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10 The Honorable Carol Murphy

8 **STATE OF WASHINGTON**
9 **THURSTON COUNTY SUPERIOR COURT**

10 THE WASHINGTON STATE
11 ATTORNEY GENERAL'S OFFICE,
12 PUBLIC COUNSEL DIVISION,
13
14 Petitioner,

13 vs.

14 WASHINGTON UTILITIES AND
15 TRANSPORTATION
16 COMMISSION,
17
18 Respondent.

18 INDUSTRIAL CUSTOMERS OF
19 NORTHWEST UTILITIES,
20
21 Petitioner,

21 v.

22 WASHINGTON UTILITIES AND
23 TRANSPORTATION
24 COMMISSION,
25
26 Respondent.

NO. 13-2-01576-2 (*Consolidated*)

OPENING BRIEF OF PETITIONER
PUBLIC COUNSEL

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I. INTRODUCTION

Public Counsel requests judicial review of a Final Order of the Washington Utilities & Transportation Commission (Commission) approving a new multi-year Rate Plan for Puget Sound Energy, Inc. (PSE).¹ PSE is the largest privately owned utility in Washington, serving approximately 1.1 million electricity and 760,000 natural gas customers in Western Washington and Kittitas County. Since 2000, PSE has filed a “pattern of almost continuous rate cases,” AR at 1043 (Final Order ¶ 186), on a nearly annual basis, requesting over \$1 billion in rate increases.

Public Counsel is a department of the Washington State Attorney General’s Office that appears as counsel for ratepayers in utility cases before the Commission, emphasizing residential and small business customer interests. RCW 80.01.100, RCW 80.04.510. *U.S. West Communications, Inc. v. Utils. & Transp. Comm’n*, 134 Wn.2d 48, 60, n.5, 949 P.2d 1321 (1997). Here Public Counsel represents PSE customers.

The legislature has delegated authority to the Commission to regulate electric and natural gas utility companies “in the public interest,” requiring the Commission to set rates for PSE and other state utilities that are “just, fair, reasonable, and sufficient.” RCW 80.01.040(3); 80.28.010(1); 80.28.020. Rates are set according to a well-settled formula at a level both fair to customers and sufficient to permit the utility company to cover its operating expenses and cover its cost of obtaining necessary capital (referred to as “cost of capital”), including a reasonable rate of return on equity for its owners.

¹ The Rate Plan was contained in two related rate dockets filed by Puget Sound Energy: (1) the “Expedited Rate Filing” (“ERF”) case, Docket UE-130137/UG-130138 (Order 07), and (2) the “Decoupling” case, Docket UE-121697/UG-121705 (Order 07), (the matters are together referred to hereafter as the “Rate Plan” or “Plan” and the joint Order 07 as the “Final Order.”)

1 In this case, however, the Commission acknowledges it departed from this
2 ratemaking methodology and decided to engage in an “experiment,” approving a
3 multiyear PSE Rate Plan which will increase customers’ rates automatically on an
4 annual basis until 2016 or 2017 at PSE’s option. Although the Commission argues this
5 experiment will relieve customers of “increase after increase” in PSE rates, the Rate
6 Plan in fact ensures that annual increases will continue, extending PSE’s cycle of
7 increases to an unbroken 15 year period since 2000, while PSE will receive over \$350
8 million in additional revenue. While the Commission has some discretion to explore
9 alternative regulatory tools, and Public Counsel does not oppose two of the three new
10 approaches adopted in the Rate Plan, the Commission erred here in three key respects:
11

- 12 • No rate case was held. Although the Rate Plan required a general rate case under
13 Commission rules because it increased electric rates over 3 percent in the first
14 year alone, the Commission did not conduct a general rate case or require PSE to
15 provide the detailed financial data mandated under Commission rules to support
16 a determination that the new rates were just and reasonable.
- 17 • The rates approved do not reflect PSE’s declining capital costs. The
18 Commission approved the Rate Plan without making a determination of PSE’s
19 new cost of capital, an essential element of rate setting under Washington law.
20 As Commissioner Jones explained in his Separate Statement, rates should have
21 been reduced based on the record evidence that PSE’s cost of capital has
22 declined due to (a) the decline in capital markets generally, and (b) the reduced
23 financial risk resulting from PSE’s new decoupling mechanism. PSE did not
24 provide a cost of capital analysis and failed to carry its burden of proof.
25
26

- The experimental “K-Factor” violates Commission precedent. The Commission approved an experimental automatic annual rate escalator mechanism called a “K-Factor” in disregard of Commission ratemaking precedent and principle, and without adequate evidentiary support, excusing PSE from its burden of proof.

As a result, the rates approved by the Commission are not just, fair, and reasonable as required by RCW 80.28.010 and 80.28.020. The Court should remand this case to the UTC to set new rates and refund the improperly collected revenues to customers.

II. STATEMENT OF FACTS

A. For the Past Century, The Commission Has Employed A Well-Settled Formula For Setting Utility Rates In Washington.

Prior to this case, the Commission has set utility rates using the well-established formula that “has evolved over the past century of public utility regulation in this country and is the one commonly accepted and used.” *POWER v. Utils. & Transp. Comm’n*, 104 Wn.2d 798, 809, 711 P.2d 319 (1985). The Commission has described its ratemaking formula as follows:

“Following long-established principles of utility ratemaking and Commission practices, we must determine on the basis of the evidence presented what levels of prudently incurred expenses the company will experience and allow for recovery of those expenses in rates. In addition, we must determine the Company’s ‘rate base’ [company plant and facilities used to provide service] and allow for an appropriate rate of return on that rate base....The sum of the two figures—expenses and return on rate base—constitutes the company’s revenue requirement that we approve for recovery in rates.”²

² *Wash. Utils. & Transp. Comm’n v. Puget Sound Energy, Inc.*, Dockets UE-111048/UG-111049, Order 08, ¶ 22, (May 7, 2012)(PSE 2011/2012 General Rate Case). 297 P.U.R.4th 1, 2012 WL 1655380(copy in Appendix A); *See also, Wash. Utils. & Transp. Comm’n v. Puget Sound Energy*, Dockets 090704/UG-090715, Order 11, ¶¶ 18-35 (PSE 2009 General Rate Case), 281 P.U.R.4th 329, 2010 WL 1383928. (Appendix B)

