelerated energy efficiency program is more beneficial to the portfolio mix than a constant rate energy efficiency program. Therefore, the Company should continue to pursue this path to provide the least-cost electric service to its ratepayers and should be only compensated for the recovery of the actual prudently incurred costs.

32 In summary, the FEA proposes that the Commission reject all proposals to provide for an incentive mechanism in the energy efficiency programs. PSE should only be allowed to recover the prudently incurred costs – no more, no less.

### III. DEPRECIATION TRACKER

#### **A. Puget's Proposed Depreciation Tracker Is Unnecessary and One-Sided and Should Be Rejected**

33 Puget apparently believes that it has an unusual attrition problem and is therefore proposing a new Depreciation Tracker mechanism that would true up revenues for changes in depreciation expense related to natural gas and electric transmission and distribution capital investment. As proposed by Puget, the tracker mechanism would provide for recovery of the Company's investments in transmission and distribution infrastructure through a surcharge to the Company's existing tariff schedules. This surcharge would be based on the incremental depreciation expense of natural gas and electric transmission and distribution investment over and above the depreciation expense reflected in existing rates. The Company proposes to

calculate the change in revenue deficiency for depreciation expense based on the unit cost recovery for this item that was allowed in the Company's most recent general rate case. If the Depreciation Tracker is approved, this unit cost would be adjusted each year to reflect the additional costs recovered in rates due to implementation of the surcharge.

34 Puget witness Story's direct testimony estimates an increased revenue requirement for Puget's electric and gas operations of \$7.879 million and \$10.885 million, for a total increase of \$18.764 as summarized in the following table:

Line No.	Depreciation in Test Year	9/30/2005	2007	2007 Tracker
1	Electric			
2	Transmission	2,162,707	2,154,681	
3	Distribution	69,255,510	77,619,411	
4		71,418,217		79,774,092
5	Delivered Load (MWH)	21,853,035	22,107,507	72,249,861
6	Unit Cost (\$/KWh)	0.003268		
7	Adjustment			7,524,231
8			Conversion	0.9549744
			Revenue Def.	7,878,988
9	Gas			
10	Transmission	2,911,749	3,752,000	
11	Distribution	47,386,339	57,900,661	
12		50,298,088		61,652,661
13	Delivered Load (thousand therms)	1,038,451	1,057,971	51,243,553
14	Unit Cost (\$/therm)			

		0.048436		
15	Adjustment			10,409,108
			Conversion	0.9563082
16			Revenue	
			Def.	10,884,680
17			Total	18,763,667

Exh. No. 421 at 74: 5-6 (Story).

35            Additionally, as an automatic adjustment clause with a surcharge, Puget’s proposal could result in additional subsequent increases to customer rates, on an annual basis, without the benefit of a complete review of Puget’s operations and without reflecting other offsetting adjustments that could decrease the revenue requirement.

36            Puget is proposing this Depreciation Tracker for the first time in the current case.<sup>3</sup> In the last three general rate cases, the Commission determined that the rates set for Puget for both its gas and electric service provided the Company with an opportunity to earn its authorized rate of return. Tr. 270: 3-8 (Valdman). However, Puget has not earned the return that the Commission has granted. Puget is proposing Depreciation Tracker in the current case because its investment in transmission and distribution plant is growing and, under normal ratemaking, Puget is not able to recover from ratepayers its depreciation expense between rate cases. See, e.g., Tr. 271: 5-10 (Valdman).

37            For several reasons, including the following, Puget’s proposed Depreciation Tracker should be rejected:

- 1) It would inappropriately shift responsibility and risk of increasing Depreciation Expense between rate cases away from shareholders and onto ratepayers.

<sup>3</sup> See, e.g., Tr. 147: 20-21 (cross of Puget witness Harris by FEA): “this is the first time it has been formally proposed in a proceeding.”

- 2) It could remove or reduce incentives to control prudently the cost of plant additions.
- 3) Depreciation Expense is not similar to fuel cost and Puget has demonstrated no history of volatile and uncontrollable Depreciation Expense.
- 4) It could encumber ratepayers with additional revenue requirements annually into the future for Depreciation Expense without capturing offsetting benefits.
- 5) It is a distortion of the test year relationships.
- 6) It is not beneficial to ratepayers.
- 7) Puget has not shown that it needs an additional ratemaking mechanism to make prudent infrastructure investments.
- 8) It is an unusual and extreme ratemaking proposal that has apparently not been adopted for any other utility in the country.

