

EXHIBIT NO. ___(MRM-5T)
DOCKET NO. UE-132027
WITNESS: MATTHEW R. MARCELIA

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

**For an Accounting Order Approving the
Allocation of Proceeds of the Sale of
Certain Assets to Public Utility District #1
of Jefferson County.**

Docket No. UE-132027

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF
MATTHEW R. MARCELIA
ON BEHALF OF PUGET SOUND ENERGY, INC.**

APRIL 22, 2014

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF

MATTHEW R. MARCELIA

CONTENTS

I. INTRODUCTION1

II. OVERVIEW OF RESPONSE TESTIMONY2

III. ADJUSTMENTS TO THE PURCHASE PRICE.....7

IV. THE GAIN CALCULATION8

V. ACCUMULATED DEPRECIATION.....10

VI. EFFECT OF REINVESTMENT32

VII. RESPONSE TO OTHER TESTIMONY35

VIII. CONCLUSION.....37

1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF**

3
4 **MATTHEW R. MARCELIA**

5 **I. INTRODUCTION**

6 **Q. Please state your name and business address.**

7 A. My name is Matthew R. Marcellia. I am employed as Director of Tax for Puget
8 Sound Energy, Inc. (“PSE” or “the Company”). My business address is 10885
9 NE Fourth Street, Bellevue, WA 98009-9734.

10 **Q. Are you the same Matthew R. Marcellia who sponsored prefiled direct**
11 **testimony in this proceeding?**

12 A. Yes, I am. I prepared prefiled direct testimony, Exhibit No. ___(MRM-1T) and
13 three supporting exhibits, Exhibit No. ___(MRM-2) through Exhibit
14 No. ___(MRM-4), filed on October 31, 2013.

15 **Q. What is the purpose of your rebuttal testimony?**

16 A. My rebuttal testimony responds to the response testimonies of Edward J. Keating,
17 Michael P. Gorman, and James R. Dittmer on behalf of WUTC Staff, Industrial
18 Customers of Northwest Utilities (“ICNU”) and Public Counsel, respectively. I
19 will discuss and explain (a) the gain calculation and its importance and centrality
20 to this filing; (b) the purpose and meaning of “depreciation expense” and impact it
21 has on the concept of “accumulated depreciation”; (c) the accounting principles
22 that apply to the transaction; (d) investor ownership of assets and the risk of loss;

1 (e) why reinvestment does not compensate the investor for loss of customers and
2 service territory; (f) as well as counter or clarify a number of other comments
3 offered by Messrs. Keating, Gorman, and Dittmer; (g) finally, I will conclude
4 with a brief summary.

5 II. OVERVIEW OF RESPONSE TESTIMONY

6 **Q. Having reviewed the responsive testimony filed by WUTC Staff, Public**
7 **Counsel and ICNU, does the Company have any general statements that it**
8 **would like to offer?**

9 A. Yes, it appears as if there is a basic misunderstanding on the part of these
10 witnesses of the facts and circumstances of this case and the reasoning that
11 underlies PSE's requested accounting treatment. In effect, the witnesses fail to
12 refute PSE's analyses or respond to the facts and issues stated in the Company's
13 accounting petition.

14 **Q. Please explain why you think these witnesses misunderstand the facts and**
15 **circumstances of the case.**

16 A. First, the witness for WUTC Staff views this case as through the lens of Centralia
17 and similar precedent. Centralia is not applicable to the facts and issues presented
18 in this proceeding. In Centralia, the question presented was whether the
19 Commission should approve or deny a proposed voluntary transfer of an asset.
20 The Commission addressed this question in Centralia by applying a "no harm
21 test," which is a four-part test to determine if a proposed asset transfer is
22 consistent with the public interest. In that context, the Commission articulated

1 rules that pertain to the allocation of gain as an aspect of a greater public interest
2 inquiry. Unlike Centralia, in this case the asset transfer is "approved" by
3 operation of law, and this question was asked and answered in Order 03, UE-
4 101217 (Feb. 1, 2011). The "no harm test" does not apply in this limited context.
5 Moreover, Centralia does not address consequences of the hostile acquisition of a
6 portion of PSE's service area.

7 Public Counsel also appears to rely upon cases and accounting principles that are
8 applicable to the retirement of utility assets in the ordinary course of business.¹
9 Like Staff, Public Counsel argues for an accounting treatment based on facts that
10 are not presented in this case. Public Counsel's presumed facts are not what
11 happened in Jefferson County.

12 Similarly, ICNU argues that this forced sale of income producing assets under
13 threat of condemnation and the corresponding loss of service area "can be
14 essentially viewed as an early plant retirement." An early plant retirement does
15 not describe the characteristics of this transaction – specifically the forced nature,
16 the threat of condemnation, and the corresponding loss of service area. Not
17 surprisingly, ICNU cites no precedent whereby any state commission has so
18 construed facts that fairly reflect what happened in Jefferson County to "be
19 essentially viewed as an early plant retirement."

20 **Q. Why is this an important distinction?**

¹ See Exh. No. JRD-1T at 7:15-16.

1 A. The question presented to the Commission in this case is narrow and resolution of
2 this case need not implicate or disturb the established rules that the Commission
3 normally applies to other circumstances. The parties' arguments suggest that the
4 Commission is presented with a "game changing" decision of far reaching
5 proportions (e.g. a "significant departure" from past precedence).² This is simply
6 not the case. The transaction with Jefferson County is readily and properly
7 distinguishable from both a voluntary transfer and an asset retirement in the
8 ordinary course of operating a utility business.

9 As the Company pointed out in its Petition, the unusual and extraordinary
10 circumstances presented in this case are the unique and harsh circumstances of the
11 liquidation of the entire business enterprise in a given locality. Considering facts
12 that are similar to the facts presented in this case, the California Public Utilities
13 Commission recognized that municipalizations result in unique consequences
14 that warrant unique treatment:

15 We are convinced that in the circumstances contemplated in this
16 rulemaking (sale of part of a public utility distribution system to a public
17 entity which then assumes the obligation to serve the customers formerly
18 served by the utility within the area served by the transferred system),
19 gains or losses from the sale should be allocated to the shareholders of the
20 public utility, provided that the ratepayers have not contributed capital to
21 the distribution system and are not adversely affected by the transfer of the
22 system.