1 The utility's rate of return is a "key outcome" of the utility ratemaking formula
2 that determines what revenues PSE will receive and "in turn, affects the level of rates
3 customers will pay." *PSE 2011/2012 General Rate Case*, Order 08, ¶ 24. A utility
4 company's rate of return is based on a determination of the cost of capital, a
5 combination of the return on equity (profit realized by investors) and the utility's debt
6 costs (interest rates to borrow).
7

8 Whenever a utility requests any increase in rates, Washington law provides "the
9 burden of proof to show that such an increase is just and reasonable shall be upon the
10 public service company." RCW 80.04.130(2). Likewise, a utility seeking regulatory
11 approval to implement a change in ratemaking methodology has the burden of proof to
12 justify the change. *U.S. West Communications, Inc. v Utils. & Transp. Comm'n*, 134
13 Wn.2d 48, 55, 949 P.2d 1321 (1997)(*U.S. West*).
14

15 **B. PSE's Rate Plan Arose From An Unusual Set of Circumstances**

16 PSE did not file the Rate Plan at issue here as a General Rate Case. The Plan
17 originated in private settlement discussions in the latter part of January 2013 between
18 PSE and Commission Staff which also involved an unrelated PSE coal transition power
19 docket. AR 950-951.³ Related to the settlement discussions, the two components of the
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24 ³ Concurrently with the Final Order, the Commission issued a joint companion order in the Rate Plan
25 dockets (hereafter "Companion Order 06") addressing the settlement process and proposals. AR at 950-
26 951, (Companion Order 06, ¶16, n.9 and ¶17). The Commission stated: "These settlement negotiations,
however, did not include Public Counsel, a statutory party in all the listed dockets, ICNU [Industrial
Customers of NW Utilities], an intervenor in all these dockets, or numerous other stakeholders who are
not parties to this docket but are known to be interested in Decoupling and the ERF."

1 Rate Plan were filed, the Expedited Rate Filing docket on February 1, 2013, and the
2 Amended Decoupling docket on March 1, 2013.⁴

3 The settlement discussions ultimately resulted in the March 22, 2013, filing of a
4 non-unanimous “Multiparty Settlement Re: Coal Transition Power Purchase Agreement
5 and Other Pending Dockets” (Multiparty Settlement) between PSE, Commission Staff,
6 and the Northwest Energy Coalition.⁵ The Multiparty Settlement recommended
7 approval effective May 1, 2013, of the two PSE Rate Plan proposals in the form filed by
8 PSE and linked the Rate Plan proposals to resolution of an unrelated matter, PSE’s
9 challenge on reconsideration to the final order in PSE’s “Coal Transition Power
10 Purchase Agreement”(PPA) docket pending before the UTC. AR at 953, 955,
11 (Companion Order 06, ¶¶ 22, 25).
12

13 The Commission described the Settlement as a “*fait accompli*” with respect to
14 the terms of the Rate Plan. AR at 950-951 (Companion Order 06, ¶17), explaining that
15 PSE had presented the Settlement as “essentially an all-or nothing, take-it-or-leave-it
16 proposal that the Commission should approve because this is the only thing that will
17 prevent PSE from walking away from the Coal Transition PPA.” Approval of the Rate
18 Plan without modification was thus framed as a *quid pro quo* for PSE’s agreement to not
19 withdraw from the Coal Transition Power Purchase Agreement. *Id.*
20

21 On March 22, 2013, the same date the Multiparty Settlement was filed, the
22 Commission set an expedited schedule for consideration of the Settlement and the Rate
23

24 _____
25 ⁴ TR. 155:10-156:1. PSE filed an earlier version of a decoupling proposal in October 2012, differing from
the March 1 filing at issue here. *Inter alia* it did not include a multi-year rate plan. Limited informal
proceedings took place but the filing was not set for adjudication.

26 ⁵ The “other pending dockets” are the Rate Plan dockets at issue on this appeal.

1 Plan docket proposals, allowing 19 days for discovery, and setting the evidentiary
2 hearing for May 16, 2013.⁶ Objections to the schedule were denied.⁷ AR at 415, 494-
3 498. The Commission issued its Final Order on June 25, 2013, approving rate increases
4 under the Rate Plan effective July 1, 2013. AR at 1058 (Final Order, ¶245).⁸

5 In Companion Order 06, the Commission rejected the Multiparty Settlement of
6 the Rate Plan and Coal Transition dockets on the grounds that the linkage to the Coal
7 Transition case was improper. AR at 955 (Order 06, ¶25). The Final Order under
8 review, however, approves the terms of the Rate Plan proposals with only minor
9 modifications from the Multiparty Settlement.
10

11 **C. The Rate Plan Is An Experiment.**

12 The Commission states that the Final Order approves “several innovative
13 ratemaking mechanisms” for PSE, embarking on what the order describes as an
14 “experiment” that is a “significant departure from traditional ratemaking practice” in
15 Washington. AR at 960 (Final Order, p. 1 (Synopsis)) and AR at 973-974 (Final Order
16 ¶24). The PSE Rate Plan approved by the Commission has three primary components:
17

18 The “Expedited Rate Filing” (ERF) mechanism. This mechanism calculated a
19 rate increase for 2013 based on an update to the rates established in PSE’s 2011/2012
20 General Rate Case, on the basis of changes in actual costs. Public Counsel is not
21 challenging the ERF mechanism on appeal.
22

23 ⁶ In APA adjudicative proceedings, the Commission ordinarily conducts “trial-type” evidentiary hearings.
WAC 480-07-300 to 885 (Adjudicative Proceedings).

24 ⁷ PSE’s last two general rate cases, for example, afforded parties approximately 7 months for discovery
and case preparation prior to the evidentiary hearing. *PSE 2011/2012 General Rate Case*, Order 08, ¶ 2;
25 *PSE 2009 General Rate Case*, Order 11, ¶¶ 7-15.

26 ⁸ Certain industrial customer parties filed petitions for reconsideration, which were resolved in Orders
08/09 in the Rate Plan dockets. The Reconsideration Orders are not challenged in this appeal.

