

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION
COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DOCKET NO. UE-060266

DOCKET NO. UG-060267

**OPENING BRIEF
OF PUBLIC COUNSEL**

OCTOBER 31, 2006

I. INTRODUCTION

1. Public Counsel's brief will focus on three major areas of this case: decoupling, PSE's depreciation tracker, and PSE's proposed changes to its power cost adjustment mechanism (PCA). On each of these issues, Public Counsel explains why it opposes the Company's proposals and asks the Commission to reject them. For decoupling and the PCA, this brief provides alternative proposals for the Commission's consideration. As this brief will explain, each of PSE's three proposals has something in common. Each of them shifts significant financial risk to PSE ratepayers. PSE's case makes no provision for compensating customers, through a reduced cost of capital for other mechanism, for this shift.
2. While there is never a justification for unreasonable and unfair rate proposals, PSE's requests in this case should receive even more careful scrutiny in this era of almost continuous upward movement in rates. As the comments from the public in the record highlight, energy costs are imposing increasingly severe hardships on customers. While PSE is entitled to the opportunity to earn a reasonable rate of return and recover prudently incurred costs, the three proposals mentioned above go beyond this. This case provides the Commission an opportunity to protect consumers from the unnecessary rate increases that would result from adoption of these unbalanced new proposals.
3. During the course of the case, Public Counsel and other parties have also had productive discussions that have led to resolution on several issues. All parties have reached agreement with PSE on electric rate spread and rate design. Public Counsel, Commission Staff and other intervenors reached multi-party settlements on gas rate spread and design, PCA, and power costs. The brief addresses these agreements as well.

4. Another important area of agreement between Public Counsel, PSE, Commission Staff, and NWEAC is that the Commission should approve an incentive mechanism for PSE's electric energy efficiency programs. While the parties propose different designs for the mechanism, all agree that adoption of such a mechanism is in the public interest.

II. PUBLIC COMMENT

A. The Renton Public Hearing.

5. A public hearing was held in Renton on June 29, 2006. Eight witnesses addressed the Commission at the Renton hearing, six against the proposed rate increases and two for the cause of renewable energy. Attendees included senior citizens, environmental organizations, and homeowner association representatives. Diana Chan of Lynnwood testified:

As a senior member of society and on a very limited income, fixed income, by the way, any increase raises a financial difficulty in the area of health, safety, medical expenses and plain survival. Living on a fixed income of SSI and a small disability, I'm also required to participate in care and expenses of my husband...who suffered a stroke two years ago, as well as pay for my own medical expenses, food for survival, and pay for all the utilities and expenses on a house...Do we need to decide between, one, disconnect the gas furnace; two, medical needs; three, food and survival; four care of a loved one in an adult home? ¹

6. John Ruegsegger testified for the Lake Meridian Ridge condominium complex in Kent:

...[T]he rate increases have been rather steady. PSE wants another increase in funds from their customers, who are put in the position of being the unlimited resource every time PSE wants more, and the reasons are endless. In October '04, PSE increased the low-income assistance program, and I do not have things against assisting people who cannot afford that, so I would not object so much to that. But in March '05, they had another rate increase. In April '05, there was another increase. In November '05, there was another increase. And in April '06, another increase took effect... [a]fter those increases, you're asking for a 17 percent increase in the electrical customer charge, a 32 percent increase in the gas customer charge, and an increase to the rate of return on equity, add a surcharge tracker for depreciation, add a decoupling mechanism to

¹ Tr. 52:22-53:2, Tr. 53:10-12.

make natural gas revenue separate from gas sales and again expand the low-income assistance program. And all this PSE says will increase residential electric rates by less than 12 percent a month. That's every month for those of us who have to pay...Please consider that we ratepayers do not have an endless supply of money. We're going broke...We don't get all these increases in our salaries. Sometimes, for years at a time, we don't get increases. We simply cannot afford this upward spiral for more and more and more. ²

B. Written Public Comments.

7. Exhibit No. 1 consists of letters, e-mails, and other written materials submitted by the public to the Commission and to Public Counsel to provide comment on this case. The exhibit includes a total of 341 written comments, of these 327 oppose and/or express serious concern over the requested rate increase; the remaining 14 neither oppose nor support the request. M.

Lynn Kole of Bellingham wrote, opposing the increase:

I have never written a comment before, but it just seems like every time they ask for an increase they get it. I think this rate increase is too large. I'm a single person making minimum wage and everything just keeps going up. My property taxes, natural gas, and now electric. I would like to stay in my home. I have lived here for 30 years and raised my kids in this house, but I just wonder how long I can stay here. I don't have medical insurance and I try to live as cheaply as I can, but I oppose this big of an increase in the electric rates. ³

8. Mr. Geoffrey Harris also expressed concern about possible economic hardships for ratepayers, writing, "Regardless of what is printed in the national media about an expanding economy, most of us are really living from paycheck to paycheck with no relief in sight."⁴

Edward and Gail Debraie of Kent, who are on social security wrote, "My husband calculated the impact of this proposed rate increase on this years Social Security increase. It was \$188.58. This is three months of our combined SS increase this year."⁵

² Tr. 49:2-25, 50:15-21.

³ Exh. No. 1, p. 275.

⁴ Exh. No. 1, p. 181.

⁵ Exh. No. 1, p. 173.

9. Thomas and Brenda Fischer expressed uncertainty regarding customer charges and billing, writing in an email, “Just what exactly is the “customer charge” for? It seems to us that their bills are fraught with charges that no one seems to understand.”⁶

10. Ms. Susan Hirz of University Place wrote:

I am opposed to the fact that a significant portion of the increase for residential natural gas customers would be in the form of a 32% increase in the monthly customer charge instead of an increase tied primarily to gas consumption. I am also suspicious of the proposed “decoupling” mechanism...I think a much fairer proposal would be to introduce a tiered rate structure in which customers who consumed more than a certain amount each month would pay a higher price per therm...In January of this year I spent over \$1300 to add insulation to my home through a Puget Sound Energy pilot program and at the recommendation of a PSE-affiliated insulation contractor. Over the first four months since the installation, I saved a total of 18.5 therms compared to the same period one year ago (with usage habits unchanged from a year ago). This corresponds to a savings of \$20.89 (an average \$5.22/month) at current natural gas rates. Clearly it is unlikely I will ever recoup my financial investment. It adds insult to injury that PSE now wants to increase the fixed monthly customer charge and further decouple their revenue from sales volume...I would like to see any current and future customer rate increases linked entirely to level of energy consumption.⁷

III. DECOUPLING

A. Overview.

11. In this case, as in other settings where it is proposed, the decoupling cause is clothed in the banner of conservation. At first blush, this seems a compelling argument. The goal of energy efficiency is a worthy one, supported and indeed advanced by industry, consumer

⁶ Exh. No. 1, p. 356.

⁷ Exh. No. 1, pp. 91-92.

12. advocates, customers, environmentalists, and regulators. It seems self-evident that implementing energy efficiency is detrimental to a utility company's financial picture. The identified problem and the proposed solution seem logical. So why should this Commission not hasten to adopt this attractive "fix" to an apparent problem? The purpose of Public Counsel's evidence and briefing in this case is to suggest that, however attractive on the surface, the decoupling proposals in this case should be examined carefully. When they are, we believe the Commission will find that decoupling is not the answer to concerns regarding utilities motivation to pursue energy efficiency. In its evaluation of the decoupling proposals in this case, the Commission should seek answers to at least the following serious questions:

- What is the actual amount of margin lost due to PSE's own energy efficiency efforts and the significance of the financial impact on the company?
- What proportion of declining customer use is attributable to company conservation efforts, as compared to other causes not related to company actions?
- What rate and revenue burden will fall on consumers and is it properly proportioned to the "lost margin" from PSE-sponsored conservation programs?
- What is PSE's track record on energy efficiency?
- Are there reasons why PSE has pursued energy efficiency without a decoupling mechanism and can it be expected to do so in the future?
- What specific additional energy efficiency programs will PSE customers see if decoupling is adopted?
- Are customers compensated for their increased risk and the reduction of risk to shareholders?
- Are there alternatives to decoupling?

13. PSE, Staff, and NWECA do not devote much time, if any, to an objective examination of these questions. They simply accept the premise that decoupling makes sense, and devote their efforts to designing their preferred mechanism. The purpose of this brief is to help the Commission find the answers to the above questions in the record of this case and to get behind the rhetorical claims to evaluate the real impact and effectiveness of decoupling for PSE's customers. Public Counsel believes that when that analysis is done, the decoupling proposals will be seen as a flawed, unnecessary, overbroad, and expensive experiment that will hurt ratepayers and make little or no contribution to conservation. Public Counsel also believes that if the Commission wishes to provide financial incentives to PSE to pursue natural gas conservation that a simpler, more affordable, and better targeted mechanism is readily at hand.

B. PSE's Decoupling Proposal is Primarily Designed to Guarantee Revenue Levels and Shift Risk, Not Provide an Incentive for Conservation.

1. Decoupling is advertised as a mechanism to encourage energy efficiency.

14. One of the consistent claims of decoupling advocates is that decoupling is critical to ensure that regulated utilities can pursue the goal of energy efficiency. This case is no different. PSE witness Ron Amen testified that current ratemaking "creates a *significant* financial disincentive for it to aggressively promote energy efficiency for its customers."⁸ Mr. Amen asserts that PSE's decoupling proposal, the Gas Revenue Normalization Adjustment (GRNA) "will enable PSE to solve the dilemma it faces as it promotes energy efficiency programs for its customers, that is, for every therm saved due to energy conservation, PSE fails to recover another unit of its authorized distribution margin."⁹

⁸ Exh. No. 21, p. 28:2-3 (Amen) (emphasis added).

⁹ *Id.*, p. 26:16-19.

15. NWEC’s support for decoupling makes the same assertions.¹⁰ Commission Staff echoes this point. In her direct testimony, Staff witness Joelle Steward offers a common formulation of the decoupling argument:

One of the primary goals for a decoupling mechanism is to remove a utility’s disincentive to promote energy efficiency. Under current rate structures, revenues are largely generated through volumetric charges; therefore, reducing energy use may result in lower profits for the utility, and may compromise the ability of the utility to recover its fixed costs. A decoupling mechanism, which restores to the utility the margins “lost” due to customer efficiency, would then allow the utility to pursue energy efficiency without losing profits and make it more likely that it would recover its fixed costs.¹¹

While Staff supports a different mechanism than PSE’s GRNA, Ms. Steward recommends that her “partial decoupling” mechanism be adopted as a three-year pilot, because it “will remove PSE’s disincentive to promote energy conservation by restoring lost margin due to customers’ non-weather related changes in usage.”¹²

2. Many factors other than PSE energy efficiency programs cause declining use.

16. PSE-sponsored energy efficiency programs are only one factor causing declining use of gas on a per-customer basis. Many other factors also play a major role. Many have more effect than Company-sponsored efficiency. As discussed in more detail later in the brief, the non-company factors, in the aggregate, have a much larger impact than company actions.

17. The table below outlines individually significant drivers of gas sales volume changes and indicates whether changes in gas usage caused by that variable would be subject to rate recovery through the decoupling tariff proposal of each of the party.

¹⁰ Exh. No. 502, p.5:10-21 (Weiss).

¹¹ Exh. No. p. 561, 5:20–6:6 (Steward).

¹² Exh. No. p. 561, 8:5-6. (Steward).

Table 1: Rate Recovery of Sales Volume Drivers

SALES VOLUME DRIVER	GENERAL ONGOING SALES VOLUME IMPACT	PSE Decoupling Proposal	NWEC Decoupling Proposal	Staff Decoupling Proposal
Number of Customers	Increasing	No	No	No
Weather Abnormality	Variable	Yes	Yes	No
Price Elasticity	Decreasing	Yes	Yes	Yes
Replacement of Inefficient Old Appliances / Furnaces	Decreasing	Yes	Yes	Yes
Construction of Buildings – Improved Building Codes	Decreasing	Yes	Yes	Yes
Customer Financed Conservation Investments	Decreasing	Yes	Yes	Yes
Utility Sponsored Conservation Investments	Decreasing	Yes	Yes	Yes

Source: Exh. No. 509, p. 5:9 (Brosch).

18. As the table indicates, PSE’s GRNA proposal and the NWEC proposal both allow rate recovery for all listed factors causing variability (weather) or decline in revenues. Staff’s proposal excludes recovery for weather-related variability, but otherwise allows recovery for all factors causing decline.

19. Most of the drivers of declining use per customer are beyond the control of the Company management and not influenced by ratemaking procedures or incentives. There will be price elasticity effects whenever higher prices, for any reason, cause customers to reduce use. Appliance manufacturers must comply with federal efficiency standards designed to produce energy savings. Improved building codes for new homes, and remodeling for existing homes

under those codes, are intended to reduce use and likely will do so. All of these trends are translated by decoupling into rate increases for customers. Even when ratepayers use their own money to conserve energy, with decoupling in place their efforts are “rewarded” by energy price increases to insulate the utility from sales losses.