23
24 We note that we have always allocated to shareholders the gains or losses
25 from the total liquidation of a public utility. The transfer of distribution
26 facilities together with the assumption of the responsibility to serve
27 customers is essentially a partial liquidation of the public utility which

² Exh. No. JRD-1T at 6:11.

1 transfers the facilities. *Thus, the rules on liquidation logically should*
2 *cover the narrowly defined circumstances we have described.*³

3 And in a later decision, referring to this precedent, the California Public Utilities
4 Commission stated:

5 Most notably, the Decision points out that the Redding II test was
6 designed to apply in 'narrow circumstances.' Thus the Decision gives a
7 reason for maintaining this precedent even if some of the logic behind it
8 differs from the rationale of the Decision. The Joint Parties, in their
9 response point out that the sale of a portion of a public utility system to a
10 municipal utility '*involves public policy considerations distinct from those*
11 *to which the new gain/loss on sale rules will apply.*' (Response of Joint
12 Parties at p. 6.) There is nothing arbitrary about the Decision's
13 determination to create an exception from its general rule.⁴

14 The "distinct" or unique considerations recognized by the California commission
15 (and other commissions) are (a) the loss of part of its customer base and (b) a
16 decline in its on-going business value, all of which is tantamount to a dissolution.
17 Under these facts, our Commission, like the California commission, must
18 recognize the right of the utility to the net capital gain resulting from the sale.

19 **Q. What are the distinguishing facts that separate this transaction from other**
20 **asset sales?**

21 **A.** In the case of the JPUD transaction, as well as the partial liquidations discussed in
22 *Redding II*, the transactions in question were forced sales, under threat of
23 condemnation, by a public entity with legal authority to compel the transfer of the

³ *In re Ratemaking Treatment of Capital Gains from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity*, 104 PUR4th 157, 160 (CPUC 1989) (emphasis added).

⁴ *Re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets Rulemaking Proceeding 04-09-003 Decision 06-12-043*, 2006 WL 3831392 (CPUC Dec. 14, 2006).

1 assets as a matter of law. The assets consisted of the operating assets deployed in
2 a given geographic area in connection with the delivery of retail electric service.
3 The assets in question were in rate base (i.e., deployed to provide electric service
4 to customers and to return future earning to investors) and upon consummation of
5 the sale, the service area was lost to the incumbent utility and the public service
6 obligations pass to the successor utility.

7 **Q. What are the distinguishing legal issues that separate this transaction from**
8 **other asset sales?**

9 A. This aspect of this case was addressed in Order 03 in U-101217 (Feb. 1, 2011).
10 To my reading of that order, the transfer of JPUD assets occurred pursuant to
11 RCW 80.12.020 as a matter of law. The "no harm" test articulated by *Centralia*
12 and its progeny is not applied or even relevant to the transfer of the Jefferson
13 County assets.

14 It is my further understanding from this order that the Commission has no
15 jurisdiction over PSE's former customers, nor any basis to allocate "benefits" to
16 any "burdens" that they might have carried, nor any basis to "reward" any "risks"
17 that they might have incurred. However, as to the utility and its investors, the
18 Commission retains jurisdiction to address the impacts associated with the loss of
19 part of its customer base and its on-going business value. I believe that the
20 Commission also retains its jurisdiction to address any harm to PSE's remaining
21 customers that is a consequence of the transfer of the Jefferson County assets to
22 JPUD.

1 **Q. Having considered the responsive testimony filed by WUTC Staff, Public**
2 **Counsel and ICNU, does the Company now wish to propose any changes or**
3 **modifications to is requested accounting treatment?**

4 **A.** No. Consistent with the principles applicable to the forced liquidation of an
5 incumbent utility's entire business and assets in a given locality, PSE is proposing
6 to allocate 75% of the gain to investors and 25% to the remaining customers.

7 **III. ADJUSTMENTS TO THE PURCHASE PRICE**

8 **Q. Are there any changes that need to be made to the purchase price or gain**
9 **calculation that you presented in your direct testimony?**

10 **A.** Yes, I am providing Exhibit No. ___(MRM-6), which updates my original gain
11 calculation to reflect the changes.

12 **Q. What changes did you make and why are these changes necessary?**

13 **A.** My direct testimony was prepared and filed with the Company's Petition for an
14 Accounting Order in October of last year. The Accounting Petition noted
15 however, with respect to the purchase price of the assets, that JPUD had
16 questioned approximately \$416,000 in charges for assets placed in service during
17 the transition period. PSE agreed to review these charges to determine if any
18 further adjustments are warranted.

19 As a result of this review, JPUD and PSE subsequently agreed to a further
20 adjustment of the purchase price, and to give JPUD a \$100,000 credit against
21 future payments due PSE on April 1, 2014. As a result, and as reflected in

1 Exhibit No. ___(MRM-6), the total amount of the proceeds has been reduced
2 from \$109,373,196 to \$109,273,196. All amounts due from JPUD on April 1,
3 2014 were paid, and the \$109,273,196 has now been paid in full.

4 As a result of the adjustment to proceeds, the final gain is \$59,864,313. The
5 Company proposes to allocate 75% (or \$44,898,235) to investors and 25% (or
6 14,966,078) to remaining customers.

7 IV. THE GAIN CALCULATION

8 **Q. Precisely what is the Company requesting the Commission to decide in this**
9 **filing?**

10 A. The Company is requesting the Commission to allocate the *gain* of \$59.9 million
11 between customers and investors.

12 **Q. Why isn't the company asking the Commission to allocate the proceeds**
13 **between customers and investors?**

14 A. The amount of proceeds becomes irrelevant once the gain has been determined.
15 The gain is the excess of the proceeds over the net book value of the asset being
16 sold, less transaction costs.

17 Both Mr. Keating⁵ and Mr. Gorman⁶ start their analysis from the wrong place –
18 the proceeds. Mr. Dittmer avoids all of the confusion around proceeds that plays
19 so heavily in the analysis of Messrs. Keating and Gorman. He focuses precisely

⁵ Exh. No. ___(EKJ-1T) at 2.