1 The Decoupling Mechanism. The Final Order approved a “full decoupling”
2 mechanism for PSE. Decoupling disconnects or “decouples” the amount of revenue
3 PSE earns from the amount of power it sells. It is designed to improve the stability of
4 PSE revenues and predictability of cost recovery. Public Counsel is not challenging the
5 decoupling mechanism itself, but is challenging the Commission’s approval of
6 decoupling as applied, that is, without reducing PSE’s cost of capital to reflect PSE’s
7 increased revenue stability and resulting reduction in financial risk, which in turn should
8 reduce PSE’s rates.
9

10 The K-Factor. The Commission approved the use of an untried automatic rate
11 increase mechanism known as a “K-Factor,” designed to address PSE’s claims of
12 attrition. Attrition is significant earnings erosion in a period of very high inflation or
13 exceptionally high levels of capital expenditure. Special rate increases to address
14 attrition (attrition adjustments) are an extraordinary form of relief and have rarely been
15 allowed in Washington.
16

17 The Expedited Rate Filing and the K-Factor are integrally related, in that the
18 Expedited Rate Filing forms the baseline upon which the subsequent K-Factor increases
19 are built. AR at 2079-2081. The K-Factor generates a series of predetermined annual
20 rate increases implemented through fixed escalation factors, increasing rates
21 automatically every year during the Rate Plan until 2016, or 2017 at PSE’s option. Rate
22 increases would exceed 9 percent by 2016 for residential electric customers, and 4.8
23 percent for residential natural gas, based on PSE projections. AR at 698. PSE is
24 projected to receive cumulative additional revenues of over \$350 million from the Rate
25
26

1 Plan. AR 2522, AR 1058 (Final Order ¶245). Public Counsel challenges the K-Factor
2 in this appeal.

3 Under the Rate Plan, PSE may not file a new General Rate Case until 2015, but
4 is required to file a new rate case no later than 2016. A 2015 General Rate Case would
5 increase rates in 2016, if approved, while a 2016 case would increase rates in 2017.

6 III. STANDARD OF REVIEW

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8 RCW 34.05.570 establishes the standards of review to be applied to the
9 Commission's action and the record. RCW 34.05.570(1)(b); *Wash. Ind. Tel. Ass'n v.*
10 *Utils. & Transp. Comm'n*, 149 Wn.2d 17, 24, 65 P.3d 319 (2005). While the
11 Commission has broad discretion to act within its regulatory sphere, the court must grant
12 relief if the Commission has acted outside its statutory authority, *In re Electric*
13 *Lightwave*, 123 Wn.2d 530, 536, 869 P.2d 1045 (1994), or inconsistently with one of its
14 own procedures or rules without adequate explanation. RCW 34.05.570(3)(b), (c), and
15 (h). The Commission may not exercise its discretion in an arbitrary and capricious
16 manner, *Jewell v. Utils. & Transp. Comm'n*, 90 Wn.2d 775, 777, 585 P.2d 1167
17 (reversing Commission ratemaking order), and may not depart from previously well-
18 established agency precedents, and policies without a reasoned explanation. *Atchison,*
19 *Topeka & Santa Fe Railway Co. et al. v. Wichita Bd. Of Trade et al.*, 412 U.S. 800, 807-
20 808, 93 S.Ct. 2367, 37 L.Ed.2d 350 (1973)(*Atchison*). The Commission's order must be
21 supported by substantial evidence, that is, evidence of a "sufficient quantity...to
22 persuade a fair-minded person of the truth or correctness of the order." *City of Redmond*
23 *v. Cent. Puget Sound Growth Mgmt. Hearings Bd.*, 136 Wn.2d 38, 46, 959 P.2d 1091
24 (1998); RCW 34.05.570(3)(e). Finally, a court shall grant relief if it determines that the
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1 agency has not decided all material issues before it requiring resolution. RCW
2 34.05.570(3)(f).

3 **IV. ARGUMENT**

4 **A. The Commission Erred by Authorizing A General Rate Increase, Without**
5 **Conducting A General Rate Case Pursuant To Its Rules, And Without**
6 **Performing A Comprehensive and Detailed Review Of PSE's Need For The**
7 **Rate Increases.**

8 **1. The Commission failed to treat the PSE Rate Plan request as a**
9 **general rate case, in violation of its rules.**

10 The Commission rules provide that a utility company rate filing which results in
11 a revenue increase of 3 percent or more for any customer class constitutes a "general rate
12 proceeding." WAC 480-07-505(1)(b) (commonly termed a "general rate case"). There
13 is no dispute that PSE's two Rate Plan dockets together requested an initial 3.4 percent
14 increase for the class of residential electric customers in 2013. AR at 967 (Final Order,
15 ¶ 9, n.10). PSE mailed a "notice of requested rate increases and public hearing" to its
16 customers stating that the net effect of the Rate Plan on the typical residential electric
17 customer would be an increase of 3.4 percent. AR at 695-696. The notice was silent as
18 to the fact that rates would increase annually and automatically until at least 2016. After
19 the initial 3.4 percent rate increase in 2013, the cumulative impact of the Rate Plan is 9
20 percent for residential electric customers as of 2016. AR at 698.

21 The Commission declined to consolidate the Rate Plan dockets, but subsequently
22 conducted proceedings entirely on a joint basis, with a common schedule, joint
23 evidentiary hearings, joint briefs, and a joint final order. AR 968, 971 (Final Order
24 ¶¶10, 18). Inconsistent with its rules and prescribed procedures, the Commission did not
25 treat the filing as a general rate case. RCW 34.05.570(3)(c),(h), Assignment of Error C.
26

1 This decision had significant consequences for the review of the Rate Plan. The
2 Final Order noted that a general rate case “opens the utility to a comprehensive and
3 detailed review of all its rates, terms and conditions of service, *raising a host of*
4 *complex issues including cost of capital and capital structure[.]*”, which it then
5 described in some detail. AR at 1043 (Final Order, ¶ 185-186) (emphasis added). The
6 Commission rules recognize that rate increases above a certain magnitude (i.e. 3
7 percent), because of their impact on the public, require detailed financial information to
8 allow a thorough evaluation by the Commission and other stakeholders. WAC 480-07-
9 510.⁹ Because the Rate Plan was not treated as a general rate case, however, the
10 Commission did not require PSE to file the supporting information required by the rule.
11 A “comprehensive and detailed review” of PSE’s need for the rates under the Plan did
12 not occur.¹⁰

13
14
15 **2. The Commission waiver of the general rate case rule was arbitrary.**

16 The Commission responded to Public Counsel and Industrial Customer
17 objections on this issue by announcing for the first time in the Final Order that it was
18 waiving the 3 percent rule for this case. AR at 967 (Final Order, ¶ 9, n.10); AR at 1042-1045
19 (Final Order ¶¶ 184-190). The Commission’s rationale was that the “purpose of these
20 [Rate Plan] filings is to avoid the need for yet another general rate case proceeding.”
21 AR at 967, (Final Order, ¶ 9, n.10).

