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**VIA FEDERAL EXPRESS
AND ELECTRONIC FILING**

Carol Washburn
Executive Secretary
Washington Utilities & Transportation
Commission
1300 S. Evergreen Park Drive, S.W.
P.O. Box 47250
Olympia, WA 98504-7250

Re: Washington Utilities & Transportation Commission vs. Puget Sound Energy, Inc.
Docket Nos. UG-060267 and UE-060266

Dear Ms. Washburn:

Enclosed please find an original and 16 copies of the Initial Brief of the Northwest Industrial Gas Users (NWIGU) in the above-referenced matter. An electronic submission will be sent to the Records Center on October 31, 2006 as well as to all parties listed on the service list.

Thank you for your assistance.

Very truly yours,



Edward A. Finklea

NH/nh
Enclosures

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND)	
TRANSPORTATION COMMISSION)	
)	
Complainant,)	
)	
vs.)	Docket Nos. UG-060267
)	UE-060266
PUGET SOUND ENERGY, INC.)	(Consolidated)
)	
Respondent.)	

INITIAL BRIEF
OF THE
NORTHWEST INDUSTRIAL GAS USERS

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I. INTRODUCTION

Pursuant to WAC 480-07-390 and the procedural schedule adopted by Administrative Law Judge Moss, the Northwest Industrial Gas Users (“NWIGU”) hereby submit this Initial Brief in the above-referenced proceeding. Puget Sound Energy, Inc. (“Puget”) filed with the Washington Utilities and Transportation Commission (“WUTC” or “Commission”) a general rate case seeking to increase natural gas sales and transportation rates by \$51.3 million and electric rates by \$148.8 million.

In this Initial Brief, NWIGU will address only three issues and except as noted in this brief, is otherwise supportive of those positions identified in the record thus far by WUTC Staff. NWIGU will address the central issues the Commission must resolve to determine Puget’s revenue requirement—the cost of equity capital. Based on the Record and Commission Precedent, Puget’s Return on Equity (“ROE”) should fall below 10 percent. NWIGU will also address why the Commission should approve the Rate Spread and Rate Design Settlement agreed to by WUTC Staff, Public Counsel and NWIGU. Finally, NWIGU will address why the Commission should reject Puget’s proposed depreciation tracker and its alternative update of alleged depreciation expense beyond the test year.

II. ARGUMENT

1. Return on Equity

A. Puget Has Not Demonstrated That Its Proposed Return On Equity Is Fair, Just and Reasonable.

Puget is seeking to increase its authorized ROE from 10.3 to 11.25 percent. Puget’s current authorized return was established in 2005 in a fully litigated case before this Commission.¹ Puget has the burden of showing by a preponderance of the evidence that an increase in its authorized return from 10.3 to 11.25 percent is needed for the Company to attract

¹ *WUTC v. Puget Sound Energy, Inc.* Docket Nos. UG-040640 and UE-040641, Order No. 06 Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent filing (Feb. 18, 2005).

equity investors at reasonable terms in today's capital markets and to maintain its financial integrity.² Puget has failed to meet its burden.

Puget, WUTC Staff and the Industrial Customers of Northwest Utilities ("ICNU") have employed well-recognized experts to address Puget's request for an 11.25 percent return on equity. These expert witnesses have widely divergent opinions on the appropriate equity return for Puget in today's capital markets. All three experts are highly respected in these fields, and all have provided detailed, well-documented analyses to support their conclusions.

Puget's witness, Dr. Roger Morin, recommends a ROE of 11.25 percent and claims that his analysis of capital markets and the risks facing Puget supports an even higher return despite current interest rates.³ Mr. Hill, on behalf of the WUTC Staff, reviewed other combined gas and electric generation companies which have a range of returns between 9.25% to 9.75%.⁴ Mr. Hill concludes that an appropriate return for Puget would be in the lower range of approximately 9.375 percent.⁵ Mr. Hill also concludes that if decoupling is adopted, the appropriate ROE would be 9.25 percent.⁶ ICNU has employed the services of Mr. Gorman, who recommends an ROE of 9.9 percent.⁷

Because of the reputation of the WUTC Staff and ICNU experts, NWIGU, Public Counsel and other intervenors did not sponsor an expert witness on cost of equity capital. The issue, however, is of critical importance to NWIGU member companies. Thus, NWIGU is setting forth its perspective on cost of capital through this Initial Brief.