38

**Puget's proposed Depreciation Tracker should be rejected because it would shift risk of fluctuating Depreciation Expense between rate cases away from shareholders and onto ratepayers inappropriately.** This inappropriate risk shift would occur in the following manner. If Puget believes that its expenses or costs, including Depreciation Expense, are increasing more rapidly than its revenues such that a revenue deficiency is being created, Puget can file for a rate increase. Currently, the risks and benefits lie with Puget's shareholders during the period between rate cases if revenues grow more slowly or more rapidly than Puget's costs. Puget's proposed Depreciation Tracker would result in shifting the risk of expense growth onto ratepayers by making ratepayers responsible for all Depreciation Expense changes occurring



between rate cases. Puget would retain the benefit of any rapid revenue growth for the shareholders.

39 **Puget's proposed Depreciation Tracker should be rejected because it would remove or reduce incentives to control prudently the cost of plant additions.** The removal or reduction in existing incentives would occur in the following manner. One of the useful functions of regulatory lag is to place financial responsibility upon the utility for fluctuations in costs between rate cases. The regulatory lag feature of Rate Base/Rate of Return regulation is essential to effective and efficient operation of such a regulatory regime. Because of the lag between placing new plant into service and obtaining rate recognition of such plant, the utility may bear the cost of new plant additions temporarily. This can encourage management to emphasize cost control to a higher degree that might be expected if cost responsibility for plant additions during the periods between rate cases were shifted away from the utility and onto ratepayers.

40 **Puget's proposed Depreciation Tracker should be rejected because Depreciation Expense is not similar to fuel cost and Puget has demonstrated no history of volatile and uncontrollable Depreciation Expense.** Puget witness Story states in his direct testimony that basing recovery on the unit cost associated with depreciation expense is similar to the calculation that the Company currently utilizes for power cost recovery in its PCA Mechanism. Exh. No. 421 at 73: 1-3 (Story). However, the Company's depreciation expense does not have the same volatile characteristics as fuel and purchased power; depreciation fluctuations are not similar to a commodity market. Tr. 148: 5-11 (Harris). Depreciation expenses related to plant investment do not tend to be volatile from month to month, in the same way that natural gas and energy costs

are. Tr. 205: 11-21 (McLain). The following chart, from FEA witness Ralph Smith's testimony demonstrates how depreciation expense is not similar to fuel expense:

<i>Fuel Expense</i>	<i><u>Depreciation Expense</u></i>
Fuel costs are determined by the world wide energy market.	Capital Expenditures, that drive depreciation expense, are subject to utility management, both as to timing and cost control.
Fuel consumed has no significant impact on other operating costs,(assumes fuel grade standards remain constant).	Installed plant may either increase or decrease operations and maintenance expenses, particularly for repairs, maintenance and operating efficiencies.
Fuel expense both increases and decreases in consort with fluctuating energy markets.	Depreciation expense changes very slowly, normally only increasing in consort with plant replacement and additions. A decrease in depreciation expense could signal that plant investments are shrinking and the Utility is disinvesting in the service territory, which in turn could be a harbinger of deferred investments and future increases of greater magnitude.

Exh. No. 492 at 7-8 (Smith).

The primary factor typically cited in justifying the implementation of fuel cost recovery mechanisms for utilities – that such expenses can be extremely volatile between rate cases and are beyond the control or ability of management to influence or control – does not apply to Depreciation Expense.