22
23 ⁹ WAC 480-07-510 requires that “[g]eneral rate filings for electric, natural gas...companies *must include*
24 *the information described*” in the rule, including testimony, exhibits, and workpapers detailing the
25 company’s financial results, a “detailed portrayal” of the support for proposed accounting adjustments
(expense increases), the capital structure and rate of return, and the company’s actual rate base [facilities
and plant used to provide service]. *Id.* (emphasis added).

26 ¹⁰ The case schedule was extraordinarily accelerated. To perform a thorough review, the Commission
ordinarily uses the full ten months permitted by statute. RCW 80.04.130(1).

1 It is not a sufficient justification for waiver for the Commission to say, in effect,
2 “we waive the rule requiring a general rate case, because we wish to avoid holding
3 another rate case.” The arbitrariness of the rule waiver is further highlighted by the fact
4 that, in prior cases, the Commission had stated that two significant components of this
5 Rate Plan — decoupling and attrition (via the K-Factor) — should be addressed in the
6 context of a general rate case to allow for thorough review on a complete record (further
7 discussed below).

8
9 The Final Order cites WAC 480-07-110 as a basis for the waiver. The rule
10 provides for modifications of the Commission rules in certain situations, if “consistent
11 with the public interest, the purposes underlying the regulation, and applicable statute.”
12 The Commission did not announce the waiver or address waiver requirements until after
13 the record was closed. Neither the public interest nor the purposes of the underlying rule
14 is served by the waiver. The general rate case rules protects the public by providing the
15 evidentiary, analytic, and procedural framework necessary to establish “just, fair,
16 reasonable and sufficient” rates, ensuring that rates are not increased substantially
17 without “comprehensive and detailed review.” RCW 80.28.010(1), 80.28.020. The
18 Final Order does not provide a reasonable basis for the waiver. RCW 34.05.570(3)(i).
19
20 Assignment of Error B(5).

21 **B. The Commission Failed To Determine PSE’s Cost of Capital Before**
22 **Approving The Rate Increase Despite Evidence It Was Declining.**

23 A determination of the utility company’s cost of capital is a key step in the
24 ratemaking process, establishing one of the major costs that go into calculating a just and
25 reasonable rate. In addition, where a decoupling proposal is filed, the Commission has
26

1 directed companies to provide an analysis of the proposal's impact on cost of capital.¹¹
2 In this case, nevertheless, "PSE did not put on a full cost of capital case." AR at 987-988
3 (Final Order, ¶ 56). On the other hand, Public Counsel and industrial customers
4 presented evidence showing that that PSE's cost of capital should be reduced because (a)
5 capital costs in financial markets were demonstrably declining; and (b) the decoupling
6 mechanism approved in this case reduces PSE's risk. The Commission did not require
7 PSE to carry its burden on this issue, improperly discounted the evidence of Public
8 Counsel and other parties, and failed to make the necessary determination of PSE's new
9 cost of capital as a basis for setting new rates under the Rate Plan. As Commissioner
10 Jones concluded in his dissenting Separate Statement:
11
12

13 the Company's return on equity (ROE) should be lowered to reflect
14 current capital market conditions and the adoption of full electric and
15 natural gas decoupling. Ratepayers should share the benefits of lower
16 capital markets and decoupling reductions in earnings volatility for PSE
17 that will likely create more rate volatility for consumers." AR 1060 (Final
18 Order, Separate Statement of Commissioner Jones, ¶ 2).¹²

19 **1. After stating that cost of capital is definitely an issue in the case, the**
20 **Commission did not update PSE's capital cost, and did not put PSE**
21 **to its burden of proof.**

22 The Commission rejected PSE's argument that capital costs were not at issue in
23 this case, stating "the question of return on equity, contrary to PSE's assertions [through]
24 Mr. Doyle, *definitely is an issue in this proceeding.*" AR at 988 (Final Order,
25

26 ¹¹ *In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives*, Docket U-100522, Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets, November 4, 2010, ¶ 28 (Decoupling Policy Statement) (Appendix C)

¹² Commissioner Jones also noted that PSE did not file a cost of capital analysis and had not met its burden of proof to demonstrate its cost of capital was reasonable. AR at 1060, (Separate Statement, ¶ 3).

1 ¶57)(emphasis added). Nevertheless, the Commission ultimately did not conduct a full
2 cost of capital analysis to update PSE's cost of capital to 2013, the start of the Plan.

3
4 The Commission's previous cost of capital analysis for PSE provides a
5 contrasting example of how the Commission ordinarily determines cost of capital as part
6 of rate setting. *PSE 2011/2012 PSE General Rate Case*, Order 08, ¶¶ 32-92. After
7 "careful deliberation and weighing of all results of the cost of capital witnesses," *Id.* at ¶
8 89, the Commission determined a return on equity, cost of debt, and capital structure,
9 incorporated into a specific authorized overall cost of capital. *Id.* at ¶¶ 92.¹³

10
11 The Commission observed that the cost of capital determination, particularly the
12 return on equity, "materially impacts the price customers pay for service." *PSE*
13 *2011/2102 General Rate Case*, Order 08, ¶ 35. In this case, for example, had PSE's
14 return on equity been reduced to 9.30 as recommended by Industrial Customers' expert
15 Michael Gorman, PSE's rate increase would have been reduced by \$10 million. AR at
16 2833.