20. The American Gas Association reports provided by PSE in response to Staff discovery, put the claims of declining use per customer in context.¹³ The primary causes of declining use cited by the study include housing characteristics, demographics, appliance efficiency gains, and reduced appliance saturation.¹⁴ Other factors identified but not quantified due to lack of data included water conservation, economic influences, environmental regulations, the popularity of gas hearth products, and the rise in seasonal homes.¹⁵ Interestingly, Company-sponsored conservation was not identified as a separate contributing factor.

21. The studies indicate that gas use by residential customers has been declining for decades, since at least 1980.¹⁶ The existence of a historic and long term decline in use is relevant for several reasons. First, its beginning predates much of today’s company sponsored energy efficiency efforts confirming that many other factors are at work. Second, the fact that companies have continued to sponsor energy efficiency in an era of declining use casts doubt both on the amount of negative financial impact caused by company sponsored programs and on the alleged disincentive to invest in such programs. Third, evidence of long term decline shows that traditional ratemaking can adequately address company financial needs even in the face of declining use per customer. Fourth, the projections that this trend will continue mean that

¹³ Exh. No. 56, pp. 3-19, Patterns of Residential Natural Gas Consumption, 1997-2001, and pp. 20-25, Forecasted Patterns in Residential Gas Consumption, 2001-2020.

¹⁴ *Id.*, p. 4, Chart 2.

¹⁵ *Id.*, p.15.

¹⁶ *Id.*, pp. 3, 20.

assertions of the neutrality of decoupling mechanism are hollow. As a practical matter, ratepayers can expect to continue to pay more as use declines over time as compared with some past baseline level.

22. To sum up, one of the most blatant flaws of decoupling is its overbreadth.. While PSE and other proponents repeat the mantra that decoupling will enable PSE to solve the dilemma “that, for every therm saved due to energy conservation, PSE fails to recover another unit of its authorized distribution margin.”¹⁷ Decoupling goes far beyond that. This is not just a conceptual problem. It has serious financial consequences for customers, as discussed later in the brief.

3. The focus on declining use per customer is misleading; total sales volumes are stable.

23. All three decoupling proposals in this case single out the declining trend of usage per customer. At the same time, PSE and other proponents ignore the total sales of the Company. It is undisputed that there is a trend of declining use on a per-customer basis, but despite that trend, PSE’s 2004 Annual Report shows that overall sales volumes have been relatively stable in recent years, despite warmer than normal weather in each of the last three years. In fact, volumes for 2005 are higher than the two preceding years.¹⁸ These facts seriously undermine Mr. Amen’s assertion that unpredictability of gas usage and the impact of weather on financial condition justify adoption of decoupling.¹⁹

24. The reality is that PSE gas margin revenues are growing as a result of adding customers and raising rates through rate proceedings. PSE’s Gas Commission Basis Reports show that gas margin revenues from sales to customers (less purchased energy costs) have grown from \$230

¹⁷ Exh. No. 21, p. 26:16-19.

¹⁸ Exh. No. 506, p.34 (Brosch).

¹⁹ Exh. No. 21, p. 26:7-21 (Amen).

million in 1997 to about \$336 million in 2005, an increase of more than \$100 million.²⁰ This shows that a major reason for stability of sales volumes is revenues provided by new customers.

PSE has strong customer growth. PSE's 2004 annual report boasts:

Puget Sound Energy hooked up approximately 27,000 new [natural gas] customers in 2004, exceeding the national average for growth in natural gas customers. This continued progress is a tribute to PSE's dedicated employees who work hard to deliver reliable, cost-effective, high-quality service."²¹

Company Senior Vice President Kimberly Harris testified at hearing that she hopes the trend of adding new customers will continue.²² Similarly, PSE witness Ms. McLain testified at hearing that most utilities view growth in customers and growth in revenues as positive.²³ The Company certainly does not treat the addition of new customers as an undesirable or financially detrimental factor.

25. PSE's GRNA proposal does not track the favorable effects of sales growth from new customers for the benefit of ratepayers. Instead, the GRNA retains these benefits for shareholders. This is accomplished by adding to its existing revenues (Base Line Margin) all of the revenues associated with new customer growth (Customer Growth Adjustment). PSE thus adds more margin to the amounts against which actual margin is tracked.²⁴ This has the effect of amplifying future revenue growth by increasing delivery prices for conservation effects on per customer sales, while letting PSE retain all revenue growth associated with adding new customers.²⁵ Back-casting the effects of the GRNA to 2001 shows that it would have generated

²⁰ Exh. No. 506, p.35:1-3 (Brosch).

²¹ 2004 Annual Report to Shareholders, p.15. This annual report was included as part of PSE's initial rate case filing in this docket.

²² Harris, Tr. 150:19-24.

²³ McLain, Tr. 204:12-19.

²⁴ Exh. No. 506(C), p.35:17-20 (Brosch).

²⁵ Exh. No. 506, p.36:7-12, footnote 19 (Brosch).

approximately \$30 million dollars over the five year period, and nearly \$10 million in 2004 and 2005 alone.²⁶

26. As Public Counsel witness Brosch testified on cross-examination:

[I]t's problematic to select usage per customer where there is an obvious declining trend and provide piecemeal ratemaking and interim rate increases between test years while ignoring and presuming unimportant the continuing revenue growth arising from serving new customers and the margins earned from serving new customers.²⁷

C. Decoupling Is An Expensive Blunt Instrument.

1. PSE actual losses through its gas conservation efforts are small.

27. As noted above, the proponents cite as justification for decoupling the revenues that PSE foregoes when it encourages its customers to conserve natural gas. Ms. Steward's testimony refers to the "margins lost due to customer efficiency."²⁸ During colloquy with Chairman Sidran, Mr. Weiss of NWECA stated "...to assume that a utility can constantly support a program that loses it money is – I think is not credible really."²⁹ Given these assertions, one would expect the amount of lost revenues to be large enough to be, in PSE witness Amens' words, a "significant financial disincentive."³⁰ Public Counsel witness Michael Brosch points out, however, that PSE sponsored programs appear to only produce a modest impact on gas sales volumes and margin revenues.³¹ PSE has set a gas energy efficiency stretch goal of 2.1 million therms for each of the years 2006 and 2007 (for a total goal of 4.2 million therms over two years). This represents only about 0.2 percent of PSE's annual sales of over 1 billion therms.³² *Id.*

²⁶ Exh. No. 506, p.37:1 (Table)

²⁷ Brosch, Tr. 661:10-17.

²⁸ Exh. No. 561, 6:4 (Steward).

²⁹ Weiss, Tr. 696:12-14.

³⁰ Exh. No. 21, p. 28: 2 (Amen).

³¹ Exh. No. 506C, p. 42:11 (Brosch).

³² If sales to transportation customers are removed from this calculation, as NWECA witness Mr. Weiss recommends in his cross-answering testimony (Exh. No. 504, p. 7), the proportion increases from .2 to .26 percent. The

28. In dollar terms, if PSE achieves the 2.1 million therms “stretch goal” mentioned above, the Company’s lost margins are estimated at \$1.035 million for the two year period 2006-2007, or only \$517,789 on an annual basis.³³ Even this estimate may be overstated, because it is based upon PSE achieving their “stretch target.”³⁴ At hearing, while PSE witness Mr. Shirley indicated “the 2.1 million therms we have currently as our target was significantly vetted through our own analytical process, and in negotiations with the CRAG,”³⁵ he also stated: “[w]hen we typically set a stretch target, the stretch target usually means that there’s probably as much as an 80% chance of us not meeting that target.”³⁶ To the extent PSE does not reach their stretch target, the actual amount of lost margins would be lower.³⁷

29. PSE’s estimated lost margin amount of approximately \$517,789 annually represents about .07 percent of PSE’s total gas operating revenues from residential, commercial, and industrial sales of \$743.6 million.³⁸ When compared to the Company’s actual gas operating revenues during the test year of \$879,440,289, PSE’s lost margins represent only about .059%.³⁹

2. Decoupling generates revenues that far exceed the size of the problem.

When PSE’s total estimated lost margins from the Company’s gas energy efficiency programs are compared to the total amount the Company would collect from ratepayers under the various decoupling proposals before the Commission, it is abundantly clear that these decoupling mechanisms would require ratepayers to provide PSE with additional revenues that

Company’s 2004 Annual Report to Shareholders shows retail sales volumes (non-transportation) of 808,558,000 therms in 2004. $2.1M / 808.6M = .26\%$. (p. 37).

³³ Exh. No. 571, p. 3.

³⁴ Steward, Tr. 727:7-9, also Commission Staff witness Ms. Steward also points out that the estimated lost margins may be higher, because her calculations used current rates. Tr. 727:1-6.

³⁵ Shirley, Tr. 592:24-593.2.

³⁶ Shirley, Tr. 593:9-12.

³⁷ Steward, Tr. 727:10-12.

³⁸ 2004 Annual Report, p. 49 (included in PSE initial rate case filing).

³⁹ Exh. No. 230, p. 2:5 shows actual gas operating revenues of \$879,440,289. $\$517,789 / \$879,440,289 = .059\%$.

far exceed the amount of lost margins. PSE’s GRNA might collect from 36 to almost 50 times as much as the Company’s annual lost margins of \$517,789, based upon the Company’s simulation using proposed rates, as shown in the table below. Even if one considers only the cumulative estimated lost margins of \$1,035,578 for the two-year period 2006-2007, PSE might collect 18 times that amount in 2007 under the GRNA, according to PSE’s simulation.

Table 2: Summary of PSE’s GRNA Simulation Under PSE’s Proposed Rates

	2007	2008	2009
Residential	\$15,795,430	\$21,236,125	\$17,323,918
C&I General (Sch 31)	\$2,487,378	\$3,512,280	\$2,174,307
C&I Heating (Sch. 36)	\$547,445	\$853,941	\$501,859
Total	\$18,830,253	\$25,602,346	\$20,000,084

Source: Exhibit 563. The original source of this data is also shown in Exhibit 59C (PSE response to Staff data request 173). Revenue from apartment building customers, included in Exhibit 59C, is not shown here.

30. Perhaps the most appropriate term to characterize the additional revenues PSE would realize as a result of the GRNA decoupling mechanism is “windfall,” as Mr. Weiss of the Energy Coalition admitted at the hearing.⁴⁰

A. [Mr. Weiss]: The existing customers, our proposal and the Company’s proposal would allow for somewhat of a windfall, they would recover for that group, and that’s one of the reasons why we have tied our conservation targets to the recovery of those margins, because otherwise there would be somewhat of a windfall from the existing customer downward trend.

Q. [Mr. ffitich]: You use the word windfall, it is possible, is it not, that if you don’t design a decoupling proposal correctly, you can create a windfall for a utility Company?

A. Yes.⁴¹

⁴⁰ Weiss, Tr. 683:13-14.

⁴¹ Weiss, Tr. 683:12-23.

31. But while NWEAC recommends conservation targets as part of their proposed decoupling mechanism, their proposal would still provide PSE with substantial additional revenues outside of a rate case, revenues that far exceed the Company's lost margins from energy efficiency programs. For example, under NWEAC's decoupling proposal, if PSE achieves its 2.1 million therms conservation target for 2007, the Company would recover 50% of their approved margin.⁴² PSE's simulation of the GRNA, shown in the table above, estimates \$18.8 million of additional revenues for 2007, so under the NWEAC proposal this would result in about \$9.4 million in increased rates.

32. Proponents of decoupling may argue that PSE's GRNA simulation is based on warmer than normal weather, which contributes to higher revenue shortfall. However, even if we consider Staff's proposed "partial decoupling," which would attempt to remove the change in usage due to variations from 'normal weather,' residential ratepayers would still be exposed to an additional \$8 million per year, as shown in the table below.

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⁴² Exh. No. 502, p, 11: 8.
OPENING BRIEF OF PUBLIC COUNSEL
DOCKET NO. UE-060266/UG-060267

Table. 3: Summary of Potential Residential Rate Increases Under Staff’s ‘Partial Decoupling’ Mechanism

	2007	2008	2009
Residential	\$7,730,125	\$8,084,258	\$8,329,527

Source: Exh. No. 565 (JRS-5). This exhibit is a simulation with an assumption of a 5% decrease in new customer usage. Staff’s recommendation is that actual usage of new customers be used in their partial decoupling mechanism. Tr. 723:4-24.