41

**Puget’s proposed Depreciation Tracker should be rejected because it would encumber ratepayers with additional revenue requirements annually into the future for Depreciation Expense without capturing offsetting benefits.** Puget proposes that its Depreciation Tracker calculations result in annual rate adjustments to recognize the presumed increase in depreciation expense. Moreover, by focusing only on certain isolated components of the revenue requirement formula, and ignoring offsetting components, Puget’s proposed Depreciation Tracker could produce rate increases without capturing offsetting benefits, such as increased revenues and expense reductions. Puget has experienced growth in customers in each of the past four years, and expects further customer growth in the next four years. Tr. 150: 19-24 (Harris). To the extent that Puget’s additional investments in transmission and distribution plant subsequent to the test year serve or enable customer growth, produce operating efficiencies, or reduce operating and maintenance expenses, those additional revenues and expense reductions would not be captured in Puget’s proposed Depreciation Tracker. Any offset for O&M expense reducing impacts of T&D plant additions is noticeably lacking in Puget’s proposed Depreciation Tracker. While Puget witnesses, such as Ms. Harris, have claimed that the Depreciation Tracker is not single issue ratemaking because it was proposed in the context of a rate case (Tr. 147: 5-11 (Harris)), and that the ratemaking problems associated with single issue ratemaking “is not a prohibition against trackers” (Tr. 145: 22-23 (Harris)), Puget’s proposed Depreciation Tracker suffers all of the typical detriments of disfavored single issue ratemaking and should be rejected

because it fails to capture offsetting benefits, while charging ratepayers for additional revenue requirements.

42 **Puget's proposed Depreciation Tracker should be rejected because it is a distortion of the test year relationships.** To understand this, it may be helpful to review the basic ratemaking calculus, i.e., the formula used to determine a utility's revenue deficiency (or sufficiency), which was explained in FEA witness Ralph Smith's testimony at Exh. No. 492 at 9:12 – 10:14. By using a test year, each element of the revenue requirement is properly matched and coordinated. For a growing electric utility, future sales and revenues, future expenses and future rate base investment levels will all likely, though not always, be larger in nominal terms. The use of a test year to quantify ratemaking values for these variables is intended to determine a revenue requirement based upon the relationship between revenue and cost levels at a common point in time. Consequently, while absolute precision in ratemaking is not required, basic consistency in the elements of the ratemaking formula is essential, such that representative levels of ongoing revenues and costs are captured in a balanced way, within a consistently applied test year approach. Puget's Depreciation Tracker distorts the relationships between the components of the ratemaking formula by focusing on only one element which would increase the revenue requirement: plant additions and depreciation expense on such additions. Puget's proposed Depreciation tracker ignores other components, such as increased revenues and other expense changes, such as repair and maintenance savings. Consequently, Puget's proposal is unbalanced.

43 **Puget's Depreciation Tracker should be rejected because it is not beneficial to ratepayers.** Puget's proposal would substantially increase Puget's revenue deficiencies for both gas and electric service in the current case and could produce additional increases annually in an unbalanced manner that considers only one component of the revenue requirement.

Additionally, if Puget's proposed Depreciation Tracker had been in place in prior years, it would have resulted in extensive rate increases. The response to FEA DR 02-008 and PC-056 indicates that the Company's rates in 2003, 2004 and 2005, would have been higher by a cumulative net amount of \$13.148 million. Exh. No. 492 at 10:20 – 11: 4 (Smith). If implemented, Puget's Depreciation tracker would shift the responsibility and risk of increasing depreciation expense between rate cases onto ratepayers. Tr. 205: 1-9 (McLain).

44 **Puget has not shown that it needs an additional ratemaking mechanism to make prudent infrastructure investments.** Puget witness McLain claimed that the Company would be forced to scale back planned transmission and distribution system investments, system maintenance, and inspections if the Company does not get its depreciation tracker mechanism approved in this proceeding. Tr. 202: 23 – 203:7 and Exh. No. 245 at 2: 13-15 (McLain). Puget has not had any Depreciation Tracker mechanism in the past. Puget has not scaled back any planned T&D investments through June 30, 2006 because it did not have a Depreciation Tracker. Tr. 203: 14-17 (McLain). For both its electric and gas utility operations, Puget like any other utility, faces similar obligations to replace aging plants. Tr. 203:21 – 204:3 (McLain). In the past, Puget has experienced customer growth on both the electric and gas utility sides of its business. Tr. 204: 12-15 (McLain). However, other utilities that are also facing the need to replace aging plants may not have the same desirable characteristics of robust customer growth that Puget enjoys. Puget has not shown that it is different from any other utility in needing to make prudent infrastructure investments including replacement of aging T&D plant.

