

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of)
)
PUGET SOUND ENERGY, INC., and)
NW ENERGY COALITION) DOCKET NOS. UE-121697/UG-121705
) (Consolidated)
For an Order Authorizing PSE to Implement)
Electric and Natural Gas Decoupling) and
Mechanisms and to Record Accounting)
Entries Associated with the Mechanisms)
)

WASHINGTON UTILITIES AND) DOCKET NOS. UE-130137/UG-130138
TRANSPORTATION COMMISSION,) (Consolidated)
)
Complainant,)
)
v.)
)
PUGET SOUND ENERGY, INC.)
)
Respondent.)

INITIAL BRIEF

OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

March 6, 2015

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I. INTRODUCTION

1 This proceeding is about establishing a reasonable return on equity (“ROE”) for Puget Sound Energy, Inc. (“PSE” or the “Company”). As with other ratemaking decisions, that involves balancing the interests of customers and the Company. It is, in other words, about fairness. Currently, PSE enjoys an ROE of 9.8%, which contributes to a higher overall rate of return than any other electric utility in the state. This, despite the fact that the Company’s ROE was awarded at a time when the cost of equity was declining and before it was authorized to implement full decoupling and its rate plan. No other utility in this State, nor any utility PSE has been compared to in this proceeding to estimate its ROE, has these combined risk-mitigating benefits; and no other electric utility in the state has an ROE at the same level it did in 2012.

2 The Washington Utilities and Transportation Commission’s (“Commission” or “WUTC”) fundamental statutory mandates are to regulate in the public interest and ensure that customer rates are “just, fair, reasonable and sufficient.”^{1/} The fact that PSE participated in an “expedited rate filing” (“ERF”) does not change these requirements. The end result of that proceeding, as a court confirmed, was not just and reasonable. The evidence in this phase of the proceeding confirms that finding. It shows that PSE’s cost of equity is substantially below its current allowed ROE. The Industrial Customers of Northwest Utilities’ (“ICNU”) witness, Michael Gorman, shows that PSE’s cost of equity in early 2013 was 9.3% and remains at the same level through 2014.

3 The reasonableness of Mr. Gorman’s recommendations is confirmed by the analyses of Staff’s witness, David Parcell. Mr. Parcell’s discounted cash flow (“DCF”) analysis

^{1/} RCW §§ 80.01.040(3), 80.28.010(1).

encompasses the same results as Mr. Gorman's and his comparable earnings ("CE") analysis shows that a 9.3% ROE yields market-to-book ratios well above 100%. While the analyses of PSE's witness, Roger Morin, show higher ROE results, these analyses are flawed in a number of respects. An objective DCF analysis that uses a consistent group of proxy companies and accounts for all of the assumptions made by Mr. Gorman and Dr. Morin demonstrates the reasonableness of Mr. Gorman's conclusions and the unreasonableness of Dr. Morin's. This result holds if one accounts for Mr. Parcell's DCF inputs as well.

4 The evidence in this proceeding, therefore, shows that PSE's ROE should be reduced for the entirety of the rate plan. PSE's ROE should be set at 9.3%, and in no circumstance should it be higher than 9.5%, Mr. Parcell's ultimate recommendation. Customers should be paying rates that reflect the cost of serving them, not rates designed to ensure the implementation of policies, particularly when they have either unproven or questionable value. The evidence that decoupling increases energy efficiency is decidedly thin, and while ERFs and rate plans may serve the goal of reducing rate case filings, this goal is only in the public interest if PSE's rates continue to be just and reasonable. That is not the case currently. The Commission has a statutory duty to remedy this situation.

II. BACKGROUND

5 This proceeding is on remand from the Thurston County Superior Court ("Court") "to establish fair, just, reasonable and sufficient rates to be charged under [PSE's] rate plan, and to order any other appropriate relief."^{2/} In Order 07 in these dockets, the Commission approved an ERF, a full decoupling mechanism, and a multi-year rate plan with fixed automatic rate

^{2/} ICNU v. WUTC, Thurston County Superior Court Case Nos. 13-2-01576-2 and 13-2-01582-7, Order Granting in Part and Denying in Part Petitions for Judicial Review ("Court Order") at 3 (July 25, 2014).