3. PSE lost margins due to Company sponsored conservation are even more minimal when seen in context.

33. In an attempt to depict the scope of the problem that PSE witness Mr. Amen refers to as the “significant financial disincentive,” we have prepared the following table comparing PSE’s estimated lost margins from the Company’s natural gas energy efficiency programs to various expenses and potential rate increases from the different decoupling proposals in this case.⁴³

Table. 4: Comparison of PSE’s Estimated Lost Margins from Natural Gas Energy Efficiency Programs to Various Expenses and Potential Rate Increases from Decoupling

Description	Amount	Source
Annual estimated lost margins from natural gas energy efficiency programs (2006 – 2007)	\$517,789	Exh. No. 571, p.3
Total amount billed as of Sept 14, 2006 for PSE’s 4 outside expert witnesses	\$673,805	Rev. Exh. No. 448
Total estimated billings for PSE’s 4 outside experts in this docket	\$787,500	Rev. Exh. No. 448
Restricted stock awards to Stephen Reynolds, CEO, in 2005 (vesting date of 2008, designed to be fully tax deductible).	\$882,381	Exh. No. 177, p. 10; Exh. No. 6
Total (cumulative) estimated lost margins, 2006-2007, if PSE achieves ‘stretch’ conservation target	\$1,035,578	Exh. No. 571, p.3
Total value of 2005 compensation to Stephen Reynolds, including grants of restricted stock and performance-based awards	\$3,014,274	Exh. No. 177, p. 10.
Total value 2005 compensation to top 5 PSE officers, including grants of restricted stock and performance-based awards	\$5,184,018	Exh. No. 177, p. 10.

⁴³ Exh. No. 21, p. 28:2.

Total estimated increase to <i>residential</i> ratepayers in 2007 under Staff’s proposed “partial decoupling” mechanism (PSE simulation, without weather, 5% decrease in new customer usage assumed).	\$7,730,125	Exh. No. 565 (Steward)
Total estimated increase to residential, commercial, and certain industrial ratepayers in 2007 under PSE’s proposed GRNA decoupling mechanism (PSE simulation under proposed rates; Sched. 23, 31, 36).	\$18,830,253	Exh. No. 563 (Steward) (summary of data in Exh. No. 59C)
Total estimated increase to <i>residential</i> ratepayers from Staff’s 3-year (2007-2009) “partial decoupling” pilot (PSE simulation, without weather, 5% decrease in new customer usage assumed).	\$24,143,910	Exh. No. 565 (Steward)
Total estimated increase to residential, commercial and certain industrial ratepayers first three years (2007-2009) under PSE’s proposed GRNA decoupling mechanism. (PSE simulation under proposed rates; Sched. 23, 31, 36).	\$64,432,683	Exh. No. 563 (Steward) (summary of data in Exh. No. 59C)
Total PSE gas operating revenues, 12 months ended September 30, 2005.	\$879,440,289	Exh. No. 230, p.2 (Karzmar)

D. Decoupling Is Not Necessary to Cause PSE to Pursue Energy Efficiency.

1. PSE has a long standing commitment to energy efficiency rather than a culture of hostility.

34. One of the arguments advanced by NVEC in favor of decoupling is that it is critical to changing a utility company’s corporate culture from opposition or reluctance to support for company-sponsored conservation. As NVEC witness Steve. Weiss puts it “[a] decoupling mechanism is essential to establishing a corporate culture that promotes aggressive cost-effective conservation investments.”⁴⁴ According to Mr. Weiss, absent decoupling, companies can be expected to oppose or disfavor direct utility investment in energy efficiency, to discourage customer sponsored conservation, and to oppose adoption of policies such as efficient appliance standards or building codes:⁴⁵

⁴⁴ Exh. No. 502, p. 5:18-20 (Weiss).

⁴⁵ Exh. No. 502, p.3:21-4:2 (Weiss).

35. The problem is that there is no connection between this hypothetical recalcitrant utility behavior and most of companies regulated by this Commission. Particularly in PSE’s case, when actual conservation performance is examined, it simply doesn’t fit with NWECA’s premise. PSE has elevated responsibility for energy efficiency to the senior vice president level and both Kimberly Harris, Senior Vice President for Regulatory Affairs and Energy Efficiency and Cal Shirley, Vice President of Energy Efficiency Services testified in this case. Ms. Harris agreed that PSE has a strong and long-standing commitment to energy efficiency initiatives. As she put it, “[PSE’s] conservation programs span decades, we have been a leader in conservation for decades.”⁴⁶ She acknowledged that PSE improved its conservation programs in the 2001 rate case settlement,⁴⁷ and observed that that they have a “very active and enhanced program.”⁴⁸ The record contains a detailed description of PSE’s energy efficiency programs.⁴⁹ PSE supports both direct and indirect utility investment in programs to reduce energy use.⁵⁰ Ms. Harris was unaware of any action by PSE during her tenure from 1999 to the present to discourage its customers from paying for measures to reduce their own energy use.⁵¹ Ms. Harris could not cite any instance since she became Senior Vice President in 2004 when PSE has opposed adoption of energy efficient building codes or appliance standards.⁵²

36. Mr. Shirley confirmed Ms. Harris’ testimony when he took the stand at hearing, agreeing that PSE has a strong long-term commitment to energy efficiency in both electric and gas

⁴⁶ Harris, Tr. 115:13-22.

⁴⁷ Harris, Tr. 116:2-11.

⁴⁸ Harris, Tr. 116:15-16.

⁴⁹ Exh. No. 399, p. 4.

⁵⁰ Harris, Tr. 117:2-8.

⁵¹ Harris, Tr. 117:9-13.

⁵² Harris, Tr. 118:18-21.

service.⁵³ He testified he was not aware of any active PSE opposition to energy efficient appliance standards, building codes, or to customer sponsored conservation during his tenure,⁵⁴ stating that on the contrary, PSE has typically “advocated” in support of such efforts. NWECA witness Weiss admitted he did not believe PSE had engaged in anti-conservation activities.⁵⁵

37. While Mr. Weiss, as noted, has made the “corporate culture” argument, he readily admits that PSE is performing well. In response to questions from Chairman Sidran, he acknowledged this, stating: “But I must admit that the Company is very good, and the day before decoupling and the day after decoupling they might not change that much.”⁵⁶ How well PSE is doing generally is further borne out by PSE’s response to Bench Request No. 9. The response indicates that PSE has achieved much more conservation, in total and on a per-customer basis, compared to Northwest Natural Gas’ performance in Oregon subsequent to that Company’s implementation of a decoupling mechanism.

2. PSE has existing legal and public service obligations to pursue energy efficiency.

38. An important fact that has not generally been highlighted by the proponents of decoupling in this proceeding is that PSE already has an existing legal obligation to pursue cost-effective energy efficiency. The Commission’s rule regarding integrated resource plans (IRP) requires gas utilities to file a plan every two years “describing the mix of natural gas supply and conservation designated to meet current and future needs at the lowest reasonable cost to the utility and its ratepayers.” WAC 480-90-238 (2)(a). Moreover, as part of the Conservation

⁵³ Shirley, Tr. 585:6-10.

⁵⁴ Shirley, Tr. 585:11-586:6.

⁵⁵ Weiss, Tr. 682:2-8

⁵⁶ Tr. 696:14-17.

Settlement in Puget Sound Energy's 2001 general rate case, the Company made the following commitment:⁵⁷

The programs funded through PSE's tariff rider and natural gas tracker will be designed to achieve all savings that are not independently captured by consumer acquisition, that are cost-effective to the Company, and economically feasible for consumers, taking into account incentives provided by PSE.⁵⁸

This commitment requires PSE to commit to pursue all cost-effective energy efficiency, as PSE witness Mr. Shirley confirmed at hearing.⁵⁹

39. In addition to these legal obligations, the Company has made it clear that they also offer conservation programs because customers expect them to do so as part of their public service obligation. For example, PSE's August 29, 2006 press release regarding its Purchased Gas Adjustment (PGA) rate increase encouraged customers to participate in energy efficiency programs. The press release states in part:

"While our geographic location and purchasing strategies help keep our customers' natural gas costs lower than elsewhere in the nation, we urge customers to follow some simple steps to help control heating bills this winter," said Darren Brady, PSE's senior vice president of Customer Services. "These include taking advantage of our energy-efficiency services and rebates to help customers save energy *and* money."⁶⁰

At hearing, Ms. Kimberly Harris, PSE's Senior Vice President for Energy Efficiency, agreed that the press release actively highlights and promotes the Company's energy efficiency programs.⁶¹ Offering these programs, and making customers aware of them, is something the Company

⁵⁷ *WUTC v. Puget Sound Energy*, Docket Nos. UE-011570 and UG-011571, Twelfth Supplemental Order (Approving and Adopting Settlement Stipulation), June 20, 2002, Exhibit F to Settlement Stipulation, (hereafter, "2002 Conservation Settlement").

⁵⁸ Exh. No. 373, p.1 (section C.3).

⁵⁹ Tr. 577:24-578:20.

⁶⁰ Exh. No. 178, p. 1. The press release also suggests PSE customers call a PSE Personal Energy Advisor, at 1-800-562-1482, and request the free brochure "How to Reduce Your Gas and Electric Costs, and directs customers to the utility's Web site (www.pse.com) for "a variety of useful energy-saving ideas." Exh. No. 178, p. 2.

⁶¹ Tr. 120:18 – 121:4.

should do as part of its public service obligation. Ms. Harris added at hearing, in discussing this press release, “We believe that it is a service to our customers to make sure they understand the opportunities and services we have available for them.”⁶²

40. As Public Counsel witness Mr. Brosch testified at hearing, providing energy efficiency programs is in the Company’s own interest:

I think that utilities have an interest in promoting the efficient use of their service. I think it’s necessary to do that to be competitive, I think it’s necessary to do that to satisfy the interests of the public and regulators in overseeing and regulating the Company’s business.⁶³

This attitude is further reflected in PSE’s own 2004 Annual Report to Shareholders, which includes a profile of Rick Yoder, PSE customer and owner of Wild Ginger Restaurant in Seattle. The profile includes the following quote from Mr. Yoder: “Unsolicited, Puget provided us with a free energy audit. That’s a long term view that may result in selling us less gas today, but keeping us as customers tomorrow.”⁶⁴

3. PSE is already stretching the limits of available natural gas energy efficiency.

41. As discussed earlier, the proponents of decoupling argue that decoupling will have a positive impact on PSE’s natural gas energy efficiency efforts. A consistent theme, however, heard from Company witnesses in this case is that PSE is essentially already stretching the limits of achievable energy efficiency in the natural gas market. This raises an important question: what purpose is served by putting ratepayers at risk for an additional \$8 - \$25 million per year from decoupling when there is no real expectation that more efficiencies can be gained based on PSE’s own characterization of the natural gas energy efficiency market.

⁶² Tr. 122:1-3.

⁶³ Tr. 666:16-21.

⁶⁴ 2004 Annual Report to Shareholders, p.7.

42. PSE's Vice President for Energy Efficiency, Mr. Shirley, testified at hearing that in his view, the natural gas energy efficiency market is not as mature or well developed as the electric energy efficiency market. He believes this is a nationwide phenomenon, not confined to Washington State.⁶⁵ During colloquy with Commissioner Jones, Mr. Shirley explained, "On the electric side we have been doing, like a lot of utilities, electric energy efficiency for nearly 30 years. We have about half that time doing gas."⁶⁶ As a result of that more limited experience on the natural gas side, Mr. Shirley explained, the trade ally network "is not nearly as practiced in terms of energy efficiency on the gas side as it is on the electric."⁶⁷ These fundamental structural differences between the electric and natural gas energy efficiency markets were also revealed in the energy service market's response to PSE's November, 2005 Request for Proposals (RFP) for demand-side or energy efficiency resources. In his rebuttal testimony, Mr. Shirley states the following:

In response to this RFP, the Company received five bids for natural gas efficiency. After an extensive evaluation process, none of these proposals showed enough potential to be selected. From the energy service market's response to the RFP, *it is apparent that there are no easy or obvious solutions to acquiring significantly more gas energy savings.*⁶⁸

In contrast to the small number of gas proposals, PSE received thirteen electric proposals and selected three energy efficiency proposals, and two demand response proposals.⁶⁹

43. PSE has also identified a range of barriers or challenges that help explain why the Company's gas conservation target for 2006-2007 is below the Least Cost Plan (LCP)

⁶⁵ Shirley, Tr. 625:4-20.

⁶⁶ Shirley, Tr. 622:3-6.

⁶⁷ Shirley, Tr. 621:25-622:3.

⁶⁸ Exh. No. 379, 26:7-11. (Shirley; emphasis added). PSE updated this to six proposals in Exh. No. 395.

⁶⁹ Exh. No. 395, p. 2.

guidance,⁷⁰ including a lack of qualified contractors.⁷¹ PSE has emphasized that these kinds of “practical challenges and uncertainties” associated with program implementation were considered when establishing the gas savings target, but were not reflected in the LCP, which helps explain why the gas conservation targets are lower than the LCP guidance.⁷² On the electric side, however, PSE’s 2006-2007 conservation target exceeds the guidance from the LCP.⁷³

E. Decoupling Violates Basic Principles of Balanced Ratemaking.

44. Decoupling, in any of the forms proposed in this case, is a piecemeal rate tracking device designed to change rate levels between cases for post-test year changes in gas usage per customer.⁷⁴ Public Counsel witness Michael Brosch discusses in his direct testimony why a discussion of traditional test year regulation, versus rate tracking and deferral accounting is relevant to this case.⁷⁵

45. A fundamental problem with decoupling as a tracking mechanism is that it can seriously distort the “matching principle” that is desirable in a rate case test year. The “matching principle” recognizes the importance of matching all revenues and costs (expenses, rate base, rate of return) at a consistent period of time to determine needed changes in utility pricing.⁷⁶ All elements of the revenue requirement calculation are dynamic. Cost increases in one area can be offset by cost decreases, or revenue increases in other areas, or vice versa. For example, adding

⁷⁰ Exh. No. 394, p. 2.