45 **Puget's proposed Depreciation Tracker should be rejected because it represents an unusual and extreme ratemaking proposal that has apparently not been adopted for any other utility in the country.** Puget is not aware of any other utility that has proposed a

depreciation tracker mechanism that is similar to the one Puget has proposed in this case. Tr. 204: 20-24 (McLain). It is not surprising that FEA and other parties, such as the Staff and Attorney General, have all recommended that Puget's proposed Depreciation Tracker be rejected. The Company's proposal is the equivalent of single-issue ratemaking. As described above, it suffers from all of the inherent concerns and problems of single-issue ratemaking (one-sided revenue requirement increases, without consideration of offsetting revenue enhancements and expense reductions. In the past, the Company has not had an automatic recovery mechanism for Depreciation Expense. It is not appropriate to now set aside this one single issue for automatic deferral and future recovery. Providing what essentially would amount to a guarantee of future depreciation expense recovery could also remove incentives on the Company to plan construction prudently and manage costs by shifting the burden of cost increases between rate cases from shareholders onto ratepayers. Puget's response to FEA DR 02-005 indicates that Puget is not aware of any other utility that has proposed a Depreciation Tracker mechanism like the one Puget has proposed in this proceeding. Indeed, throughout the country many electric utilities have fuel cost recovery mechanisms and many gas utilities have gas cost recovery mechanisms, but no other utility has a Depreciation Tracker mechanism such as Puget proposes. Puget's proposed Depreciation Tracker should be rejected because it is a bad regulatory policy.

**B. A Known and Measurable Adjustment Could Be an Acceptable Alternative, If Properly Limited.**

46

FEA witness Ralph Smith recommended that, if the Commission wants to address post-test year plant additions in the current case, an acceptable alternative for accomplishing this would be through a known and measurable adjustment to recognize non-revenue producing, non-

expense reducing transmission and distribution plant additions for a limited period (such as one calendar quarter) beyond the end of the test year. Moreover, in order that such a post-test year adjustment be computed in a balanced manner, the Company's continued accruals of accumulated depreciation on transmission and distribution plant should be recognized through the same date as the plant additions. Exh. No. 492 at 14: 7-17 (Smith). As Mr. Smith explained:

The further outside the test year the net additions to plant in service are recognized, the greater the danger of completely destroying the test year relationships between rate base, revenues and expenses. In my judgment, allowing recognition of non-revenue producing, non-expense reducing T&D plant additions for one additional quarter beyond the end of the test year would not result in a complete distortion of the test year relationships, as would extending for a longer period could. Also, Puget's transmission and distribution additions during the calendar quarter following the end of the test year has a closer temporal connection to the test year than a more extended time period. Some of the plant placed in service during the quarter may have been under construction by the end of the test year. Finally, in other jurisdictions with which I am familiar that undertake post-test year rate base updates for periods as long as six months, the updates are usually for all test year components, and not limited to net plant additions. Because recognition of post-test year net plant additions, without other post test year changes, is inherently unbalanced, providing a means of addressing Puget's attrition concern by recognizing post-test year plant additions, if allowed, should be confined to one quarter subsequent to the test year.  
Exh. No. 492 at 15: 4-20 (Smith).

47 Puget has indicated that it would prefer its proposed Depreciation Tracker; however, the Company acknowledges that there have been other alternatives that have been suggested by other parties in this proceeding, such as the FEA proposal for a known and measurable adjustment. Tr. 105: 11-16 (Harris). Puget's proposed version of the known and measurable adjustment, however, is not the same adjustment as the FEA proposal Tr. 105: 17-19 (Harris).

48 FEA supports a limited known and measurable adjustment as described in Mr. Smith's testimony. FEA does not support Puget's proposed alternative adjustment for the following reasons:

- Only plant that is both non-revenue producing and non-expense reducing should be considered. Post test year expense-reducing plant additions should not be allowed in the adjustment.
- Going nine months beyond the test year, to June 30, 2006, as Puget proposes<sup>4</sup>, is too far. Shifting only one revenue requirement component (plant additions -- which is one that increases the revenue requirement) by an additional nine months destroys the ratemaking calculus.
- Since plant in service is being extended beyond the test year (by three months under the FEA proposal, by nine months under Puget's proposal), the accumulated depreciation on existing end-of-test-year gas and electric T&D plant that continues to accrue should also be extended by the same period, and should be reflected as an offset to the non-revenue producing, non-expense reducing post-test year plant additions.
- Puget's calculation includes a "return on" amount of additional revenue deficiency, which is based on Puget's proposed rate of return. If a similar calculation is to be used for a known and measurable adjustment, it should, at minimum, use the Commission's authorized ROR, which presumably would be lower, or, preferably should exclude a "return on" revenue requirement amount altogether, which would make the alternative more directly comparable with Puget's proposed Depreciation Tracker, which only included a "return of" post-test-year depreciation and no "return on" post-test year T&D plant additions.