increases for PSE while maintaining the Company’s ROE of 9.8%, which had been set in its 2011-2012 general rate case.^{3/} The Court determined that “the Commission’s findings of fact with respect to the return on equity component of [PSE’s] cost of capital in the context of a multi-year rate plan are unsupported by substantial evidence and the Commission improperly shifted the burden of proof on this issue”^{4/}

6 Following the Court’s Order, ICNU filed with the Commission a Motion to Modify Order 07 (“Motion”) and a Petition for Accounting Order (“Petition”). ICNU’s Motion requested that the Commission modify its finding in Order 07 to recognize that there was sufficient evidence in the record of the original proceeding to support an ROE for PSE of 9.3%, which was the level Mr. Gorman’s multiple cost of capital analyses showed to be reasonable.^{5/} ICNU’s Petition sought an accounting order requiring PSE to refund excess revenue already collected from customers under its illegal rates and to defer for later refund to customers revenue it continues to collect under its illegal rates.^{6/} In its prehearing conference order establishing the process for this remand phase of the proceeding, the Commission denied ICNU’s Motion in favor of a comprehensive process in which “the Commission will consider all relevant evidence admitted on the question of return on equity”^{7/} The Commission held ICNU’s Petition in abeyance until the conclusion of this remand phase of the proceeding.^{8/}

^{3/} Docket Nos. UE-121697 *et al.*, Order 07 ¶¶ 216-249; WUTC v. PSE, Docket Nos. UE-111048/UG-111049, Order 08 ¶ 89 (May 7, 2012).

^{4/} Court Order at 2.

^{5/} Docket Nos. UE-121697 *et al.*, ICNU Motion to Modify Order 07 ¶ 1 (July 30, 2014).

^{6/} Docket Nos. UE-121697 *et al.*, ICNU Petition for Accounting Order ¶ 1 (July 30, 2014).

^{7/} Docket Nos. UE-121697 *et al.*, Order 10 ¶ 25 (Oct. 8, 2014).

^{8/} Id. ¶ 5.

7

In its direct case in this phase of the proceeding, PSE proffered the testimony of its Chief Financial Officer, Daniel A. Doyle;^{9/} its Corporate Treasurer, Brandon J. Lohse;^{10/} Dr. Roger A. Morin, a cost-of-capital expert;^{11/} and Dr. Michael J. Vilbert, a principal at the Brattle Group, which has purported to study the impact of decoupling on a utility's cost of equity.^{12/} Through its witnesses, PSE proposes no change to its currently authorized 9.8% ROE for the duration of its rate plan, and argues that the Commission should not consider the impact its Company-specific rate mechanisms, including decoupling, have on its allowed ROE.^{13/}

8

ICNU filed the response testimony of Michael P. Gorman, a cost-of-capital expert.^{14/} Mr. Gorman was the only cost-of-capital expert to testify and present a full cost-of-capital analysis in the original phase of the proceeding, during which he found that PSE's cost of equity for the first half of 2013 was 9.3% based on the results of three DCF analyses, a risk premium analysis, and a capital asset pricing model ("CAPM") analysis.^{15/} He also recommended that PSE's capital structure include 46.64% common equity, 51.71% long-term debt, and 1.65% short-term debt, which reflected the Company's actual average capital structure for the four quarters of 2012.^{16/} This capital structure and ROE resulted in an overall rate of return recommendation of 7.60% before adjusting for the cost of long-term debt.^{17/} In this phase of the proceeding, Mr. Gorman performed an ROE analysis for the second half of 2014 that is

^{9/} Doyle, Exh. No.__(DAD-4T).

^{10/} Lohse, Exh. No.__(BJL-1T).

^{11/} Morin, Exh. No.__(RAM-1T).

^{12/} Vilbert, Exh. No.__(MJV-1T).

^{13/} Doyle, Exh. No.__(DAD-4T) at 16:8-10, 6:4-6.

^{14/} Gorman, Exh. No.__(MPG-25T).

^{15/} Exh. No.__(MPG-3).

^{16/} Gorman, Exh. No.__(MPG-1T) at 10:3-6.