NWIGU urges the Commission to resolve the cost of equity debate in this proceeding based on principles of fairness, common sense, the extensive record and in a manner consistent with historic precedent of this Commission. Balancing these factors argues for lowering Puget's

² *WUTC v. Pacific Power & Light Co.*, Cause No. U-84-65, Fourth Supplemental Order, 68 P.U.R. 4th 396, 85 WL 514900, 20 (August 2, 1985).

³ Exh. 301, p. 58, lines 4 – 18 to p. 59 lines 1-3 (Dr. Morin Prefiled Direct).

⁴ Exh. SGH-1TC, p. 4 lines 16-22 (Stephen Hill Direct).

⁵ *Id.*

⁶ *Id.*

⁷ Exh. 471, p. 1, lines 16-18 (Michael Gorman Direct).

authorized return from the 10.3 percent level adopted in 2005. NWIGU will show that based on this case and prior Commission precedent there is no justification for allowing Puget to earn an 11.25 percent return in today's capital markets. In particular, the Commission should lower Puget's authorized return in recognition of the lower cost of long term debt facing Puget today, even compared to two years ago. In addition, if either the depreciation tracker or Puget's decoupling mechanism is adopted, Puget's return should be further lowered to reflect the reduction in risks facing the company.

B. It Is Essential To Measure Puget's Requested Return In The Context Of Today's Capital Markets.

Puget's expert, Dr. Roger Morin, contends that given the risks Puget faces today, it requires a return of at least 11.25 percent to attract capital.⁸ Dr. Morin, however, has not demonstrated that this return is fair, just and reasonable, and accordingly it should be rejected.

Today's capital markets and economic realities dictate that Puget's authorized ROE can not be raised above 10.3 percent, the ROE approved by the Commission in Puget's last general rate proceeding. Moreover, strong technical and common sense arguments exist for reducing its authorized return to below 10 percent. Supreme Court precedent and prior decisions of this Commission establish that Puget is entitled to an opportunity to earn a return on equity that is sufficient to maintain its financial integrity and attract capital on reasonable terms.⁹ The return should be comparable to other enterprises of corresponding risk.¹⁰ An essential element of the regulatory compact is that rates should be set to allow the utility an opportunity to earn a reasonable return on its shareholders' equity investment. As the Supreme Court explained more recently in *Duquesne Light Co. v. Barash*,¹¹ the constitutional standard is that the overall rates of

⁸ Exh. 301, p. 58, lines 4-18 to p. 59 lines 1-3 (Dr. Morin Prefiled Direct).

⁹ *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679, 690, 43 S.Ct. 675, 67 L.Ed. 1176 (1923); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 88 L.Ed. 333 (1944).

¹⁰ *Hope Natural Gas Co.*, 320 U.S. at 603.

¹¹ 488 U.S. 299, 307-08, 109 S.Ct. 609, 102 L.Ed.2d 646 (1989)

a utility must provide the company with a reasonable opportunity to attract capital and earn a fair return on its investments. The Supreme Court also clarified that the focus for constitutional analysis is not on any one decision within the process of establishing the utility's rates, but rather on whether the final result gives the company an opportunity to earn a reasonable return.¹² Ratepayers' interests are not properly protected, however, if a utility is authorized to earn a return that is higher than necessary to attract capital in today's equity markets. The Commission must employ its sound judgment and properly balance the shareholders' interests in being fairly compensated for their investments with the Commission's duty to protect ratepayers from excessive rates and charges.¹³ In doing so, the WUTC should employ its common sense as well as weighing the highly technical arguments of expert witnesses.

In order to apply the legal standards established in *Bluefield, Hope and Duquesne Light Co.*, it is critical to consider both the overall cost of capital in today's markets and to determine the true degree of risk Puget faces as a combined gas and electric utility serving Washington customers in the mid-2000s. Puget's customers and shareholders want the Company to both attract capital in the future on reasonable terms and maintain financial integrity.