⁷¹ Exh. No. 396, p.2

⁷² *Id.*, See also, Exh. No. 379, pp. 26-27 (Shirley Rebuttal).

⁷³ Exh. No. 394, p. 2.

⁷⁴ Exh. No. 506, p.11:1-16 (Brosch).

⁷⁵ *Id.*

⁷⁶ *Id.*, p. 11:17 – p. 12:7.

customers and the related revenue growth can help offset any increase in operating expense.⁷⁷

The Commission has recently reaffirmed the application of this principle for ratemaking in Washington, *WUTC v. Avista Corporation*, Docket Nos. UE-050482, UG-050483, Order No. 05, ¶ 111.

46. Commission Staff witness Steward’s testimony confirms that the adoption of a decoupling mechanism can disturb the matching principle. She expresses a concern with allowing a decoupling mechanism to go on too long because “we risk violating the cost-based principle of regulation, creating a potential mismatch between current costs and rates.”⁷⁸ It is ratepayers that will bear the risk of the unfair rates that would result.

47. An additional significant problem raised by this issue is that it is potentially very difficult to correct. Unless PSE files a general rate case during or at the end of the pilot, the burden of proof would be on customers or the Commission to show that the violations of the matching principle were occurring. Rates could be distorted. Overearnings, even windfall profits, could occur for the entire period of the pilot, and continue in any renewal period. This could not be reviewed and corrected unless a complaint against general rates were brought by a party other than PSE.

F. Decoupling In This Case Violates the Guidelines of the Commission’s PacifiCorp Order.

48. In the most recent PacifiCorp general rate case order, the Commission set out a 12-point list of components to be addressed in a decoupling mechanism.⁷⁹ PSE’s proposal in this case either omits or fails to adequately address a number of these.

⁷⁷ Exh. No. 506, p. 12:8-17. Brosch , Tr. 674:7-11.

⁷⁸ Exh. No. 561, p. 20-22..

⁷⁹ *WUTC v PacifiCorp*, Docket No. UE-050684, Order No. 04, ¶¶ 108-109 (PacifiCorp Order).

1. Cost of capital.

49. The PacifiCorp order requires that a decoupling proposal address the “rate of return” implications of the proposal.⁸⁰ Because decoupling shifts significant risks from shareholders to ratepayers, adoption of any decoupling proposal should be reflected in a downward adjustment to the cost of capital. PSE’s recommendation in this case is to instead, increase its authorized return on equity, notwithstanding its request for approval, not only of decoupling but of two other risk shifting proposals (the depreciation tracker and the PCA modifications). This issue is discussed more generally in the Cost of Capital portion of the brief.

2. Incremental conservation measures.

50. In the PacifiCorp order the Commission rejected the joint electric decoupling proposal offered by PacifiCorp and the Natural Resources Defense Council (NRDC), in part because “The Company has failed to identify and commit to incremental conservation measures as a counterbalance to its potential reduction in risk.”⁸¹ In this case, PSE fails the same test. The Company has made no specific commitment to any additional measures or incremental energy efficiency programs that would be undertaken as part of their proposed decoupling mechanism. Indeed, PSE’s decoupling witness, Mr. Amen, stated at hearing that he did not even focus on PSE’s conservation efforts or the degree to which they would increase,⁸² though he went on to say that “it’s been my experience that the Company would do everything it possibly could; that is what is cost-effective[.]”⁸³ Mr. Amen failed to identify any specific incremental conservation

⁸⁰ *Id.*

⁸¹ PacifiCorp Order at ¶108.

⁸² Amen, Tr. 529:9-18.

⁸³ Tr. 530:13-16.

efforts in response to Commissioner Oshie's question.⁸⁴ PSE also opposes the inclusion of any conservation targets in the decoupling mechanism.⁸⁵

51. Despite the Commission's guidance in the PacifiCorp Order, Commission Staff has said that they do not expect a decoupling mechanism to result in incremental conservation benefits for PSE's customers. At hearing, Staff witness Ms. Steward indicated that "for this utility, I'm not looking for incremental conservation, because I think customers have already been getting that benefit."⁸⁶

52. Chairman Sidran asked Staff witness Ms. Steward at hearing about Staff's lack of any specific expectation that any incremental conservation measures would be undertaken as a result of decoupling:

Q. [Chairman Sidran]: All right, maybe just one follow up. If you can't identify any particular incremental conservation goal, why is the decoupling mechanism going to advance the conservation objective? I mean I understand the Company's problem that you have identified on the recovering its margin, but I don't quite understand the decoupling mechanism as a conservation tool in the context that you described.

A. [Ms. Steward]: Yeah, that was a dilemma actually when we started working on this for this utility, because I think they already have stepped up and made that commitment. I think customers have already benefited from that. But I didn't feel comfortable saying, well, since they've already done that, then we shouldn't do a decoupling mechanism, because they have been the ones incurring the lost margins from their programs, so it – I can't say that there will be incremental benefits, but it certainly, I think the same as with the incentives on the electric side, *it will hopefully not hold them back* since they have nothing to lose from the lost margins by within each program period of capturing all the cost effective conservation they can on the gas side.⁸⁷

⁸⁴ Tr. 528:4-531:12.

⁸⁵ Exh. No. 31, p. 3:19-20 (Amen).

⁸⁶ Tr. 747:25-748:2.

⁸⁷ Tr. 767:9-768:5 (emphasis added).

53. Staff's stated premise is that "[o]ne of the primary goals for a decoupling mechanism is to remove a utility's disincentive to promote energy efficiency."⁸⁸ If Staff also says they do not expect incremental conservation efforts from PSE as a result of decoupling, it is unfair to ask ratepayers to pay as much as an additional \$8 million to \$25 million per year under a decoupling mechanism. Again, decoupling appears to offer ratepayers the very real potential for significant rate increases outside of a rate case, and little, if anything in the way of incremental conservation benefits.

3. Low-income customer impact.

54. Another issue which the PacifiCorp order requires decoupling proponents to address is the impact on low income customers.⁸⁹ Commission Oshie pressed Mr. Amen on the point that as customers in a class conserve, the shortfall in fixed costs will be spread across everyone in the class. For those that cannot afford to make their homes or appliances more efficient, over time those customers will pay more and more of the overall cost to the class. Mr. Amen agreed with this assumption.⁹⁰ He also stated it is the responsibility of the provider of energy conservation programs to ensure low income customers have the ability to fund those conservation measures.⁹¹

Commissioner Oshie questioned Mr. Weiss on the same point and Mr. Weiss also agreed with the Commissioner's assumption:

A. [Mr. Weiss]: I would agree with Mr. Amen's conclusion, it does do what you say, there's no doubt about it, but there's a few things that mitigate. One is that one thing you do is you ramp up your low income programs, both assistance and weatherization, so even the customers who can't do much conservation. But everybody can put in an efficient light bulb I mean. But you've got to ramp up programs, so that is true. The

⁸⁸ Exh. No. 561, 5:20-21.

⁸⁹ PacifiCorp Order, ¶ 109.

⁹⁰ Amen, Tr. 533:24-534:23.

⁹¹ Amen, Tr. 534:15-20.

second fact is that if the savings from this are reflected in a lower rate of return, it lowers everybody's bills. I think the numbers are going to show that the lowering in bills is almost comparable to, except for a very warm year where you have a big, big surcharge, the lowering of the bill through rate of return reduction pretty much balances out that effect. So you offer a lot of – you offer everybody a program, you fund it very well, but there is some risk, yes, I agree.”⁹²

Notably, Mr. Weiss' premise here is that impact on low-income customers can only be mitigated if gas energy efficiency programs (presumably something other than light bulbs) are ramped up and if rate of return reductions are so sizeable as to offset rate increases. These points might be made for all ratepayers. Neither of these conditions is present in this case.

G. Decoupling Introduces Unnecessary Technical Complexity and Burdens to Regulation.

1. There are wide disparities among proponents about how best to implement decoupling.

55. One indication of the problems with decoupling is the veritable cacophony of voices, even among supporters, about how it should work. While all proponents contend there is at least some relationship between decoupling and conservation, they don't agree on how much. The proponents disagree about many components, including: whether weather should be included in the mechanism; what is the correct weather normalization methodology (see below); how to account for new customers (see below); whether there should be conservation targets; whether receipt of decoupling revenue should be linked to performance against those targets; and, about whether decoupling alone is enough to motivate pursuit of energy efficiency.

56. Cal Shirley, in his rebuttal testimony in this case, recalled this Commission's guidance with respect to the establishment of new regulatory mechanisms in Docket No. UE-900385.⁹³ There the Commission identified four general principles such programs: it must be measurable; it

⁹² Tr. 714:12-715:3.

⁹³ Exh. No. 379, p. 6:15-19, (Shirley).

must be simple to administer; it must be intuitive enough to allow a straightforward explanation to customers; and, it must be an improvement, on balance, over the current method of regulation. The decoupling proposals in this case fall short of these principles.

2. Weather normalization.

57. All three decoupling mechanisms would require a weather normalization methodology, as part of the calculations that would be performed to annually set customer rates. This represents another example of the technical complexities involved in the proposed decoupling mechanisms. Staff's 'partial decoupling,' which excludes weather from the mechanism, requires calculations to estimate the changes in usage resulting from variations from 'normal weather,' however that is ultimately defined as part of this proceeding.⁹⁴ As Public Counsel witness Mr. Brosch stated in his direct testimony, "Puget's GRNA proposal would adjust rates to eliminate gas usage and revenue fluctuations due to weather or conservation effects, effectively guaranteeing collection by the utility of the gas margin revenue per customer that was used to set rates. At the same time, PSE would be allowed to collect and retain for its shareholders (not track through rates) steadily increasing margin revenues associated with adding new customers."⁹⁵

58. PSE's gas margin revenue per customer used to set rates is established using weather-normalized gas volumes, as determined in the rate case.⁹⁶ Based upon the fact that PSE estimates it will spend a total of \$380,000 on its weather normalization witness, Dr. Dubin, it would appear that the Company is extremely concerned with the particular assumptions and mechanics

⁹⁴ Tr. 728:14-19. Exh. No. 570.

⁹⁵ Exh. No. 506C, p. 32:12-17.

⁹⁶ *See, e.g.* Exh. No. 552, pp. 3-5 (Mariam).

embedded in the weather normalization methodology that may ultimately be adopted in this case.⁹⁷ Weather normalization was a contentious issue in this case, and was the focus of an ongoing collaborative between the Company and Commission Staff.⁹⁸ Commission Staff witness Dr. Mariam stated in his direct testimony that PSE failed to perform a load research study to justify its proposed change in base or balance point temperature.⁹⁹ Dr. Mariam recommends Commission acceptance of PSE’s weather normalization methodology, but for purposes of this case only.¹⁰⁰ Dr. Mariam has recommended the Commission order PSE to take several steps to overcome the deficiencies with the Company’s methodology.¹⁰¹ Customer rates would be adjusted each year that a decoupling mechanism is in place, presumably using the weather normalization methodology accepted by the Commission for this case, a mechanism still in dispute.¹⁰²

3. New customers.

59. PSE, Staff, and NWEAC contend that in order to make an “apples-to-apples” comparison, revenues from new customers must be taken into account. As discussed in Section B.3 above, all three of their proposed mechanisms would add the revenue from new customers to the “baseline” margin the Company would be allowed to recover each year. At that point the proposals diverge. PSE and Staff recommend competing methodologies for calculating new customer impact. NWEAC proposes either postponing resolution of this issue to a collaborative where issues such as the impact of line extension policy would be considered, or simply leaving out new customers

⁹⁷ (Rev. Ex. No. 448).

⁹⁸ Tr. 449:1-13.

⁹⁹ Exh. No. 552, pp. 7:7-24.

¹⁰⁰ *Id.*, p. 6:10-12.

¹⁰¹ *Id.*, p. 8:22-9:5.

¹⁰² Exh. No. 570.

altogether because the issue is “so contentious.”¹⁰³ Regardless of the outcome of the debate, the end result is the same. The shareholders still receive the benefit of new customer revenue, however calculated, under any of the proposals.

4. Regulatory burden.

60. An additional drawback to adoption of a decoupling mechanism is the additional burden created on the Commission, its Staff, and consumer intervenors. New tariff filings are required, along with new audit procedures, and with discovery and dispute resolution procedures if disputes arise. Additional customer notice is required. Public Counsel disagrees with the sanguine predictions of other parties to this case about limited burden. Decoupling would add to the PGA, the PCA, and the PCORC, yet another fast-track filing and review process that allows constrained opportunities for either Staff, Public Counsel, or other intervenors to analyze, pursue discovery, or raise questions about the request before it goes into effect and changes rates. The ability of the ratepayers and their representatives to protect customers from unjustified charges in this kind of environment is compromised, when compared with the level of review in a rate case.