⁶ Exh. No. ___(MPG-1T) at 6:7.

1 on the book gain. So while I disagree with his conclusion, I agree with his focus
2 on the gain as being the issue in this proceeding.

3 **Q. Why does it matter? Won't you get the same result regardless of the starting**
4 **point?**

5 A. No, because from an accounting perspective, there is only one number at issue:
6 the gain. From a regulatory perspective, there is a slightly different issue: who
7 gets the gain. The only number that is available to anyone, investor or customer,
8 is the gain.

9 **Q. How does the composition of the proceeds affect allocation of the gain?**

10 A. It has no impact. Trying to infer or divine the anatomy of the proceeds is
11 ultimately a meaningless exercise. It leads to terms like "gross gain" or
12 "appreciation" or some other term that requires a unique definition as it has no
13 basis in the accounting literature.

14 The reality is that the proceeds are the amount that JPUD was willing to pay PSE
15 for the assets and service territory, and the avoidance of protracted and uncertain
16 litigation.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27

V. ACCUMULATED DEPRECIATION

Q. Mr. Keating and Mr. Gorman allocated all of the accumulated depreciation to remaining customers. Is this appropriate?

A. No. Allocating accumulated depreciation to remaining customers is inconsistent with the basic concept of depreciation, the matching principle, and the cost of service model of rate making.

Q. Please explain what depreciation is and why is it reflected in the cost of service?

A. For accounting purposes, the Accounting Standard Codification (“ASC”) 360-10-35-4 states that depreciation accounting

is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of *allocation*, not *valuation*. [emphasis added]

In the FERC Uniform Systems of Accounts (Part 101, Definitions, paragraph 12), depreciation is defined as follows:

Depreciation, as applied to depreciable electric plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities.

In short, the goal of depreciation is to allocate the original cost of the asset (less estimated salvage) over the estimated life of the asset. This has the effect of matching the consumption/wasting of the asset (which occurs through wear and

1 tear, decay, and action of the elements) over the time period for which the asset is
2 employed in the provision of electric service to customers.

3 **Q. How does PSE establish its annual depreciation expense?**

4 A. Depreciation expense is determined by applying the depreciation rate to the
5 original cost of the assets. The depreciation rates are determined in a depreciation
6 study.

7 **Q. What is a depreciation study?**

8 A. In a depreciation study, the Company evaluates the mortality characteristics of the
9 property to establish appropriate depreciation rates for all depreciable assets. The
10 service life and net salvage estimates in the study are based on the Company's
11 historical retirement data, the Company's outlook related to plant operations and
12 retirements, and current industry trends and practices, including the Iowa curves.
13 The rates are set to recover the remaining net book value less net salvage over the
14 remaining service life in a levelized or smooth manner (e.g. straight-line) even
15 though wear and tear does not occur evenly. The Company's last depreciation
16 study was completed for the 2007 general rate case, based on December 31, 2006
17 balances.

18 The rates determined in the study are applied to the original cost of the assets to
19 determine the annual depreciation expense. The summation of annual
20 depreciation expense is recorded in accumulated depreciation.

1 **Q. Did the Company implement the depreciation rates from the 2007 study?**

2 A. Yes, and those rates have been in effect since that time.

3 **Q. Does the Company believe those rates are still appropriate in light of the**
4 **significant gain in the JPUD transaction?**

5 A. Yes. The Company believes those rates are still appropriate. The JPUD
6 transaction did not occur in the ordinary course of business. The JPUD
7 transaction was not contemplated in the establishment of depreciation rates.
8 Under the Company's proposed treatment, the transaction has no impact on the
9 depreciation rates going forward as neither the assets nor the accumulated reserve
10 will remain on the books and so will not impact future depreciation studies.

11 In addition, in the Jefferson transaction, JPUD purchased more than just the
12 assets. The depreciation study only captures the service life over which the
13 remaining costs should be recovered. It does not capture any of the externalities
14 that are present in this transaction such as the going concern value, the customer
15 lists, the service territory, or the value of avoiding litigation.

16 In other words, the presence of a gain in a condemnation setting is not necessarily
17 indicative of excess depreciation (i.e. inappropriate depreciation rates) in prior
18 years as there are numerous other factors at play in a condemnation. In fact, even
19 asking the question confuses two concepts called out in the ASC definition:
20 depreciation is a process of *allocation*, not *valuation*. Depreciation is capturing
21 the wear and tear, not necessarily the change in value.

1 **Q. Do customers pay PSE for PSE's depreciation expense?**

2 A. No, not directly. PSE's depreciation expense is a recoverable item and it is
3 included when PSE sets its revenue requirement in a general rate case, along with
4 a host of other items. However, whenever PSE earns less than its allowed rate of
5 return, something has not been recovered. For example, in its 2013 10K, page 33,
6 PSE disclosed that actual depreciation expense *exceeded* the amount allowed in
7 rates by \$36.4 million in 2013 and \$38.2 million in 2012. Clearly, customers
8 have not paid for all of PSE's depreciation expense or accumulated depreciation.
9 Customers are paying for a service – electrical service. That fact is clear by a
10 review of any customer's bill. They are not paying for depreciation expense
11 specifically, and do not cover it in its entirety.

12 **Q. Does the Company's depreciation expense or accumulated depreciation**
13 **reserve represent customers' contribution to capital?**

14 A. No. The Company's accumulated depreciation balance represents the portion of
15 the assets that have been consumed, i.e., used up, in the provision of electric
16 service to customers. It is the exact opposite of a contribution to capital. Rather,
17 it denotes the missing capital, the part of the asset that has been worn away.

1 **Q. How does Mr. Gorman reach the conclusion that customers should be**
2 **reimbursed for their payment of JPUD investment costs?**

3 A. Mr. Gorman states the “customers made significant contributions to the gross
4 plant value of the JPUD assets.”⁷ He also opines that “the original investment
5 funding of the JPUD assets has been shared between PSE and its customers.”⁸
6 With no support for such statements, he concludes that customers deserve to be
7 reimbursed for their investment in JPUD assets.

8 **Q. Are his statements accurate?**

9 A. No. Customers made no “contribution to the gross plant value.” Customers
10 provided no “original investment funding.” The original investment and the gross
11 plant value were funded solely by investor capital.