FEA witness Smith's direct testimony (Ex 492, at page 19) proposed a calculation methodology that would address some recovery for post-test year non-revenue producing, non-expense reducing T&D plant additions for three months beyond the end of the test year, with an appropriate offset to the plant additions for accumulated depreciation accruals through the same date. Exh. No. 492 at 19 (Smith). Based on hypothetical illustrative figures, Mr. Smith's example an adjustment would be made to increase Puget's electric revenue requirement by \$1.45 million. That illustrative example included a "return on" net rate base investment of approximately \$900,000 and a "return of" post-test year depreciation expense (net of tax) of approximately \$200,000. With the tax gross-up factor of 0.6207334, the equivalent amounts are

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<sup>4</sup> Tr. 206:23 – 207:1 (McLain). The test year being used in the current case is the test year ended September 30, 2005. For its alternative to the depreciation tracker, Puget proposes reflecting transmission and distribution plant additions from October 1, 2005 through June 30, 2006.



\$1.128 million for the “return on” post test year net T&D plant, and \$322,000 for the “return of” post-test year depreciation on the non-revenue producing, non-expense reducing T&D plant.

50

During the cross examination of Puget witness John Story, FEA introduced Exhibit 752 into the record, which is the Company’s corrected version of its response to FEA Data Request 03-001. Tr. 788: 1-4 (Story). Using that exhibit and Mr. Story’s Exhibit 445, FEA introduced specific figures into the record, should the Commission adopt the FEA’s recommendation and use actual amounts for the accumulated depreciation. FEA believes the alternative would be a reasonable way of addressing some of Puget’s concerns, by means of a limited known and measurable adjustment, consistent with the illustrative example presented in FEA witness Smith’s testimony. After reviewing the testimony provided at the hearings by Puget witnesses Valdman and Story, FEA believes there may be a preferable alternative that provides for limited known and measurable recovery by Puget of post test year depreciation expense (“return of”) but avoids recovery of the “return on” post-test year T&D plant investment. This preferable alternative, by providing a “return of” but not a “return on” would also be more consistent with Puget’s Depreciation Tracker proposal (which would increase the revenue requirement for a “return of” but not a “return on”).

51

Puget witness Valdman stated in his rebuttal testimony that Puget was agreeable to the type of alternative proposal suggested by the FEA witness Smith. Exh. No. 457 at 32: 1-6 (Valdman). Mr. Valdman explained that Puget is open to ways outside of trackers to recover its depreciation. Tr. 274: 14-20 (Valdman). In response to clarifying questions by Judge Moss, Puget witness Valdman stated clearly that Puget’s request for a Depreciation Tracker was only asking for recovery of post-test year depreciation, either through a tracker or some other mechanism. Tr. 274:23 – 275:14 (Valdman). Mr. Valdman testified that Puget was not asking

for a return on investment through the Depreciation Tracker or some other alternative mechanism:

THE WITNESS: We're asking for recovery of depreciation, either through a tracker mechanism or some other mechanism, that would provide us economically a similar result.

JUDGE MOSS: But the alternative, are you asking [for a] return of and return on?

THE WITNESS: No. We're not asking for return on.

JUDGE MOSS: That's what I wanted to clarify.

THE WITNESS: We're clearly not asking for that.

Tr. 275: 3-14 (Valdman; emphasis supplied)

Based on the clarification provided by Puget witness Valdman of what Puget was requesting under its proposed Depreciation Tracker alternative or some other mechanism, the "return on" component of Puget's "Known and Measurable" alternative calculation should be removed in order to put that on a comparative basis. Removing the "return on" component from the "Known and Measurable" alternative would leave the amount of increase to Puget's revenue requirement related only to the post-test-year increase in depreciation expense.