H. Decoupling Is Not a National Trend.

61. PSE also attempts to create the sense that decoupling is part of a national wave that this Commission should catch. Ms. Harris stated in her pre-filed testimony that decoupling is “widely accepted,”¹⁰⁴ though she was unable to say on cross-examination how many states have accepted and adopted this approach, deferring to PSE witness Amen.¹⁰⁵ Mr. Amen confirmed

¹⁰³ Weiss, Tr. 687:21-689:19.

¹⁰⁴ Exh. No. 173, p.12:4-5 (Harris).

¹⁰⁵ Tr. 122:8-124:5 (Harris).

that assertions of wide acceptance are simply not accurate. As of the time of the hearing, according to Mr. Amen, only five states in the country have adopted decoupling mechanisms for companies they regulate.¹⁰⁶

62. Decoupling is not a new idea. As Ms. Harris noted, the Commission approved a form of decoupling for PSE 16 years ago known as the PRAM (Periodic Rate Adjustment Mechanism). The PRAM was discontinued by agreement a few years later in 1995. In approving the termination the Commission noted a number of failings with the PRAM and observed that the PRAM had become “complex to administer, controversial, and difficult to explain to customers.”¹⁰⁷

63. Decoupling may be an idea whose time has passed, dating to an era when environmental issues, energy efficiency and renewables were finding difficulty gaining mainstream acceptance by utilities, policy makers and even consumers. Things have changed dramatically in the last quarter century, particularly in the Pacific Northwest. Virtually all of the major utilities in the region have active energy efficiency programs, public commitments to conservation goals, and real achievements in the field. Least cost planning (aka integrated resource planning) is taken seriously and is given substantial resources by the companies. There is broad consensus in support of energy efficiency. As discussed above, PSE has been a part of this trend. The fact that these developments have occurred without the benefit of decoupling mechanisms casts serious doubt on whether the underlying premise remains valid in today’s environment.

¹⁰⁶ Amen, Tr. 485:24. Exh. No. 50 (PSE response re decoupling activity, listing four at time of response). Subsequent to the hearing, one of the pending cases mentioned by Mr. Amen, Citizens Gas in Indiana, Exhibit No.50, p.4, has been decided, with the commission denying the decoupling (“VVCA”) request. *Petition of Citizens Gas & Coke*, Indiana Utility Regulatory Commission, Cause No. 42767, Order, October 19, 2006, pp. 77-84.

¹⁰⁷ Harris, Tr. 124:6-125:7. Exh. No. 176, p.2. PSE’s Periodic Rate Adjustment Mechanism (PRAM) was adopted in the Third Supplemental Order, *WUTC v. PSE*, Docket No. UE-901183-T, 901184-P. It was terminated in *WUTC*

I. RECOMMENDATION: If TheWUTC Wants To Encourage Additional Natural Gas Conservation, An Incentive Mechanism Is A More Appropriate Tool.

64. As this brief argues, decoupling, as proposed by PSE, NVEC, and Staff, is an expensive, complex, and ineffective way to address energy efficiency. If PSE is seeking decoupling simply for revenue stabilization and fixed cost recovery purposes, they have not made that case either. If the Commission concludes that PSE needs additional financial motivation to pursue conservation in its gas operations, Public Counsel believes that the Commission has a superior alternative available to it – an incentive/penalty mechanism for the gas side that parallels the proposals on the electric side in this case.

65. This case raises an obvious question. If parties are supporting an incentive payment mechanism for energy efficiency on the electric side, why isn't such a mechanism proposed on the gas side? None of the decoupling proponents seem to have a clear answer.

Cal Shirley's answer to Chairman Sidran's direct question on this point is revealing:

Q. [By Chr. Sidran]: Mr. Shirley, on the electric side the Company proposed a mechanism with measurable goals, incentives, and penalties. On the gas side, the Company proposed none of the above as part of its decoupling proposal. Why the difference?

A. [Cal Shirley]. The Company has made a decision that we would pursue decoupling to start out with on the gas side, and not an incentive. And I don't have anything more scientific to offer than that at this point.¹⁰⁸

This is a carefully worded non-answer. In essence, Mr. Shirley is saying "we decided to do it because we decided to do it, but I am not going to say why." For reasons unknown, PSE is not willing or able to disclose the specific Company reasons for this important policy choice.

66. When Chairman Sidran pursued the question of "why goals and incentives are a

v. Puget Sound Power & Light Co., UE-950618, Third Supplemental Order. The background and history of the PRAM is discussed at pp. 2-9.

¹⁰⁸ Tr. 623:9-19.

reasonable proposal on the electric side and not on the gas side,” Mr. Shirley made the curious argument that “it’s going to be a lot easier to start with one first, and see how we can make this work”¹⁰⁹ He went on to say “So I think it makes sense to start with one side of this, and especially where we have a lot more experience.”¹¹⁰

67. This rationale simply makes no sense. Important components of an incentive mechanism are already in place on both the electric and gas side. Energy efficiency targets have been established on both the gas and electric sides since the settlement of the 2001 rate case. The target setting process using the CRAG has been an effective and collaborative success story. The 2001 settlement also put in place penalties for not meeting targets on both the gas and electric side, as Mr. Shirley acknowledged.¹¹¹ Energy efficiency goal setting is also an important part of the IRP process. There are years of experience with those components and a long track record of support and cooperation among stakeholders. Building on this proven framework to adopt the electric incentive mechanism is an evolution, not a radical experiment. The same would be true on the gas side.

68. Mr. Shirley is telling the Commission that rather than build on this successful experience, PSE instead decided to propose an expensive, complicated, and untried mechanism, adopted in only five states in the country, that is a radical departure from fundamental ratemaking principles, and about which none of the proponents agree as to the correct way to implement. This hardly can be portrayed as the conservative option.

69. Public Counsel recommends that the Commission reject the choice made by PSE and

¹⁰⁹ Tr. 624:4-9.

¹¹⁰ Tr. 624:14-16.

¹¹¹ Tr. 623:19-23.

direct the parties to further develop a gas energy efficiency regulatory incentive building on past successes and the existing framework. A workable gas incentive mechanism would have the following components:

- An energy efficiency target would be set based on levels of therms saved through Company-sponsored energy conservation. The target would developed in consultation with the CRAG and approved by the Commission..
- Incentive payments tied to achievement of energy efficiency above the target levels, with increasing payment increments as levels of performance increase.
- Penalty payments would be incurred if energy efficiency performance fell significantly below target.¹¹²
- Payment levels would be scaled to revenues lost due to Company-sponsored conservation, as opposed to capturing all declines.
- A reasonable deadband that would avoid imposition of penalties or incentives if Company performance was within a certain proximity to the target. For example, the deadband could be such that if a “therms saved” was within 80 to 100 percent of the established target no penalty or incentive would accrue.
- Design criteria would be established to set threshold eligibility requirements to be met before incentives would be paid, similar to those recommended for the electric mechanism in Exh. No. 513.

Public Counsel respectfully requests that the Commission direct the Company to bring this issue to its existing CRAG and to file a proposal with the Commission for a gas incentive program either in its next general rate case filing, or by July 1, 2007, whichever is earlier.

IV. ENERGY EFFICIENCY INCENTIVE MECHANISM

A. Overview.

70. Public Counsel supports an electric efficiency incentive mechanism for PSE at this time to encourage the Company to expand upon the electric conservation efforts that were developed and implemented since the 2002 Conservation Settlement. We have made this determination

¹¹² Exh. No. 510, p. 13:3-12 (Klump). The penalties in the electric conservation incentive are tied to the amount the company could invest with third parties to achieve savings.

after careful review, and for a range of important reasons, as outlined in the testimony of Public Counsel witness Ms. Elizabeth Klumpp.¹¹³ Prior to requesting an incentive mechanism, the Company has demonstrated it has the professional capability and corporate commitment to aggressively pursue conservation. PSE's conservation targets increased after the 2002 Conservation Settlement from approximately 7-8 aMW of annual achievement in 2000-2001 to at least 15 aMW in the settlement to the current annual performance of 20 aMW in 2004 and 2005.¹¹⁴ PSE met its conservation targets, on average, in 2003, 2004 and 2005.¹¹⁵

71. In addition to its enhanced electric energy efficiency programs, PSE has taken other important steps that cause us to support an incentive mechanism at this time. These include the creation and development of the Conservation Resource Advisory Group (CRAG), and the experience that the Company and the CRAG have gained with the resource analysis and target-setting methodologies, by virtue of the fact that PSE has operated under a penalty mechanism since the 2002 Conservation Settlement.

72. In comparing the proposed incentive mechanisms now before the Commission, the proposals of the various parties—Public Counsel, Commission Staff, NWEA, and PSE—have considerable similarities. Public Counsel, Commission Staff, and NWEA jointly recommend twelve “Design Criteria for Electric Efficiency Incentive Mechanism.”¹¹⁶ These parties also utilize a similar two-part design to determine the level of any incentive payment. In the rebuttal testimony of Mr. Shirley, PSE modified its original proposal, recommending a structure similar to the other parties’ mechanisms, as well as some, but not all, of the “design criteria.”¹¹⁷

¹¹³ Exh. No. 510, 6:6-8:6. (Klumpp).

¹¹⁴ *Id.* 7:8-11.

¹¹⁵ Exh. No. 510, 3:7-8.

¹¹⁶ Exh. No. 513.

¹¹⁷ Exh. No. 379, 3:4-23:17.

B. Public Counsel Proposal.

73. Public Counsel's recommended incentive mechanism is set forth in the testimony and exhibits of Ms. Klumpp.¹¹⁸ We propose that financial incentives should be calculated based on total electricity savings. Our proposal includes two components in the incentive calculation. The first component is a dollar per megawatt-hour (MWh) saved figure. The second component is a "shared net incentive," designed in part to provide some motivation for the Company to manage its program costs. Taken together, the total incentive payments escalate as more conservation is achieved.¹¹⁹ The full detail of Public Counsel's proposal is outlined in Exh. No. 512.

74. With respect to the issue of what savings target should be used to evaluate PSE's performance as part of the incentive mechanism, Public Counsel recommends that the appropriate target is 20 aMW for 2007, or what the Company sometimes refers to as their "stretch" target. This target is one-half of the two-year savings goal that the Company filed with the Commission in its 2006-2007 Program Targets and Budgets.¹²⁰

75. Recognizing that the 20 aMW target represents an aggressive goal, upon which the Company's program budget and program mix is based, and also that the Company currently faces potential penalties if their performance falls below 16.5 aMW (under the terms of the 2002 Conservation Settlement), we propose to provide the first level of incentives at 90% of the 20 aMW "stretch" target, or for 2007, at 18 aMW. In this regard, our proposal has a "dead-band" from 80% to 90% of the Company's "stretch" target, which is currently 20 aMW.¹²¹

¹¹⁸ Exh. Nos. 510-514.

¹¹⁹ Exh. No. 510, 11:1-12:2.

¹²⁰ See Exh. No. 514 (ECK-5).

¹²¹ Exh. No. 510, 9:8-12. (Klumpp).

C. Response to Proposals of Other Parties.

76. As we have noted, there are many similarities between the various incentive mechanism proposals now before the Commission. A graphic representation of the different proposals is provided in Exh. No. 574. This exhibit shows, for example, that in general PSE and NWEC would provide for much higher levels of incentive payments to PSE at high levels of conservation achievement. In this section we highlight some of the major differences between the proposals.

1. PSE's Recommended Design Criteria Are Insufficient.

77. As noted above, Public Counsel, the Commission Staff and NWEC jointly recommend a set of "Design Criteria" for PSE's incentive mechanism – a list of requirements that are threshold issues for the Company to meet prior to being awarded incentives.¹²² These requirements are critical to ensure that ratepayers benefit from a diverse range of high-quality conservation programs, before PSE is deemed eligible for an incentive payment. The Company's proposed incentive mechanism incorporates many of these criteria, but falls short on several key elements.

a. The weighted average measure life of the total program portfolio must meet a minimum of 9 years to be eligible for an incentive.

78. All parties proposing an incentive mechanism reward the Company's shareholders based on the magnitude of savings the Company acquires in a year. This type of performance incentive should encourage the Company to achieve savings, but without threshold design requirements, it is very likely to encourage the Company to achieve the lowest cost measures that may also have

¹²² Exh. No. 513.

the shortest life, thus losing the opportunity to capture longer-term energy efficiency resources such as new residential or commercial construction, new heating or air conditioning equipment, and new refrigerators.¹²³ For this reason, we strongly oppose PSE's recommendation that there should be *no requirement* for a minimum average measure life. It is in the interest of the ratepayers and the power system to secure efficiency investments in long-term measures.

b. Three years is the appropriate sunset period for this incentive-penalty mechanism.