Complex financial and analytical techniques have been employed by all three expert witnesses to support their recommendations for an appropriate ROE. To rebut Puget's request for an 11.25 percent ROE, WUTC Staff and ICNU have each forwarded well-supported cases for an authorized return below 10 percent. The technical work of Mr. Hill and Mr. Gorman is extremely thorough and carefully reasoned. Both experts make a strong case for reducing Puget's authorized return on equity to less than 10 percent. This expert testimony coupled with common sense and historic precedent require this Commission to reject Puget's request for an authorized return of 11.25 percent in today's capital markets.

¹² *Id.* at 314.

¹³ See *Washington Natural Gas Co.*, 1993 WL 500058 at 19-20.

Despite his outstanding credentials, the details contained in his analysis, and the expense Puget incurred to forward his effort, Puget's witness Dr. Morin has failed to carry the Company's burden of showing that, in today's capital markets, an authorized return of 11.25 percent is reasonable for Puget or any other entity having corresponding risk. Instead, the record in this case and past precedent of this Commission supports a reduction in Puget's currently authorized return of 10.3 percent, especially if risk reducing elements such as decoupling or the depreciation tracker are added to Puget's rate structure.

In the 2005 Puget case, NWIGU urged the Commission to review the requested return on equity in the context of the cost of long-term debt facing Puget. NWIGU showed that the 11.75 percent return Puget was seeking was unprecedented when viewed in comparison to the cost of long-term debt facing Puget at the time. NWIGU showed that in a series of cases dating back to the mid-1980's, equity returns were approximately 22 to 60 percent higher than the cost of long-term debt.¹⁴ The Puget case that authorized a ROE 60 percent higher than the utility's cost of long term debt occurred when Puget was an electric only utility facing \$100's of millions in write-offs for abandoned nuclear plants.¹⁵ No such extreme circumstances exist today. Ultimately, the return this Commission granted Puget in the last case was approximately 50 percent higher than its actual cost of long-term debt, which was 6.88 at that time.¹⁶

NWIGU is not suggesting this Commission can determine the proper return on equity by simply applying a percentage multiplier to the cost of long-term debt. The extensive analytical work performed by the three expert witnesses in the case must be weighed. The experts retained

¹⁴ *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-83-54, Fourth Supplemental Order, 62 P.U.R. 4th 557, 5-6 (Sept. 28, 1984) (Where Puget faced \$100s of millions in write-offs for abandoned nuclear plants, the authorized equity return was approximately 60 percent higher than the actual cost of long term debt included in Puget's capital structure); *Pacific Power & Light Co.*, 68 P.U.R. 4th 396, 85 WL 514900. (1985) (Where authorized equity return was approximately 52 percent higher than PacifiCorp's cost of long-term debt); *Washington Natural Gas Co.*, 1993 WL 500058, 1 (1992) (Where authorized return on equity was 22 percent higher than the cost of WNG's long-term debt).

¹⁵ *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-83-54, Fourth Supplemental Order, 62 P.U.R. 4th 557, 5-6 (Sept. 28, 1984).

¹⁶ *WUTC v. Puget Sound Energy, Inc.* Docket Nos. UG-040640 and UE-040641, Order No. 06 Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent filing, p. 32 (Feb. 18., 2005).

by WUTC Staff and ICNU have performed their analyses consistent with the accepted methods for establishing returns. Applying a common sense way of measuring proper equity returns, however, also supports lowering Puget's authorized return below the 10.3 percent level adopted in 2005.

NWIGU notes that Puget's cost of long-term debt has declined since the last case, from 6.88 to 6.64 percent.¹⁷ A twenty basis point drop in the cost of long-term debt is strong evidence that Puget's cost of capital has declined in the past two years. An equity return 50 percent higher than Puget's cost of debt would equal 9.96 percent, almost precisely the figure recommended by ICNU's expert Mr. Gorman.¹⁸ Common sense principles do not support granting Puget a higher return on equity in the face of declining cost of long-term debt. The return it seeks is approximately 70 percent higher than its actual cost of long-term debt. Such a large risk premium defies precedent and common sense.