12 Accumulated depreciation is not investment in capital. There is no accounting
13 theory, regulatory theory, or logic to support this notion.

14 **Q. In his concluding argument, Mr. Gorman slightly recasts his allocation logic**
15 **on the need “to reimburse customers for payment of depreciation expense for**
16 **the JPUD assets”.⁹ Is this appropriate?**

17 A. This is an extremely puzzling proposition. First, as I explained above, the
18 customers have never compensated PSE on a dollar-for-dollar basis for the

⁷ Exh. No. ___(MPG-1T) at 3:12-13.

⁸ *Id.* at 3:16-17.

⁹ Exh. No. ___(MPG-1T) at 15:19-20.

1 depreciation expense. So it is not suitable to “refund” customers for costs they
2 have not paid.

3 Second, no witness has presented any evidence that the depreciation rates that
4 were applied to the property were inaccurate or excessive. The presence of a gain
5 or a loss is not evidence that the depreciation rates were inappropriate. As the
6 definition of depreciation indicates, the depreciation calculation is an exercise of
7 allocation, not valuation. JPUD acquired more than just the assets and the
8 purchase price reflects more than the sale of assets. The presence of a gain does
9 not impugn the depreciation calculation.

10 Third, the amount of accumulated depreciation represents the portion of the
11 property that was used up and consumed in the provision of electric service to the
12 customers of Jefferson County. Had those assets been newer or not as worn as
13 they were, the Company could have demanded a higher selling price because they
14 would have had more life remaining. The fact that JPUD may have placed a
15 different value on the remaining life of the asset does not imply that PSE net book
16 value was deficient or that its charges to customers for power were too high.

17 Fourth, Mr. Gorman’s proposal to reimburse remaining customers for the
18 accumulated depreciation on the JPUD assets would result in more than doubling
19 the benefit to remaining customers. In the first case, departing customers paid for
20 a significant amount of the remaining distribution system. In the second case,
21 remaining customers would get a refund in *excess* of their share of the

1 depreciation on the JPUD assets, as it must certainly be true that the departing
2 JPUD customers paid for some portion of their accumulated depreciation.

3 Fifth, if Mr. Gorman's proposition is correct, the proper treatment is NOT a
4 refund of the depreciation expense.

5 **Q. Please explain the proper treatment under Mr. Gorman's proposal.**

6 A. The proper treatment would be for the Company to record "excess depreciation"
7 (i.e. the customer's portion of the gain) to the accumulated reserve of the
8 remaining assets and flush through the consequences in the Company's next
9 depreciation study when the new depreciation rates are determined. As I
10 explained above, a key element in setting depreciation rates in a depreciation
11 study is to evaluate the Company's historical data which is why gains or losses
12 which occur in the normal course of business are posted to the accumulated
13 reserve. This would be the proper and accepted method for dealing with the
14 retirement of distribution property in the ordinary course of business. A refund
15 would be inappropriate.

16 **Q. Who paid for the accumulated depreciation on the JPUD assets?**

17 A. As the Company has pointed out on a number of occasions, rates are set in
18 common across the system. Because of this, it is not possible to identify with
19 precision which rate payer paid for what. However, as the testimony of Mr.
20 Piliaris makes clear, what we do know about the JPUD customers indicates that
21 their contribution was more-or-less equivalent to their share of the revenue
22 requirement. Mr. Piliaris defines the "bookend" and provides a reasonable

1 analysis which shows that departing customers likely covered their share of
2 depreciation.

3 By contrast, no witness has provided any evidence that remaining customers
4 actually covered the accumulated depreciation on the JPUD assets. They have
5 only inferred the possibility of such an occurrence due to the way that rates are set
6 across the system.

7 **Q. Will PSE double recover its depreciation expense if it is permitted to keep the**
8 **accumulated depreciation portion of the gain?**

9 A. No. It is nonsensical to say the “accumulated depreciation portion of the gain.”
10 Accumulated depreciation is not part of the gain. The gain is the proceeds less the
11 net book value less transaction costs.

12 Let me explain. Since accumulated depreciation represents the wear and tear
13 which has occurred on the assets, it is that part of the assets that has been worn
14 away. It does not exist. The assets have been worn down. The assets are less
15 than 100% of what they were when they were purchased. That wear has passed to
16 JPUD. It is incorrect to “assign” it to anyone. PSE attempted to recover it once
17 as the wear was occurring by reflecting depreciation expense in the revenue
18 requirement.

19 In addition, as Mr. Levin discusses at Exhibit No. ___(SLL-1T), assigning
20 accumulated depreciation to remaining customers denies the Company the return
21 of the investment as it was depreciated, with the result being the opposite of
22 double recovery. It is important to look back to the definition of depreciation – it

1 is a process of allocation, not valuation. Perhaps this illustration will help. If I
2 have a shirt with a hole in the elbow, that shirt has suffered wear and tear. If I sell
3 that shirt for more than I paid for it, have I “double recovered” the hole in the
4 elbow? Of course not. The hole is still there. In fact, I could have realized a
5 higher price had the shirt been newer. The purchaser did not pay for the hole.
6 The hole did not add value to the sale. The purchaser bought the shirt despite its
7 accumulated depreciation. There are two different issues at play. One is the fact
8 that the shirt is depreciating (suffering wear and tear). The other is its value to
9 someone else. Often, the two issues have little or no correlation.

10 **Q. Mr. Gorman states that the sale of the JPUD assets is similar to an early**
11 **plant retirement.¹⁰ Is this true?**

12 A. No. In fact, it is dissimilar to an early retirement in a number of important ways.
13 First, early retirements are contemplated in setting the depreciation rates for
14 electric distribution assets. When rates are set in a depreciation study, the
15 Company determines the service life of the assets. That service life contemplates
16 the fact that within a class (or group) of assets, there will be a distribution of
17 mortality. Some assets will have an extremely long life, while others will have an
18 extremely short life (i.e. some will be retired early). Through statistical analysis,
19 the average service life is determined and that is an important part of setting the
20 depreciation rate. In fact, for the depreciation rate to be correct, early retirements
21 are required. The early retirements offset the impact of abnormally long lived

¹⁰ Exh. No. ___(MPG-1T) at 7:15-16.