52 Referring to Puget witness Story's rebuttal exhibit, Exh. No. 445 at 1, Puget's "Known and Measurable" alternative proposal would increase electric rates by an additional \$8.773 million per year, and would increase gas rates by \$3.546 million per year. Tr. 783:22 – 784:1 (Story). These increases would remain in effective indefinitely, until new rates are established for Puget. Tr. 784: 2-10: (Story). For the electric, the additional \$8.773 million per year that

Puget seeks under its alternative proposal is even higher than the \$7.879 million that Puget had requested for its Depreciation Tracker. Tr. 787: 11-18 (Story).

53 Of Puget's proposed additional electric rate increase amount of \$8.773 million, \$7.687 million of this is for the return on post test year T&D investment. Tr. 787: 1-6 (Story). The remainder of approximately \$1.086 million, is for the return of post-test-year depreciation expense. Similarly, for Puget's proposed additional gas rate increase amount of \$3.546 million, \$3.043 million of that is for a return on post test year T&D investment. Tr. 787: 7-10 (Story). The remainder of approximately \$503,000, is for the return of post-test-year depreciation expense.

54 FEA proposes<sup>5</sup>, as an alternative to Puget's proposed Depreciation Tracker (which should be rejected for all of the reasons stated above), that Puget be allowed to recover an additional revenue requirement for the return of post-test-year depreciation expense. If the Commission determines that Puget should be awarded an additional revenue requirement for recovery of depreciation expense on non-revenue producing, non-expense reducing post-test year transmission and distribution plant additions, FEA recommends limiting such amounts to approximately \$1.086 million for Puget's electric and \$503,000 for Puget's gas utility operations.

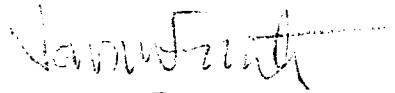
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<sup>5</sup> FEA is concerned that Puget's figures extend nine months beyond the test year, rather than be limited to the three month post-test year adjustment suggested by FEA witness Smith; however, FEA would not object to Puget's nine month extension provided that the "return on" component is eliminated from the alternative as shown above.

#### IV. CONCLUSION

For the reasons set forth above, FEA urges this Commission to adopt its recommendations on the matters addressed in its testimony and brief.

Respectfully submitted,



Norman J. Furuta  
Associate Counsel  
(Regulatory Law)  
Federal Executive Agencies  
333 Market ST, 10<sup>th</sup> Floor MS 1021A  
San Francisco, CA 94105-2195  
TEL: (415) 977-8808  
FAX: (415) 977-8760  
e-mail: [norman.furuta@navy.mil](mailto:norman.furuta@navy.mil)

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

Docket Nos. UE-060266  
UG-060267

### CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this date I caused to be served the foregoing Initial Brief of the Federal Executive Agencies by mailing with postage prepaid to the following:

Washington Utilities and Transportation  
Commission  
Chandler Plaza Building  
1300 S. Evergreen Park Drive S.W.  
Olympia, WA 98504-7250  
Phone: 360-664-1160

Robert D. Cedarbaum, Senior Counsel  
1400 S. Evergreen Park Drive SW  
PO Box 40128  
Olympia, WA 98504-0128  
Phone: 360-664-1188  
Fax: 360-586-5522  
Email: [bcedarba@wutc.wa.gov](mailto:bcedarba@wutc.wa.gov)

Tom DeBoer  
Director, Rates & Regulatory Affairs  
Puget Sound Energy, Inc.  
PO Box 97034  
Bellevue, WA 98009-9734  
Phone: (425) 462-3495  
e-mail: [tom.deboer@pse.com](mailto:tom.deboer@pse.com)

Simon J. ffitch  
Public Counsel Section  
Office of Attorney General  
800 Fifth Avenue, Suite 2000  
Seattle, WA 98104-3188  
Phone: 206-389-2055  
Fax: 206-389-2079  
Email: [simonf@atg.wa.gov](mailto:simonf@atg.wa.gov)

Mike Kurtz  
Kurt Boehm  
Boehm, Kurtz and Lowry  
36 East Seventh St., STE 1510  
Cincinnati, OH 45202  
Phone: 513-421-2255  
Fax: 513-421-2764  
Email: [mkurtz@bk1lawfirm.com](mailto:mkurtz@bk1lawfirm.com)