17
18 The Commission's Final Order in this case excuses PSE from carrying its burden
19 on the cost of capital issues, in effect shifting the burden to Public Counsel and the
20 industrial customer intervenors, contrary to statute. RCW 80.04.130(2). PSE seeks to
21 benefit from its affirmative choice not to file a general rate case in this matter and to not
22 present its own cost of capital evidence.¹⁴ While PSE opted to not present its own
23

24 ¹³ The Commission extensively reviewed the technical analysis and methodologies presented by the cost
25 of capital witnesses and analyzed the methodologies employed and their results in detail. *Id.* ¶ 58-89.
(reviewing Discounted Cash Flow, Risk Premium and Capital Asset Pricing Model evidence).

26 ¹⁴ TR. 253:17-254:16 (Doyle examination by Commissioner Jones)(cost of capital issues were "set aside"
by the global Multiparty Settlement). Although PSE advocated for a very expedited schedule, Mr. Doyle

1 analysis, Industrial Customers presented a comprehensive cost of capital analysis,
2 corroborated by experts for Public Counsel, Kroger Stores, and NUCOR Steel.

3
4 Analyzing “the irrefutable observable market evidence ... that capital market
5 costs are lower than they were at the time of the commission’s last [PSE rate] order,”

6 Mr. Gorman recommended that PSE’s return on equity be reduced from 9.8 to 9.3
7 percent, based in part on evidence that utility bond yields had declined significantly
8 since PSE’s 2011 case. AR at 277-2778; TR. 191:1-3; AR at 986 (Final Order ¶ 50).

9 Corroborating Mr. Gorman’s evidence, Public Counsel expert Stephen Hill provided
10 evidence that capital costs had declined since 2011 based on his review of corporate
11 bond yields, and that PSE’s existing cost of capital, based on two-year old data had
12 become stale. He recommended a reduction from 9.8 percent to 9.5 percent for PSE’s
13 return on equity. AR at 2543.

14
15 In addition to these reductions, to account for the reduced risk resulting from the
16 adoption of decoupling, Mr. Gorman also recommended a 0.25 percent (25 basis point)
17 reduction in return on equity based on the spread between different bond yields. Mr.
18 Hill for Public Counsel recommended a 0.5 percent reduction based on an earlier
19 analysis of PSE cost of capital. This evidence was corroborated by the quantitative
20 analysis of Kevin Higgins on behalf of NUCOR Steel and Kroger Stores, recommending
21 a 0.25 percent reduction based on the volatility of PSE usage per customer as applied to
22 the PSE rate base. AR at 2926-2956 (KCH-1T); AR at 2969-2985 (KCH-5T).

23
24
25 _____
26 excused the failure to file a cost of capital analysis because he “just did not have time.” *Id.* The analysis
would have taken approximately one week to produce. AR at 1061 (Separate Statement, ¶ 3).

1 **2. The Commission improperly discounted the evidence of declining**
2 **cost of capital.**

3 In a brief dispositive section of the order, the Commission found “on balance that
4 the evidence in this case is simply too spare” to support a reduction due to declining
5 capital markets. AR at 989 (Final Order, ¶58). This conclusion is unsupported by the
6 record. Mr. Gorman, upon whom the Commission relied to set PSE’s return on equity in
7 the last case, presented a comprehensive analysis using the same methodology, TR. 195-
8 212, corroborated by Public Counsel’s cost of capital expert. Indeed, the Final Order
9 effectively agreed that PSE’s cost of capital had declined, finding that the previous
10 return on equity was now at the “higher end” of the range set in the prior case. AR at
11 989 (Final Order, ¶ 58). The Commission does not explain how it could reach this
12 conclusion if the evidence was “too “spare” for a cost of capital analysis. The
13 Commission’s Final Order also acknowledged that “equity returns continue to trend
14 downward.” *Id.*¹⁵ The Commission disregarded the basic precept which it referenced in
15 the prior PSE rate order, that “capital markets are not static but constantly changing.”
16 *PSE 2011/2012 General Rate Case*, Order 08, ¶ 34.

17
18 The Commission also refused to reduce PSE’s cost of capital to reflect the
19 approval of its new decoupling mechanism. In 2010 the Commission issued a major
20 Decoupling Policy Statement, addressing *inter alia* the impact of decoupling on utility
21 risk:
22
23

24 ¹⁵ Six months after the Final Order in this case, the Commission reduced PacifiCorp’s Return on Equity
25 from 9.8 percent to 9.5 percent, after conducting a “careful deliberation” and a detailed analysis of the
26 traditional cost of capital methodologies. *Utils. & Transp. Comm’n v. PacifiCorp*, Docket UE-130043,
Order 05, ¶ 71 (December 4, 2013). 2013 WL 6384505 PacifiCorp is Washington’s third largest electric
utility.

1 By reducing the risk of volatility of revenue based on customer
2 usage, both up and down, such a mechanism can serve to reduce risk to
3 the company, and therefore to investors, which in turn should benefit
4 customers by reducing a company's debt and equity costs. *This reduction
5 in costs would flow through to ratepayers in the form of rates that would
6 be lower than they otherwise would be, as the rates would be set to reflect
7 the assumption of more risk by ratepayers.*¹⁶

8 The Commission's Decoupling Policy Statement further provided that when a
9 Washington utility filed a decoupling proposal it should be filed as part of a general rate
10 case, *Decoupling Policy Statement*, ¶ 18 n.33, ¶¶ 28, 34, and 36,¹⁷ and should be
11 accompanied by "[e]vidence evaluating the impact of the proposal on risk to investors
12 and ratepayers and its effect on the utility's ROE [return on equity]." *Decoupling Policy
13 Statement*, ¶ 28. The Final Order in this case explains that "[t]he Commission's
14 rationale for preferring consideration of decoupling in the context of a general rate case
15 was to facilitate consideration of the impact on return on equity of any reduced risk to
16 the company as a result of the decoupling mechanism under consideration." AR at
17 1007-1008 (Final Order, ¶97). PSE ignored this reasoned guidance and filed its proposal
18 outside a rate case without the required cost of capital evidence.