79. Instituting an incentive-penalty mechanism for electric energy efficiency for PSE would represent a significant policy change. The burden should be on the Company to demonstrate to the Commission and its stakeholders the results of the mechanism and its achievements in conservation at the end of three years, in order to justify continuation. As set forth in item eleven of the joint design criteria, the Company may file a request to extend or modify the mechanism beyond the three year pilot period, either as part of a general rate case proceeding or as part of a separate filing.¹²⁴ We believe three years is an appropriate duration for an initial pilot mechanism, and therefore oppose PSE's recommended duration of five years.¹²⁵ We also observe that in the event Initiative 937 becomes law, PSE would be required to meet certain conservation resource analysis requirements beginning in 2010, or not until after the three year pilot.

2. The incentive mechanism should utilize an aggressive target.

80. A key element of an incentive mechanism is the target level for conservation

¹²³ Exh. No. 510, 15:3-10. (Klumpp).

¹²⁴ Exh. No. 513, p. 3.

¹²⁵ Exh. No. 379, 23:10-17 (Shirley Rebuttal).

achievement that will be used to evaluate the Company's performance. The parties recommending an incentive mechanism have diverging views as to what the appropriate target should be. As described above, Public Counsel recommends that the appropriate target should be what PSE has referred to as their "stretch" target, which is 20 aMW for 2007. PSE and NWECA instead propose that what PSE has referred to as the "penalty threshold" should be the target, or 16.5 aMW for 2007.¹²⁶ Commission Staff recommends a baseline target of 18.3 aMW for 2007.¹²⁷

81. For several reasons, Public Counsel believes that PSE's "stretch" target, which has consistently been in the range of 20 aMW, is the appropriate target. As PSE's witness Mr. Shirley testified at hearing, this is the target that PSE reports to the Northwest Power and Conservation Council.¹²⁸ In addition, as Mr. Shirley also confirmed at hearing, the Company's annual budget for its energy efficiency programs is associated with an annual conservation target of 20 average megawatts (aMW)¹²⁹, not the 16.5 aMW "baseline" target as proposed by the Company and NWECA. The "stretch" target of approximately 20 aMW is also what PSE reported to its customers in their most recent conservation report to customers.¹³⁰ Consistent with the 2002 Conservation Settlement, PSE currently faces a potential penalty—granted, a much smaller penalty than proposed here—if they fail to achieve 33 aMW during the 2006-2007 period (or 16.5 aMW annually). This 16.5 aMW performance level has therefore been referred to as the

¹²⁶ Exh. No. 372, p. 9:1-3 (Shirley); Exh. No. 499, p. 7:13-14 (Glaser)

¹²⁷ Exh. No. 561, 31:10-32:16 (Steward).

¹²⁸ Shirley, Tr. 580:15-23.

¹²⁹ Shirley, Tr. 580:8-14. See also, Exh. No. 514.

¹³⁰ Exh. No. 414.

“penalty threshold,” as shown in PSE’s November 18, 2005 filing with the Commission regarding 2006-2007 conservation targets.¹³¹ Public Counsel believes that a “penalty threshold” is unacceptable as a measure for achievement for an incentive. The Company should be encouraged to continue to set its program budgets and conduct its cost-effectiveness analyses on its high, though potentially achievable targets. The culture of the Company should continue to focus on its higher goals, rather than shift its attention to its lower penalty targets.

V. DEPRECIATION TRACKER

A. PSE’s Depreciation Tracker Proposal.

82. PSE presents the depreciation tracker as designed to directly address a major cause of attrition facing the Company.¹³² In summary, PSE proposes that the increased expense associated with growth in depreciation for electric and natural gas transmission and distribution plant investment be recovered by means of a tracker mechanism and ultimately through a surcharge on PSE’s existing tariff schedules. The surcharge would be based on the incremental depreciation expense over that reflected in existing rates.¹³³

B. PSE’s Arguments For the Tracker are Not Persuasive.

83. The depreciation tracker violates fundamental principles of ratemaking. Energy utilities have traditionally been regulated based upon their cost to provide service, including an opportunity to earn a reasonable return on investment. These factors and the resulting revenue requirement are reviewed in a rate case, in which a balanced review of jurisdictional expenses, rate base investment, cost of capital, and revenue at present rates is undertaken at a common

¹³¹ Exh. No. 394.

¹³² Exh. No. 421, p. 66:16 – p. 67:8. (Story).

¹³³ Exh. No. 421, p. 67:17-p. 68:4 (Story).

point in time referred to as a “test period” or “test year.”¹³⁴ A synchronized review of these factors is essential due to the dynamic nature of utility costs and expenses. For example, in the instant case, PSE must account for its higher customer count and sales volumes and its current capital market conditions, at the same time as it seeks recognition of a larger rate base and increased depreciation expense.

84. A major problem with the use of a depreciation tracker, as with decoupling, is the potentially serious distortion of the “matching principle.”¹³⁵ Again, the matching principle recognizes the necessity of matching all revenues and costs (expenses, rate base, rate of return) at a consistent period of time to determine needed changes in utility pricing. *See, e.g., WUTC v. Avista Corporation*, Docket Nos. UE-050482, UG-050483, Order No. 05, ¶ 111. The depreciation tracker proposed by PSE in this case violates the matching principle. For these reasons, isolation of individual cost elements for recovery outside of test year ratemaking, so-called “single-issue ratemaking” is strongly disfavored.¹³⁶

1. Attrition.

85. PSE witness Story argues that regulatory lag and attrition create the need for the depreciation tracker when a utility is experiencing considerable growth or replacement of infrastructure.¹³⁷ In fact, utilities with considerable growth normally see accretion to earnings as margin contributions are added which recover fixed costs and overhead.¹³⁸ If attrition is

¹³⁴ Exh. No 506,, p. 4:5-11 (Brosch).

¹³⁵ Exh. No. 506 , pp. 11:19-12:6 (Brosch).

¹³⁶ Exh. No. 506, p. 14:3-14, (Brosch)

¹³⁷ Exh. No. 421, p. 66:18-p.67:16. (Story).

¹³⁸ Exh. No.506 , p. 23:11-18 (Brosch).

occurring in a period of growth, the solution lies in line extension policy or rate design, not in creating a new tracker mechanism.¹³⁹

86. While there is some surface appeal to the infrastructure replacement argument, the reality is that utility companies are continually retiring old plant and replacing new plant at what are generally higher replacement prices.¹⁴⁰ This activity is triggered by many factors including: the need to serve new customers, the need to expand capacity, the need to deal with leaks or excessive outage response costs, the replacement of worn out plant, the relocation of facilities for public improvements, replacement of plant that is not cost-effective to maintain, compliance with regulatory mandates, and installation of automation.¹⁴¹ If PSE's argument were correct, every utility in the country would need a rate increase every year to deal with this attrition phenomenon. While they undoubtedly would like such an increase, it is neither necessary financially, nor fair to ratepayers.

2. The depreciation tracker would distort test period relationships.

87. PSE proposes to include new electric and gas distribution plant investment in the depreciation tracker. All customers would pay the rates resulting from the tracker on new investments. Shareholders on the other hand would retain all revenues and margins resulting from the growth between test years since no tracker is put in place to account for the incremental profit margins from the new customers. This is patently not a fair result.¹⁴² The depreciation tracker purports to account for load growth, but does so only indirectly and ineffectively.¹⁴³

¹³⁹ *Id.*

¹⁴⁰ Exh. No.506 , p. 24:3-6 (Brosch); McLain, Tr. 192:13-23.

¹⁴¹ *Id.*, p. 24:6-14 (Brosch); McLain ,Tr. 192:24-193:2.

¹⁴² Exh. No. 506. , p. 26:7-13(Brosch).

¹⁴³ *Id.*, p. 26:13-18.

88. PSE was asked in discovery what capital investments it would not make if the depreciation tracker were not granted, assuming those investments were necessary and prudent.¹⁴⁴ PSE responded by saying that the date request misinterpreted the testimony and that the question is one of timing not of prudence.¹⁴⁵
89. Ms. McLain’s attempts to create the impression that Commission ratemaking policy and decisions have prevented the Company from recovering its costs, and that this is a reason to approve the tracker.¹⁴⁶ On cross-examination, however, McLain agreed that PSE makes no assertion that the Commission denies PSE recovery of its prudently incurred costs, whether for depreciation, or any other expense. Its simply a matter of timing.¹⁴⁷
90. Likewise, Ms. McLains’ written testimony asserts that if PSE is restricted from cost recovery, presumably by not getting approval of the depreciation tracker, it will have to “scale back” on planned investment, maintenance and inspections. On cross examination, however, she disclaimed any intent on the part of the Company to issue an ultimatum to the Commission that it would not make necessary investments unless the tracker was approved.¹⁴⁸

3. Incentive in regulatory lag would be disturbed.

91. Importantly, test year based ratemaking creates a significant incentive for utility management. By controlling and reducing costs between rate cases, the utility maximizes the opportunity to actually earn at or above the authorized rate of return established by the regulator. Shareholders are rewarded with higher earnings between test years. Conversely, unfavorable

¹⁴⁴ Exh. No. 249.

¹⁴⁵ *Id.*; Tr. 195-199.

¹⁴⁶ Exh. No. 245, p.2:10-15 (McLain).

¹⁴⁷ Tr. 200:16.

¹⁴⁸ Tr. 198:23-199:7.

changes such as cost increases can bring earnings below authorized levels. Management also has an incentive not to allow this to occur. Thus, so-called “regulatory lag” provides a symmetrical incentive to management.¹⁴⁹

92. If depreciation expense is tracked piecemeal between rate cases, the incentive to control the cost of capital expenditure is disturbed. PSE management would be likely to focus on other business issues and care less about stringent cost controls over capital expenditures that will simply be tracked into higher depreciation tracker levels that will be charged to customers.¹⁵⁰

4. New investments create operational efficiencies that reduce expenses.

93. There is another factor that is not reflected in the depreciation tracker. Many types of operations and maintenance (O&M) expenses are influenced by the age and condition of utility plant, for example: services calls for gas leaks, leak repair costs, systematic replacement of problem areas. In the case of electric facilities, replacement, restoration, undergrounding, and automation of plant can significantly affect staffing and O&M expenses. While PSE characterizes infrastructure investments as creating “financial pressures,”¹⁵¹ these expenditures are intended to efficiently serve new and existing customers, increase margin revenues, and control expense levels. In theory, a fairly designed tracker would include both the operational impacts of investment, as well as the depreciation expense. As a practical matter, actually designing a tracker to capture all of the complex impacts of an investment throughout the utility’s business operations is not feasible.¹⁵²

¹⁴⁹ Exh. No. 506 , p. 7:13-16 (Brosch).

¹⁵⁰ Exh. No.506, p. 27:4-10 (Brosch).

¹⁵¹ Exh. No. 421, p. 77:9-10 (Story).

¹⁵² Exh. No. 506, p. 29:3-6 (Brosch) .

5. Transmission and distribution depreciation expense is not completely beyond management control.

94. Significant capital investment is continuously required by utilities to replace, extend and modernize T&D facilities, as PSE witness McLain acknowledged at the hearing.¹⁵³ In fact, management has considerable discretion and control over the timing and cost levels of capital expenditures. Prudent management should be actively involved in facilities planning and design, construction workforce management, materials procurement, contractor bidding and administration, and other elements of capital expenditure optimization.¹⁵⁴

6. The depreciation tracker should be rejected.

95. The depreciation tracker introduces unfair imbalance into ratemaking. The attrition arguments are not persuasive or well supported. The investment and expenses that PSE cites are within the normal course of doing business for a utility company, and are largely within the control of management. There is no evidence that the Company is being denied recovery of prudently incurred costs, or that it will not be able to make necessary investments to provide service. The fact that the Company would like to accelerate the timing of its depreciation cost recovery is not a reason to impose this new burden on ratepayers.

VI. POWER COST ADJUSTMENT (PCA)

A. Summary of Recommendation.

96. Public Counsel, the Commission Staff, and ICNU are in agreement on this issue and have filed joint testimony with the Commission in this case.¹⁵⁵ The parties jointly recommend that the

¹⁵³ Tr. 192:13-23.

¹⁵⁴ Exh. No. 506TC, p. 29:17-p. 30:4 (Brosch).

¹⁵⁵ Exh. No. 599 (Lazar, Schoenbeck, Mariam).

current PSE Power Cost Adjustment mechanism remain basically unchanged. The dead band should remain at \$20 million and the sharing bands at the current levels of \$40 million and \$120 million. Power supply contracts should continue to be priced according to the current mechanism. Exhibit E should remain a part of the PCA mechanism. The joint parties do support one of PSE's recommendations --- inclusion of hedging expenses as an allowable cost within the PCA mechanism.¹⁵⁶

B. Background of the PCA Mechanism.

97. The joint testimony reviews the evolution of the current PCA mechanism. PSE has had a number of regulatory mechanisms to address variations in power costs, including the drought surcharges of 1980-81, the Energy Cost Adjustment Clause (ECAC) from 1982-88, the Periodic Rate Adjustment Mechanism (PRAM) from 1991-1996, and the current PCA from 2002 to the present.¹⁵⁷ The current PCA was established as part of the comprehensive settlement in the 2001 general rate case.¹⁵⁸

C. PSE's Proposed Changes to the PCA.

98. PSE proposes eliminating the deadband and imposing a smaller sharing requirement so that electric customers bear a larger share of the power cost risk. The Company proposes eliminating Exhibit E to the original PCA, which limits increases to power contracts from flowing through the PCA without a PCORC. In addition, the Company proposes adding a new category of allowable costs to the PCA – power supply hedging costs.