Nancy Glaser  
NW Energy Coalition  
219 First Avenue, Suite 100  
Seattle, WA 98104  
Phone: 206-621-0094  
Fax: 206-621-0097  
Email: [NGlaser@nwenergy.org](mailto:NGlaser@nwenergy.org)

Kirstin S. Dodge  
Sheree Strom Carson  
Perkins Coie LLP  
10885 NE 4<sup>th</sup> ST, STE 700  
Bellevue, WA 98004-5579  
Phone: 425-635-1400  
Fax: 425-635-2400  
Email: [ksdodge@perkinscoie.com](mailto:ksdodge@perkinscoie.com)

Paula E. Pyron  
Executive Director  
Northwest Industrial Gas Users  
4113 Wolf Berry Court  
Lake Oswego, OR 97035-1827  
Phone: 503-636-2580  
Fax: 503-636-0703  
Email: [ppyron@nwigu.org](mailto:ppyron@nwigu.org)

S. Bradley Van Cleve  
Matthew Perkins  
Irion A. Sanger  
Davison Van Cleve  
333 S.W. Taylor STE 400  
Portland, OR 97204  
Phone: 503-241-7242  
Fax: 503-241-8160  
Email: [mail@dvelaw.com](mailto:mail@dvelaw.com)

Elaine L. Spencer  
Graham & Dunn PC  
Pier 70, STE 300  
2801 Alaskan Way  
Seattle, WA 98121-1128  
Phone: (206) 624-8300  
Email: [espencer@grahamdunn.com](mailto:espencer@grahamdunn.com)

Mr. Robert Sheppard  
Seattle Steam Co.  
30 Glacier Key  
Bellevue, WA 98006

Fred Meyer Stores, Inc.  
3800 Southeast 2<sup>nd</sup> Street  
Portland, OR 99202

Michael Early, Executive Director  
Industrial Customers of Northwest Utilities  
333 SW Taylor ST, STE 400  
Portland, OR 97204

Edward A. Finklea  
Chad M. Stokes  
Cable Huston Benedict Haagensen & Lloyd  
1001 SW Fifth Avenue, Suite 2000  
Portland, OR 97204  
Phone: 503-224-3092  
Fax: 503-224-3176  
Email: [efinklea@chbh.com](mailto:efinklea@chbh.com)

Ronald L. Roseman  
2011 – 14<sup>th</sup> Avenue East  
Seattle, WA 98112  
Phone: 206-324-8792  
Fax: 206-568-0138  
Email: [ronroseman@comcast.net](mailto:ronroseman@comcast.net)

Donald W. Schoenback  
Regulatory & Cogeneration Services, Inc.  
900 Washington Street, Suite 780  
Vancouver, WA 98660  
Phone: (360) 232-6155  
Fax: (360) 737-7628  
Email: [dws@r-c-s-inc.com](mailto:dws@r-c-s-inc.com)

James Lazar  
Microdesign Northwest  
1063 Capital Way South, #202  
Olympia, WA 98501  
Phone: 360-786-1822  
Email: [jimlaz@callatg.com](mailto:jimlaz@callatg.com)

Quality Food Centers, Inc.  
10116 NE 8<sup>th</sup> Street  
Bellevue, WA 98004

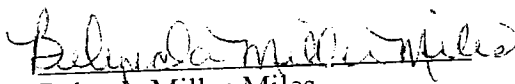
The Kroger Co.  
1014 Vine Street STE G-07  
Cincinnati, OH 45202  
Michael P. Alcantar  
Don Brookhyser  
Alcantar & Kahl, LLP  
1300 SW Fifth, STE 1750  
Portland, OR 97201

Kay Davoodi  
Naval Facilities Engineering Command-HQ  
Utilities Rates and Studies Office  
1322 Patterson Avenue SE. Bldg. 33  
Washington Navy Yard, DC 20374-5018

Michael P. Gorman  
Brubaker and Associates, Inc.  
1215 Fern Ridge Parkway, STE 208  
St. Louis, MO 63141

I declare under penalty of perjury under the laws of the District of Columbia that the foregoing is true and correct.

Dated this 31<sup>st</sup> day of October, 2006, in Washington, DC.

  
Belynda Miller-Miles