^{17/} Id. at 6:6.

similar to his 2013 analysis and finds that PSE's cost of equity continues to be 9.3%.^{18/} Mr. Gorman also critiques Dr. Morin's ROE analyses and shows that Dr. Morin's results are inflated for a number of reasons.^{19/}

9 Public Counsel filed the response testimony of Stephen G. Hill, also a cost-of-capital expert.^{20/} Mr. Hill recommends a 9.0% ROE for PSE based on four different cost of capital analyses.^{21/} He recommends an additional 35 basis point reduction (for an ROE of 8.65%) to account for the risk-mitigating effects of decoupling.^{22/}

10 ICNU and Public Counsel also jointly sponsored the testimony of Dr. Christopher A. Adolph, a professor of political science at the University of Washington and an expert in statistical analysis.^{23/} Dr. Adolph reviewed the studies performed by the Brattle Group and his testimony shows that they tend to support the conclusion that decoupling reduces the cost of capital for a utility such as PSE, and in no case do they demonstrate that decoupling does *not* reduce the cost of capital.^{24/} Dr. Adolph testifies that, while Dr. Vilbert insists on a 95% confidence level when interpreting the results of the Brattle studies, such a confidence level is not statistically required.^{25/} The various Brattle studies show that decoupling reduces the cost of capital between 25 and 49 basis points with confidence levels between 83% and 93%.^{26/}

^{18/} Gorman, Exh. No. __ (MPG-25T) at 2:7-9

^{19/} Id. at 39:17-57:8.

^{20/} Hill, Exh. No. __ (SGH-2T).

^{21/} Id. at 44:1-3.

^{22/} Id. at 44:3-8.

^{23/} Adolph, Exh. No. __ (CAA-1T).

^{24/} Id. at 6:17-23.

^{25/} Id. at 24:13-18.

^{26/} Id. at 6:20-23, 29 (figure 4).

11 Staff filed the testimony of Thomas E. Schooley and David C. Parcell, a cost-of-capital expert.^{27/} Mr. Schooley testifies that Staff does not believe decoupling is at issue in the remand because the Court did not specifically include this issue in its order on remand.^{28/} Mr. Parcell recommends an ROE for PSE of 9.5% based on DCF and comparable earnings (“CE”) analyses.^{29/}

12 In rebuttal testimony, PSE did not respond to, nor did it challenge, Mr. Parcell’s recommendation to reduce PSE’s ROE to 9.5%.^{30/} In cross-answering testimony, Mr. Gorman shows that Mr. Parcell’s 9.5% recommendation is, at best, at the high end of the range of reasonableness due to Mr. Parcell’s reliance on inappropriately high DCF results and a flawed CE methodology. Mr. Gorman’s cross-answering testimony continues to recommend a 9.3% ROE for the Company.

III. ARGUMENT

A. The Commission must hold PSE to its burden of proof in this case.

13 Despite the Court’s Order explicitly finding that the Commission did not hold PSE to its burden of proof in the original proceeding in these dockets, the Company continues to take a position that would unlawfully shift this burden to other parties. The Company’s witness, Dr. Morin, testifies that his “understanding is that the purpose of this proceeding is to determine if the [ROE] of 9.8% authorized by the Commission in Order 08 in Dockets UE-111048 and UG-

^{27/} Schooley, Exh. No.__(TES-6T); Parcell, Exh. No.__(DCP-1T).

^{28/} Schooley, Exh. No.__(TES-6T) at 3:11-14.

^{29/} Parcell, Exh. No.__(DCP-1T) at 27:21-28:2. Although Mr. Parcell also performed a CAPM analysis, he did not factor these results into his ultimate recommendation.

^{30/} Morin, Exh. No.__(RAM-16T) at 3:3-8. Dr. Morin testified that “Mr. Parcell’s recommended range of 9.0%-10.0% concludes that the ROE of 9.8% authorized by the Commission ... is [] reasonable. In that regard, Commission Staff’s recommendation is largely consistent with my own conclusion” Dr. Morin did not, however, address Mr. Parcell’s ultimate recommendation to set PSE’s ROE at 9.5%.