¹⁵⁶ *Id.*, Exh. No. 599, p.2:17-19.

¹⁵⁷ Exh. No. 599, pp. 4-7.

¹⁵⁸ *WUTC v. PSE*, UE-011570, UG-011571, Twelfth Supplemental Order, Ex. A to Settlement Stipulation.

D. The PCA is Working as Expected.

99. The PSE PCA was intended to protect shareholders from severe earnings attrition caused by power cost variations beyond the Company's control, to provide incentives for power supply cost control, and to provide relatively stable rates for consumers.¹⁵⁹

100. The PSE PCA was designed to place the Company at risk for only a portion of its power supply cost variations. This was done by limiting PSE's risk to only a fraction of its "retention" or "retained earnings" each year so that its ability to pay its dividend out of current earnings was not in jeopardy due to weather or power market variations.¹⁶⁰ The design has worked well. PSE's utility earnings have in fact been adequate to support the dividend since the PCA was adopted.¹⁶¹ As shown on Figure 2 of the joint testimony, earnings have consistently exceeded the \$1.00 dividend.¹⁶²

101. With regard to rate stability, while there have been increases due to PCORC filings and the 2004 general rate case, the PCA itself has not resulted in any rate increases for consumers because the variations in PSE's power supply costs have been small enough that the mechanism has not triggered an increase or a decrease. This is confirmation that the mechanism was well designed at its inception.

102. PSE attempts to support its position by setting forth the unrealistic, catastrophic scenario of power costs varying by \$120 million each year over a four-year period. Under these circumstances, PSE asserts that shareholders may be exposed to approximately \$152 million more in excess power costs without the cost cap.¹⁶³ The implausibility of PSE's example is

¹⁵⁹ *Id.*, p. 10:2-7.

¹⁶⁰ *Id.*, p. 10:10-12:22.

¹⁶¹ *Id.*, p.13:1-11.

¹⁶² *Id.*, p. 13.

¹⁶³ Exh. No. 14, p.4:6 – 5:3 (Aladin).

illustrated by the Company's own testimony, which reveals that the probability of PSE's catastrophic scenario actually occurring is extremely low.¹⁶⁴ Moreover, PSE fails to explain that the cost cap will play no role whatsoever in the more likely event that excess power costs do not exceed \$40 million. PSE Is In Much Better Financial Condition Than When The PCA Was Created.

103. PSE's PCA was adopted at a time when the Company faced financial challenges. The PCA was one of the tools agreed to in the 2002 settlement to improve PSE's financial strength.¹⁶⁵ Since the 2002 settlement, the Company's situation has improved markedly. PSE has significantly enhanced its equity ratio by issuance of new stock.

104. Figure 5 in the joint testimony reflects PSE's improved condition, showing a comparison of financial strength indicators and PCA exposure between 2001 and 2005, based on data from the Company's annual report. Electric revenues are up 32 percent, net income 46 percent, and shareholder equity 49 percent. At the same time, the risk exposure under the PCA has not changed at all in dollar terms. As a result, PSE's exposure under the mechanism is much smaller now than when the PCA was adopted.

105. PSE's proposed changes in the sharing band would reduce the Company's exposure to risk of earnings variations, shifting that risk to customers. If power costs increase \$200 million, for example, there would be a 40 percent decrease in risk to shareholders under the PSE proposal.¹⁶⁶ The columnar chart in Exh. No. attached to the joint testimony shows in more detail the effect of the proposed changes as compared to the current mechanism. Under the PSE

¹⁶⁴ *Id.*, p. 5:15 – 6:6; Exh. No.15.

¹⁶⁵ Exh. No.599, p. 17:4-18.

¹⁶⁶ Exh. No. 599, p. 19:8-17.

proposal, the maximum adverse impact is reduced by about one third (from 31 cents per share to 20 cents per share). Moreover, the range of risk is narrowed so that nearly all outcomes are within a range of only 15 cents per share, a risk reduction of over 50 percent.

106. PSE has made the assertion that the expiration of the \$40 million 4-year cap in the original PCA mechanism “results in a massive shift of exposure to PSE to absorb extreme power costs going forward unless changes are made to the existing PCA mechanism in this case.”¹⁶⁷ This is an attempt to create the false impression that the expiration of the cap is unexpected, unplanned, and unfair.

107. The 4-year cap was just that – a temporary measure. It was put in place because PSE had a weak capital structure at the time of the 2001 settlement. The parties agreed to the 4-year cap in conjunction with the equity tracking mechanism and penalties. During the settlement hearing for the original PCA, Staff witness Merton R. Lott explained: “The mechanism, as we designed it, was without the \$40 million cap, and the \$40 million cumulative cap was laid on top of it with an intent to help the Company achieve their equity ratios during that first four years.”¹⁶⁸

108. Customers therefore assumed more risk by capping the shareholders’ liability at \$40 million for a four-year period. However, the PCA itself was designed as a long-term mechanism that would continue after the cap expired, as evidenced by the fact that the sharing bands go up to \$120 million. The cap was always intended to be temporary and to expire once PSE had rebuilt its capital structure from 30% to 40% equity. At 40% equity PSE can absorb some earnings variation without undue risk to its credit rating. PSE has now rebuilt its equity to in

¹⁶⁷ Exh. No. 14, p.2:1-3 (Aladin)

¹⁶⁸ *Re PSE, WUTC*, Docket Nos. UE-011570 & UG-011571, Settlement Hearing Transcript at 2131:14-18 (Lott (June 17, 2002)).

excess of 40%. It is misleading and inaccurate of PSE to suggest that the expiration of the temporary cap shifts unanticipated risk to PSE when the expiration was intended and when the condition it was designed to remedy has been resolved.

E. The Financial Community Has Responded Positively to the Current PCA Mechanism.

109. The financial community has been very positive about the PCA mechanism. D.A. Davidson and Company, for example, comment on the value of the PCA mechanism, note the Commission Staff position on revenue requirement in this proceeding, and issue and reaffirm a “buy” rating on PSE stock.¹⁶⁹
110. The JP Morgan report predicted the PSE shares would trade lower as a result of the Staff revenue recommendation. In fact, PSE stock traded up.¹⁷⁰ The market is responding positively to the past actions this Commission has taken, including the currently-designed PCA mechanism.
111. Mr. Valdman has included numerous reports from the financial community in his Exhibit Nos. 455 and 459. One of the common threads of these is that measures that stabilize earnings are desirable, and reduce the perceived risk of the Company. The PCA is one of these mechanisms. It has worked to stabilize PSE’s earnings under the existing design. Notably, Mr. Valdman has not acknowledged the tremendous benefit that the existing PCA provides, nor has he quantified the additional value that the Company’s proposed changes to the PCA, the proposed decoupling mechanism, or the proposed depreciation tracking mechanism would all provide. Instead he takes care to base his opinions only on the required return for PSE on its existing regulatory framework, while asking the Commission to weaken the ratepayer protections currently in place, without any compromise on either capital structure or rate of return.

F. Except for Hedging Expense, PSE’s Proposed Changes to the PCA Should Be Rejected.

1. Hedging expense should be allowed in the PCA.

112. The joint parties support PSE’s proposal to include hedging costs as allowable PCA expense. Hedging manages the specific costs which the PCA is designed to track, and if successful will ultimately reduce fuel expenses. It is reasonable, therefore, to include hedging expense in the PCA mechanism. It should be noted, however, that hedging further enhances the risk reduction caused by the PCA. The inclusion of hedging should be reflected in a further downward adjustment in the cost of capital.¹⁷¹

113. PSE’s other proposed changes ignore the fact that the Company is far better situated to manage power cost risk than are its individual customers. It can manage risk by buying long-term fixed price resources, favorable structuring of power purchase contracts, hedging fuel costs, and minimizing down time on its own power plants.¹⁷²

2. The “Exhibit E” component of the PCA should be retained.

114. PSE proposes, *inter alia*, to eliminate “Exhibit E,” a component of the PCA 2002 settlement which addresses contracts. The PSE proposal would allow any increase in the contract price to be included in the PCA. This is an unreasonable approach. As the joint testimony explains, Exhibit E was part of a balanced compromise in the original PCA. Under the

¹⁶⁹ Exh. No. 459, pp. 10, 29 (Valdman); Valdman, Tr. 247:6-248:1

¹⁷⁰ Valdman, Tr. 246:6-10.

¹⁷¹ Exh. No. 599, p.21:14-22:3; No specific reduction due to hedging is recommended in the joint testimony because it is anticipated that PSE will be filing another general rate case within the next 18 months.

¹⁷² *Id.*, p.22:5-22.

compromise, PSE's allowed contract cost recovery was capped in return for allowing other costs to rise between rate cases, such as those included in a PCORC.¹⁷³

3. PSE's proposals are not consistent with the guidance on PCAs provided in the 2006 PacifiCorp rate case order.

115. The Commission has stated that a "properly designed" PCA should allow ratepayers to "receive the benefit of a reduction in cost of capital, as a power cost adjustment introduces rate instability for ratepayers and earnings stability for stockholders."¹⁷⁴ The amount of risk apportioned by a PCA is one of the most important factors that the Commission considers when deciding whether a reduction in the cost of capital is warranted.¹⁷⁵ The Commission has recognized deadbands and sharing bands as "useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs."¹⁷⁶

116. Contrary to the Commission's guidelines, PSE proposes to eliminate the deadband and narrow the sharing bands. Not only would such changes shift more risk to customers despite PSE's improved financial condition, but they would also provide little incentive for the Company to efficiently manage its power costs. The Commission recently rejected PacifiCorp's proposed PCA mechanism based partly on the fact that it lacked a deadband.¹⁷⁷

117. At the same time as it proposes eliminating the deadband, PSE proposes sharing bands that would significantly increase customers' risk. PSE's proposal would force customers to assume 50% of *any* power cost variations up to \$25 million, 90% of any variations over \$25

¹⁷³ *Id.*, 22:12-23:16.

¹⁷⁴ *Re PacifiCorp*, WUTC Docket No. UE-050684, Order No. 4 at ¶¶ 91 (Apr. 17, 2006).

¹⁷⁵ *Id.* at ¶ 97.

¹⁷⁶ *Id.* at ¶ 96.

¹⁷⁷ *Id.* at ¶ 99.

million, and 95% of any variations over \$120 million.¹⁷⁸ The Company, however, is in a much better position than customers to manage this risk. The Company justifies its proposed sharing bands based on the assertion that PSE cannot control hydro risk.¹⁷⁹ Although hydro risk is indeed variable, the current PCA adequately addresses this risk by providing for deferral and amortization of hydro variations.¹⁸⁰ Additionally, PSE can take steps to address this risk, such as choosing less volatile resources and using fuel hedging.¹⁸¹

118. Furthermore, in the Company's latest PCA Annual Report, PSE reported that its actual power costs were approximately \$10.5 million below projections.¹⁸² As of June 30, 2006, the deferral balance under the PCA mechanism had only reached \$6.2 million.¹⁸³ The deferral balance must reach a "trigger point" of \$30 million before PSE is allowed to request a rate adjustment, an amount that was determined not to put PSE at financial risk.¹⁸⁴ Due to the minimal deferral balance that has accrued during the life of the PCA despite the fact that four of the last five years have had below normal hydro, PSE cannot assert that the current PCA design places a disproportional amount of risk on the Company.

119. PSE's proposal also shifts more risk to customers without accounting for any corresponding compensating benefits to customers. Astonishingly, PSE actually proposes a higher return on equity and a higher equity ratio.¹⁸⁵ Without such evidence, the Commission and

¹⁷⁸ Exh. No. 11C, p. 20:1-3 (Aladin).

¹⁷⁹ *Id.* at 21:5-7.

¹⁸⁰ Exh. No. 599, p.23:20 – 24:5 (Joint PCA).

¹⁸¹ *Id.*, p. 24:7-14.

¹⁸² *Re PSE 2006 PCA Report*, WUTC Docket No. UE-061410, Petition of PSE for Approval of its 2006 PCA Mechanism Annual Report at ¶ 8 (Aug. 31, 2006).

¹⁸³ *Id.* at ¶ 10.

¹⁸⁴ Exh. No. 599 at 12:1-3 (Joint Testimony).