1 assets and validate the use of the average service life. In contrast, the JPUD
2 municipalization was not contemplated in the depreciation study nor would it ever
3 be reflected in depreciation rates.

4 **Q. Why does ICNU compare the JPUD transaction to early plant retirement?**

5 A. ICNU refers to the Company's response to ICNU Data Request No. 3.06¹¹ and
6 No. 6.01¹² as support for its proposed treatment of the JPUD transaction. I will
7 respond to both.

8 a. In ICNU DR 3.06, Mr. Gorman posed the hypothetical of an early
9 retirement in the context of PSE electing to retire plant, "If PSE
10 *decides* that an early retirement of this hypothetical asset is
11 *justified...*" (emphasis added). The remainder of the data request is
12 not relevant. PSE never *decided* that the JPUD transaction was
13 *justified*. PSE opposed the JPUD transaction and stated that it was
14 NOT in the best interest of Jefferson customers. Not even the
15 Commission could stop this transaction as it falls outside of their
16 jurisdiction. The data request that Mr. Gorman uses as support reflects
17 a completely different reality than the facts in this case.

18 Under Mr. Gorman's hypothetical, normal retirement rules would
19 apply and the original cost of the asset would be recorded to

¹¹ Exh. No. ___(MPG-3) at 1-2)

¹² Exh. No. ___(MPG-3) at 7-9

1 accumulated depreciation. The balance would reside there until the
2 next depreciation study where it would be one of many factors
3 considered in setting the new depreciation rate.

4 PSE's response to DR 3.06 is complete and accurate. But the question
5 posed by ICNU is not relevant to the JPUD transaction.

6 b. In ICNU DR 6.01, Mr. Gorman requested information covering the
7 sale of the White River Hydroelectric Plant, the Issaquah Operating
8 Base, and Seaway Property. All three properties were sold in the
9 ordinary course of business, following a determination by the
10 Company and regulatory approval by the Commission that such
11 transaction were in customers' interest. For White River, "PSE
12 declined a FERC license because certain provisions of the federal
13 agency's approval made the project *uneconomic*."¹³ For the Issaquah
14 Operating Base, it "was *determined* to be no longer 'used and
15 useful.'"¹⁴ For the Seaway property, it also "was *determined* to be no
16 longer 'used and useful.'"¹⁵ In each situation, PSE made a
17 determination that the property was either uneconomic or no longer
18 "used and useful". In each situation, PSE made decisions and took
19 actions that were expressly in the interest of customers. In each

¹³ Exh. No. ___(MPG-3) at 8 (emphasis added).

¹⁴ Exh. No. ___(MPG-3) at 8 (bottom of page, emphasis added).

¹⁵ Exh. No. ___(MPG-3) at 9 (emphasis added).

1 situation, the Commission approved the transaction and allowed the
2 Company's proposed accounting treatment. In each situation, the
3 Company continued to serve the same customer base. In none of these
4 transactions did the Company lose customers or service territory. In
5 the JPUD transaction PSE did not decide that the JPUD assets were
6 uneconomic or that they were no longer used and useful. PSE opposed
7 the transaction. The JPUD transaction originated under the
8 condemnation statutes and the transfer did not require the approval of
9 the Commission. PSE lost 1.8% of its customers.

10 PSE's response to DR 6.01 is complete and accurate. But the question
11 posed by ICNU is not relevant to the JPUD transaction.

12 **Q. How else is the JPUD transaction different from the early retirement of**
13 **plant?**

14 A. The JPUD transaction was not a sale of assets resulting from a business decision
15 to remove these assets from service. JPUD acquired our service territory and the
16 going concern value of an established business under threat of condemnation.
17 The only thing volitional about this transaction was a decision to avoid the
18 significant costs and risks of protracted litigation. Early retirements that occur in
19 the ordinary course of business do not shrink the utility's service territory. In fact,
20 early retirements in the ordinary course require the utility to invest in additional
21 resources in order to fulfill its obligation to meet the customers' continued
22 demand for electric service.

1 **Q. Mr. Gorman states customers assume significant asset risk related to**
2 **damages caused by storms and that PSE has fully recovered its restoration**
3 **costs for these natural disasters.¹⁶ Is this true?**

4 A. No. Mr. Gorman has confused historical cost-based regulation with asset risk.
5 PSE's distribution system has faced storms, earthquakes, wildfires, and
6 landslides. However, as explained in PSE's response to ICNU Data Request
7 No. 5.01 (Exh. No. ___(MPG-3), 3-6), none of these situation required regulatory
8 treatment related to the capital costs.

9 **Q. Why didn't PSE file for regulatory recovery of the damage caused by natural**
10 **disasters to its distribution capital assets?**

11 A. Natural disasters, while uncertain in degree and timing, are not unexpected. In
12 fact, they are reflected in the asset mortality analysis that informs the selection of
13 the service life in the depreciation study. The impacts of these types of events are
14 reflected in PSE's historical balances, which are a key component of the
15 depreciation study.

16 **Q. Does PSE's storm deferral mechanism place on customers the risk of capital**
17 **asset replacement resulting from storm damage?**

18 A. No.

¹⁶ Exhibit No. ___(MPG-1T) at 12:1-2.

1 **Q. Please explain the purpose of PSE’s current storm deferral mechanism.**

2 A. PSE is allowed to defer storm restoration O&M costs associated with storm
3 events that meet or exceed the Institute of Electrical and Electronics Engineers
4 (“IEEE”) standard 1366-2003 by \$8 million. This deferral is only available for
5 O&M costs, not capital costs. New assets that are installed as a result of storm
6 damage are capitalized.

7 **Q. Why does the deferral only cover O&M costs that exceed the standard by \$8**
8 **million?**

9 A. The Company incurs storm costs every year. In working with the Commission,
10 the Company has established that it is very highly likely to incur \$8 million in
11 storm related O&M costs each year and that amount is reflected in regular utility
12 rates. Any qualifying amounts beyond the \$8 million base amount may be
13 deferred and presented to the Commission in a future rate filing.