111049 remained within the range of reasonableness when the Commission issued its Order 07 in these proceedings and remains within the range of reasonableness through the rate plan period.”^{31/}

14 By arguing that the Commission’s task in this proceeding is to justify a previously approved ROE, rather than to set the ROE based exclusively on the evidence in the record in this proceeding, PSE’s position requires other parties to demonstrate that a 9.8% ROE is *not* within a reasonable range, rather than requiring PSE to demonstrate that 9.8% (or some other level) *is* a reasonable ROE. This plainly shifts the burden of proof away from the Company, as the burden of proof includes the burden of persuasion.^{32/} “The burden of persuasion is the burden of persuading the trier of fact that the alleged fact is true.”^{33/} Thus, PSE must persuade the Commission that 9.8% (or some other ROE) is reasonable, rather than other parties persuading the Commission that 9.8% is unreasonable.

15 The Commission previously has recognized these principles in a prior PacifiCorp decision:

[T]here is no “tradition” that somehow creates a presumption that an ROE determined a number of years ago should carry over. This argument resembles [PacifiCorp’s] argument regarding capital structure: *it attempts to shift the burden of proof to others to prove that the previously approved ROE is inappropriate, rather than leaving the burden on [PacifiCorp], as the law requires.*^{34/}

If the Commission accepts PSE’s argument that it need only determine if the previously approved 9.8% ROE is reasonable, it will, again, unlawfully shift the burden of proof away from the Company, as the Commission’s own prior decisions recognize.

^{31/} Morin, Exh. No.__(RAM-16T) at 2:9-13.

^{32/} WAC § 480-07-540; Fed. Signal Corp. v. Safety Factors, 125 Wn.2d 413, 433 (1994).

^{33/} Fed. Signal Corp., 125 Wn.2d at 433 (citation and internal quotations omitted).

^{34/} WUTC v. PacifiCorp, Docket No. UE-100749, Order 07 ¶ 26 (May 12, 2011) (emphasis added).

16

That PSE's rates at issue in this proceeding were originally set in the context of an ERF is irrelevant to the requirement that the Company carry its burden of proof. On judicial review of Order 07, both PSE and Staff appeared to suggest that, because the ERF proceeding allegedly did not contemplate an evaluation of the Company's ROE, standard burden of proof requirements should not apply.^{35/} The Court rejected this position in finding that PSE was statutorily obligated to carry its burden of proof.^{36/} The Commission must comply with both the law and the Court's Order, which require the Commission to hold PSE to its burden of proof in establishing a reasonable ROE.^{37/}

17

Nor is it relevant that PSE filed for an ERF less than a year after its ROE was set in its 2011-2012 rate case.^{38/} Again, on judicial review both PSE and Staff used the length of time between proceedings to attempt to justify the position that the Commission's task was only to determine whether the previously approved ROE remained reasonable.^{39/} The Court also rejected this argument, finding that PSE had a statutory duty to carry its burden of proof.^{40/} Furthermore, this is not a unique circumstance. PacifiCorp did the same thing between its 2011 and 2013 rate cases.^{41/} There, the Commission did not proceed by using PacifiCorp's currently authorized ROE as a starting point. It considered the evidence as it existed in the record and set

^{35/} See Schooley, Exh. No.__(TES-7) at 35:7-36:18, 45:11-47:19.

^{36/} Court Order at 2.

^{37/} RCW § 80.04.130(4); Court Order at 2.

^{38/} The Commission issued its final order (Order 08) in PSE's last rate case (Docket Nos. UE-111048/UG-111049) on May 7, 2012. PSE filed its ERF petition in these dockets approximately nine months later, on February 1, 2013.

^{39/} Exh. No.__(TES-7) at 40:24-41:1.

^{40/} Court Order at 2.

^{41/} As with the time between the Commission's final order in PSE's last rate case and the Company's ERF filing, the duration between the final order in PacifiCorp's 2011 rate case (Docket No. UE-111190, Order 07 (Mar. 30, 2012)) and its initial filing in its 2013 rate case (Docket No. UE-130043, Initial Filing on behalf of Pacific Power & Light Co. (Jan. 11, 2013)) was approximately 9 months.

a new ROE based on that evidence.^{42/} In fact, the Commission specifically found that the “Company failed to carry its burden in this case to support its proposed ... return on equity” despite the fact that PacifiCorp put on a full cost of capital case.^{43/}

18 In short, the Commission’s task in this proceeding is no different from its task in any proceeding in which a utility’s ROE is at issue. It must determine a reasonable ROE for the Company based exclusively on the evidence in the record, with the Company carrying the burden of proof. Any process that begins with a presumed ROE against which evidence must be marshalled is unlawful and may be subject to reversal on judicial review.