In this proceeding, Puget has also requested a decoupling mechanism and a depreciation tracker. Both of these mechanisms would reduce the level of risks facing Puget as compared to the risk facing Puget during its last general rate case. If either mechanism is adopted, the Commission should further reduce Puget's ROE to reflect the lower risk.

This Commission should not artificially inflate Puget's authorized return to help Puget's bond rating or to help Puget actually earn a reasonable return. The extensive testimony of WUTC Staff and ICNU's experts combined with common sense support a reduction in Puget's authorized return to a level below its last authorized return of 10.3 percent. Such a return would fairly balance the interests of shareholders and customers.

¹⁷ Exh. 131, p. 3 lines 11 (Donald Gaines Prefiled Direct Testimony).

¹⁸ Exh. 471, p. 1, lines 16-18 (Michael Gorman Direct).

2. Rate Spread and Rate Design Settlement

A. The Commission Should Adopt the Rate Spread and Design Supported by the Joint Parties

NWIGU has joined with the WUTC Staff and Public Counsel in supporting a rate spread and design proposal for this case that strikes a proper balance among the various gas customers' interests.¹⁹ The Commission should adopt the Joint Parties' rate spread and design as an appropriate step towards bringing Puget's gas rates more in line with cost of service principles. Puget does not object to the rate spread, although it does not support the compromise. Puget has raised minor objections to portions of the rate design. Seattle Steam objects to the rate spread, arguing that interruptible customers should receive a rate decrease regardless of the size of the increase ultimately granted to Puget.

The cost of service study presented in this case by Puget shows that its industrial customers taking service under transport Schedule 57 or sales Schedules 85, 86 and 87 pay a disproportionate share of the Company's cost under current rates.²⁰ Movement toward cost of service is necessary to address the disparities that exist in Puget's current rates.

The Joint Parties support a rate spread for gas customers that will limit the size of the increase for Puget's sales Schedule 85, 86, 87 and transportation Schedule 57 customers to \$576,000, regardless of the size of the gas rate increase granted Puget.²¹ The recommendation is made in recognition of the fact that under either Puget's cost of service study or the "Commission Basis" study, Puget's industrial schedules are far above cost of service levels. By allocating only a small, fixed portion of any rate increase to these customers, the industrial schedules would realize significant movement toward the results of a cost of service analysis. The Company's firm rate schedules should, and will, receive the vast majority of any gas increase under the proposal supported by the Joint Parties.

¹⁹ Exh. 581, Prefiled Response Testimony re Natural Gas Rate Spread, Rate Design and Low Income Bill Assistance (Lazar, Schoenbeck, Steward).

²⁰ Exh. 41, p. 1, line 39 (Third Exhibit of the Prefiled Direct Testimony of Janet K Phelps).

²¹ *Id.* at p. 6 lines 13-17.

The rate disparities that exist in Puget's current rate structure have existed for many years and need to be eliminated promptly. Rather than litigating the issue of how a proper cost study should be conducted or what changes should be considered to the Commission Basis cost study, NWIGU reached a fair and balanced compromise with WUTC Staff and Public Counsel. The settlement achieves very significant movement toward eliminating current rate disparities among all classes of customers and does so recognizing cost disparities within the industrial schedules. Seattle Steam, however, has expressed dissatisfaction with the settlement, as the results of cost of service studies justify decreasing Schedules 85, 86, 87 and 57 even if Puget's proposed rate increase is approved in its entirety. While in an ideal world Puget's cross-subsidies would be eliminated completely with one rate adjustment, the Joint Parties' proposal is a very significant movement in the right direction.

The Joint Parties' proposal also appropriately addresses the cost of service disparities presented within these industrial schedules as well, particularly with regard to Schedules 57 and 87. Whether examined under the Commission Basis study or under Puget's cost of service study, Schedule 57 rates are at a magnitude of disparity to their cost of service substantially greater than Schedule 87 rates. The Joint Parties' proposal appropriately addresses this inequity by moving both schedules closer to their relative cost of service by adjusting the distinct charges for Schedule 87 (i.e., the procurement charge) so that the overall cost of service stance is improved for both schedules. Under the Joint Parties' proposal, both schedules move closer to their relative cost of service when considering all charges applicable to the particular service. The Joint Parties' compromise on rate spread and design is in the public interest and should be adopted by this Commission.