¹⁸⁵ *Id.* at 25:17-20.

the parties to this proceeding lack sufficient information to fully evaluate PSE's proposed changes.¹⁸⁶ Ultimately, the Commission should leave the PCA as is to ensure that the Company has an incentive to minimize power costs and to ensure an appropriate balance of risk between shareholders and customers.

4. The recent Avista ERM order provides a useful comparison.

120. The Commission recently approved modifications to Avista Energy Recovery Mechanism (ERM), a form of PCA. The joint testimony presents a comparison between the ERM and PSE's PCA.¹⁸⁷ Measured on a revenue basis, PSE's mechanism has a somewhat lower level of risk than Avista's. Measured on an earning's basis, PSE has a slightly higher risk level for shareholders. Overall the current PSE PCA exposes Puget shareholders to a comparable level of risk to the modified Avista ERM.

G. If PCA Changes Are Made They Should Reflect PSE's Healthier Financial Condition.

121. As argued above, the PCA changes recommended by PSE are not appropriate. The PCA is essentially working as planned and need not be modified at this time, except as to hedging costs. If the Commission were to consider changes of any kind to update the PCA, they should reflect the fact that PSE is a larger and financially healthier utility than when the PCA was adopted. The joint testimony recommends a methodology for updating the dead band and sharing bands to reflect PSE's financial situation.¹⁸⁸

¹⁸⁶ See *WUTC v. Avista*, WUTC Docket Nos. UE-050482 and UG-050483, Order No. 5 at ¶¶ 67, 71 (Dec. 21, 2005) (finding an insufficient record to authorize a change in the deadband where Avista failed to account for any compensating benefit to customers).

¹⁸⁷ Exh. No. 599, pp. 14-16.

¹⁸⁸ Exh. No. 599, pp. 26-28.

122. Using financial indicators, at Figure 8 of the joint testimony,¹⁸⁹ the parties show that updates to the PCA would result in the dead band increasing to \$25 million, the 50 percent band increasing to \$50 million, the 90 percent band to \$100 million, the 95 percent band moving up to costs over \$150 million. The trigger would increase to \$40 million. At this time, the joint parties do not recommend adoption of these modifications. Instead, the Commission should direct a study of the financial risks posed by power costs under the current PCA from the date of inception to the present. The study should be presented to the Commission by the Company at least three months prior to filing its next general rate case. This would be a predicate to updating the sharing bands and trigger threshold. Any changes in the PCA should be deferred until that study is completed and reviewed in the next general rate case.¹⁹⁰ Until then, the Commission should allow the current PCA to continue to operate as it was designed.

VII. COST OF CAPITAL

A. PSE's Cost of Capital Request Is Not Reasonable.

123. While Public Counsel has not presented a cost of capital witness in this case, the issue is nonetheless an important one from the consumer perspective. Public Counsel believes the cost of capital recommendations of Staff's witness Steve Hill and ICNU witness Gorman are in a far more reasonable range than the request of PSE. Without commenting on the more technical analyses offered by the experts, a number of observations can be made.

124. PSE's suggestion that its return on equity (ROE) should be 11.25¹⁹¹ is simply extreme. Even without engaging in technical cost of capital analysis, numerous common sense factors

¹⁸⁹ Exh. No. 599, p. 28.

¹⁹⁰ *Id.*

¹⁹¹ Exh. No. 301, p.15:15 (Morin)

indicate that their request is outside any reasonable range. This Commission has not set ROE above 11 percent for any Washington energy Company in a number of years. It recently indicated that the proper ROE for an all-electric regulated utility in Washington, PacifiCorp, was 10.2 percent.¹⁹² PacifiCorp does not have gas operations that lower its risk, nor does it have a PCA or PCORC mechanism that do likewise, as PSE does. If anything, PSE's correct ROE level might reasonably be expected to be below that of PacifiCorp. It is difficult to imagine that PSE's ROE should really exceed PacifiCorp's by 105 basis points.

125. PSE's stock price has remained at least steady since the last rate case. Indeed, during this rate case, PSE has outperformed the S&P.¹⁹³ PSE litigated cost of capital quite recently in its 2004 rate case and the Commission set the shareholder profit rate at 10.3 percent.¹⁹⁴

126. Public Counsel does not suggest that these factors can be used simplistically to set PSE's cost of capital. Each company is different. Each is subject to different risks, and has a different capital structure. Wall Street analysts should not be allowed to dictate ROE levels. Nevertheless, these factors do provide some sense of a "reality check" as to the reasonable expectations for current cost of capital in Washington. Given these factors, it is appropriate to ask why PSE would chose to present such an untenable position. Perhaps the purpose of such a filing is to "raise the average" by setting a high top end such that a midpoint compromise is higher. The Commission should resist such any such attempt to manipulate this issue. If the Commission is developing a range within which to set ROE, it should be a range of reasonableness, not one skewed by unrealistic and extreme requests.

¹⁹² PacifiCorp order, ¶ 264.

¹⁹³ Exn. No. 599, p. 20:8-13.

¹⁹⁴ *WUTC v. PSE*, Docket Nos. UG-040640, UE-040641, Order No. 06.

B. PSE's ROE Request is Inconsistent With its Simultaneous Request for Significant Risk Reduction Mechanisms.

127. PSE's requested ROE appears even more unfounded in light of the fact that the Company is seeking three different risk reduction mechanisms in this case that shift risk to ratepayers and away from shareholders: a decoupling mechanism, a depreciation tracker, and modifications to the PCA. There is a serious disconnect between asking for such significant risk reduction while simultaneously asking, not just to maintain current ROE, but to increase it by more than a percentage point.

128. PSE's approach flies directly in the face of clear guidance from the Commission on the cost of capital effects of decoupling and PCA mechanisms. The need for cost of capital reductions to accompany risk shifting mechanisms is no longer a matter of debate in Washington.

VIII. SETTLEMENTS ON OTHER ISSUES

A. Electric Rate Spread and Rate Design.

129. As one of the signatories, Public Counsel supports the electric rate spread and rate design settlement between the parties and PSE. The joint testimony establishes that settlement is a fair and comprehensive resolution of these issues.¹⁹⁵

B. Gas Rate Spread and Rate Design.

130. Public Counsel joins in the gas rate spread and rate design settlement.¹⁹⁶ This brief supports and incorporates by reference the arguments made by Staff in its brief on this issue.

¹⁹⁵ Exh. Nos. 2, 3.

¹⁹⁶ Exh. Nos. 581-587

C. Power Costs.

Public Counsel has a joint position with Staff and ICNU on power costs and participated in the joint testimony on that issue.¹⁹⁷ Public Counsel adopts the ICNU brief on this issue.

D. Revenue Requirement

131. Public Counsel did not present any revenue requirement witnesses. Public Counsel does not take a position on the revenue requirement stipulation filed by PSE and Staff.

IX. CONCLUSION

132. For the reasons discussed in this brief, Public Counsel asks the Commission to reject the decoupling proposals of PSE and the other parties and to direct the parties to pursue a gas incentive mechanism. The Commission should reject the depreciation tracker and the Company's PCA modifications.

133. Public Counsel urges the Commission to accept an electric conservation incentive mechanism in the form proposed by Public Counsel, and to adopt the settlement proposals of the parties on other issues.

134. DATED this 31st day of October, 2006.

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TABLE OF CONTENTS

- I. INTRODUCTION..... 1
- II. PUBLIC COMMENT 2
 - A. The Renton Public Hearing..... 2
 - B. Written Public Comments..... 3
- III. DECOUPLING 4
 - A. Overview..... 4
 - B. PSE’s Decoupling Proposal is Primarily Designed to Guarantee Revenue Levels and Shift Risk, Not Provide an Incentive for Conservation..... 6
 - 1. Decoupling is advertised as a mechanism to encourage energy efficiency..... 6
 - 2. Many factors other than PSE energy efficiency programs cause declining use..... 7
 - 3. The focus on declining use per customer is misleading; total sales volumes are stable..... 10
 - C. Decoupling Is An Expensive Blunt Instrument. 12
 - 1. PSE actual losses through its gas conservation efforts are small. 12
 - 2. Decoupling generates revenues that far exceed the size of the problem. 13
 - 3. PSE lost margins due to Company sponsored conservation are even more minimal when seen in context. 16
 - D. Decoupling Is Not Necessary to Cause PSE to Pursue Energy Efficiency..... 17
 - 1. PSE has a long standing commitment to energy efficiency rather than a culture of hostility. 17
 - 2. PSE has existing legal and public service obligations to pursue energy efficiency. 19
 - 3. PSE is already stretching the limits of available natural gas energy efficiency. 21
 - E. Decoupling Violates Basic Principles of Balanced Ratemaking. 23

F.	Decoupling In This Case Violates the Guidelines of the Commission’s PacifiCorp Order.....	24
1.	Cost of capital.....	25
2.	Incremental conservation measures.....	25
3.	Low-income customer impact.	27
G.	Decoupling Introduces Unnecessary Technical Complexity and Burdens to Regulation.....	28
1.	There are wide disparities among proponents about how best to implement decoupling.	28
2.	Weather normalization.	29
3.	New customers.	30
4.	Regulatory burden.	31
H.	Decoupling Is Not a National Trend.....	31
I.	RECOMMENDATION: If TheWUTC Wants To Encourage Additional Natural Gas Conservation, An Incentive Mechanism Is A More Appropriate Tool.....	33
IV.	ENERGY EFFICIENCY INCENTIVE MECHANISM.....	35
A.	Overview.....	35
B.	Public Counsel Proposal.	37
C.	Response to Proposals of Other Parties.	38
1.	PSE’s Recommended Design Criteria Are Insufficient.	38
a.	The weighted average measure life of the total program portfolio must meet a minimum of 9 years to be eligible for an incentive.....	38
b.	Three years is the appropriate sunset period for this incentive-penalty mechanism.	39
2.	The incentive mechanism should utilize an aggressive target.	39
V.	DEPRECIATION TRACKER.....	41
A.	PSE’s Depreciation Tracker Proposal.....	41

B.	PSE’s Arguments For the Tracker are Not Persuasive.	41
1.	Attrition.	42
2.	The depreciation tracker would distort test period relationships.	43
3.	Incentive in regulatory lag would be disturbed.	44
4.	New investments create operational efficiencies that reduce expenses.	45
5.	Transmission and distribution depreciation expense is not completely beyond management control.	46
6.	The depreciation tracker should be rejected.	46
VI.	POWER COST ADJUSTMENT (PCA)	46
A.	Summary of Recommendation.	46
B.	Background of the PCA Mechanism.	47
C.	PSE’s Proposed Changes to the PCA.	47
D.	The PCA is Working as Expected.	48
E.	The Financial Community Has Responded Positively to the Current PCA Mechanism.	51
F.	Except for Hedging Expense, PSE’s Proposed Changes to the PCA Should Be Rejected.	52
1.	Hedging expense should be allowed in the PCA.	52
2.	The “Exhibit E” component of the PCA should be retained.	52
3.	PSE’s proposals are not consistent with the guidance on PCAs provided in the 2006 PacifiCorp rate case order.	53
4.	The recent Avista ERM order provides a useful comparison.	55
G.	If PCA Changes Are Made They Should Reflect PSE’s Healthier Financial Condition.	55
VII.	COST OF CAPITAL	56
A.	PSE’s Cost of Capital Request Is Not Reasonable.	56

B. PSE’s ROE Request is Inconsistent With its Simultaneous Request for Significant Risk Reduction Mechanisms.....58

VIII. SETTLEMENTS ON OTHER ISSUES.....58

 A. Electric Rate Spread and Rate Design.58

 B. Gas Rate Spread and Rate Design.58

 C. Power Costs.59

 D. Revenue Requirement.....59

IX. CONCLUSION59

TABLE OF AUTHORITIES

Rules

WAC 480-90-238 (2)(a) 19

Commission Orders

Docket No. UE-900385 28

Petition of Citizens Gas & Coke, Indiana Utility Regulatory Commission,
Cause No. 42767, Order, October 19, 2006, pp. 77-84 32

Re PSE 2006 Report, WUTC Docket No. UE-061410..... 54

WUTC v. PacifiCorp,
Docket No. UE-050684, Order No. 04, (PacifiCorp order)..... passim

WUTC v. Avista Corporation,
Docket Nos. UE-050482, UG-050483, Order No. 05, 24, 42, 55

WUTC v. Puget Sound Energy,
Docket Nos. UE-011570 and UG-011571, Twelfth Supplemental Order 20, 47, 50

WUTC v. PSE,
Docket No. UE-901183-T, 901184-P 32

WUTC v. PSE,
Docket Nos. UG-040640, UE-040641, Order No. 06 57

Tables

Table 1: Rate Recovery of Sales Volume Drivers 8

Table 2: Summary of PSE’s GRNA Simulation Under PSE’s Proposed Rates 14

Table 3: Summary of Potential Residential Rate Increases Under Staff’s ‘Partial Decoupling’ Mechanism 16

Table 4: Comparison of PSE’s Estimated Lost Margins from Natural Gas Energy Efficiency Programs to Various Expenses and Potential Rate Increases from Decoupling 16