14 In order to ensure that customers only pay for actual storm damage (not potential
15 or theoretically possible storm damage), this Commission has not allowed a
16 higher storm allowance in regular utility rates. This arrangement has the benefit
17 of keeping customer rates low, while still allowing the utility to recover legitimate
18 costs to provide electric service to customers only after those costs have been
19 incurred.

1 **Q. How does the storm deferral or the capital costs related to storms relate to**
2 **the JPUD transaction?**

3 A. There is no relationship or comparison, and Mr. Gorman’s analogy is incorrect.
4 The recovery of O&M costs has no bearing on the proper treatment of the JPUD
5 gain. Likewise, storm damage to distribution system has no bearing on the proper
6 treatment of the JPUD gain. Storm damage, whether O&M or capital, does not
7 result in the loss of customers or service territory. It does not require customers to
8 contribute to capital to replace distribution facilities. It does not diminish the size
9 of the utility’s investment opportunity. It does not relieve the utility from its
10 obligation to provide electrical service to impacted customers.

11 **Q. Does “Rate Base Rate of Return Regulation”, referred to by Mr. Keating,**
12 **require gains to be divided between net book value (“NBV”) and**
13 **accumulated depreciation?**

14 A. No, contrary to Mr. Keating’s discussion on pages 8-9 of Exhibit No. ____ (EJK-
15 1T), the gain is determined by comparing the proceeds to the net book value. The
16 gain is the amount that is available to allocate between investors and customers.

1 **Q. Mr. Keating states that “when the asset is sold, 100 percent of the**
2 **accumulated depreciation should be returned to ratepayers”.¹⁷ Is this**
3 **required by “Rate Base Rate of Return Regulation”?**

4 A. No, it is not. Let me illustrate why. Assume an asset costs \$100 and has been
5 depreciated by \$45 down to a net book value of \$55. Let’s say the asset is sold
6 for \$75. The gain to allocate between investors and customers would be \$20 (i.e.
7 \$75 proceeds less \$55 net book value = \$20 gain). Mr. Keating would allocate
8 100% of net book value to investors (i.e. \$55). He would allocate 100% of
9 accumulated depreciation to customers (i.e. \$45). That completes his allocation.
10 The major flaw is this: by allocating \$45 to customers, the Company will have to
11 record a LOSS on the sale of \$25, not a gain.

12 **Q. Please explain.**

13 A. In order to allocate 100% of the accumulated depreciation to customers, as Mr.
14 Keating argues, they must get \$45. However, as stated above, and as would be
15 reflected on PSE’s books, the gain is only \$20. Therefore, the Company would
16 have to record a \$25 loss on the sale of the assets in order to return 100% of the
17 accumulated depreciation to customers as Mr. Keating’s proposal requires. This
18 is wrong and illustrates why the gain must be allocated, not the proceeds.

¹⁷ Exh. No. __ (EJK-1T) at 8: 9-10.

1 **Q. Mr. Keating thinks that PSE’s allocation will result in double recovery of the**
2 **investment at the expense of ratepayers.¹⁸ Will it?**

3 A. No, Mr. Keating is mistaken. As I explained above, customers have not fully paid
4 for the accumulated depreciation in the first instance. In addition, Mr. Keating’s
5 proposal will result in remaining customers receiving a portion of their electric
6 service for no charge. He does not account for the contribution that departing
7 customers made to the distribution system. He would “refund” remaining
8 customers amounts they never paid. In effect, he would create a greater than
9 double benefit to the remaining customers.

10 To the extent that PSE recovered any of the investment expense in rates, it did so
11 in prior years as part of the cost of service for the electric service, as the original
12 costs of the assets was allocated over the estimated service life (aka depreciation
13 expense). The depreciation expense was designed to match up with the timing of
14 the delivery of electrical services to which it related. When JPUD purchased the
15 assets, it did not pay for the accumulated depreciation. It purchased the assets
16 notwithstanding their flaws (“as is, where is, with all faults and defects”). The
17 presents of the accumulated depreciation did not enhance the value of the assets
18 nor did JPUD pay for the accumulated depreciation. JPUD paid for the value of
19 the assets, the customers and service territory, the going concern value, and the
20 avoidance of litigation.

¹⁸ Exh. ___(EJK-1T) at 9:7.

1 **Q. Please elaborate on Mr. Keating’s home loan analogy.¹⁹**

2 A. Mr. Keating’s home loan analogy completely misapplies the facts by defining
3 PSE as the lender and customers as the borrower. He concludes that if the
4 borrower sells the house for a gain, the lender only receives his principal back and
5 nothing more. This is true enough for the lender. However, PSE is not the lender
6 in this case and customers are not the borrower.

7 **Q. Can you correct the analogy?**

8 A. Yes, here is the proper analogy. PSE is the owner of the house. It received its
9 capital from investors (debt and equity). Customers are renters. They do not own
10 the house. Customers pay rent and some part of their rent reflects their
11 consumption (depreciation) of the house. If the house is sold for a profit, lenders
12 get repaid for the outstanding loan balance. Shareholders get what’s left. Renters
13 do not share in the gain. Renters do not get their rent back. Renters paid for their
14 housing services, not for an ownership interest in the property.

15 **Q. When regulation is considered, doesn’t that change the relationship and**
16 **impart quasi-ownership on renters/customers?**

17 A. Not at all. There is no aspect of regulation that would impute ownership of assets
18 to customers. For example, when rates are set, the regulator only allows the
19 utility to recover certain types of costs and a return on investment. Limitations
20 are placed on both parts of the revenue requirement (or “rent” in the home

¹⁹ Exh. No. ___(EJK-1T) at 12:14.

1 analogy). For example, O&M costs must be “known and measurable” and the
2 assets that are included in rate base must be “used and useful”. The utility cannot
3 recover anything outside of these parameters. As part of the regulatory compact,
4 the utility must provide service to everyone in the service territory.

5 In any business enterprise, regulated or not, prices must be set at a level which
6 compensates the business for the costs and risks it undertakes. In a regulated
7 business, setting the price is more transparent than in an unregulated business.
8 But regardless of the level of transparency, the reality is unchanged. In the
9 regulatory situation, customers cover nothing but what is included in the rate
10 model. Whenever an event occurs outside of that model, the company is left fully
11 exposed to the risk without any compensation from customers – this is precisely
12 by design. It is done on purpose. The company may seek recovery of certain
13 costs from the regulator at that time. Under the regulatory compact, customers
14 only bear the cost of events that actually come to pass. There is no speculation
15 involved. As a result, customers pay a lower rate and the utility does not reflect
16 that risk in its general rates.