3. Depreciation Tracker

A. The Commission Should Reject Puget's Requested Depreciation Tracker and the Last-Minute Proposal to Allow a One-Time Adjustment to Rate Base

Puget should not be granted extraordinary rate relief in the form of a depreciation tracker or end of test period adjustment to allow into rate base expenditures that will occur outside the test period. This Commission has a long-standing tradition of only allowing utilities to recover known and measurable expenditures that were incurred in the test year. Puget has failed to make a compelling case for adjusting rates beyond the traditional levels.

There are numerous reasons why Puget should not be granted the extraordinary rate relief it seeks. First and foremost, Puget has failed to demonstrate why the Commission should depart from long-standing Commission precedent to limit rate increases to known and measurable changes that occurred during the test period.

NWIGU, WUTC Staff, Public Counsel, ICNU, the Federal Executive Agencies and Kroger have offered multiple reasons for rejecting the depreciation tracker requested by Puget. The tracker inappropriately singles out depreciation for single issue ratemaking treatment, even though depreciation is not the type of expense this Commission has treated through single issue adjustments before. The depreciation tracker is single-issue ratemaking that isolates one of dozens of factors that impact a utility's earnings between rates cases, does not advance shareholders' and ratepayers' interests and should be rejected.²²

The Puget depreciation tracker is unsupportable. It would put in place a mechanism that could raise natural gas rates by \$10.9 million annually for many years, without regard to whether offsetting factors should negate the alleged need for more revenue.²³ Deprecation is just one of many elements that shareholders take the risk of incurring between rate cases.²⁴ Since Puget is

²² Exh 495, p.2 lines 6-17 (Direct Testimony of Don Schoenbeck).

²³ Exh. 421, p. 75, lines 12-13 (Direct Testimony Story)

²⁴ *Id.* at p.2 lines 18 to p. 3, line 2.

always free to file for another rate increase, the depreciation tracker would serve to allow Puget to raise rates without the rigorous review provided by a full rate case.

Faced with overwhelming opposition to the depreciation tracker, on rebuttal, Puget has forwarded a variation on its original request.²⁵ Puget now seeks permission to make a one time adjustment to its gas revenue requirement by approximately \$3.5 million adding depreciation expenses incurred outside the test period to its overall revenue requirement.

NWIGU fundamentally disagrees with Puget's assertion that the Company is experiencing expenditures that warrant special treatment of depreciation expense. Puget alleges that this tracker is necessary to enable Puget to earn its authorized return. There is no compelling evidence in this record, however, that shows that Puget will not have a reasonable opportunity to earn its authorized return on equity in this case without an end of period adjustment to depreciation. To the contrary, the evidence suggests that if Puget is authorized to make an end of period adjustment, that it could easily over earn on its equity especially if other aspects of the rate case cut in its favor.

Staff witness Russell has offered a compelling rebuttal to Puget's last minute request for a one-time out of period adjustment to its depreciation expenses.²⁶ First, as Mr. Russell notes it will be extremely difficult to verify at this late stage in the case whether all the projects will indeed become used and useful.²⁷ Puget is essentially asking this Commission to take on faith the numbers it puts forth. Such a proposal is unworkable, as the WUTC Staff and intervenors have the right to determine if the expenditures were indeed made or if after the adjustment Puget is realizing an excessive return on equity.

These expenditures will go beyond the test period and thus if included in rates would do so in violation of the test period matching principle.²⁸ The expense may or may not have

²⁵ Exh 439, p. 2 lines 3-15, Rebuttal Testimony of John Story.

²⁶ Exh. 527 p. 1 line 1 to page 7 line 7. (Surrebuttal Testimony of James Russell).

²⁷ *Id.* p. 3 lines 14 to p. 5 lines 26.

²⁸ *Id.* p. 6 lines 20 to page 7 line 4.

offsetting benefits, such as better efficiencies, that in a general rate case would offset the expenditures. Puget's proposal would enable the Company to ignore the offsets and simply reflect the higher depreciation expense.