B. PSE’s cost of equity is 9.3%, and should be set no higher than 9.5%.

19 PSE is currently operating with a 9.8% ROE that was set when “authorized returns on equity were generally declining,”^{44/} and before PSE was awarded full decoupling and a multi-year rate plan with fixed automatic rate increases. The cost of equity analyses performed by Mr. Gorman, Mr. Parcell, and Mr. Hill all demonstrate that a 9.3% ROE for PSE is “commensurate with returns on investments in other enterprises having corresponding risks” and that it is “sufficient to assure confidence in the financial integrity” of the Company.^{45/} Mr. Parcell’s recommended 9.5% ROE should establish the upper bound of the range of reasonableness in this case given his DCF and CAPM results, and the high market-to-book ratios this ROE produces. Even Dr. Morin, using inflated and subjective data, derives ROEs for PSE that fall within this range.^{46/}

^{42/} WUTC v. PacifiCorp, Docket No. UE-130043, Order 05 ¶¶ 43-70 (Dec. 4, 2013).

^{43/} Id. ¶ 63.

^{44/} Parcell, Exh. No.__(DCP-1T) at 28:9-11.

^{45/} Fed. Power Comm’n v. Hope Nat. Gas Co., 320 U.S. 591, 603 (1944).

^{46/} Morin, Exh. No.__(RAM-1T) at 29 (table 2) (showing that PSE’s 2014 cost of equity was 9.4% based on DCF study with *Value Line* growth rates).

20

Furthermore, the general economic conditions that have persisted between early 2013 and today support reducing PSE's ROE. In his testimony in both the original and remand phases of this proceeding, Mr. Gorman notes that the credit rating outlook of the utility industry is strong and "supportive of the industry's financial integrity and access to capital."^{47/} He also observes that "regulated utilities' stocks have exhibited strong price performance over the last several years, which is evidence of utility access to capital."^{48/} Based on these conclusions, Mr. Gorman finds in his remand testimony that "the market continues to embrace the regulated utility industry as a safe-haven investment, and views utility equity and debt investments as low-risk securities."^{49/}

21

Mr. Parcell concurs with Mr. Gorman's economic observations. Although his testimony in this case did not discuss the economic conditions that prevailed in early 2013, Mr. Parcell's testimony in other proceedings covering this period does. In testimony he filed with the Delaware Public Service Commission, which considered Delmarva Power & Light Company's ("Delmarva") ROE in early 2013, Mr. Parcell noted that "[c]urrent levels of inflation are at the lowest levels of the past 35 years ... which is reflective of lower capital costs."^{50/} He also indicated that "both U.S. and corporate bond yields have declined to their lowest levels in the past four business cycles and in more than 35 years, with even corporate lending rates remaining at historically low levels, again reflective of lower capital costs."^{51/} These economic conditions have persisted through 2014, according to Mr. Parcell.^{52/} As Dr. Morin succinctly put it, "I've

^{47/} Gorman, Exh. No.__(MPG-25T) at 6:1-2; Exh. No.__(MPG-3) at 1:23-2:2.

^{48/} Gorman, Exh. No.__(MPG-25T) at 6:2-4.

^{49/} Id. at 6:6-8.

^{50/} Exh. No.__(DCP-20CX) at 5:4-6.

^{51/} Id. at 5:21-24.

^{52/} Exh. No.__(DCP-21CX) at 7:5-8.

been forecasting higher yields for several years now and they haven't materialized yet.”^{53/} The consequence of these general economic conditions is “a decline in investor expectations of returns, including stock returns,”^{54/} and accordingly, “authorized returns on equity were generally declining from 2012 to 2013.”^{55/}

22 Nevertheless, PSE proposes to maintain its 9.8% ROE for the duration of its rate plan that the Commission originally authorized in May of 2012.^{56/} Both the PSE-specific and general economic evidence in this case, however, support Mr. Gorman's recommendation to reduce the Company's ROE to 9.3%, and in no case should it be set higher than Mr. Parcell's recommended ROE of 9.5%.

1. