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** **(*consolidated*)**

REPLY BRIEF OF PUGET SOUND ENERGY, INC.

NOVEMBER 14, 2006

REDACTED VERSION

PUGET SOUND ENERGY, INC.

TABLE OF CONTENTS

I. INTRODUCTION 1

II. POWER COST ADJUSTMENT MECHANISM 3

III. MECHANISMS TO ADDRESS HIGH ENERGY DELIVERY SYSTEM CAPITAL INVESTMENT NEEDS AND REGULATORY LAG 7

A. Depreciation Tracker 8

B. Known and Measurable Adjustment...10

IV. CAPITAL STRUCTURE AND COST OF CAPITAL...13

A. The Commission Should Adopt PSE's Proposed Capital Structure With an Equity Ratio Of 45% 13

1. The Commission Should Reject Staff's Arguments That PSE's Proposed Capital Structure Is Speculative and Excessive 14

2. The Commission Should Reject ICNU's Argument That Capital Structure Must Satisfy the Known and Measurable Standard 19

B. The Commission Should Adopt PSE's Proposed ROE Of 11.25% 20

1. PSE Failed To Earn Its Authorized ROE Each Year From 2002-2005 20

2. PSE's Requested ROE Of 11.25% On a Capital Structure Containing 45% Equity Is Fair, Just, Reasonable and Sufficient..22

3. Staff and ICNU Each Proposes an ROE Based On Flawed Financial Models That Significantly Understate PSE's Cost Of Equity..25

4. Other Parties Overstate the Effect of the Company's Proposed Mechanisms On Its ROE..26

5. Staff and ICNU Misstate the Company's Credit Ratings...............29

6. A Flotation Cost Allowance Is Necessary For PSE To Recover Costs Incurred in the Issuance of Equity 31

V. DECOUPLING—GAS REVENUE NORMALIZATION ADJUSTMENT.........34

A. Staff, NWEC, and the Company All Favor Revenue and Bill Stabilization Mechanisms That Prevent Over and Under Collection and Payment of Gas Margin Due To Variations in Customer Usage........34

B. Staff, NWEC, and the Company All Agree That the GRNA As Proposed By the Company Will Prevent Over- And Under-Collection and Payment of Margin Due To the Effects of Conservation and Weather. 34

C. A Decoupling Mechanism Should be Adopted To Prevent Over and Under Collection and Payment of Margin Due to Weather Variability 35

D. The GRNA Should Not Be Tied To a Conservation Target......................36

E. No Cap On The Annual Adjustment Should Prevent Later Recovery 36

F. The GRNA Decoupling Mechanism As Proposed By the Company Includes an Appropriate Adjustment For Growth In Customers...............37

G. Administration of the GRNA Would Not Be Unduly Burdensome 38

H. Public Counsel's Other Arguments Against Decoupling Should Be Rejected 38

I. Decoupling and an Increased Gas Residential Customer Charge Work Together To Decrease Bill Volatility 40

VI. ELECTRIC ENERGY EFFICIENCY INCENTIVE..40

VII. WEATHER NORMALIZATION...43

VIII. REVENUE REQUIREMENTS: CONTESTED ADJUSTMENTS 46

A. Adjustment 20.03—Power Cost 46

1. Re-running the AURORA Model. 47

2. AURORA Model Prices 48

3. Hydro Shaping 49

4. Minimum Up and Down Times for Gas-Fired Combustion Turbines 50

5. Additional Generation Capacity 52

6. Peak Loads 53

B. Adjustments 20.12 and 12.20 —Director and Officer Insurance 53

IX. GAS RATE SPREAD AND RATE DESIGN 54

A. Cost of Service Studies and Rate Spread 54

B. Rate Design 57

1. A $17 Monthly Gas Residential Customer Charge Benefits Customers and the Company 57

2. A Low Customer Charge Does Not Benefit Low Income Customers 59

3. Other Schedules 60

X. CONCLUSION 60

PUGET SOUND ENERGY, INC.

TABLE OF AUTHORITIES

Statutes

RCW 80.04.130(1). 23

Regulations and Rules

WAC 480-07-510(3)(b) 20, 56

United States Supreme Court Decisions

Bluefield Water Works Improvement Co. v. Pub. Serv. Comm'n of W.Va., 262 U.S. 679 (1923)..24

Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) 24

Washington Utilities and Transportation Commission

WUTC v. Avista Corp. , Docket UE-050482 & UG-050483, Order No. 05 (2005)...........4, 11

WUTC v. Cascade Natural Gas Corp. 84 PUR4th 119 (1987) 59

WUTC v. Olympic Pipe Line Co., Docket TO-011472, 20th Supp. Order (2002).....................5

WUTC v. PacifiCorp., Docket UE-050684, Order No. 04 (2006)..4

WUTC v. Puget Sound Power & Light Co., Cause Nos. UE-920433, et al., Eleventh Supp. Order (1993) 13, 14

I. INTRODUCTION

1. Puget Sound Energy, Inc. ("PSE" or "the Company") has presented the Commission with a strong case that demonstrates the Company's commitment to energy conservation, its desire to make investments in transmission and distribution infrastructure that benefit customers, and its prudent acquisition of electric generation resources to serve its customers.

2. Staff for the Washington Utilities and Transportation Commission ("Staff") and intervenors do not dispute the good things PSE has done for its customers over the past five years and plans to do in the future. They laud PSE's energy conservation efforts, acknowledge PSE's reliable energy delivery system, support the prudency of PSE's electric resource acquisitions and do not dispute PSE's sound financial management of the Company. Yet, with few exceptions, they decline to support the rate relief and mechanisms PSE has proposed to allow the Company to more efficiently provide high quality service to customers. They fail to recognize that the Company's interests are linked with the customers' interests. A financially healthy utility can provide highly reliable energy services at lower costs than a utility that is kept on the brink of "junk" credit-rating status. And there are regulatory mechanisms available to this Commission that will promote the financial health of the Company while at the same time benefiting customers. Rather than focusing on how PSE can maintain its high level of performance in the twenty-first century, the other parties in this case look backwards and advocate only for the status quo.

3. Although PSE has been a leader in providing reliable energy service and promoting energy conservation, the Company will not be able to continue at its planned pace without assistance in removing regulatory and financial obstacles. As Staff and intervenors in this case recognize, many of these obstacles are not new. The longer the Company is unable to obtain

regulatory relief to address these obstacles, the more difficult it becomes to carry out the important tasks facing the Company.

4. The Company's corporate credit rating remains at BBB-, where it has languished for several years. Regulatory lag has prevented PSE from achieving its authorized return on equity ("ROE") for several years. These financial impediments affect customers because a low credit rating translates to higher overall costs due to higher costs to access credit facilities. A low credit rating and regulatory lag affect the Company's ability to move forward with infrastructure replacement at the pace that the Company feels appropriate--if provided sufficient financial support. Slowing that pace could impact the reliability of the energy delivery system on which customers depend.

5. PSE has presented solid evidence in this proceeding demonstrating the need for mechanisms such as the Depreciation Tracker as well as the reasonableness of the Company's alternative known and measurable adjustment, to support its infrastructure replacement program. Although the other parties expect a highly-reliable energy delivery system, they oppose the mechanisms proposed by PSE to achieve this goal. They view the status quo of regulatory lag as being sufficient for the Company's situation. Their view is short-sighted.

6. Additionally, Staff and the Industrial Customers of Northwest Utilities ("ICNU") oppose the Company's efforts to earn an authorized ROE of 10.5-11.25%. This level of ROE is consistent with the average ROE approved for regulated companies nationwide after adjustment for PSE's particular circumstances—its level of power cost risk, its high infrastructure investment, its flotation costs, and its imputed debt from purchased power agreements. The parties also oppose PSE's proposed revisions to the Power Cost Adjustment ("PCA") Mechanism, while ignoring the level of extreme power cost risk that has been shifted to the

Company by the recent expiration of the $40 million cumulative cap. With respect to all of these issues, the other parties are not entirely forthcoming with the Commission.

7. PSE also faces obstacles to continued progress in energy conservation. PSE is a leader, nationwide, in promoting conservation in spite of the disincentives the Company faces. In this proceeding, PSE asks the Commission to remove these obstacles by approving the Company's gas decoupling proposal, electric energy efficiency incentive, and gas rate design proposal.

8. The relief PSE seeks in this case is supported by the evidence and will advance the common goals of PSE's customers and the Company.

II. POWER COST ADJUSTMENT MECHANISM

9. PSE appreciates the support of the other parties for PSE's proposal to open a new line of credit to support hedging transactions where costs associated with the credit line are passed through the PCA and Purchased Gas Adjustment ("PGA") mechanisms. However, some parties suggest that the credit line for hedging will reduce power costs, thus supposedly further reducing the need for PCA Mechanism revisions.[1] In fact, while PSE's hedging transactions are designed to reduce risk, they may or may not result in lower power costs. As Mr. Mills explained: "PSE's power procurement efforts are not designed to 'beat the market' by obtaining power at prices that are less than spot market prices at the time the power is consumed. Instead, PSE's primary purpose for executing commodity purchases is to reduce volatility and spot market exposure."[2]

10. Continuing the theme in their response testimonies, the other parties' initial briefs

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[1] *See, e.g.,* Public Counsel Br. ¶ 112; FEA Br. ¶ 18; Kroger Br. at p. 7.

[2] Mills, Exh. 269C 6:13-16. There is another potential source of confusion in Public Counsel's Initial Brief at ¶ 98, which states: "the Company proposes adding a new category of allowable costs to the PCA – power supply hedging costs." This is incorrect. Many of the costs associated with power supply hedging are already included in the PCA Mechanism, including the costs of fixed price transactions. In this proceeding, PSE is asking for approval to add the costs for the new hedging credit line to the PCA (and PGA) because the variability of the costs associated with the credit line that PSE proposes would make it very difficult to adequately capture and recover them in general

overstate PSE's ability to control power cost risks.[3] As summarized in PSE's Initial Brief at paragraphs 17-19, PSE's ability to control power costs through hedging or other portfolio management efforts is limited, especially with respect to hydro risk.

11. The Joint Parties on the PCA Mechanism (through the Initial Brief of Public Counsel) acknowledge that hydro variability is a risk, but claim that "the current PCA adequately addresses this risk by providing for deferral and amortization of hydro variations."[4] This is an argument without merit. It ignores that deferral and amortization of excess power costs begins only after PSE has absorbed excess power costs to the full extent of the deadband each year.

12. The evidence in this case shows that it would be fair, just and reasonable to eliminate the deadband in PSE's PCA Mechanism and instead move to 50/50 sharing in the first band, and to implement PSE's proposed changes to the other PCA bands.[5] Contrary to the PCA Joint Parties' argument,[6] the Company would continue to have significant incentive to manage its power costs efficiently within the first band as well as in the subsequent bands.[7]

13. The other parties claim that elimination of a deadband is inconsistent with the Commission's recent *PacifiCorp*[8] and *Avista*[9] decisions.[10] However, the *Avista* Order approved a settlement and did not decide the issue based on a contested record. Moreover, both of those orders were based on different records. PSE respectfully suggests that the analysis it has undertaken and presented to the Commission in this proceeding is much more extensive and

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rate cases along with PSE's other costs of debt. *See* Mills, Exh. 251C 32:7-8; Story, Exh. 421 51:10 – 52:6.

[3] *See* Public Counsel Br. ¶¶ 113, 117; FEA Br. ¶ 18; Kroger Br. at pp. 7-8.

[4] Public Counsel Br. ¶ 117.

[5] *See* PSE Br. ¶¶ 25-31. The fact that customers may have paid more for power costs in three of the last four years had PSE's proposed bands been in place does not make PSE's proposal unfair or prove that PSE is attempting to shift inappropriate amounts of risk to its customers. *See* Aladin, Exh. 14 9:1 – 12:4.

[6] *See* Public Counsel Br. ¶ 116.

[7] *See* Aladin, Exh. 11C 22:14 – 23:1, 23:15-19; Aladin, Exh. 14:3-11.

[8] *WUTC v. PacifiCorp.,* Docket UE-050684, Order No. 04 (2006) ("*PacifiCorp* Order").

[9] *WUTC v. Avista Corp. ,* Docket UE-050482 & UG-050483, Order No. 05 (2005) ("*Avista* Order").

sheds more light on the range and extent of power cost risks associated with PSE's PCA mechanism.[11] Moreover, the Commission's prior decisions are not binding in future cases and with respect to different companies.[12] The *PacifiCorp* Order expressly stated that the "application and appropriateness of [guiding principles for power cost mechanisms] must take into account the specific circumstances facing the utility . . . all power cost adjustment mechanisms for Washington utilities need not be the same."[13] PSE has demonstrated in this case that its proposed changes to its PCA Mechanism should be approved.

14. In discussing the relative risks associated with the PCA Mechanism for customers and for the Company, the other parties' briefs continue to ignore the expiration of the $40 million cap in mid-2006 and the resulting shift of risk onto the Company.[14] The expiration of the cap at the end of June 2006 results in a massive shifting of the risk of extreme power cost events onto PSE in the rate year and beyond if not changed by the Commission in its order in this case.[15]

15. The PCA Joint Parties are incorrect that PSE can continue to absorb the power cost risks presented by a PCA without the cap.[16] Mr. Valdman explained in his rebuttal testimony why the Company is not in a position to absorb those risks.[17] Areas of continuing concern include the Company's poor credit rating, insufficient free cash flow to support the investments it is making to serve customers, and its lagging stock performance.[18]

16. The PCA Joint Parties' argument that everyone knew in 2002 that the PCA cap would

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[10] *See* FEA Br. ¶¶ 9-12; Kroger Br. at p. 7; Public Counsel Br. ¶¶ 115-116.
[11] *See* Aladin, Exh. 11C; Aladin, Exh. 14.
[12] *See, e.g., WUTC v. Olympic Pipe Line Co.,* Docket TO-011472, 20th Supp. Order ¶ 50 (2002).
[13] *PacifiCorp* Order ¶ 91.
[14] *See* FEA Br. at p. 2 (footnote to Table 1 suggests that the 4-year cumulative cap is still in place); FEA Br. ¶¶ 13-14 and Public Counsel Br. ¶ 105 (their claims that PSE's proposed changes result in a 40% risk reduction to the Company ignore the expiration of the cap).
[15] *See* PSE Br. ¶ 30.
[16] *See* Public Counsel Br. ¶¶ 102-104, 121.
[17] *See* Valdman, Exh. 457C 22:1 – 28:10.

expire in 2006[19] is irrelevant. The Company has learned a great deal about the magnitude of its power cost risks and the difficulties associated with setting the Power Cost Baseline since 2002. In addition, PSE continues to face challenging financial circumstances.[20] Nothing in the 2002 PCA settlement prevents the Company or any other party from requesting changes to the PCA Mechanism in a future general rate case. It is appropriate for PSE to request changes to the PCA Mechanism based on experience. The evidence in the record shows that the PCA Mechanism should be revised at this time.

17. The Commission should reject the PCA Joint Parties' suggestion that the Commission first order PSE to conduct a study of the PCA Mechanism before making any changes.[21] The Company has already undertaken a study far more extensive than requested by the PCA Joint Parties, and PSE presented that information as part of PSE's direct case in this proceeding.[22] It was incumbent upon the other parties to challenge or counter that evidence if they found fault with it, but they have not. Instead, they largely ignore PSE's evidence and argue that "all is well" under the current PCA Mechanism. Their fall-back argument that PSE should present more evidence for future consideration amounts to nothing more than a stalling tactic.

18. PSE has already addressed the Joint Parties' "retention" argument,[23] at paragraphs 34-36 of PSE's Initial Brief. Paragraphs 21-23 of PSE's Initial Brief address the claim that the Company has allegedly failed to acknowledge that any reduction in its authorized ROE is

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[18] *See id.*; *see also* Valdman, Exh. 451C 2:15 – 3:22.
[19] *See* Public Counsel Br. ¶¶ 107-108.
[20] *See* PSE Brief ¶¶ 11, 27; Aladin, Exh. 11C; Harris, Exh. 171 20:10 – 21:7; Valdman, Exh. 451C 11:1 – 12:5; Valdman, Exh. 457C 22:1 – 28:10; Harris, TR. 109:22 – 110:20.
[21] *See* Public Counsel Br. ¶ 122.
[22] *See* Aladin, Exh. 11C; Aladin, Exh. 14 12:5-16.
[23] *See* Public Counsel Br. ¶ 100.

appropriate as part of approval of the Company's proposed changes to the PCA Mechanism.[24] The Company has also already responded to the Joint Parties' arguments about Exhibit E of the PCA Mechanism,[25] at paragraphs 32-33 of PSE's Initial Brief.

III. MECHANISMS TO ADDRESS HIGH ENERGY DELIVERY SYSTEM CAPITAL INVESTMENT NEEDS AND REGULATORY LAG

19. Staff and intervenors do not dispute the necessity of massive investments that PSE is making, and plans to make over the next several years. This investment is required to maintain system reliability for PSE's customers—to replace aging infrastructure, to meet increasingly stringent reliability requirements, and to comply with mandated programs such as the bare steel and cast iron replacement programs.[26] They do not dispute that customers benefit from this investment by having a reliable transmission and delivery system; nor do they dispute that under the current regulatory system, customers are benefiting from new infrastructure long before the Company is allowed recovery of, or return on, the plant. Unbelievably, they extol the alleged virtues of this regulatory lag, claiming that it forces PSE to operate efficiently. What these parties fail to recognize is that regulatory lag hurts customers as it impedes the Company's ability to timely replace transmission and distribution infrastructure.[27]

20. Moreover, regulatory lag deprives the Company of the opportunity to earn its authorized ROE. This negative financial effect is amplified even more when PSE is investing and borrowing hundreds of millions of dollars for its transmission and delivery system annually.

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[24] *See id.* ¶ 111.

[25] *See id.* ¶ 114.

[26] *See* McLain, Exh. 241C 9:1 – 35:21.

[27] Staff suggests that the Company's infrastructure investments will continue forward on their current pace with or without the Depreciation Tracker. *See* Staff Br. ¶ 42. The fact that PSE has not identified specific projects that would be eliminated does not mean that PSE will be able to keep up its current pace of investment absent its requested relief. The evidence shows that projects will need to be re-prioritized or delayed. *See* McLain, Exh. 241C 16:15 – 17:4; McLain, Exh. 245C 2:10-19; McLain, Exh. 249 1-2; McLain, TR. 192:13 – 200:17.

These investments provide benefits to PSE customers and the region from the moment that they are placed in service. It is not unreasonable for customers to pay for part of these investments at the time when they start to receive benefits, rather than waiting for the conclusion of the next general rate case, which may be a couple years later.

A. Depreciation Tracker

21. The details of PSE's proposed Depreciation Tracker are set forth at pages 15-16 of PSE's Initial Brief. The Depreciation Tracker will allow the Company a better opportunity to earn its authorized ROE, access credit at more favorable rates, and proceed with the massive investments needed to maintain a reliable energy delivery system for its customers. It provides a balanced approach to the problem of regulatory lag and PSE's need to make significant investments in its energy delivery systems. The Depreciation Tracker permits the Company recovery of the plant put into service after the test year. However, the Company will not recover its rate of return on that new infrastructure as part of the Depreciation Tracker. Rather, the Company must wait until the plant is added into rate base in the next general rate case before it recovers the costs associated with return on these investments.[28] Thus, the Depreciation Tracker is balanced and provides a strong incentive for the Company to prudently manage its capital expenditures, despite the claims by the Federal Executive Agencies ("FEA")[29] and Public Counsel[30] to the contrary.

22. The Commission should reject the argument that the Depreciation Tracker constitutes single-issue rate making and thus is improper. The concerns against single issue ratemaking do not apply in this context. The Depreciation Tracker is proposed as part of a general rate case

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[28] *See* Story, Exh. 421 67:9-16; 76:17 – 77:4
[29] *See* FEA Br. ¶ 38.
[30] *See* Public Counsel Br. ¶ 92.

with a complete test year as well as several years of historic information and future projections. The evidence demonstrates the Depreciation Tracker is needed and would support infrastructure investment that will benefit customers.[31] It is a better policy to approve the balanced approach that the Depreciation Tracker provides so that the Company may move forward with its delivery system investments. In any case, there is no prohibition against single-issue rate making. If the Commission finds good cause to address individual issues through trackers, it is not prohibited from so doing.

23. Kroger Co. ("Kroger") and FEA argue that the Depreciation Tracker should be rejected because PSE's existing trackers are sufficient.[32] But the evidence demonstrates that PSE has not had a fair opportunity to earn its authorized ROE with the existing mechanisms.[33] Moreover, Kroger and FEA advocate a backward-looking approach. They accept mechanisms that have been approved in the past to address specific issues such as fuel cost volatility,[34] but they refuse to recognize that evolving needs--such as massive infrastructure replacement and investment--drive the need for the Depreciation Tracker. Timely recovery of such investments is not addressed by the PCA Mechanism, power cost only rate cases, or any of the regulatory mechanisms that have been established for particular purposes as areas of concern have been identified by PSE and addressed by the Commission.

24. Staff is wrong in claiming that PSE did not conduct sufficiently rigorous attrition studies to support the need for the Depreciation Tracker. In addition to performing trended attrition analyses that demonstrate regulatory lag on the Company, PSE provided a financial model,

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[31] *See* McLain, Exh. 245 7:7 – 8:4.
[32] *See* Kroger Br. at pp. 5-6; FEA Br. ¶ 44.
[33] *See* Bench Exhibit, Exh. 005 (PSE Response) 1-7; Valdman, Exh. 451C 12:6 – 14:13; Morin, Exh. 301 64:14 – 65:18.
[34] *See* Kroger Br. at pp. 5-6; FEA Br. at ¶ 40.

which shows electric and gas operations for 2007 and provides in detail the complex interactions of different economic factors that Staff claims were not considered.[35] On brief, Staff claims that this information has not been sufficiently "scrutinized."[36] This is an insufficient reason for the Commission to reject the Depreciation Tracker. Staff and the other parties have had since February 2006 to scrutinize the information provided by PSE and to bring forward their own evidence if they believe PSE's evidence is inaccurate.

B. Known and Measurable Adjustment

25. In response testimony, FEA proposed an alternative to the Depreciation Tracker that would permit PSE a one-time adjustment for plant put in service from September 30 through December 31, 2005. PSE agreed, in theory, that an adjustment of known and measurable plant in service would be an acceptable alternative to the Depreciation Tracker, but such an adjustment should include all non-revenue producing and non-expense reducing plant put into service from October 1, 2005 through June 30, 2006. PSE submitted evidence of the projects that meet this criteria and the effect on the revenue requirement that such an adjustment would have.[37]

26. The Northwest Industrial Gas Users ("NWIGU") exaggerates the complexity of this one-time adjustment, claiming that the Company has included more than 20,000 projects.[38] This is incorrect. Ms. McLain testified that the proposed adjustment contains less than one-third of the total number of projects claimed by NWIGU.[39] Further, NWIGU incorrectly argues that it will be difficult to verify that the projects will become used and useful.[40] The evidence shows that

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[35] *See* Story, Exh. 421 63:8 – 66:14; Story, Exh. 431 1-6; Story, Exh. 439 29:4 – 30:3; *see also* Karzmar, Exh. 222 35:9 – 39:12; Karzmar, Exh. 228 1-4.

[36] Staff Br. ¶ 39.

[37] *See* McLain, Exh. 747 1-7; McLain, Exh. 748 1-4; Story Exh. 439 31:5-7; Story, Exh. 746 1-7.

[38] *See* NWIGU Br. at p. 11.

[39] *See* McLain, Exh. 747 1-7; McLain, Exh. 748 1-4.

[40] *See* NWIGU Br. at p. 10.

the projects are already in service for customers.[41] Thus, by definition, they are used and useful.[42]

27. The Commission should reject the unsupported argument that PSE's adjustment *might* include projects that are expense reducing. PSE has submitted evidence that the projects included in its known and measurable adjustment are non-revenue producing and non-expense reducing.[43] The other parties have provided no evidence to the contrary, only speculation. This is insufficient to rebut PSE's evidence.[44]

28. NWIGU asserts that the known and measurable adjustment "offers nothing to ratepayers in exchange for the higher rates."[45] This ignores that the plant is already serving customers and customers are receiving the benefit of this plant without paying the associated costs. This argument also disregards the evidence in this case of the damage being done by lack of timely recovery of these costs.[46] NWIGU takes for granted the investments PSE has been making on behalf of its customers. It does not help customers or the region to pretend that PSE can move forward with this level of investment without regulatory support, and it is patently unrealistic to expect that shareholders will be willing to shoulder this burden.

29. NWIGU incorrectly claims that this adjustment would recover depreciation expense only. This is incorrect. The Company would recover its depreciation expense and also include the

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[41] *See* McLain, Exh. 747 1-7; McLain, Exh. 748 1-4.

[42] Staff argues for the first time on brief that some of the projected costs included in the known and measurable adjustment are already included in the pro forma adjustment for Wild Horse. *See* Staff Br. ¶ 44. If Staff had raised this issue at hearing, PSE would have been able to clarify that the Wild Horse transmission project costs included in the known and measurable adjustment are for the upgrade of an existing transmission line and are not part of the pro forma adjustment.

[43] *See* McLain, Exh. 747 1:18 – 3:8; 4:4 – 6:9.

[44] *See WUTC v. Avista Corp.,* Docket UG-041515, Order No. 06 at ¶ 24 (2004) (noting that in "any rate proceeding, other parties risk that if they do nothing—do not cross examine it or present responding evidence—the Company's evidence will prevail.").

[45] NWIGU Br. at p. 12.

[46] *See* Bench Exhibit, Exh. 005 (PSE Response) 1-7; Valdman, Exh. 451C 12:6 – 14:13; Morin, Exh. 301 64:14–

plant in ratebase, thus recovering its return on the investment.[47] "Return on" the plant will help to offset the fact that this alternative is not an ongoing tracker, thus PSE will immediately suffer a similar regulatory lag problem that gave rise to its proposal to implement a tracker.

30. For this reason, the Commission should reject the eleventh-hour proposal made on brief by NWIGU and FEA that the Commission should allow *only* recovery of depreciation for the known and measurable projects, but not a return on these investments. No party offered evidence supporting this proposal, and PSE had no opportunity to rebut this proposal.[48] If a one-time adjustment is made for known and measurable plant in service, this plant should be included in ratebase and the Company should be allowed to recover its investment in the plant.

31. Staff argues for the first time on brief that only a select few of the known and measurable plant in service investments should be recovered in this adjustment.[49] No evidence was presented to support this proposal and PSE has not had the opportunity to rebut Staff's untimely proposal. If the Commission were to allow a limited adjustment along the lines Staff recommends for the first time on brief, the list of projects should be expanded as discussed in Appendix A.[50] In any case, Staff's proposal concedes PSE's point that the Company is being required to invest millions of dollars each year to provide mandated infrastructure replacements, ensure service reliability and comply with NERC/WECC reliability standards and that without the known and measurable adjustment, PSE will not be able to recover this critical investment in

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65:18.

[47] *See* Story, Exh. 746 1-7.

[48] NWIGU and FEA misrepresent the record by claiming that Mr. Valdman testified that the known and measurable adjustment would include only a return of depreciation expense, and not a return on the investment. *See* NWIGU Br. at p. 12; FEA Br. ¶ 51. Mr. Valdman corrected his testimony at the hearing and made clear that the Company's alternative proposal for a known and measurable adjustment includes recovery of depreciation expense and recovery on the investment in ratebase. *See* Valdman, TR. 302:8 – 303:9.

[49] Staff Br. ¶¶ 45-46.

[50] An adjustment for the projects discussed in Appendix A as well as the projects identified by Staff results in an additional revenue requirement of $1,720,000 for gas operations and $7,930,000 for electric operations.

rates until its next general rate case.[51]

IV. CAPITAL STRUCTURE AND COST OF CAPITAL

A. The Commission Should Adopt PSE's Proposed Capital Structure With an Equity Ratio Of 45%

32. As discussed in the Company's Initial Brief, the Commission should adopt PSE's proposed capital structure that consists of 45.00% common equity, 48.44% long-term debt, 2.11% short-term debt, 0.70% trust preferred stock, and 3.75% preferred stock as it (i) is reasonable, (ii) properly balances safety and economy, and (iii) is the capital structure most likely to prevail, on average, over the course of the rate year.[52]

33. Staff and ICNU criticize the Company's proposed capital structure because it (i) is based on the expected rate year average of the monthly averages for PSE's capital structure and (ii) excludes the equity of PSE's unregulated subsidiaries.[53] They do not acknowledge, however, that the Company's methodology is the exact same methodology approved by the Commission in PSE's last general rate case.[54]

34. Staff's assertion that PSE's proposed capital structure fails to satisfy the standard of safety and economy[55] defies logic, particularly given this Commission's recent holding that "46 percent is a reasonable equity share to include in a capital structure for PacifiCorp that appropriately balances safety and economy"[56] and that, on average across the nations, commissions have set

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[51] Staff Br. ¶¶ 45-46.
[52] *See* PSE Br. ¶¶ 47-50.
[53] *See* Staff Br. ¶¶ 78-80; ICNU Br. ¶¶ 85-87.
[54] *See WUTC v. Puget Sound Energy, Inc.*, Dockets UE-040640, *et al.*, Order No. 06, at ¶ 40 (2005) ("PSE 2004 GRC Order").
[55] *See* Staff Br. ¶ 77. Staff incorrectly describes PSE's proposed capital structure as consisting of 45% common equity, 3.75% preferred stock, 0.70% trust preferred securities, 47.87% long-term debt, and 2.68% short-term debt. *See id*.
[56] *PacifiCorp* Order ¶ 233.

rates on equity ratios averaging 47.82%.[57]

1. The Commission Should Reject Staff's Arguments That PSE's Proposed Capital Structure Is Speculative and Excessive

35. Staff alleges that the use of the expected rate year average of the monthly averages for PSE's capital structure is speculative because it is based on the issuance of common stock projected for 2007.[58] This argument ignores prior Commission rulings regarding the safety and economy standard. In *WUTC v. Puget Sound Power & Light Company*,[59] this Commission held that the approved capital structure "need not be the actual capital structure the company experienced during the test year" and that the Commission "determines an appropriate balance of debt and equity within the capital structure on the bases of economy and safety."[60] Similarly, in the Company's last general rate proceeding, the Commission recognized that it "has used actual, pro forma, or imputed capital structures to strike the right balance and determine overall rate of return on a case-by-case basis."[61] Thus, the Commission has expressly recognized that the approved capital structure may be forward-looking, including projected rate year equity issuances and retained earnings. In failing to acknowledge this precedent, Staff also fails to provide any reason why the Commission should depart from its historic practice in this area.

36. Moreover, Staff's analysis of PSE's proposed and historic capital structure is riddled with inaccuracies. While PSE understands that it is Staff's role to carefully examine the Company's rate case filings, it is alarming to face allegations and arguments from Staff and its expert regarding the Company's financial circumstances that are, at best, inaccurate and, at worst, misleading and calculated to confuse.

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[57] *See* Exhibit No 147 2.
[58] *See* Staff Br. ¶ 80.
[59] *WUTC v. Puget Sound Power & Light Co.*, Cause Nos. UE-920433, *et al.*, Eleventh Supp. Order (1993).
[60] *Id.* at 25-26.

37. First, Staff alleges that PSE projected, in its last general rate case, a common equity issuance designed to reach a 45% average equity ratio during the rate year for that proceeding, but then subsequently failed to satisfy that average. This allegation is incorrect. PSE requested an *end of rate period* capital structure of 45%, not a 45% average equity ratio:

> PSE proposes that we approve an equity ratio of 45%. This is the goal PSE hopes to achieve by the end of the rate period through the growth of retained earnings in excess of dividends and by issuing new shares of common stock.[62]

In November 2005, PSE issued $310 million of equity--*earlier than the date PSE projected in its last general rate case*.[63] As of December 31, 2005, the Company's capital ratio was 44.13%. Any suggestion that PSE acted improperly by issuing equity in November 2005 is not well founded, given that this issuance occurred *earlier* than PSE had projected.

38. Second, Staff incorrectly asserts that Puget Energy, Inc. elected to retain most of the proceeds from the sale of InfrastruX, and instead lend a portion of those proceeds to PSE, thereby increasing the utility's short-term debt ratio. This allegation is patently false. Puget Energy, Inc. received after-tax net proceeds of $95.9 million from the sale of InfrastruX. Of that $95.9 million, Puget Energy, Inc. (i) invested $60 million into PSE as equity, (ii) used $15 million pre-tax ($9.8 million after-tax) to fund the creation of the Puget Sound Energy Foundation--a charitable foundation, and (iii) lent $26.5 million to PSE through an inter-company loan.[64]

39. As previously noted, Puget Energy, Inc. invested the bulk of the sale proceeds directly into PSE as equity. Puget Energy, Inc.'s decision to lend $26.5 million to PSE through an inter-company loan rather than invest it directly as equity was necessary to mitigate potential ongoing

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[61] PSE 2004 GRC Order ¶ 27.
[62] *Id.* ¶ 33.
[63] *See* Gaines, Exh. 131C 2:7-9.

liabilities associated with the InfrastruX transaction while at the same time benefiting PSE. Puget Energy, Inc. certainly did not "squander an opportunity" to boost PSE's equity ratio.[65] In the InfrastruX transaction, Puget Energy, Inc. was required to make certain indemnifications to the buyer. The indemnifications obligate Puget Energy, Inc. to make potential payments to the buyer, capped in amount and limited to certain periods of time, under certain circumstances. Additionally, some of the required payments by Puget Energy, Inc. related to the sale are to be made over a period of time. Puget Energy, Inc. elected to hold the amounts related to those future payments and potential liabilities so that funds were available in the event Puget Energy, Inc. must indemnify the buyer. In the meantime, Puget Energy, Inc. agreed to support PSE by lending the funds to PSE as an additional source of liquidity.[66]

40. Third, Staff inaccurately states that the Company's common equity ratio at year-end 2005 is 42%--not 44.13%--when "all unregulated common equity is removed from the Company's balance sheet."[67] Again, this allegation is incorrect. Rather than simply removing non-regulated subsidiary equity from total common equity, Staff witness Mr. Hill erroneously subtracts $157.3 million of "unregulated assets" from Puget Energy, Inc.'s "Other Property & Investments." Puget Energy, Inc.'s "Other Property & Investments" is an asset, not equity, and includes investments that are directly related to utility operations.[68]

41. Further, Staff's assertions regarding the cost of PSE's capital structure is grossly misleading. Staff alleges that

> The additional 5% common equity that PSE requests in this case over its 2005 capital structure will cost ratepayers $35.8 million more per year. PSE argues

[64] *See* Gaines, Exh. 137C 22:20 – 23:12; *see also* Gaines, Exh. 149 1-4.
[65] *See* Staff Br. fn. 188.
[66] *See* Gaines, Exh. 137C 23:12 – 24:8.
[67] Staff Br. ¶ 79.
[68] *See* Gaines, Exh. 137C 11:1 – 12:18.

> that that amount overstates the impact by ignoring partially offsetting decreases in the debt ratio. Taking into account that decrease in debt ratio still increases the total cost of capital by $22 million per year without evidence of overriding benefits for ratepayers.[69]

Staff proposes a capital structure that maintains the Company's currently authorized capital structure that contains 43% equity but compares the cost of an increase in equity ratio from 40% to 45%. The proper comparison would be the cost of an increase in equity ratio from 43% to 45%, which is $9 million.[70]

42. Although this increase in the Company's equity ratio results in an incremental cost increase ($9 million in this case) because equity capital costs more than debt, this increase will provide significant benefits to customers as well as the Company. It will better enable the Company (i) to attract external capital necessary to fund the Company's significant infrastructure and new resource construction programs; (ii) to engage in energy hedging strategies; (iii) to offset the imputed debt from purchased power agreements; and (iv) to provide electric and gas service to customers on reasonable terms.[71]

43. Staff further alleges that "PSE has lower purchased power risk than the companies selected by Mr. Hill for his cost of equity analysis (13.1% v. 23%), according to the same measurement (purchased power expense as a percent of electric plant) advocated by the Company."[72] This allegation is false, incomplete, and irrelevant. Rating agencies only view the *capacity portion of long-term purchased power expenses* as fixed obligations with debt-like characteristics. Staff's allegation relies upon FERC Form 1 data that includes *all* purchased

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[69] Staff Br. ¶ 83 (citations omitted).
[70] *See* Gaines, Exh. 137C 13:4-13; *see also* Gaines, Exh. 142 1:32.
[71] *See* Gaines, Exh. 137C 13:14 – 14:18.
[72] Staff Br. ¶ 85.

power expenses--short-term spot purchases as well as long-term purchases.[73] Furthermore, PSE's FERC Form 1 data is net of (i.e.. has been reduced by) the Bonneville Residential Exchange credit.[74] In short, Staff's allegation that the Company has less purchased power risk than the companies selected by Mr. Hill for his cost of equity analysis only demonstrates Staff's, and their financial witness's, misunderstanding of the manner in which ratings agencies compute purchased power risk and the complexities of PSE's power purchases.

44. Even assuming *arguendo* that purchased power expense as a percent of electric plant were a relevant metric (which it is not), reliance upon FERC Form 1 data without close analysis of such data is fraught with error. If Staff or their financial witness had investigated the utilities that had a higher purchased power expense as a percent of electric plant metric than PSE, they would have discovered that most, if not all, were pure transmission and distribution utilities that do not generate any power whatsoever.[75]

45. Finally, the Staff Brief alleges that the

> 45% equity ratio requested by PSE contains significantly more equity and less total debt than is used on average in the electric industry today. The average

[73] The Staff Brief criticizes PSE for providing an estimate of the amount of additional debt Standard & Poors ("S&P") attributes to its purchased power obligations, when PSE has made no such analysis of Dr. Morin's sample companies. *See* Staff Br. fn. 197. Such an analysis, however, would be difficult, if not impossible without S&P's analysis of the appropriate risk factors for these other companies (even if one could effectively segregate long-term power purchases from short-term power purchases in each utility's FERC Form 1 data). The effective debt ratio (including consideration of purchased power expenses) is specific to the utility purchase power agreement ("PPA") in question. *See* Gaines, Exh. 133 1-5; Morin, Exh. 344 1-3. PSE is aware of its own PPA arrangements and how S&P analyzes them, but PSE is simply not in possession of information about other utilities' PPA arrangements or how S&P would analyze them.

[74] *See* Gaines, Exh. 137C 16:1 – 17:1.

[75] *See*, *e.g.,* Morin, Exh. 326 1-4. Of the twenty-four utilities listed in Exhibit 145 as having more purchase power, relative to electric plant, than PSE, thirteen are subsidiaries of a utility in Dr. Morin's comparable group. Eight of these thirteen utilities are pure transmission and distribution utilities that do not generate any power whatsoever. One of the utilities (Consolidated Edison of New York) has sold off the vast majority of its generation facilities and self-generates only a small fraction of the load it serves, and another utility (New York State Electric & Gas Corporation) reports power that it wheels to its retail customers from a third-party generator as self-generated power. Of the four remaining utilities that are not pure transmission and distribution companies, none relied more on purchased power to meet their loads than did PSE if one were to compare the percentage of total load met with purchased power. *See id.*

> common equity ratio of the combination gas and electric utility industry is 42%. The average common equity ratio for combination utilities with a similar BBB bond rating to PSE is 38%.[76]

This allegation is extremely misleading and confuses the equity ratio used to establish rates for regulated utilities with the equity ratio of the capital structure of their holding companies. The average authorized equity ratio of regulated gas and electric utilities upon which various state commissions have set rates since January 1, 2005, is 47.82% (282 basis points higher than the Company's requesting equity ratio).[77] The average authorized equity ratio of Mr. Hill's sample group of electric utilities is 48.5% (350 basis points higher than the Company's requesting equity ratio), and the average authorized equity ratio of Mr. Hill's sample group of natural gas utilities is 51.0% (600 basis points higher than the Company's requesting equity ratio).[78] Staff's allegation that PSE's requested capital structure is outside the norm is simply not supported by the evidence.

2. The Commission Should Reject ICNU's Argument That Capital Structure Must Satisfy the Known and Measurable Standard

46. ICNU argues that the Commission should reject the use of the expected rate year average of the monthly averages for PSE's capital structure because "PSE has not satisfied its burden . . . of showing that these pro forma adjustments to the Company's capital structure are 'known and measurable changes that are not offset by other factors.'"[79] This argument is a variation of Staff's argument and also fails because the Commission has expressly approved of the use of a projected rate year capital structure, as long as such capital structure satisfies the safety and economy standard. ICNU does not provide any evidence or argument that PSE's proposed capital

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[76] Staff Br. ¶ 84 (citations omitted).
[77] *See* Gaines, Exh. 137C 18:9-12; Gaines, Exh. 147 1-2.
[78] *See* Morin, Exh. 315 37:12 – 39:6.
[79] ICNU Br. ¶ 85.

structure fails to meet this standard.

47. In effect, ICNU is improperly seeking to apply the Commission's requirements for pro forma accounting adjustments to the determination of the appropriate capital structure. Commission rules require parties to a rate case to file work papers that contain a detailed portrayal of restating actual and pro forma adjustments, which are accounting adjustments unrelated to PSE's capital structure.[80] This Commission has never applied the known and measurable standard applicable to accounting adjustments to capital structure determinations. Indeed, this Commission reaffirmed in PSE's 2004 general rate case that it allows "actual, pro forma, or imputed capital structures to strike the right balance and determine overall rate of return on a case-by-case basis."[81] If the Commission were to apply ICNU's version of the known and measurable standard, it would effectively eliminate the use of pro forma and imputed capital structures. ICNU has provided no reason why the Commission should depart from its precedent in this area. The Commission should reject ICNU's attempt to recharacterize the known and measurable standard and apply it to the capital structure determination.

B. The Commission Should Adopt PSE's Proposed ROE Of 11.25%

1. PSE Failed To Earn Its Authorized ROE Each Year From 2002-2005

48. PSE failed to earn its authorized ROE each year during the period 2002-2005, according to PSE's audited financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP") and Securities Exchange Commission ("SEC") regulations:[82]

[80] *See* WAC 480-07-510(3)(b).

[81] PSE 2004 GRC Order ¶ 27.

[82] *See* Bench Exhibit, Exh. 005 (PSE Response) 1-7. Adjusting the ROE for the Company's actual equity, the Commission allowed a leveraged ROE of 13.33%, 11.75%, 11.05% and 11.05% for calendar years 2002, 2003, 2004 and 2005, respectively. *See id.*

Year	Actual ROE	Authorized ROE
2002	7.51%	11.00%
2003	7.70%	11.00%
2004	8.02%	11.00%
Rate Year	9.38%	10.59%
2005	8.20%	10.42%

Staff criticizes PSE's use of SEC financial information because such information is consolidated and includes the results of PSE's unregulated subsidiaries, Puget Western Inc. and Hydro Electric Development Co. Even if one were to isolate regulated utility operations, PSE has systematically failed to earn its authorized ROE for each year during the period 2002-2005:[83]

Year	Actual ROE	Authorized ROE
2002	9.23%	11.00%
2003	9.85%	11.00%
2004	9.04%	11.00%
Rate Year	9.65%	10.59%
2005	9.17%	10.42%

Even Staff's calculations[84] demonstrate that PSE has systematically failed to earn its authorized ROE for each year during the period 2002-2005:[85]

Year	Actual ROE	Authorized ROE
2002	9.21%	11.00%
2003	10.22%	11.00%
2004	9.59%	11.00%
Rate Year	10.14%	10.59%
2005	9.79%	10.42%

Thus, no party disputes that PSE has systematically failed to earn its authorized ROE over the past four years.

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[83] *See id.*

[84] Staff's calculations improperly exclude regulated assets from its ratebase calculation, including, but not limited to, Construction Work in Progress, investments in PSE's subsidiaries, investments in corporate-owned subsidiaries, California ISO Receivables originating in calendar year 2000, qualified pension plan prepaid assets, and Financial Accounting Standard No. 133 – Unrealized Gaines/Losses on Derivative Instruments. *See id.* 1-2.

49. Staff blames PSE's systematic failure to earn its authorized ROE on PSE's unregulated subsidiaries.[86] ICNU states that "poor performance by PSE's unregulated subsidiaries has been the major factor keeping the Company from earning its authorized ROE."[87] The Commission should dismiss these arguments as the red herrings that they are--PSE's unregulated subsidiaries are extremely small and have a very small, if not immaterial, effect on PSE's actual ROE.

50. Staff and ICNU ignore the actual causes of PSE's systematic failure to earn its authorized ROE--regulatory lag.[88] PSE projects capital expenditures of $850 million in calendar year 2006.[89] Of this amount, over half ($444 million) is for energy delivery, technology and facilities that would not have cost recovery during the rate year, absent adoption of the Depreciation Tracker or similar mechanism that addresses delivery system regulatory lag.[90] In other words, customers will benefit from $444 million of investments during the rate year, and PSE would not be able to earn a return of, or return on, such investments until calendar year 2008, at the earliest.[91] This two-year delay is a far more significant cause of the Company's systematic lack of opportunity to earn its authorized ROE than its small, non-regulated subsidiaries.

2. PSE's Requested ROE Of 11.25% On a Capital Structure Containing 45% Equity Is Fair, Just, Reasonable and Sufficient

[85] *See* Bench Exhibit, Exh. 005 (Staff Response) 1-7.

[86] *See* Staff Br. ¶ 14.

[87] ICNU Br. ¶ 49.

[88] *See* Morin, TR. 383:5-10.

[89] The Staff Brief states that "the apex of PSE's capital budget ($850 million) occurs in 2006." Staff Br. ¶ 19. Contrary to Staff's assertions, the Company's capital expenditures are not necessarily forecasted to decline in 2007 and 2008. The 2005 SEC Form 10-K and rating agency presentation Staff references include projected capital expenditures for generation assets for 2006 but not for 2007 or 2008, which explains what appears to be decreases in 2007 and 2008. *See* Valdman, TR. 236:9 – 237:1 and 278:12-17. Moreover, the Power Cost Only Rate Case is not a panacea for the recovery of capital expenditures for generating resources. For example, PSE may purchase an existing generating asset in the middle of a general rate case. PSE would have to wait until the conclusion of that general rate case before filing a Power Cost Only Rate Case before that generating facility is added to ratebase.

[90] *See* Valdman, Exh. 457C 6:10-13.

[91] Without the Depreciation Tracker, energy delivery, technology and facilities could only be added to rate base through a general rate case. The earliest PSE could file for its next rate case would be February 2007, after the completion of the present rate case. General rate cases continue for a period not exceeding ten months from the time the proposed new rates would have gone into effect absent suspension by the Commission. *See* RCW 80.04.130(1).

51. Staff asserts that its recommended ROE of 9.375% and equity ratio of 43% reflect current investor return requirements.[92] The extreme ROE proposed by Staff, however, would place PSE at a significant disadvantage in the competition for equity. PSE's cost of capital proposal is the *only* proposal that generates a weighted average cost of equity (5.06%) that is even close to the average authorized weighted average cost of equity (5.04%):[93]

	ROE	**Capital Structure Equity**	**Weighted-Average Cost of Equity (WACE)**	**Differential from Industry Average WACE**
Industry Average (01/01/05-06/30/06)	10.51%	47.82%	5.04%	--
PSE Proposal	11.25%	45.00%	5.06%	+2 basis points
Staff Proposal	9.375%	43.00%	4.03%	-101 basis points
ICNU Proposal	9.9%	44.13%	4.37%	-67 basis points

Significantly, PSE's proposed weighted-average cost of equity of 5.06% is lower than the average weighted-average cost of equity of each of Mr. Hill's and Mr. Gorman's respective comparable groups:[94]

	ROE	**Capital Structure Equity**	**Weighted-Average Cost of Equity (WACE)**	**Differential from PSE Proposed WACE**
PSE Proposal	11.25%	45.00%	5.06%	--
Hill Electric Comparables	10.80%	48.50%	5.24%	+18 basis points
Hill Gas Comparables	10.86%	51.00%	5.54%	+48 basis points
Gorman Comparables	10.88%	49.00%	5.33%	+27 basis points

52. Staff attempts to obfuscate the above data by asserting that "most of the authorized equity returns presented by PSE are either undated, the result of settlement, or were established in rate cases litigated in 2005 or before."[95] PSE presented data on all electric and natural gas rate case

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[92] *See* Staff Br. ¶ 3.

[93] *See* Gaines, Exh. 138 1 for the weighted average cost of equity of each proposal and Gaines, Exh. 147 2 for the average authorized weighted average cost of equity from January 1, 2005, through June 30, 2006.

[94] *See* Valdman, Exh. 457C 17:10 – 19:2, Valdman, Exh. 461 1, Valdman, Exh. 462 1 and Valdman, Exh. 463 1 for the average authorized ROE of each comparable group of Messrs. Hill and Gorman; and *see* Morin, Exh. 315 37:13 – 39:6 and 85:3-5 for the average authorized capital structure of each comparable group of Messrs. Hill and Gorman.

[95] Staff Br. ¶ 54. The Staff Brief also alleges that authorized ROEs must overstate the current cost of capital because utility market prices far exceed book value. *See id.* Utility market prices, however, have exceeded book

decisions for the period beginning January 1, 2005, and ending June 30, 2006, and this data demonstrate that the average authorized ROE for electric and gas utilities was 10.51%, the average authorized capital structure contained 47.82% equity, and the average weighted average cost of equity was 5.04%.[96] Contrary to Staff's assertions, none of the data was undated or established in rate cases decided before 2005. In fact, Staff's expert witness acknowledged that the average authorized ROE for calendar year 2005 was 10.51%.[97] Even if some of the decisions resulted from settlements, PSE has to compete for capital against the utilities that obtained approval of these higher ROEs, whether through settlement or a litigated decision.

53. Staff also asserts that its cost of capital properly balances the interests of ratepayers and investors in accordance with statutory and constitutional requirements. In support of this assertion, the Staff Brief cites to two Supreme Court cases[98] for the following proposition:

> A utility is not guaranteed profitability. It is entitled only to the *opportunity* to earn a rate of return sufficient to maintain its financial integrity, attract capital on reasonable terms, and receive a return commensurate with other enterprises of comparable risk.[99]

Staff fails to explain how its proposal would satisfy this standard. If the Commission were to grant Staff's proposed ROE of 9.375%, then PSE would receive the lowest authorized ROE granted by any Commission since January 1, 2005. Such an extreme ROE, if granted, would make it difficult, if not impossible, for PSE to maintain its financial integrity, attract capital on reasonable terms, and receive a return commensurate with other enterprises of comparable risk.

54. Finally, Staff argues that the Commission should reject the "use of allowed returns to

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value for more than two decades. *See* Morin, Exh. 315 7:12-14. In effect, Staff makes the ridiculous argument that commissions across the nation have been systematically overstating utilities' costs of capital for over twenty years.

[96] *See* Gaines, Exh. 134 1-3 and Gaines, Exh. 147 1-2.

[97] *See* Hill, Exh. 531C 6:11-12.

[98] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944) and *Bluefield Water Works Improvement Co. v. Pub. Serv. Comm'n of W.Va.*, 262 U.S. 679, 692 (1923).

estimate the current cost of capital."[100] This argument, however, ignores guidance provided by the Commission in PSE's last general rate case regarding its approach to ROE determinations:

> We note that an equity return between 10.0% and 10.5% falls within the range of equity awards in other jurisdictions and that such a check is useful to fulfill the common sense approach . . . .[101]

Under this "common sense" approach, Staff's and ICNU's proposed ROEs of 9.375% and 9.9%, respectively, obviously fall short of the average authorized ROE of 10.51%[102] and are far below the range of reasonableness of 10.3% to 10.8% anticipated by the investment community.[103]

3. Staff and ICNU Each Proposes an ROE Based On Flawed Financial Models That Significantly Understate PSE's Cost Of Equity

55. Staff's proposed ROE of 9.375% rests upon the seriously flawed testimony of Mr. Hill that significantly understates PSE's cost of common equity. The prefiled rebuttal testimony of Dr. Morin[104] and PSE's Initial Brief[105] discuss the major infirmities of Mr. Hill's testimony in detail. As described there, correction of Mr. Hill's errors would increase Mr. Hill's recommended ROE from 9.375% to approximately 10.775%.[106]

56. ICNU's proposed ROE of 9.9% rests upon the testimony of Mr. Gorman that also understates PSE's cost of common equity. The prefiled rebuttal testimony of Dr. Morin[107] and PSE's Initial Brief[108] discuss how Mr. Gorman departs significantly from his past testimonies and previous practices in arriving at his recommendation. Correction of Mr. Gorman's errors would

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[99] Staff Br. fn. 10 (emphasis in original).
[100] *Id.* ¶ 54.
[101] PSE 2004 GRC Order ¶ 80.
[102] *See* Gaines, Exh. 147 2.
[103] *See* Valdman, Exh. 457C 15:10 – 16:10.
[104] *See generally* Morin, Exh. 315 4:17 – 69:8 (criticizing Mr. Hill's cost of equity analysis).
[105] *See generally* PSE Br. ¶¶ 47-86 (discussing PSE's proposed cost of equity and criticizing cost of equity proposals of Staff and ICNU).
[106] *See* Morin, Exh. 315 96:2-10.
[107] *See generally id.* 315 69:9 – 94:4 (criticizing Mr. Gorman's cost of equity analysis).
[108] *See generally* PSE Br. ¶¶ 47-86 (discussing PSE's proposed cost of equity and criticizing cost of equity

increase his recommended ROE from 9.9% to approximately 11.2%.[109]

4. Other Parties Overstate the Effect of the Company's Proposed Mechanisms On Its ROE

57. Staff criticizes the Company's proposed ROE of 11.25% because Staff alleges that capital costs are "near all time lows"[110] and because of the likely effect of the Company's proposed decoupling mechanism, Depreciation Tracker and PCA revisions.[111] Similarly, Public Counsel and ICNU argue that the Company's proposed mechanisms require an extremely low ROE.[112]

58. These arguments ignore the fact that the Company's current ROE of 10.3% was set when the PCA Mechanism protected the Company from excess power costs with a $40 million cumulative cap.[113] With the expiration of that cap, the Company faces much higher exposure to excess power cost risk, even if the Commission accepts the Company's revisions to the PCA Mechanism,[114] and thus the Company requires an ROE that reflects the increased risk. The massive capital investments anticipated over the next several years provide further justification for the Company's requested ROE of 11.25%. If the Commission approves all of the proposals offered by PSE--the Depreciation Tracker, the GRNA, the increased customer charge, and the revisions to the PCA Mechanism--an ROE less than 11.25% could be appropriate. However even then, an ROE level in the high 10% range would be required to account for the risk associated with the Company's construction plans that are not addressed by the Depreciation

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proposals of Staff and ICNU).

[109] *See* Morin, Exh. 315 97:1-7.

[110] *See* Staff Br. ¶ 2 (allegedly quoting Valdman, Exh. 457C at 7:6). Mr. Valdman actually stated that "*borrowing costs* are near all-time lows." Valdman, Exh. 457C at 7:6 (emphasis added). Staff's conflation of *capital costs* with *borrowing costs* ignores the evidence presented by Dr. Morin regarding the inverse behavior between authorized risk premiums and interest rates. In other words, the fact that PSE's borrowing costs are near all-time lows does not necessarily mean that its capital costs are near all-time lows. *See* Morin, Exh. 301 38:16 – 41:4; Morin, Exh. 315 63:12 – 65:9 and 90:7-19.

[111] *See* Staff Br. ¶ 2.

[112] *See* Public Counsel Br. ¶¶ 127-128; ICNU Br. ¶ 50.

[113] *See* Valdman, TR. 253:2 – 255:3.

Tracker, PSE's increased exposure to excess power costs with the expiration of the $40 million PCA cap, flotation costs, and other cost pressures.[115]

59. The Northwest Energy Coalition ("NWEC") Brief adopts Staff witnesses' assertion that "PSE's decoupling mechanism would reduce its revenue requirement by approximately $14 million annually (approximately a 50 basis point reduction in the cost of capital)."[116] Mr. Hill's alleged $14 million reduction in ROE due to decoupling, however, fails to prove the effect of the decoupling mechanism on PSE's ROE. Mr. Hill states that the "historical volatility of the income or revenue stream of a firm can be viewed as a normal distribution around a mean—a "'bell-shaped' distribution."[117] He then alleges that the effect of the reduction in volatility of the income or revenue stream would re-shape the normal distribution around the mean income level --the extreme tails of volatility of the income or revenue stream would be reduced.[118] Mr. Hill alleges that the "probability of a revenue margin reduction represents approximately $14 Million annually."[119] He offers nothing more than a statistical regression to justify this inflated figure without demonstrating that such statistical relationship is even relevant to PSE's ROE.[120] Moreover, Mr. Hill uses PSE's *total* ratebase of approximately $4.2 billion[121] instead of PSE's *gas* ratebase of approximately $1.2 billion[122] to determine the effect of his inflated $14 million reduction due to *gas* decoupling. Presumably, Mr. Hill uses *total* ratebase because *gas* ratebase would produce absurd results.

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[114] *See* Aladin, Exh. 14 3:8 – 12:16.
[115] *See* Valdman, Exh. 457C 14:10 – 16:5; Valdman, TR. 292:20 – 293:14; Morin, TR. 382:12 – 383:2.
[116] NWEC Br. ¶ 7.
[117] Hill, Exh. 531C 60:13-16.
[118] *See id.* 61:1-5.
[119] *Id.* 62:20-21.
[120] *See* Hill, Exh. 548 1-3.
[121] *See id.* 3.
[122] *See* Karzmar, Exh. 234 1.

60. Assuming *arguendo* that Mr. Hill's statistical regression is relevant to PSE's ROE, Mr. Hill fails to acknowledge that the nature of the normal distribution of the income or revenue stream necessarily means that the positive and negative extremes are eliminated by the narrowing of the bell curve. Even assuming that Mr. Hill's numbers are correct (an assumption that PSE does not concede), then while PSE would benefit from a reduction in probability of an extreme under-collection of revenue, customers would also benefit from a corresponding reduction in probability of an extreme over-collection of revenue. In other words, Mr. Hill's alleged $14 million reduction in probability of the Company under-collecting margin would be offset by a corresponding $14 million reduction in probability of the Company over-collecting margin. Mr. Hill's analysis inappropriately examines only one side of the bell curve.

61. Finally, the NWEC Brief asserts that Dr. Morin's rebuttal testimony supports Mr. Hill's analysis.[123] This allegation misrepresents the record. The portion of Dr. Morin's testimony cited by NWEC states as follows:

> In my judgment, the removal of [the Company's proposed PCA revisions, decoupling mechanism and Depreciation Tracker] *would increase the Company's cost of common equity by 25 to 50 basis points* on account of additional risk faced by the Company.[124]

Thus, Dr. Morin's proposed ROE of 11.25% incorporates the assumption that the Commission would adopt PSE's proposed PCA revisions, decoupling mechanism and Depreciation Tracker. If the Commission were to reject all of PSE's proposed mechanisms and revisions, then Dr. Morin would propose that the Commission adopt an ROE between 11.50% and 11.75% for PSE. In no way does this recommendation support Mr. Hill's assertion that adoption of PSE's proposed decoupling mechanism requires a reduction in ROE of approximately 50 basis points.

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[123] *See* NWEC Br. ¶ 7 (allegedly citing to Morin, Exh. 315 94:10-12).

5. Staff and ICNU Misstate the Company's Credit Ratings

62. The Company's corporate credit rating is the lowest investment grade rating possible (BBB-), and the Company's secured bond rating is only slightly higher (BBB). The Company's credit ratings are substantially affected by PSE's limited cash flow and leveraged capital structure, especially in light of the amount of imputed debt the rating agencies add to total debt. At this time, the Company seeks to improve its corporate credit ratings to BBB+, a rating that the Company believes reflects the appropriate balance of cost (economy) and risk (safety) while providing the Company with the financial flexibility needed to access the capital markets on reasonable terms. A BBB+ corporate credit rating is important because such a rating would: (i) enable the Company to borrow at lower interest spreads; (ii) provide the Company with a reasonable "ratings cushion" above non-investment grade status; (iii) support the Company's anticipated resource capital spending program; and (iv) facilitate expanded risk management activities.[125]

63. Despite the Company's low corporate credit ratings, ICNU astoundingly asserts that PSE "has maintained a strong credit rating."[126] ICNU further misstates the Company's position by stating that the Company has argued "that it requires the cost of capital it is requesting in order to

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[124] Morin, Exh. 315 94:10-12 (emphasis added).

[125] *See* Gaines, Exh. 131C 11:4 – 14:4.

[126] ICNU Br. ¶ 49. The other parties' briefs are replete with overstatements of the Company's financial status. For example, Staff and Public Counsel each allege that the Puget Energy, Inc.'s stock has outperformed the S&P 500. *See* Staff Br. ¶ 13; Public Counsel Br. ¶ 125. The referenced source indicates only that Puget Energy, Inc.'s stock outperformed the S&P 500 for *three months* in which the S&P 500 *lost* approximately 4%. *See* Joint PCA Parties, Exh. 599 20:8-13. Neither Staff nor Public Counsel acknowledge the fact that Puget Energy, Inc.'s stock declined 7.39% over the three years ending December 31, 2005, including a decline of 16.82% in calendar year 2005. This decline in Puget Energy, Inc.'s stock price pales in comparison to the tremendous stock increases in the utility industry over the same period--the Philadelphia Stock Exchange Utility Index increased by 64.63% and the Dow Jones Utility Index increased by 88.28% between January 1, 2003 and December 31, 2005. In calendar year 2005 alone, the Philadelphia Stock Exchange Utility Index increased by 13.83% and the Dow Jones Utility Index increased by 20.96%. *See* Valdman, Exh. 451C 15:1-14.

maintain its credit."[127] As discussed above, PSE hopes to achieve a corporate credit rating of BBB+, not maintain its current BBB- status, and PSE has never alleged that it would fall to non-investment grade status absent the rate relief it requests in this proceeding. But it is simply the case that the risk that PSE could fall to non-investment grade status will be higher without the additional safety net that would be provided by a corporate credit rating higher than BBB-.[128]

64. Staff criticizes PSE for not guaranteeing that it will reach a BBB+ corporate credit rating if the Commission were to adopt PSE's recommended rate relief.[129] No utility can make such a guarantee because the credit rating agencies decide for themselves how they view the Company's financial status and any rate relief granted. Credit rating agencies examine a number of qualitative and quantitative factors in determining a credit rating, and there is no absolute formula for combining assessments of these factors to arrive at a specific credit rating.[130] However, approval of PSE's 45% requested equity level, along with the 11.25% ROE and the other regulatory mechanisms and relief the Company has requested in this case, will likely place the Company in a position to improve its corporate credit rating from its current BBB- rating to a BBB+ corporate credit rating.[131] The Company's belief that its requested rate relief will provide the financial results necessary to support the Company's targeted corporate credit rating of BBB+ rests, in part, on statements made by the credit rating agencies:

> Consideration of a positive rating outlook will depend on more favorable rate relief in future years (beginning with the forthcoming GRC), consistently strong cash flow coverage metrics, and Puget Sound Energy's ability to improve its equity capitalization. An improved mechanism for commodity cost recovery could also provide support for a positive outlook. Alternatively, a negative outlook could result due to several factors, including additional

[127] ICNU Br. ¶ 10.
[128] *See* Gaines, TR. 423:21-425:6; Gaines Exh. 137C 39:13-17.
[129] *See* Staff Br. ¶ 7.
[130] *See* Gaines, Exh. 131C 14:10-13.
[131] *See id*. 2:13-18.

> commodity cost disallowances, the excessive accumulation of power cost deferrals, inadequate regulatory treatment of capital additions, a disproportionate reliance on debt financing to meet its capital needs, or significant power cost deficits beginning in 2007.[132]

65. Given the myriad considerations employed by ratings agencies in determining credit ratings and statements by these agencies such as that cited above, any allegations by Staff and ICNU that their respective rate relief proposals will either maintain or improve the Company's credit ratings are, at best, speculation and, at worst, inconsistent with the record.[133] Moreover, Staff and ICNU emphasize the Company's Standard & Poor's business risk profile score of 4. The Commission should not be distracted by such arguments--the Company's *financial corporate credit rating* (the rating that matters in the marketplace) is one notch above non-investment (i.e., "junk") status. Thus, the Company has no cushion from "junk" status should any unexpected events occur. In other words, the Company's current credit ratings provide no safety net in the event of unforeseen circumstances, and the Company's *business credit rating* does not provide much harbor in the event of a storm.

6. A Flotation Cost Allowance Is Necessary For PSE To Recover Costs Incurred in the Issuance of Equity

66. Staff opposes the Company's request to recover flotation costs--the costs incurred by PSE in the issuance of equity. Staff's argument should be rejected for several reasons. First, Staff's argument that the majority of the flotation costs are not out-of-pocket expenses incurred by the issuing utility and, as such, should not be recovered,[134] if taken to a logical conclusion, suggests that depreciation expenses associated with plant should not be recovered because depreciation

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[132] *Id.* 14:18 – 15:4 (quoting Standard & Poor's, "Research Update: Puget Energy 'BBB-' Corp. Ratings Affirmed; Outlook Remains Stable" at 2 (Dec. 30, 2005)).
[133] *See, e.g.*, ICNU Br. ¶ 88.
[134] *See* Staff Br. ¶ 71.

expense is not an out-of-pocket expense.[135] But, as Mr. Valdman explained, recovery in rates of such depreciation expense is critical to a utility's cash flow.[136]

67. The expense and recovery of flotation costs would burden current customers with the full costs of raising capital when the benefits of that capital extend indefinitely. Moreover, common stocks, unlike bonds, have no finite life over which flotation costs could be amortized. Therefore, the most appropriate method to recover flotation costs is via an upward adjustment to the authorized ROE.[137]

68. Second, Staff argues that flotation costs are unnecessary to prevent dilution of stockholder investment when the market price of utility stocks exceed book value.[138] This argument fails to address the fact that, in issuing common stock, a company's common equity account is credited by an amount less than the market value of the issue. Therefore, the Company must earn slightly more on its rate base to produce a return equal to that required by shareholders. The stock's market-to-book ratio is irrelevant. Flotation costs are present, irrespective of whether the stock trades above, below, or at book value.[139]

69. Third, Staff's Brief makes the argument that the flotation cost allowance is unwarranted because investors factor these costs in the stock price.[140] Such circular reasoning could be used to justify any regulatory policy, regardless of the propriety of the policy.[141]

70. Finally, both Staff and ICNU ignore recent Commission guidance when they argue that the Commission should reject any flotation cost adjustment because Dr. Morin's recommended

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[135] *See* Morin, Exh. 315 16:10-14.
[136] *See* Valdman, Exh. 457C 30:3-17.
[137] *See* Morin, Exh. 315 16:15 – 17:3.
[138] *See* Staff Br. ¶ 73.
[139] *See* Morin, Exh. 315 16:1-7.
[140] *See* Staff Br. ¶ 74.
[141] *See* Morin, Exh. 315 17:4-9.

flotation cost adjustment is not based on known and measurable common stock flotation expenses that are attributable to PSE.[142] This argument directly contravenes the Commission's recent decision that held that adjustments for flotation costs are appropriate where the utility issued equity in the test year or plans to do so in the future:

> While, in some circumstances, we have permitted adjustments to a Company's cost of equity to reflect issuance expenses or flotation costs, we cannot do so in this case because PacifiCorp did not incur such expenses in the test year, nor does the Company expect to incur such expenses in the future.[143]

Puget Energy, Inc. issued common stock during the test year and expects to incur such expenses in the future to finance PSE's considerable construction program. Therefore, an upward adjustment for flotation costs is appropriate.

71. PSE presented empirical finance literature that demonstrates that total flotation costs amount to 5% of gross proceeds--4% for the direct component and 1% for the indirect (market pressure) component.[144] This empirical evidence is consistent with the direct component flotation costs of 3.12% of gross proceeds incurred by Puget Energy, Inc. in its October 2005 equity issuance.[145] Flotation costs of 5% of gross proceeds approximate an increase to the allowed ROE of approximately 30 basis points, depending on the magnitude of the dividend yield component.[146] Each of the market-based ROE estimates presented by Dr. Morin includes a flotation cost adjustment of 30 basis points. In contrast, Mr. Hill and Mr. Gorman fail to include any allowance whatsoever for flotation costs in their ROE recommendations. Therefore, their ROE estimates are downward-biased by approximately 30 basis points from that omission

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[142] *See* Staff Br. ¶ 72; ICNU Br. ¶ 62. Staff also alleges that flotation costs are somehow offset by other issuance costs, such as brokerage fees. *See* Staff Br. ¶ 72. Neither the Staff Brief nor the record supports this allegation.

[143] *PacifiCorp* Order ¶ 122 (footnotes omitted).

[144] *See* Morin, Exh. 301 52:3 – 56:2; *see also* Morin, Exh. 314 1-9; Morin, Exh. 315 12:15 – 18:4 and 70:13 – 71:21.

[145] *See* Bench Exhibit, Exh. 9 1.

alone.[147]

V. DECOUPLING—GAS REVENUE NORMALIZATION ADJUSTMENT

A. Staff, NWEC, and the Company All Favor Revenue and Bill Stabilization Mechanisms That Prevent Over and Under Collection and Payment of Gas Margin Due To Variations in Customer Usage

72. Staff states that "[t]here are compelling reasons for the Commission to implement a gas decoupling mechanism for PSE."[148] However, Staff opposes the GRNA as proposed by the Company because Staff believes the GRNA introduces undue bill volatility.[149] As discussed below, (i) the GRNA will not produce undue bill volatility and (ii) any potential bill volatility is mitigated by increasing the customer charge and by using weather normalized billing to account for the effect of weather variability on margin recovery.

73. NWEC and the Company support an adjustment to correct for margin over- and under-recovery and payment due to variations in customer usage caused by conservation, weather, and other causes. However, NWEC favors tying the GRNA adjustment to meeting conservation targets[150] and favors other modifications to the Company's proposal.

B. Staff, NWEC, and the Company All Agree That the GRNA As Proposed By the Company Will Prevent Over- And Under- Collection and Payment of Margin Due To the Effects of Conservation and Weather.

74. Staff acknowledges that the GRNA as proposed by the Company captures "all weather-related effects"[151] as well as "customer conservation or efficiency improvements."[152] Similarly, the NWEC Brief urges "the Commission to approve the weather-adjustment component of PSE's

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[146] *See* Morin, Exh. 301 51:3 – 56:2; *see also* Morin, Exh. 314 1-9.
[147] *See* Morin, Exh. 315 14:3-6; 70:16 – 71:1.
[148] Staff Br. ¶ 89.
[149] *See id.* ¶ 96.
[150] *See* NWEC Br. ¶¶ 27-28.
[151] Staff Br. ¶ 95.

decoupling proposal.[153] Even Public Counsel witness Brosch recognized merit in a weather-adjustment decoupling mechanism.[154]

C. A Decoupling Mechanism Should be Adopted To Prevent Over and Under Collection and Payment of Margin Due to Weather Variability

75. Staff argues that decoupling should be limited to non-weather related changes in consumption.[155] However, mechanisms to adjust for weather to avoid over and under recovery and payment of margin are widely accepted by utility regulators.[156]

76. The Company's inclusion of weather in the GRNA will not cause undue bill volatility.[157] The proposed GRNA will result in a uniform monthly adjustment that will change only once each year. The annual adjustment to the GRNA amount cannot fairly be characterized as volatile or unstable. Further, the effect of the GRNA is to correct for overpayment and underpayment of fixed costs over time. This correction is expected to be small with respect to individual customers[158] and does not shift risk to customers, but rather reduces risk for both customers and the Company.[159] This amount of correction would be further reduced by combining the GRNA with a larger customer charge (and correspondingly lower delivery charge), as discussed below.

77. Staff in effect argues that customers and the Company should not receive the benefits of decoupling with respect to the effects of weather variability on *margin* payment and recovery

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[152] Steward, Exh. 561 7:21.
[153] NWEC Br. ¶ 10.
[154] *See* Brosch, TR. 672:22-25.
[155] *See* Staff Br. ¶ 94.
[156] *See* PSE Br. ¶ 94.
[157] *See* Amen, Exh. 31 18:5-9.
[158] Staff witness Ms. Steward analyzed the projected potential effects on customer bills from (i) the GRNA as proposed by the Company and (ii) the GRNA but with weather variations excluded. The maximum difference in any one year between Ms. Steward's "with" and "without" weather scenarios is 2.01% of revenues for the residential class, which translates to about $.024 per therm or $1.65 per month for a typical residential customer. *See id.* 18:14-17.
[159] Staff witness Ms. Steward erroneously asserts that inclusion of weather variability in the GRNA would shift risk to customers. In fact, the GRNA benefits, and reduces risk symmetrically for, both Company and customers.

because the PGA adjusts for the effects of weather variability on gas costs (*non-margin)* payment and recovery.[160] But the "69% of the Company's gas revenues . . . already protected from the impact of weather under the PGA"[161] has no bearing on the recovery and payment of the Company's margin.[162]

78. Staff witness Ms. Steward recognized that weather normalized billing would stabilize both the Company's earnings and customers' bills: "The true variable costs, i.e., gas commodity costs, could be billed on metered volumes and the fixed cost energy component billed [under weather normalized billing] on weather normalized volumes."[163] She noted that such stabilization "could be a win-win situation."[164]

D. The GRNA Should Not Be Tied To a Conservation Target

79. NWEC supports the Commission's approval of the weather-adjustment component of PSE's decoupling proposal, but suggests that margin paid by customers should be reduced if Puget does not meet 150% of PSE's "stretch goal" for conservation.[165] The benefits from decoupling--lower volatility and risk--flow to both customers and the Company. Decoupling should not be tied to specific conservation goals. Such a tie would unnecessarily condition the customers' benefits of decoupling on realizing aggressive conservation goals.[166]

E. No Cap On The Annual Adjustment Should Prevent Later Recovery

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See id. 18:5-6.

[160] *See* Staff Br. ¶ 98.

[161] *Id.*

[162] *See* Amen, Exh. 31 19:1-4.

[163] Steward, Exh. 569 12:6-10.

[164] *Id.* 11:10-11.

[165] *See* NWEC Br. ¶ 9. The NWEC Brief's argument assumes that PSE's decoupling mechanism will generate "estimated savings" of $14 million annually by reducing the ROE component of the Company's revenue requirement. The $14 million in fact overstates the reduction in ROE that results from decoupling. *See* Morin, Exh. 315 94:7-12. Nevertheless, decoupling benefits the Company and customers and should be adopted.

[166] *See* Amen, Exh. 31 3:19-21.

80. Staff proposes a cap on the decoupling annual surcharge[167] with a deferral mechanism for subsequent collection of any margin undercollection as a result of the cap.[168] NWEC testimony and Brief proposed a cap on the annual rate adjustments pursuant to decoupling but were silent regarding recovery of any residual amount in excess of the cap.[169]

81. Any proposal to cap the annual decoupling adjustment without subsequent recovery of the excess undermines the effectiveness of the decoupling mechanism and should not be adopted. Accordingly, any under-collection of distribution costs that remains un-recovered due to the application of an annual rate adjustment cap should be deferred for recovery in the subsequent annual period.[170]

F. The GRNA Decoupling Mechanism As Proposed By the Company Includes an Appropriate Adjustment For Growth In Customers

82. The Commission has indicated that adjustment for customer growth (or decline) is one of the elements it expects to be addressed in decoupling proposals to provide a greater level of confidence that the resulting margin revenue target will reflect current conditions on the Company's system.[171] The GRNA includes such an adjustment for growth in customers. Public Counsel erroneously asserts that "PSE's GRNA proposal does not track the favorable effects of sales growth from new customers for the benefit of ratepayers."[172] Similarly, Public Counsel witness Mr. Brosch asserts that the Company's GRNA decoupling proposal is unnecessary because "margin revenues in total are growing due to customer growth."[173] Both these assertions

[167] *See* Staff Br. ¶¶ 107-108.
[168] *See* Steward, TR. 769:18-25 (indicating that "customers will still be at risk for recovery of that [deferral balance] in later years."
[169] *See* Weiss, Exh. 502 24:17-18; NWEC Br. ¶ 12.
[170] *See* Amen, Exh. 31 13:18 – 14:13.
[171] *See* PSE Br. ¶ 90.
[172] Public Counsel Br. ¶ 25.
[173] Brosch, Exh. 506C 37:6-7; *cf* Staff Br. fn. 208 (pointing out that "the fact of three general rates cases in five years dispels any notion that customer growth alone adequately compensates PSE.")

ignore the fact that additional customers generate not only revenue but also additional costs--and ignore the erosion of margin recovery caused by new customers.[174]

83. Mr. Amen's rebuttal testimony describes examples of decoupling mechanisms adopted by other gas utilities and accepted by the regulators that incorporate adjustments for changes in the number of customers. The Staff Brief[175] and NWEC witness Mr. Weiss[176] suggest that the decoupling mechanism should attribute a level of gas consumption to new customers that is lower than the average customer consumption. But none of the other decoupling mechanisms reviewed by Mr. Amen attribute a lower usage level to new customers.[177]

G. Administration of the GRNA Would Not Be Unduly Burdensome

84. Contrary to Public Counsel's argument,[178] administration of a decoupling mechanism such as the GRNA would not be unduly burdensome. PSE's proposed GRNA relies on basic ratemaking formulas, well established deferral accounting methods and related interest calculations that have been utilized for decades by utilities. This promotes an ease of verification under customary audit processes by the appropriate parties. According to Staff witness Ms. Steward, "[t]here are no incremental costs for Staff to review, audit and administer the pilot."[179]

H. Public Counsel's Other Arguments Against Decoupling Should Be Rejected

85. Public Counsel argues that decoupling is not necessary to motivate PSE to pursue conservation and that therefore no decoupling mechanism should be adopted. The fact that PSE has vigorously pursued conservation should not be the basis for continuing the shortcomings of

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[174] *See* Amen, TR. 505:19-21.
[175] *See* Staff Br. ¶ 101.
[176] *See* Weiss, Exh. 502 23:5-10.
[177] *See* Amen, Exh. 31 27:3 – 28:11 and fn. 2.
[178] *See* Public Counsel Br. ¶ 60.

traditional ratemaking and permitting under recovery or overpayment of margin. It would be ironic indeed, and unfair, if PSE's pursuit of conservation were to become the basis for denying decoupling—penalizing customers by causing them to overpay in cold weather and penalizing the Company by causing it to under collect due to warm weather or as a result of conservation.

86. Public Counsel also erroneously states that "the additional revenues PSE would realize as a result of the GRNA decoupling mechanism is a 'windfall.'"[180] The only evidence cited by Public Counsel is the "admission" by Mr. Weiss that "if you don't design a decoupling proposal correctly, you can create a windfall for a utility company…."[181] However, this statement in no way demonstrates that the GRNA is incorrectly designed or would create a windfall for the Company. To the contrary, the GRNA will prevent margin overpayment and under collection.[182]

87. Public Counsel has it backwards in arguing that decoupling can seriously distort the rate making "matching principle" for revenues and costs.[183] It is the "matching" of non-volumetric costs for recovery through commodity sales to the extent proposed by Public Counsel that causes distortion, not the Company's proposal for decoupling those costs from volumetric sales. In fact, the effect of the GRNA is to help ensure that margin is not over or under paid or recovered, thereby maintaining the appropriate match that is established in the rate case.[184]

88. Public Counsel erroneously argues at the beginning of paragraph 48 that "Decoupling In This Case Violates the Guidelines of the Commission's PacifiCorp Order." The referenced "guidelines" at paragraphs 108-109 of that order instruct PacifiCorp to include detailed information regarding twelve topics in any future request for a decoupling mechanism. Public

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[179] Amen, Exh. 36 2.
[180] Public Counsel Br. ¶ 30.
[181] Weiss, TR. 683:19-23.
[182] *See* Amen, Exh. 31 2:22-23.
[183] *See* Public Counsel Br. ¶ 45.

Counsel touches on three of those topics, but in doing so does not identify any information contemplated by the PacifiCorp order that has not been addressed by the Company.[185]

I. Decoupling and an Increased Gas Residential Customer Charge Work Together To Decrease Bill Volatility

89. As discussed above, the GRNA would not increase bill volatility. However, bill volatility can be significantly decreased by adopting both the Company's proposed GRNA and its current proposal of a $17 residential gas customer charge, which is discussed below.[186] These two proposals are not mutually exclusive, and indeed work very well together: "The higher customer charge subjects less fixed costs to be recovered in a volumetric rate . . . because then there's less that is subject to recovery under a decoupling mechanism."[187]

90. The bill impact of adopting these two PSE proposals is reflected in Exhibit 802, which shows significant reduction in bill volatility (average residential monthly bill impacts) that results from adopting these two proposals together. The Exhibit also shows the impact of these two proposals on customers who are on bill assistance programs, which is very similar to the impact on the customer population as a whole but with a slightly smaller magnitude of adjustment.[188]

VI. ELECTRIC ENERGY EFFICIENCY INCENTIVE

91. The Company appreciates Staff, Public Counsel, and NWEC's support for an electric

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[184] *See* Amen, Exh. 31 20:5-14.

[185] *See* Public Counsel Br. ¶¶ 49-52. The Staff Brief may be read to erroneously imply that the order set forth substantive parameters for future decoupling filings when in fact it instead identified the issues to be addressed by PacifiCorp in a future filing. In addition, the Staff Brief references "PacifiCorp Order Factor 1" in arguing that "[d]ecoupling should be limited to non-weather-related changes in consumption." Staff Br. ¶ 94. But the *PacifiCorp* Order expressly recognizes that the scope of risk to be covered by a decoupling mechanism may include both conservation and weather: "[t]he scope of risk to be covered by the mechanism—conservation, weather or both…" *PacifiCorp* Order ¶ 109.

[186] *See* PSE Br. ¶ 144. The NWEC Brief asserts that there should be a "minimal customer service charge." NWEC Br. ¶ 33. However, such a charge has the effect of increasing bill volatility.

[187] Amen, TR. 503:2-10.

energy efficiency incentive and penalty plan that encourages outstanding electricity conservation while addressing inherent disincentives for conservation. The Company disagrees, however with specific details of each of the plans proposed by the parties.

92. PSE's proposed baseline target of 16.5 aMW was established by the Conservation Resources Advisory Group ("CRAG"). This baseline is also supported by NWEC.[189] The Company and NWEC's baseline target recognizes that there may be factors out of PSE's control that affect conservation. A 16.5 aMW baseline, along with a symmetrical deadband of 95%-105%, allows for some fluctuation in conservation levels before either an incentive or penalty applies. In contrast, both Staff and Public Counsel set a baseline far above 16.5 aMW, yet begin incentive payments immediately upon reaching the baseline, or even below the baseline.[190] A baseline should be just that--a measure from which either incentives or penalties will stem. A baseline should not be the incentive target in and of itself.

93. Although NWEC and Public Counsel initially proposed an unbalanced mechanism where the penalty far exceeded program incentives,[191] NWEC has now accepted PSE's balanced penalty ranges.[192]

94. PSE agrees with all but four of the electric conservation plan design criteria proposed by NWEC, Staff and Public Counsel. The four that PSE rejects are unnecessarily restrictive. First, the program portfolio should not be required to meet a minimum average measure life of nine years. Such a restriction will potentially exclude beneficial, cost effective measures.[193] In fact, the second largest program in PSE's current electric conservation portfolio has a measure life of

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[188] *See* Bench Exhibit, Exh. 802 2 and 17-19.
[189] *See* Glaser, Exh. 499 6:9 – 7:7.
[190] *See* Steward, Exh. 567 1; Klumpp, Exh. 510 9:8-11.
[191] *See* Glaser, Exh. 499 8:6-13, 20-22; Klumpp, Exh. 510 13:4-21.
[192] *See* NWEC Br. ¶ 36.

six years.[194] Public Counsel concludes that "[i]t is in the interest of the ratepayers and the power system to secure efficiency investments in long-term measures."[195] However, no party in this proceeding has provided any evidentiary support for excluding short-term measures in favor of long-term measures.[196] As Staff stated in its initial brief, "[s]ince 1999, the average measure of PSE's electric efficiency programs has been nine years or greater."[197] PSE has, therefore, without any mandate, pursued long-term measures as well as beneficial and cost effective short-term measures. The Commission should reject a nine-year average measure life design criterion because it is an unnecessary and arbitrary restriction on the Company's conservation portfolio.

95. Second, the Commission should reject Staff, Public Counsel and NWEC's design criterion of only counting savings from the Northwest Energy Efficiency Alliance ("NEEA") for activities being funded in that year.[198] This is another unnecessary restriction on potentially beneficial, cost-effective programs.[199] NEEA itself has recognized that annual funding should be only one consideration whether or not to count energy efficiency savings.[200]

96. Third, the Commission should reject Staff, Public Counsel and NWEC's design criterion of establishing an evaluation committee in addition to CRAG to evaluate the Company's energy efficiency program. Such a committee would duplicate the role CRAG already plays in review of PSE's energy efficiency program. This proposal would increase the administrative burden on PSE, Staff and other parties, some of which are already active members of CRAG.[201]

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[193] *See* Shirley, Exh. 379 20:4-7.
[194] *See id.* 20:14-15.
[195] Public Counsel Br. ¶ 78.
[196] *See* Klumpp, Exh. 513 ¶ 5 and Steward, Exh. 568 ¶ 5, each of which merely list a nine-year average measure life as a design criterion without any support.
[197] Staff Br. ¶ 141.
[198] *See* Klumpp, Exh. 513 ¶ 6; Steward, Exh. 568 ¶ 6.
[199] *See* Shirley, Exh. 379 21:1 – 22: 5.
[200] *See* Shirley, Exh. 384 at pp. 2-3.
[201] *See* Shirley, Exh. 379 22:6 – 23: 2.

97. Finally, the Commission should accept the Company's proposal of a five-year pilot period rather than a three-year period.[202] All of the pilot electric energy efficiency programs proposed in this proceeding involve evaluation of cycles of implementation, review and potential adjustments. As Public Counsel stated in its initial brief, instituting an incentive-penalty mechanism would represent a significant policy change for the Company.[203] Further, the proposals all involve incentive disbursements and penalty payments, which create administrative lag. While PSE could request to extend the mechanism in a general rate case proceeding or other filing,[204] PSE would prefer to focus its efforts on its conservation programs. A five-year pilot would reduce the need to prepare for and pursue interim administrative contingencies.

VII. WEATHER NORMALIZATION

98. The Commission should approve PSE's weather normalization methodology and find that it is sound. PSE has developed a highly accurate model based on multiple balance point heating degree days. PSE's methodology results in a revenue requirement that is approximately $1.4 million less than it would have been under PSE's prior methodology.[205] Staff agrees to use PSE's methodology for purposes of this case but is unwilling to concede its merits and accuracy.

99. Staff provides no basis or evidence to dispute that PSE's improved model is accurate and highly reliable. Staff does not dispute that PSE's model explains 97% of the variation in historical demand.[206] Given the high level of accuracy of PSE's proposed methodology, it is not in the best interest of the Company or its customers for PSE to expend another $3.5 million to

[202] *See* Klumpp, Exh. 513 ¶ 11 and Steward, Exh. 568 ¶ 11.
[203] *See* Public Counsel Br. ¶ 79.
[204] *See id.*
[205] The calculation is as follows: [145,418 MWH (Dubin, Exh. 81, Table 2, line ElecEQ10) – 129,654 MWH (Dubin, Exh. 81, Table 2, line 2005PCORC)] x [$11,960,058 (Story, Exh. 440, line 28) / 135,823 MWH (Story, Exh. 440, line 16)]
[206] *See* Dubin, Exh. 81 28:4.

develop an expensive load research study[207] (and to have to re-prove Dr. Dubin's work in this case in PSE's next general rate case) when there is no evidence that the load research study Staff proposes could provide any information or data that would explain more than the 97% of the variation in historical demand that PSE's model explains.

100. Staff asserts that the Company has failed to meet its burden of proof to demonstrate that changing the balance point temperature will ensure that rates are just and reasonable. Staff is wrong for several reasons. First, PSE did not *change* the balance point; rather, it *added* new balance points to capture the non-linear relationships between weather and load.[208] Second, Staff ignores the extensive testimony by Dr. Dubin explaining that PSE relied on separate data by customer class in its weather normalization. PSE uses the rate level data to adjust system level weather normalization and to allocate the adjustment to rate sensitive classes.[209]

101. Staff's concern regarding the use of data collected from Sea-Tac International Airport also lacks merit. Staff speculates that "average temperature and socio-economic differences" between Sea-Tac and other counties in PSE's service territory might affect energy consumption.[210] But the evidence shows that Sea-Tac weather is highly correlated with PSE system weather.[211]

102. Staff erroneously argues that there is no practical or theoretical support for using only the Sea-Tac data in the analysis. This is not true. In fact, Staff provided a report that found that a single temperature measurement was sufficient to develop a balance point temperature for the

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[207] *See* Dubin, Exh. 85 18:12-16; Hoff, Exh. 186 21:1-13; *see also* Hoff, Exh. 190 1-3.
[208] *See* Dubin, Exh. 85 6:8 – 7:2.
[209] *See* Dubin, Exh. 81 41:2-5, 44:8 – 45:17.
[210] *See* Staff Br. ¶ 176.
[211] *See* Dubin, Exh. 81 31:7-13; Dubin, Exh. 85 15:12-13 and fn. 22.

entire country of Ireland.[212] Because PSE requires a single weather normalization for its system, aggregation is a practical necessity, not a choice. Dr. Dubin cited several papers that demonstrate that it is not necessarily better to use more refined data when attempting to aggregate effects.[213] In addition, Sea-Tac is a first-order station with high quality data.[214]

103. Staff attempts to cast doubt on PSE's model because the Company uses "a 1985 thermal engineering model to support its multiple balance point temperatures."[215] Staff's argument is irrelevant because the science that is used in the model has not changed and is as valid today as it was in 1985. What is relevant is that the model was "populated" with 2004 data.[216] Therefore, the model's implications are current. Staff's criticism is simply misplaced.

104. Staff asserts incorrectly that PSE "admitted that the thermal model was insufficient to model customer behavior."[217] Staff has misconstrued Exhibit 93, which it relies upon for its assertion. Exhibit 93 states that the Company does not have any studies that show that the thermal model, which was originally developed for National forecasting, is appropriate to model consumer behavior at a more detailed regional level. Nevertheless, as Exhibit 93 states, the model was successfully applied both in Florida and the Pacific Northwest.[218]

105. Staff also attempts to discount the importance and validity of the Company's work by asserting that the "one-time survey from 2004 . . . was limited to the residential class."[219] Staff ignores Dr. Dubin's 100-page report that states clearly the 2004 survey was but one in a sequence

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[212] *See* Dubin, Exh. 85 12:8-13.
[213] *See id*. 17:3-18.
[214] *See* Dubin, Exh. 81 31:14-18.
[215] Staff Br. ¶ 177.
[216] *See* Dubin, Exh. 93 at p. 1.
[217] Staff Br. ¶ 177.
[218] *See* Dubin, Exh. 93 at p. 1.
[219] Staff Br. ¶ 178.

of annual surveys PSE conducted.[220] Dr. Dubin's report described in detail PSE's research, which was based on granular data. The Company's survey was for the residential class as this is the class that is most weather sensitive, where lower balance point temperature are more likely to be seen. Exhibit 89 also describes the sampling process used in collecting the data. Contrary to Staff's assertion that the Company "has no evidence that the survey results are representative of any other rate year or any other customer costs,"[221] Exhibit 94 explains that the results presented by PSE should apply for several years after 2004.[222]

VIII. REVENUE REQUIREMENTS: CONTESTED ADJUSTMENTS

A. Adjustment 20.03—Power Cost

106. ICNU's initial brief contains several misleading assertions relating to power costs that require correcting. First, ICNU states, "[t]he updated average price at Sumas for the rate year in PSE's supplemental filing was $8.57/MMBtu. In contrast, by the time of the hearing, the average Sumas gas price for the 2007 rate year (calculated as of September 21, 2006) was less than $█/MMBtu." This statement is misleading because, for the entire paragraph in which ICNU discusses PSE's market prices, ICNU uses a three-month average power cost. However, in declaring that the updated average Sumas gas price is less than $█/MMBtu, ICNU uses a daily forward price.[223] The updated 3-month average price for the rate year, at September 21, 2006, was actually $█/MMBtu.[224]

107. ICNU also states that a reduction of gas prices of 10 cents/MMBtu can impact PSE's power cost by several millions but provides no evidentiary support for such a specific

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[220] *See* Dubin, Exh. 85 9:5-8.
[221] Staff Br. ¶ 178.
[222] *See* Dubin, Exh. 94.
[223] ICNU Br. ¶ 12.
[224] *See* Mills, Exh. 289C.

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statement.[225] Mr. Mills addressed this issue in his hearing testimony by stating that because of the complexity of the relationship between gas prices and power costs, it would be "folly" to attempt to apply a rule of thumb in order to determine the impact of gas prices on power costs.[226]

108. ICNU cites the Mills rebuttal testimony in support of the statement, "the Company takes an all-or nothing approach, suggesting that anything other than a complete review [of AURORA's data set] is unacceptable."[227] The rebuttal testimony cited actually states that while the Company would not expect the Joint Parties to review each and every resource line and column, it does not follow that downward adjustments to PSE's power costs should be made outside the AURORA model based on partial or arbitrary review.[228]

1. Re-running the AURORA Model.

109. ICNU suggests that the Company be required to rerun AURORA calculations with the Joint Parties' power cost adjustments and updated gas prices.[229] The Joint Parties recommend using the average of the 2007 forward market prices from the three month period September 1, 2006 through November 30, 2006.[230] While PSE disagrees with the Joint Parties' adjustments as noted below, PSE does not object to rerunning AURORA with updated gas prices; however, other known and measurable rate year power cost assumption updates, such as contract quantities and prices must be updated as well.[231] This will in turn change all of the Joint Parties' proposed power cost adjustments.

110. The Company asks the Commission to take this issue into account when it "state[s] in its

[225] *See* ICNU Br. ¶ 11.
[226] *See* Mills, TR. 866:8 – 867:14.
[227] ICNU Br. ¶ 17.
[228] *See* Mills, Exh. 269C 13:18 – 14:2.
[229] *See* ICNU Br. ¶ 1.
[230] *See id.* ¶ 14.
[231] *See* Mills, TR. 921:9 – 923:3.

final order . . . the date by which the compliance filing must be made and the effective date that should appear on any tariff sheets that are required as part of a compliance filing,"[232] and to leave sufficient time between the issuance of the order and the end of the suspension period.[233] PSE requests that the Commission schedule a conference for a date after the order is issued to clarify, if necessary, AURORA and Not in Model assumptions the final order may require.[234]

2. AURORA Model Prices

111. ICNU proposes using 3-month averages of forward gas and electric prices rather than PSE's hourly AURORA results to calculate power costs.[235] To support this departure from Commission-approved AURORA power cost pricing,[236] ICNU claims that forward prices would eliminate the need to constantly update the AURORA specifications.[237] ICNU also claims that using forward prices would eliminate the need for parties to scrutinize every line of the AURORA data set and would reduce the impact of data set errors.[238] But even if forward electric prices were used, AURORA must still be run to calculate market purchase prices, as dispatch of generation units is dependant on AURORA market prices.[239] Frequent updates would also be required due to the many factors such as stream flow, loads and temperature incorporated into the determination of forward market prices.[240] These conditions change

[232] WAC 480-07-883(3)(a).
[233] It generally takes two to three days to rerun AURORA with new inputs and another day to recalculate power costs based on the AURORA results, plus another three days to spread the total revenue requirement to rates and generate the tariff sheets required for a compliance filing.
[234] *See* WAC 480-07-840.
[235] *See* ICNU Br. ¶ 37.
[236] PSE's method of modeling costs was approved by the Commission in PSE's 2001 general rate case, 2003 PCORC, 2004 general rate case, 2005 PCORC, and 2005 PCORC update. *See* Mills, Exh. 269C 11:11 – 12:11.
[237] *See* ICNU Br. ¶ 37.
[238] *See id.* ¶ 42.
[239] *See* Mills, Exh. 269C 32:13-19.
[240] *See id.* 30:5-31:6.

quickly.[241]

112. As additional support for using forward electric prices, ICNU refers to Commission approval of 3-month averages of forward gas prices as an input to AURORA.[242] There are significant differences, however, between the gas and power markets. AURORA prices should not be replaced with forward power market prices without conducting extensive analyses such as was performed by Drs. Dubin and Mariam in PSE's 2004 general rate case.[243]

113. ICNU further argues that PSE's AURORA model incorrectly assumes that 100% of PSE's hourly need is purchased in the spot market and proposes an adjustment to assume 100% of the purchases are made in the short-term market.[244] In fact, PSE considers actual rate year short-term, fixed price power purchases and sales contracts and includes them in the projected rate year power costs by adjusting for these contracts in the "Not In Models" section of the rate year power cost calculations.[245] Such approach has been repeatedly approved by the Commission and should be relied upon again in this proceeding to project PSE's rate year power costs.[246]

3. Hydro Shaping

114. ICNU claims that PSE has not projected enough dispatch of its hydro resources during on-peak hours because PSE's April 14, 2006, position and exposure report modeled more on-peak hydro shaping than PSE's AURORA modeling.[247] But the AURORA model and PSE's risk assessment model are two different models generating different outcomes for different

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[241] *See id.* 30:17 – 31:6.
[242] *See* ICNU Br. ¶ 38.
[243] *See* Mills, Exh. 269C 29:12 – 30:4.
[244] *See* ICNU Br. ¶ 40.
[245] *See* Mills, Exh. 296C 32:19 – 33:2.
[246] *See id.* 12:3-11.
[247] *See* ICNU Br. ¶ 29.

purposes.[248] The risk assessment model does not reflect how actual hydroelectric systems are operated, and should not be used for hydro shaping in setting rates. This is because factors other than price limit PSE's ability to optimize hydroelectric generation during on-peak hours.[249]

115. PSE also used five years of actual data to show that PSE's AURORA hydro shaping is not flawed. These data showed that PSE was actually able to achieve less on-peak hydro operations than projected by AURORA.[250] ICNU criticizes PSE's use of this data because three to four of these years were considered poor water years.[251] Nevertheless, there is no historic evidence in this case that supports ICNU's claim that AURORA's on-peak hydro projections are too low.

116. ICNU advances on brief a claim that was not made in its response testimony when it states that PSE's AURORA hydro shaping conflicts with the hydro shaping factors used in the BPA 2006 Risk Analysis Study.[252] The potential applicability of BPA's 2006 Risk Analysis Study to PSE was suggested for the first time through ICNU's cross examination of Mr. Mills. Mr. Mills thoroughly explained why BPA's hydro shaping assumptions cannot be applied to PSE's operations.[253] It is utterly inconsistent with the record in this case for ICNU to represent to the Commission that "the BPA study reflects the amount of energy that PSE can expect to receive through its Mid-C contracts."[254]

4. Minimum Up and Down Times for Gas-Fired Combustion Turbines

117. In its initial brief, ICNU states that the Joint Parties reviewed PSE's specification for

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[248] *See* Mills, Exh. 269C 23:9-25:3; *see also* PSE Br. ¶ 115.
[249] *See* Mills, Exh. 269C 24:5 – 26:28.
[250] *See id.* 23:18 – 24:8.
[251] *See* ICNU Br. ¶ 34.
[252] *See id.* ¶¶ 30-31.
[253] *See* Mills, TR. 884:17 – 893:18.
[254] ICNU Br. ¶ 35; *see* Mills, TR. 884:17 – 893:18. The Commission should disregard the table presented at

most of the new large combined cycle combustion turbines ("CCCTs") that have been added within the Western Electric Coordinating Council ("WECC") in recent years.[255] ICNU also states that the Joint Parties reviewed "several" contracts in support of their recommendation that the Commission require shorter up and down times.[256] In fact, the Joint Parties' recommendation for minimum up and down times is based on a review of only three contracts totaling 1,820 megawatts,[257] whereas their requested changes would apply to a total of 37 CCCT plants amounting to over 23,000 megawatts of generating capacity.[258] This superficial review is insufficient to support ICNU's claim that PSE has not used reasonable values for the minimum up and down times of the CCCT facilities.[259]

118. ICNU states that PSE reduced the minimum up and down times of its own CCCTs, and suggests that this shows that the operating parameters supplied by EPIS are not accurate. ICNU further states that PSE reviewed the minimum up and down times in a number of contracts for the AURORA resources and found that the EPIS numbers were incorrect, yet only changed the up and down times for its own resources.[260] ICNU's statement that PSE reduced minimum up and down times is wrong. Exhibit 290C, which ICNU cited as support for the statement, shows that PSE actually increased minimum up and down times of PSE-owned CCCT facilities.[261] It was appropriate for PSE to limit its adjustment of the EPIS database to PSE's facilities since it

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paragraph 32 of ICNU's Initial Brief because it attempts to introduce new data into the record that is not in evidence in this case and has not been verified, tested or responded to through the adjudicative process.

[255] *See* ICNU Br. ¶ 20.

[256] *See id.* ¶ 24.

[257] *See* Mills, Exh. 269C 17:14 – 18:2; Mills, Exh. 277 1.

[258] *See* Mills, Exh. 269C 18:6-7.

[259] *See* ICNU Br. ¶ 20.

[260] *See id.* ¶¶ 24-25.

[261] The minimum up and down times for PSE's Encogen CCCT was increased from 16/8 to 48/8 and PSE's Frederickson CCCT was increased from 16/8 to 24/24. *See* Mills, Exh. 290C; *see also* Mills, TR. 875:4 – 876:2.

has sufficient, specific knowledge of its own resources to make appropriate adjustments.[262]

119. In addition to EPIS' data, which is updated and back tested, PSE relies on its operational experience in dispatch of its own CCCT generating plants.[263] PSE estimates that applying the Joint Parties' proposed minimum up and down times might increase variable operation and maintenance costs by $█ to $█ per MWh, which could nearly offset, and possibly exceed, their proposed reduction in power costs.[264] ICNU characterizes PSE's estimates of increases in maintenance cost for other resources as "mere speculation" because PSE did not attempt to determine the change in the number of starts and the number of hours of operation that would occur if the Joint Parties' recommendation was adopted, nor did PSE rerun AURORA with the Joint Parties' minimum up and down times.[265] As the revised minimum up and down times were proposed by the Joint Parties, it is actually the Joint Parties that did not provide evidence that maintenance costs would not increase, particularly give that the contract provided by the Joint Parties shows additional costs associated with different start scenarios.[266]

120. In its initial brief, ICNU also persists in providing an incorrect description of how AURORA dispatches resources,[267] which Mr. Mills refuted in his rebuttal testimony.[268]

5. Additional Generation Capacity

121. PSE accepted the Joint Parties' proposal to include additional generation facilities in its AURORA database and updated AURORA for all of the Joint Parties' proposed capacity

[262] *See* Mills, TR. 875:8 – 876:2 and 910:7 – 913:25.
[263] *See* Mills, TR. 872:16 – 873:4; *see also* Mills, TR. 906:19 – 907:14.
[264] *See* Mills, Exh. 269C 19:23 – 20:9.
[265] *See* ICNU Br. ¶ 26.
[266] *See* Mills, Exh. 269C 21:11-19.
[267] *See* ICNU Br. ¶ 22.
[268] *See* Mills, Exh. 269C 22:13 – 23:7.

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increases.[269] PSE accepted this proposal because it was consistent with the newest version of EPIS, thus retaining the coherency of the AURORA model as a whole.

6. Peak Loads

122. ICNU recommends that in future filings, the Commission require PSE to calculate the peak temperature for extreme peak loads based on a historical record of at least 30 years.[270] PSE does not agree that peak temperature should be based on the same period as used for weather normalization. The Commission should reject ICNU's unsupported mandate. Nevertheless, PSE is willing to discuss with concerned parties how peak temperatures should be calculated.[271]

B. Adjustments 20.12 and 12.20 —Director and Officer Insurance

123. In WUTC Docket Nos. UE-920433, UE-920499, and UE-921262, the Commission explicitly approved the Staff's proposed method for calculating the director and officer ("D&O") insurance adjustment, and PSE applied that methodology in this case.[272] Staff argues for a change to this method based only on an unsupported statement that Staff's proposed new method bears a rational relationship to D&O coverage.[273] Staff's proposed new method is based in part on the number of employees of the entities covered by the D&O insurance.[274] This is a faulty premise, as there is no relationship between the number of employees and D&O insurance.[275]

124. Staff introduces a new argument in its initial brief when it suggests that PSE should have reassessed its need for D&O insurance following Puget Energy's sale of InfrastruX.[276] Such a requirement is not necessary, since Puget Energy's directors and officers continue to face

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[269] *See id.* 269C 15:13 – 16:2; *see also* PSE Br. ¶ 116.
[270] *See* ICNU Br. ¶¶ 8, 44-45.
[271] *See* Mills, Exh. 269C 34:15 – 35:6.
[272] Karmar, Exh. 232C 13:4-6.
[273] *See* Staff Br. ¶¶ 169-173.
[274] *See* Russell, Exh. 521 11:15-20.
[275] *See* Karzmar, Exh. 232C 13:13-16.
[276] *See* Staff Br. ¶ 171.

potential liability following the sale of InfrastruX.[277]

125. Staff's statement that PSE's adjustment does not allocate any D&O insurance to InfrastruX[278] is misleading because a portion of the test year insurance premiums has in fact been allocated to InfrastruX.[279] In addition, Staff's allocation method inappropriately allocates premiums to InfrastruX even though it will not exist during the rate year. Further, although Staff states that it allocates insurance premiums to InfrastruX and "other subsidiaries",[280] Staff completely omits PSE's non-utility subsidiaries, Puget Western Inc. and Hydro Energy Development Corp.[281] Staff's allocation method, excluding InfrastruX, would therefore result in 100% of all future D&O insurance premiums being improperly allocated to PSE.[282]

126. Finally, Staff refers to WUTC Docket Nos. UE-921262 *et al.* to point out that the Commission in that case excluded premiums for half of the test year. Unlike a general method of allocation, which may be appropriately applied in a subsequent rate case, the reasons for excluding a particular cost are typically based on the facts in that particular docket. Staff does not explain why premiums were excluded in Docket Nos. UE-921262, *et al.,* or why the reasons for such exclusion would apply to this proceeding.[283]

IX. GAS RATE SPREAD AND RATE DESIGN

A. Cost of Service Studies and Rate Spread

127. Staff and NWIGU claim that the Company does not object to the gas rate spread proposal

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[277] *See* Karzmar, Exh. 232C 13:19-21.
[278] *See* Staff Br. ¶ 170.
[279] *See* Karzmar, Exh. 232C 12:18-19.
[280] *See* Staff Br. ¶ 169.
[281] *See id.* fn. 325 (discussing Staff's calculation allocating all premiums to electric, gas and InfrastruX); Karzmar, Exh. 232C 13:21 – 14:2.
[282] *See* Karzmar, Exh. 232C 13:17 – 14: 2.
[283] *See* Staff Br. ¶¶ 169-173.

presented jointly by Staff, NWIGU and Public Counsel.[284] This statement is incorrect. PSE had no need in its rebuttal testimony to present additional evidence on gas rate spread because the Joint Parties presented no new evidence in support of their proposal, just argument.[285] As Mr. Amen made clear at the hearing, however, PSE does not agree that the Joint Proposal on gas rate spread is appropriate, or that it is supported by the evidence.[286] The Company's arguments and citations to the record are set forth in PSE's Initial Brief beginning at paragraph 127.

128. The Joint Parties state that "the rate spread recommended by the Joint Parties is explained in Exhibit No. 585 at page 1."[287] That page, however, only describes what their proposal is; it does not explain why the proposal is reasonable. Similarly, the NWIGU Brief argues that the "compromise" on gas rate spread among NWIGU, Staff and Public Counsel (but not other Parties) is "fair" and "achieves very significant movement toward eliminating current rate disparities among all classes of customers…."[288] This argument is unsupported and erroneous. In fact, their proposed rate spread would increase the disparity between cost of service and revenue from rates for a number of customer classes, regardless of whether one looks at PSE's cost of service study ("COS Study") or the 1995 Commission Basis Methodology cost of service.[289]

129. Rather than taking issue with PSE's COS Study, the Joint Parties claim that their proposal reflects a compromise between the COS Study and the Commission Basis study that PSE also prepared and presented with its direct case.[290] The Joint Parties argue for continued reliance on

[284] *See* NWIGU Br. at p. 7; Staff Br. ¶ 145.
[285] *See* PSE Br. ¶ 128.
[286] *See* Amen, TR. 470:25 – 472:4.
[287] Staff Br. ¶ 146
[288] NWIGU Br. at p. 8.
[289] *See* Seattle Steam Br. ¶¶ 10-13.
[290] *See* Staff Br. ¶ 147.

the Commission Basis study because it "uses methodologies approved previously by the Commission for natural gas cost studies."[291]

130. There is nothing magical or binding about a Commission Basis study. PSE provided the Commission Basis study in its initial filing as a convenience to the other parties and the Commission, consistent with WAC 480-07-510(3)(b). WAC 480-07-510(3)(b) provides:

> If a party proposes to calculate an adjustment in a manner different from the method that the commission most recently accepted or authorized for the company, it must also present a work paper demonstrating how the adjustment would be calculated under the methodology previously accepted by the commission, and a brief narrative describing the change. Commission approval of a settlement does not constitute commission acceptance of any underlying methodology unless so specified in the order approving the settlement.

131. While WAC 480-07-510(3)(b) applies to accounting adjustments, not cost of service studies for rate spread, PSE knew that the other parties would immediately demand through data requests that PSE perform a "Commission Basis" version of its cost study, thus PSE provided that information in its direct case. Because PSE's gas cost of service was last litigated to final order before the Commission in Docket Nos. UG-940034 and UG 940814 (by Washington Natural Gas Company), and has been settled in all subsequent cases, PSE's Commission Basis cost study necessarily had to apply methodologies that were last reviewed and approved by the Commission over twelve years ago.

132. The fact that the Commission approved a particular methodology twelve years ago, such as the historic peak method, does not mean that the same approach continues to be sound. PSE's use of a design day peak demand allocation is more appropriate than continued reliance on a methodology that is inconsistent with the manner in which PSE designs and invests in its gas

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[291] *Id.* fn. 285.

system.[292]

133. Staff argues that change to the twelve-year old historic peak method "is unnecessary given the fair and reasonable results of the Joint Parties overall recommendations."[293] But this statement is circular and begs the question that Staff claims it answers. The Commission cannot rationally determine that the Joint Parties' recommendation is fair and reasonable based on a twelve-year old cost of service study methodology when the unrebutted evidence in this proceeding shows that PSE's costs related to its gas delivery system are incurred consistent with the design day peak demand method, not the historic peak demand method.

134. None of the other parties argue that PSE's COS Study is flawed,[294] and Seattle Steam Company specifically endorses it. It is time to update the 1995 "Commission Basis" cost of service methodology by adopting the methodology represented by the Company's COS Study.

B. Rate Design

1. A $17 Monthly Gas Residential Customer Charge Benefits Customers and the Company

135. The residential gas customer charge should be increased to $17 per month (and the delivery charge correspondingly decreased), even if the Company's decoupling proposal is accepted in its entirety. A $17 per month customer charge is supported by the customer costs derived from the Company's cost of service study.[295] This charge would reduce customer bill volatility, alleviate margin recovery instability, be fair and understandable, and send an

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[292] *See* PSE Br. ¶¶ 130-132 and evidence cited therein.

[293] Staff Br. ¶ 165.

[294] Staff argues that it is "unnecessary" to abandon the Commission's "longstanding cost allocation methodology" in light of the Joint Parties' overall recommendations. *See id*. These recommendations are, as discussed above, a "compromise" among the Joint Parties that does not demonstrate flaws in PSE's COS Study methodology.

[295] *See* Hoff, Exh. 186 2:11-15.

appropriate price signal with respect to recovery of margin, all without undue bill impact.[296]

136. NWEC argues that a price signal "by nature needs to reflect the marginal societal cost of any change in a customers' marginal usage."[297] The only citation to the record offered by NWEC as support for this proposition is a portion of Mr. Amen's responses to questions in this area. In fact, Mr. Amen stated that "the appropriate price signal relates … to the commodity cost of gas. It's some 69 percent of the rate that they pay. You get an adequate incentive from that alone."[298] NWEC, without evidentiary support or quantification, in effect argues that the Company should include in its volumetric charge, costs (such as societal costs) that it does not incur.[299]

137. Mr. Amen's rebuttal testimony points out that including non-volumetric costs in the volumetric rate: (1) increases revenue variability that then must be corrected through the operation of the decoupling mechanism; (2) fails to account for cost differences between and within customer classes; (3) promotes inefficient use of the gas utility's system; and (4) needlessly inflates bills in the winter months, when customers face the greatest pressure on their household budgets from utility bills.[300]

138. Staff erroneously argues that a 1987 Commission decision regarding Cascade Natural Gas established "clear Commission guidance that increasing the basic charge more than 25% constitutes unacceptable rate shock."[301] The *Cascade* case did not establish a fixed percentage or mechanical rule for a maximum percentage increase. Rather, the Commission stated that "[a]lthough the Commission is in favor of cost-based rates generally, other factors such as rate shock must also be taken into account" and, in that case, allowed minimum bill charges to

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[296] *See* Amen, Exh. 31 4:11-17; Hoff, Exh. 186 2:4-6.
[297] NWEC Br. ¶ 32.
[298] Amen, TR. 501:15 – 18.
[299] *See* NWEC Br. ¶ 33.
[300] *See* Amen, Exh. 31 8:16-21.

increase by amounts ranging from 25% to 67%.[302]

139. NWEC argues that "the Company's late-introduced proposal to raise [the residential gas customer] charge to $17 for residential customers should be rejected … because it was unexpectedly introduced at rebuttal, leaving little opportunity for Parties to present counter-evidence."[303] The Company's direct case demonstrated that a $17 customer charge was consistent with the cost of service study and indicated that this level was appropriate in the absence of the Company's decoupling proposal.[304] Thus, parties were apprised that a $17 customer charge was part of the Company's proposal and were apprised of the cost of service evidence presented in the Company's direct supporting that charge. Further, Staff witness Ms. Steward analyzed and presented detailed, numerical evidence regarding a residential gas customer charge of $25.81 based on the concept of "straight fixed/variable rate design" and the bill impacts of such a charge.[305] A potential $17 customer charge was advanced and supported in the Company's direct case, and the Company responded in rebuttal to the rate principles, the straight fixed/variable rate design and the analysis advanced by Ms. Steward.[306]

2. A Low Customer Charge Does Not Benefit Low Income Customers

140. NWEC witness Mr. Weiss discusses the challenges faced by low-income customers under traditional rate design, which "ties recovery of fixed costs directly to commodity sales."[307] He states that, during cold winters, low-income customers "must struggle with paying energy

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[301] Staff Br. ¶ 157 (citing, in footnote 305, *WUTC v. Cascade Natural Gas Corp.* 84 PUR4th 119 (1987)).
[302] *Cascade*, 84 PUR.4th at 132-133.
[303] NWEC Br. ¶ 3 (citations omitted). Staff advances a similar argument. *See* Staff Br. ¶ 156.
[304] *See* Amen, Exh. 38 33:6-15.
[305] *See* Steward, Exh. 561 11:10 – 12:2.
[306] *See* Hoff, Exh. 186 2:9-15.
[307] Weiss, Exh. 502 3:9-10.

bills which are needlessly inflated by the current rate structure . . . ."[308] Mr. Weiss' preference for reducing the customer charge to a bare bones level and loading up the volumetric portion of the Company's distribution rate will only magnify weather risk and exacerbate the winter utility bills for low-income customers. This is the situation he would presumably seek to alleviate.[309]

141. The Company has considered the effects of its proposals on low income customers and believes that low income customers will, in fact, benefit from its proposals.[310]

3. Other Schedules

142. PSE's Initial Brief addresses the Joint Parties' arguments and the evidence in the record regarding the proposed increases for Schedules 57 and 87 at paragraphs 145-146.[311] Schedules 31 and 41 are discussed at paragraphs 145 and 147 of PSE's Initial Brief.[312] Schedules 101 and 106 are addressed at paragraphs 145 and 148.

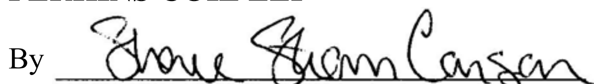
X. CONCLUSION

143. PSE respectfully requests that the Commission approve its requested relief.

DATED this 14th day of November, 2006.

Respectfully submitted

PERKINS COIE LLP

By 

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[308] *Id.* 4:13-15.

[309] *See* Amen, Exh. 31 13:6-17.

[310] *See* Amen, TR. 532:24 – 533:14. It should also be noted that the increase of $525,000 for low income gas bill assistance supported by Staff, the Company, Public Counsel and NWIGU will mitigate the impact, if any, of an increased customer charge (or the GRNA) on monthly bills of low income customers.

[311] *See also* Amen, TR. 510:17 – 513:16.

[312] *See also* Amen, TR. 466:12 – 468:9.

APPENDIX A

If the Commission were to allow a limited adjustment along the lines Staff recommends for the first time on brief, the list of projects should be expanded to include the following additional projects (all of which are included in Exhibit 247) because they are also mandated by NERC/WECC reliability standards, like the projects proposed at paragraph 45 of the Staff Brief. All three projects enable NERC/WECC reliability standard TPL-001-0 to be met.

- **Novelty Hill Project ($23.2 million) –** The Novelty Hill Project was constructed to increase reliability within the North King County Service Area by reducing the number of potential customers impacted due to an outage on the Sammamish-Lake Tradition line, and by providing an alternate means for transmission service in the Novelty area. The project also includes the addition of a new 230 - 115 kV transformer to relieve equipment overloads that would otherwise occur due to customer growth and thus place PSE out of compliance with NERC/WECC reliability standards.

- **Foss-Banger Transmission Project ($7.9 million) –** The Foss-Banger Transmission Project was constructed to add a third transmission line providing service to Central & North Kitsap County. The project reduces transmission related outages to customers served from 10 substations by providing an alternative source to a major switching station for North Kitsap County. Construction of a new 10 mile long 115 kV transmission line with substation improvements at Foss Corner and U.S. Navy Bangor were completed to meet NERC/WECC reliability standards.

- **March Point Substation Rebuild Project ($4.8 million) –** In order to comply with the standard, it was necessary to upgrade the March Point Substation with a new 115 kV line bay and circuit breaker with additional bus improvements. It was also necessary to reroute the March Point to Whidbey #2 line to the new line bay. The project also allows critical 115 kV lines to remain in service during circuit breaker maintenance.

Using Staff's methodology for adjusting for the above projects as well as the projects identified by Staff provides additional revenue requirement of $1,720,000 for gas operations and $7,930,000 for electric operations.