Staff witness Russell also notes that there will be no true method of verification if Puget is allowed to make an adjustment to test year depreciation to capture out of test period expenditures.²⁹ Even if the size of the expenditure can be verified, there will be no way to determine if a portion of the increased expenditure should be offset by lower maintenance expenditures or other costs incurred outside the test period.

A critical aspect of any out of period adjustment would be to ensure that the plant addition being reflected in depreciation expense was both non-revenue producing and non-expense reducing. If the capital addition also results in more revenue to the company, reflecting the higher depreciation expense without reflecting the greater revenue would violate fundamental ratemaking principles. Given the way Puget has forwarded this requested adjustment, however, there is no way for Staff or other intervenors to verify that an expenditure is truly non-revenue producing and non-expense reducing.

Staff witness Russell noted in his rebuttal testimony that there are over 20,000 projects that Puget could include in a depreciation adjustment over just the nine months the company seeks to focus on for the one-time adjustment.³⁰ It would become an extremely daunting task to verify the level of expenditures and then ascertain whether there should be offsetting revenue adjustments upward, or offsetting expense adjustments downward, before allowing the out of period adjustment.

Puget has tried to focus the Commission's attention on the fact that certain investments are being made now that are not included in the test year figures. Puget is well aware that this is

²⁹ *Id.*

³⁰ Exh. 527 p. 4 lines 15-21.

a normal experience for utilities, as this Commission has made it clear for many years that rates must be set based on known and measurable expenditures and revenues.

There is no rational basis for allowing a \$3.5 million adjustment to the Company's revenue requirement by focusing on gas system additions beyond the test period. It is unprecedented to allow such an adjustment late in a case based on rebuttal testimony and a simple assertion that the expenditures did not result in offsetting increases in revenues or decreases in other expenses. This Commission should reject Puget's efforts to update its depreciation expenses beyond the test period.

Puget's rebuttal proposal offers nothing to ratepayers in exchange for the higher rates. It does not come as part of a package that promises to lower the Company's return in exchange for the depreciation adjustment. The update is also not part of any package that gives ratepayers some rate stability by holding rates constant for a couple of years in exchange for the higher rates immediately.

Even if the Commission is inclined to grant Puget some depreciation adjustment, the current proposal to add \$3.5 million for gas operation transmission and distribution investment outside the test year grossly overstates the level of such an adjustment. Puget's proposal would grant the Company \$3.043 million of return on its post test year investment, and approximately \$503,000 in return of the depreciation expense.³¹ Yet even Puget's witness Mr. Valdman admitted in questioning by Judge Moss that a proper post-test period adjustment would only provide Puget with a return of its post-test period depreciation expense, not a return on such investment.³²

Public Counsel also properly notes that Puget's equity return should be lowered if another tracker mechanism is introduced. Even the adjustment requested in rebuttal testimony would warrant a lower return, as the Company's current return was granted when the risks facing

³¹ Tr. 787: lines 7-10 (Story).

³² Tr. 275: lines 3-14 (Valdman).

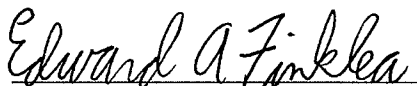
the company's shareholders included the risk of post-test period investments and related depreciation expenses. The Commission should reject Puget's original proposal and the adjustment proposed in its rebuttal testimony.

III. CONCLUSION

NWIGU urges the Commission to lower Puget's authorized return on equity from the current level of 10.3 percent. An equity return below 10 percent is both supported by the WUTC Staff and ICNU witnesses and is consistent with common sense ways of measuring a capital cost in today's markets. The depreciation tracker is unsupportable and should be rejected. Finally, the rate increase the Commission authorized should be spread in accordance with the rate spread and design settlement agreed to by WUTC Staff, Public Counsel and NWIGU.

Dated in Portland, Oregon, this 31st day of October, 2006.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing document upon the parties of record in these proceedings listed below by mailing a copy properly addressed with first class postage prepaid. Electronic copies will be e-mailed to all parties of record on October 31, 2006.

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Dated in Portland this 31st day of October, 2006.

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