17 **Q. Is Mr. Keating correct when he comments that PSE is “faced with virtually**
18 **no risk of capital loss and severely diminished risk of earnings loss”²⁰ or that**

²⁰ Exh. No. ___(EJK-1T) at 17:20-21.

1 **“ratepayers are at risk for any capital losses related to the value of utility**
2 **assets”?**²¹

3 A. No, he is not. In the ordinary course of business, PSE faces all of the capital risk.
4 That cost associated with that risk can only pass to customers (the risk does not
5 pass, only the cost does) after the capital investment is deemed prudent under the
6 regulatory compact. Even when that requirement is satisfied, PSE still bears the
7 earnings risk which can be significant depending on the lag between the time the
8 investment is incurred and the time that the investment is included in rates. There
9 is some mitigation of this risk under the decoupling order which is a modification
10 to the historic regulatory compact that has been in place between PSE and the
11 Commission.

12 If customers did bear capital risk, they would need to put in capital. The fact that
13 the cost of assets is spread out and dispensed to them over the useful life is a
14 significant indicator that they do not bear any capital risk. Customers are
15 consumers of electric service, not investors in electric distribution assets.

16 It bears repeating, in response to Mr. Keating, that the JPUD transaction did not
17 take place in the ordinary course of business. PSE bears all the risk, including
18 capital loss and earnings diminishment, in a municipalization. Remaining
19 customers have lost nothing.

²¹ Exh. No. ___(EJK-1T) at 19:1-2.

1 **Q. Please respond to Mr. Keating’s statement that “Rate Base Rate of Return**
2 **Regulation allows the utility the opportunity to earn a fair rate of return on**
3 **and a return of its investment, and nothing more.”²²**

4 A. Mr. Keating’s proposal would create a harsh and unfair result: that investors
5 receive no gain when their assets have been taken, their customers and service
6 territory have been reduced, and their investment opportunity has been
7 diminished. As explained by Dr. Stanford Levin in Exhibit No. ___(SLL-1T),
8 Staff’s proposal of denying investors the net gain on their assets is actually
9 contrary to Rate Base Rate of Return Regulation because investors would be
10 denied a return of their investment, and they are denied the appreciation on the
11 assets resulting from their ownership.

12 A couple of examples will illustrate the point. First, when Puget Energy was
13 acquired in 2009, equity investors received a premium over their previous stock
14 price once the merger was announced. In that case, investors expected and, in
15 fact, received the full premium.

16 In another example, consider a complete liquidation scenario. In that situation,
17 how much of the gain would investors expect to share with customers? The
18 reality is that investors expect all of the gain or loss in a complete liquidation.
19 Investors have this expectation because they are owners.

²² Exh. No. ___(EJK-1T) at 13: 4-5.

1 **Q. What does the “Rate Base Rate of Return Regulation” say about**
2 **municipalizations or loss of customers/service territory?**

3 A. It says nothing about municipalizations. Municipalizations do not occur within
4 the normal regulatory context. It says nothing about how to compensate a utility
5 when it loses customers or service territory.

6 **Q. Isn’t PSE’s proposal a “significant departure from that which occurs with**
7 **the majority of depreciable utility plant that is removed from service”?**²³

8 A. Yes, but only in the sense that it is specific to a very unique situation that falls
9 outside the rules set by the Commission in *Centralia* or the normal treatment for
10 plant retirements.

11 This transaction is not normal. It is not like “the majority of depreciable utility
12 plant that is removed from service”. For all of the reason set forth in the
13 Company’s original petition and as explained above, this transaction requires
14 treatment that considers and is responsive to these unique and extraordinary facts
15 and circumstances.

²³ Exh. No. JRD-1T at 6: 11-12.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19

VI. EFFECT OF REINVESTMENT

Q. How will PSE’s reinvestment of the proceeds in the service of remaining customers compensate it for the loss of Jefferson customers?

A. It will not compensate for the loss of these customers. PSE has suffered a permanent diminishment to its investment opportunity. Whatever investment opportunity lies within its remaining customer base is unchanged by the departure of the JPUD customers. It has in no way increased by the loss of JPUD customers. However, the investment opportunity that would have been provided by 18,000 former customers has been lost.

Q. Isn’t PSE expecting growth from its remaining customer base?

A. Yes. However, Mr. Gorman mischaracterizes the issue.²⁴ While PSE’s remaining customer count may grow and even exceed that customer count at the time of the JPUD transaction, PSE has nevertheless suffered a loss of customers today. Its earnings base is smaller and its investment opportunity has diminished. PSE’s earning base will remain smaller and its investment opportunity will be diminished from what it would have been before the loss of Jefferson County service territory. Today, the JPUD customers are gone. Whatever growth is to be had in the remaining customer base is unchanged and unaffected by the transaction.

²⁴ Exh. No. ___(MPG-1T) at 8:12-16.

1 **Q. Does the speed of reinvestment matter, as Mr. Keating indicates?**²⁵

2 A. No. The speed of reinvestment does not change or restore the Company's
3 investment opportunity with the departing customers. It has been eliminated
4 permanently. PSE expected growth before the transaction, as well. No amount of
5 growth nor the speed of growth can restore the company's lost opportunity.

6 **Q. Did PSE increase its planned capital expenditures ("capex") to reflect the**
7 **reinvestment of the proceeds?**

8 A. No. The Company's planned capex is largely unchanged. The reinvestment is
9 required under §1033 of the Internal Revenue Code in order to defer the tax gain
10 on the involuntary conversion. The Company will meet this requirement, not
11 through increased investment, but through identifying capex that is already in the
12 plan as qualified replacement property. Incremental investment above planned
13 capex is not necessary for PSE to satisfy the IRS requirements.

14 **Q. Could PSE increase its planned capex and recoup its lost opportunity that**
15 **way?**

16 A. No. The amount that can be invested economically in the system is finite. If
17 investors put their equity back into the smaller business, it would distort the
18 approved capital structure. They would, in effect, be earning a portion of their

²⁵ Exh. No. ___(EJK-1T) at 33:15.

1 equity return at the debt rate (e.g. under earning because the approved capital
2 structure would differ from actual).

3 If the Company increased its borrowings in order to maintain the approved capital
4 structure, it would have cash in excess of investment needs of the smaller
5 business.

6 **Q. Please respond to Mr. Keating’s statement that “[l]osing future revenue may
7 be an opportunity cost, but it is *not* a risk of a capital loss”.²⁶**

8 A. I disagree. “Losing future revenue” is the essence of a capital loss. If there is no
9 revenue, how can there be recovery, not to mention profit? That is certainly the
10 recipe for a capital loss.

11 Mr. Keating also incorrectly states that “receiving the full book value of the sold
12 assets ... makes shareholders whole”. (page 33, lines 8-9). First, I believe he
13 means “net book value”, not “full book value”, since his overall testimony only
14 restores the net book value to investors. Second, to return the net book value to
15 investors simple gives them what they already have. It fails to compensate
16 investors for any element of their loss (i.e. customers, investment opportunity,
17 etc.).

18 **Q. Won’t investors be rewarded if they receive the equivalent of a brokerage
19 fee, as suggested by Mr. Keating?²⁷**

²⁶ Exh. No. ___(EJK-1T) at 33:7.

1 A. The problem with this concept is that the investors are owners, not brokers. The
2 investors owned the assets and the service territory. Awarding investors with the
3 equivalent of a brokerage fee is evidence that his proposal is inadequate. Owners
4 don't get a brokerage fee, they get the gain.

5 **VII. RESPONSE TO OTHER TESTIMONY**

6 **Q. Mr. Gorman claims that, "It is noteworthy, however, that in 2013, "PSE's**
7 **earnings exceeded its authorized rate of return." How do you respond?**

8 A. Unfortunately, no, the Company did not earn its authorized return in 2013.
9 While Mr. Gorman provided no support for his claim, page 33 of the Company's
10 publicly-available 10K confirms that PSE's did not exceed its authorized rate of
11 return in 2013. Mr. Gorman has, again, miscalculated PSE's actual rate of return.
12 Here, Mr. Gorman makes the same calculation error he made in PSE's 2011
13 general rate case and 2013 decoupling proceeding, in which he considers PSE's
14 non-regulated subsidiaries and OCI when calculating return on equity and capital
15 structure. In those cases, the Commission rejected this "misleading picture"
16 painted by Mr. Gorman.²⁸

17 **Q. Mr. Keating is challenging the Company's inclusion of \$317,805 in labor**
18 **charges to the JPUD transaction costs. Please elaborate.**

²⁷ Exh. No. ___(EJK-1T) at 35:14-16.

²⁸ Dockets UE-121697/UG-121705, Order 07, ¶ 62.

1 A. As part of the transaction, PSE incurred labor charges. Those charges were
2 properly recorded to the transaction. Generally accepted accounting principles,
3 FERC, and the Commission require that labor be charged to the job to which it is
4 related. PSE followed its longstanding procedures to ensure that all labor charges
5 were recorded to the proper work orders. Note that Mr. Keating is not
6 challenging the work that was performed but instead is challenging the
7 accounting. He believes that the “labor expenses duplicated costs that are already
8 included in rates” from PSE’s most recent rate filings, the Expedited Rate Filing
9 (“ERF”, UE-130138) and most recent Power Cost Only Rate Case (“PCORC”,
10 UE-130617).²⁹ This is not correct. There is no overlap or duplication between
11 the labor expenses recovered in the ERF and PCORC and those charges reflected
12 in the JPUD retirement orders. They are different charges for different work.
13 PSE’s accounting system does not permit the posting of the same time to more
14 than one work order.

15 **Q. How do you respond to Staff’s claim that PSE’s proposal here is contrary to**
16 **its proposal for the Electron Hydroelectric transaction?**

17 A. The Electron proposal provides a contrast to the JPUD transaction. First, the
18 proposal to sell Electron required Commission approval in which (a) it applied a
19 no harm test, and (b) PSE demonstrated that the proposal represented the least
20 cost alternative and was in the public interest. In contrast, the Commission did

²⁹ Exh. No. ___(EJK-1T) at 36:16-17.

1 not and could not approve or disapprove of the JPUD transaction and the “no
2 harm” test was not applicable.

3 Second, the cost of the plant is to be reflected in customer rates under the
4 mechanics of the regulatory compact that is in place. The risk of Electron closing
5 down early due to economic obsolescence and other factors was not reflected in
6 rate making. That risk became a reality and led the Company to look for a buyer.
7 This is the kind of risk that the Company can pass to customers only after the fact
8 via Commission approval. In contrast, the risk of a condemnation proceeding
9 cannot be passed along to remaining customers as it is a risk of owning assets and
10 not a component of the costs of service regulatory model. This risk would never
11 be reflected in rate making. It falls entirely on investors.

12 Finally, no customers or service territory will be lost under the Electron proposal
13 nor will the Company’s investment opportunity be diminished. In fact,
14 replacement generation must be secured in order to meet the undiminished needs
15 of all customers. In contrast, PSE lost 1.8% of its customers and service territory
16 in the JPUD transaction and it has a smaller investment opportunity.

17 VIII. CONCLUSION

18 **Q. Please summarize your testimony.**

19 A. The testimonies of Staff, ICNU, and Public Counsel are nonresponsive to the facts
20 and circumstances that are present in this case. It is the gain that must be
21 allocated. Depreciation is an allocation exercise, not a valuation analysis. There

1
2
3
4
5
6
7
8
9
10

is no double recovery of the investment as JPUD did not acquire accumulated depreciation. They purchased the assets in spite of the wear and tear present, not because of it. The possibility that PSE may reinvest does not compensate it for the loss of customers and investment opportunity.

In short, reason, logic, and the regulatory compact demand that investors be compensated for the risk that they bore and the loss that they incurred. I believe that allocating the gain 75% to the Company and 25% to customers will satisfy this demand.

Q. Does this conclude your rebuttal testimony?

A. Yes.