19 Consistent with the Decoupling Policy Statement, the Final Order states: "It
20 seems apparent that decoupling the recovery of fixed costs from throughput [energy
21 usage]...reduces PSE's risk of fully and timely recovering its fixed costs. In addition, it
22 reduces volatility and smoothes the Company's cash flow. The benefits that flow from
23 these factors may improve PSE's bond ratings, thereby reducing its overall cost of
24 capital consistent with the analyses by Mr. Gorman and Mr. Hill that are grounded in

25 ¹⁶ Decoupling Policy Statement, ¶ 27.

26 ¹⁷ The Commission Decoupling Policy Statement reaffirmed the preference it had stated in 2005 for
considering decoupling in the context of a general rate case. AR at 1000 (Final Order, ¶ 82).

1 differences in bond yields that are tied to ratings.” AR at 1011-1012 (Final Order 07,
2 ¶103). The Commission further observes that “the shift of risks from PSE to its
3 ratepayers is *unquestionably the result of implementing decoupling.*” AR at 1013. (Final
4 Order, ¶ 107)(emphasis added). By definition, PSE’s cost of capital cannot remain the
5 same as in 2011, when it had no decoupling mechanism.

6
7 Nonetheless, despite the evidence of three expert witnesses in the record, the
8 Commission refused to reduce cost of capital because of the absence of what the
9 Commission termed “empirical evidence.” As the Commission’s general rate case
10 orders reflect, however, the Commission’s cost of capital determinations are based on
11 the very type of evidence present in this record, testimony of cost of capital experts,
12 using well-understood analytical financial methodologies, relying on such information
13 as interest rates, bond rates, present value calculations, and risk premiums.¹⁸ If these
14 established methods of analysis produce results sufficient to set cost of capital in dozens
15 of Commission rate cases, they are sufficiently “empirical” to be relied on here. Neither
16 the Decoupling Policy Statement nor Commission prior rate case orders make mention
17 of an “empirical evidence” requirement. The Commission has arbitrarily imposed a new
18 standard for setting cost of capital of which parties had no prior notice.

19
20 In a further inconsistency, the Commission excused PSE’s failure to file its
21 decoupling proposal in a general rate case by stating that “the record is sufficient and the
22 matter can be given full and fair consideration in the context presented.” AR at 1008
23 (Final Order ¶ 98). This directly conflicts with the Commission’s conclusion that the
24

25 ¹⁸ See, e.g., TR. 207:4-13 (Gorman testimony describing his quantitative methodology for reducing return
26 on equity due to decoupling); AR 2926-2956, AR 2969-2985 (Higgins quantitative analysis of impact on
return on equity of volatility in usage per customer).

1 record is “spare” and lacks the “empirical evidence” needed to determine the cost of
2 capital impact of decoupling, a key issue identified by the Commission itself.

3 The Commission majority has created a “Catch 22”. They express the “opinion
4 that it is more appropriate to consider the impact of ROE [return on equity] of this
5 decoupling mechanism in the context of a fully developed record, with more objective
6 facts and data, in PSE’s next general rate case.” AR at 1013 (Final Order, n.162). Yet
7 review in a general rate case is the very approach Public Counsel and other consumer
8 parties urged the Commission to take from the outset of these proceedings, and which
9 the Commission declined to pursue. Had the Commission stood by its Decoupling
10 Policy Statement and required PSE to file a general rate case in early 2013, the
11 Commission could have created a “fully developed record with more objective facts and
12 data” in this case. Because it did not, consumers are now told the record was
13 insufficient to enable the Commission to update PSE’s cost of capital.
14

15
16 **3. The Commission erred by postponing the recognition of reduced cost
of capital, locking in unjust and excessive rates for a period of years.**

17 Although effectively conceding that decoupling substantially reduces PSE’s
18 financial risk, and that capital markets are declining, the Final Order requires customers
19 to wait several years until the next rate case to benefit from a reduction in PSE’s cost of
20 capital. AR at 1012-1013 (Final Order ¶¶ 103-106). This ignores that the cost of capital
21 is determined as of the time that rates are set, finding a *present* cost of capital in order to
22 calculate rates.¹⁹ PSE’s cost of capital should have been determined, as it would have
23
24

25 ¹⁹ Failure to do so violates, *inter alia*, the “matching principle” which requires consideration of all factors
26 affecting the rate change (revenues, costs and rate base) within the same time frame. PSE 2009 General
Rate Case, Order 11 ¶27.

1 | been in any ordinary case seeking a \$350 million increase in rates, by a comprehensive
2 | analysis on a full record before the Commission. Because it was not, ratepayers will be
3 | paying in rates for an excessive cost of capital until at least 2016. As Commissioner
4 | Goltz observed at the hearing, “locking in 9.8 [PSE’s return on equity from the last
5 | case]...cuts in favor of the company[.]” TR. 131:9-13 (obtaining confirmation from
6 | staff witness).

7 |
8 | Ratemaking is prospective. RCW 80.28.020 (Commission sets rates “to be
9 | thereafter observed and in force”). It is critical to recognize that, even if the
10 | Commission reduces PSE’s cost of capital in a future case, that order would only
11 | determine PSE’s cost of capital at that future point, and any reduction benefitting
12 | customers would only have a prospective effect. There is no opportunity for the
13 | customers to retroactively recoup excessive rates paid for the years of the Plan based on
14 | an improperly high rate of return.²⁰ For this reason, Commissioner Jones recommended
15 | an immediate and specific ROE reduction based on the record evidence in the case,
16 | concluding that “the evidence clearly supports making a downward adjustment to PSE’s
17 | ROE now in order to provide ratepayers some relief over the long duration of this Rate
18 | Plan.” AR at 1062 (*Id.* ¶ 9). This court should remand so that the Commission can set a
19 | proper cost of capital for PSE reflecting PSE’s reduced risk and customer rates can be
20 | reduced accordingly.
21 |
22 |
23 |
24 |

25 | _____
26 | ²⁰ This result would be barred by the rule against retroactive ratemaking. *See, e.g., State ex rel. Utils. Comm. v. Edmisten*, 21 N.C. 451, 469, 232 S.E. 2d 184 (1977).

1 **C. Approval of Automatic Rate Increases By Means Of The K-Factor Is An**
2 **Unlawful Departure From Ratemaking Law And Precedent**

3 **1. Attrition adjustments are an extraordinary remedy rarely used in**
4 **Washington.**

5 The PSE Rate Plan uses an automatic rate escalator called a "K-Factor" to
6 address PSE's claims of attrition. AR 2363 (DJR-1T, p.4:7)(purpose of K-Factor is to
7 "address attrition"). The K-Factor increases rates every year potentially until 2017, at
8 PSE's option. "Conceptually distinct" and independent from decoupling,²¹ the K-Factor
9 is a previously untried experimental version of an "attrition adjustment," itself a rarely
10 used tool in Washington ratemaking. Under long-standing Commission precedent, an
11 attrition adjustment "is an extraordinary measure, not generally included in general rate
12 relief. A request for such an adjustment should be based on extraordinary
13 circumstances." *Wash. Utils. & Trans. Comm'n v. Washington Natural Gas Co.*, Docket
14 UG-920840, Fourth Supp. Order, pp. 29-30, 1993 WL 500058 (Appendix D). The last
15 attrition adjustment expressly approved by the Commission for a Washington utility
16 company was over twenty five years ago. *Wash. Utilities & Transportation Commission*
17 *v. Pacific Power & Light Co.*, Cause No. U-86-02, Second Supp. Order, pp. 32-33, 1986
18 *Wash. UTC Lexis 7* (Appendix E).²² Attrition analysis is disfavored because it relies on
19 projected data. In setting rates, the Commission has required use of company data that
20 can be measured with a high degree of certainty and "in all but exceptional cases" is
21 available for audit. Projected data more than a few months in the future is "inherently
22
23

24 _____
25 ²¹ "Decoupling does not require adoption of predetermined annual rate increases [the K-Factor], nor does a
rate plan [based on the K-Factor] require decoupling." AR at 1025, Final Order, ¶ 138.

26 ²² As discussed below, in 2012, the Commission approved a general rate case settlement for Avista,
Washington's second largest regulated utility, where attrition was debated but not fully determined.

1 suspect.” *PSE 2009 General Rate Case*, Order 11, ¶ 22, 29, 33. Also for this reason,
2 attrition adjustments have been limited to a one-time rate increase, after which the
3 company must again prove a need for a rate increase in a new general rate case.²³

4 **2. The K-factor lacks an “attrition study,” the evidentiary support that**
5 **the Commission has always required before making attrition**
6 **adjustments, and therefore it is not supported by substantial**
7 **evidence.**

8 Prior to this case, the Commission has consistently placed the burden of proof
9 upon utilities requesting attrition adjustments to provide detailed evidentiary support in
10 the form of a company specific “attrition study”²⁴ to justify the extraordinary relief.
11 *Wash. Utils. & Transp. Comm’n v. Wash. Water Power*, Docket U-84-28, Second Supp.
12 Order, pp. 19-20, 1985 Wash. UTC LEXIS 88 (Appendix F). In its Final Order, the
13 Commission acknowledges that neither PSE nor Commission staff conducted or
14 presented an attrition study in this docket to support the K-Factor escalators. AR 1029
15 and 1030 (Final Order, ¶146, ¶149). In contrast to earlier cases, Commission staff here
16 supported the K-Factor at the general policy level, but offered no detailed analysis of its
17 own regarding earnings erosion or attrition, instead relying on PSE’s analysis for its
18 conclusions. AR at 2692-2693.

19
20
21
22
23 ²³ The Commission has approved a limited number of multiyear rate plans that were not based on attrition.
24 For example, in the PacifiCorp 1999 General Rate Case, a rate increase was agreed to in settlement, but
25 was phased in over three years to avoid rate shock, to be followed by a two year rate freeze. *Public*
26 *Counsel v. Utils. & Transp. Comm’n*, 128 Wn. App 818, 116 P. 3d 1064 (2005).

²⁴ Company studies have included econometric studies, budgeted costs, detailed function by function
analysis, financial modeling, and elasticity studies. See, e.g. *Wash Utils & Transp. Comm’n v. Pacific*
Power & Light Co., Docket U-84-65, Fourth Supp. Order, p. 36 (Appendix G).

1 The Final Order finds support in the Commission's most recent case involving
2 attrition, the Avista 2012 General Rate Case.²⁵ There are clear distinctions between the
3 two cases, however. Avista expressly requested an attrition adjustment in the context of
4 a general rate case, supporting its request with expert testimony, a detailed attrition
5 study, and a supporting analysis. AR at 2501. In addition, in the Avista case the
6 Commission staff prepared and presented its own independent attrition study in the case.
7 The Final Order does not address these important differences.

9 Nor does the Avista case provide new guidance on the attrition issue. The case
10 was ultimately resolved in a "black box" settlement in which the parties did not
11 expressly agree to an attrition adjustment. AR at 1027-1028 (Final Order, ¶144). The
12 Commission refused to endorse either of the attrition methodologies used by Avista or
13 Staff, and stated it was unable to thoroughly evaluate the attrition evidence. *Id.*; AR at
14 1027-1028 (¶ 147). Importantly for the current case, the Commission's final order in the
15 Avista case stated:

16
17 Historically, the Commission has approved attrition adjustments *only in*
18 *the context of litigated rate cases*, although the Commission has not ruled
19 on such an adjustment in recent years. Such a context permits a thorough
20 review of the evidence necessary for an appropriate adjustment. In the
21 context of the Settlement, however, *we have not had the opportunity*
22 *either to articulate the appropriate standards by which to assess a*
23 *proposed attrition adjustment nor evaluate thoroughly the evidence in*
24 *support of such an adjustment.* *Avista 2012 General Rate Case*, Order
25 14, ¶70 (emphasis added).

26 The Commission went on to say:

²⁵ *WUTC v. Avista*, Dockets UE-120436 & UG-120437, Order 09, consolidated with *WUTC v. Avista*,
Dockets UE-110876 & UG-110877, Order 14 (December 26, 2012)(Avista 2012 General Rate Case). 303
P.U.R.4th 113, 2012 WL 6725639. Avista is Washington's second largest regulated electric and gas
utility. (Appendix H)

1 [W]e intend to clarify the conditions wherein attrition can be
2 considered when setting rates. As noted above, the Settlement has
3 limited our opportunity to do so here. Accordingly, we will in the
4 near future initiate an inquiry into the appropriate use of attrition
analysis in setting rate, including the appropriate methodology to
use in preparing attrition studies. *Id.*, ¶ 77.

5 To date, the Commission has not conducted such an inquiry proceeding to clarify
6 its attrition policy.²⁶ The Commission in this case thus departs from its prior precedent
7 and dispenses with in-depth evidentiary support of the type required and provided in
8 previous attrition requests. Given that an attrition adjustment has required proof through
9 an attrition study for many decades in Washington, the Commission approval of the K-
10 Factor is not supported by the record, RCW 34.05.570(3)(i), or by substantial evidence
11 of the type “sufficient to provide a fair minded person of the truth of the premises.” *In*
12 *re Electric Lightwave*,¹²³ Wn.2d at 542-543; RCW 34.05.570(3)(e).

14 Finally, as noted, PSE must justify an attrition adjustment either on the basis of
15 excessively high inflation or exceptionally high capital expenditure projections. *PSE*
16 *2011/2012 General Rate Case*, Order 08, ¶ 491. PSE has not carried its burden to
17 establish the high capital expenditures through the Plan term.²⁷ PSE provided no
18 attrition study and its initial evidence consisted of only a one-page schedule of projected
19 growth in capital expenditures. AR at 1749-1750. At the hearing, Commission staff
20 conceded that there was an apparent declining trend in PSE’s capital investment during
21 the term of the Rate Plan and that this “could be” a concern. TR. 282:3-13 (Schooley).
22 The Final Order expressly stated that “our record lacks detailed documents regarding
23

24 _____
25 ²⁶ The Commission set out a detailed description of its methodology for determining an attrition allowance
in *Wash. Utils & Transp. Comm’n v. Pacific Power & Light*, Docket U-82-12 *et al.*, Fourth Supp. Order,
pp. 30-31, 1982 Wash. UTC LEXIS 3 (Appendix I).

26 ²⁷ PSE does not argue that inflation justifies adopting the K-Factor.

1 planned capital expenditures[.]” AR at 1053 (Final Order, ¶ 212). In a tacit admission
2 that PSE did not prove this part of its case the Final Order requires more capital
3 investment data to be filed *after the Final Order*. *Id.* The Commission erred by not
4 making specific findings with respect to whether exceptional capital expenditures would
5 continue throughout the Rate Plan, a required precondition for allowing an attrition
6 adjustment. RCW 34.05.570(3)(f).

8 **3. The Commission’s adoption of the K-Factor was arbitrary and
9 capricious**

10 The Commission’s approval of the K-Factor Rate Plan in this case was arbitrary
11 and capricious. The Commission has a “duty to explain its departure from prior norms.”
12 *Atchison*, 412 U.S. at 808. “[A]n agency changing its course must apply a reasoned
13 analysis indicating that prior policies and standards are being deliberately changed, not
14 casually ignored[.]” *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (DC
15 Cir.), *cert. denied*, 403 U.S. 923 (1971). The Commission did not meet this standard.

16 Prior to this case, the Commission has approved attrition adjustments only in the
17 context of general rate cases to permit a thorough review of the evidence necessary, has
18 limited attrition adjustments to a single year, and importantly, has required the utility to
19 support its attrition claims by filing an attrition study, a requirement reiterated just ten
20 months before the Final Order, but disregarded in this case. *PSE 2011/2012 General
21 Rate Case*, Order 08, ¶ 491 (“attrition allowance based on an attrition study”).

22 Because the Commission has yet to conduct an inquiry regarding “the
23 appropriate use of attrition analysis” and “the appropriate methodology to use in
24 preparing attrition studies,” *Avista 2012 General Rate Case*, Order 14, ¶ 77, no reasoned
25
26

1 guidance has been established for a change in attrition policy. As with the cost of capital
2 issue, the Commission could have required PSE to file a general rate case in early 2013
3 and developed a full record for consideration of the K-Factor Rate Plan and attrition
4 issues, as well as decoupling cost of capital issues. The Commission has not provided
5 an adequate reasoned justification for the disregard of established attrition precedent.
6 RCW 34.05.570(i); Assignments of Error B(3).
7

8 V. CONCLUSION

9 As the Commission stated over twenty years ago, "new approaches to regulation
10 must explicitly address the balance of risks and costs between customers and the
11 company. As we have long noted, ratepayers should not shoulder the burden of risks
12 shifted to them by any regulatory mechanism without receiving demonstrable and
13 commensurate benefits." *Wash. Utils. & Transp. Comm'n v. Puget Sound Power &*
14 *Light Company*, Docket UE-950618, Third Supp. Order, p. 7, 1995 WL 735607
15

16 Pursuant to RCW 34.05.570 and 34.05.574, Public Counsel respectfully requests
17 the Court to enter a judgment reversing the Final Order and remanding this case to the
18 UTC to remove the improper amounts from current rates, set new rates that are fair, just,
19 and reasonable, and refund the improperly collected revenues to customers.

20 RESPECTFULLY SUBMITTED this ^{20th} day of February, 2014.

21
22 ROBERT W. FERGUSON
23 ATTORNEY GENERAL

24 Simon J. ffitc, WSBA No. 25977
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PROOF OF SERVICE

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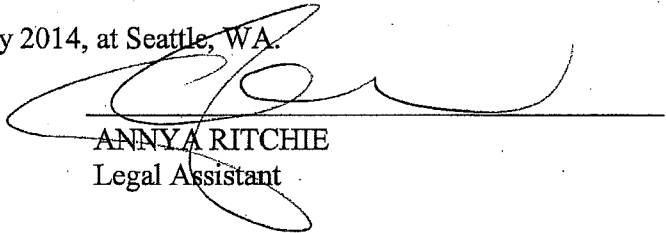
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11 I certify under penalty of perjury under the laws of the state of Washington that the
12 foregoing is true and correct.

13 DATED this 20th day of February 2014, at Seattle, WA.

14 
15 ANNYA RITCHIE
16 Legal Assistant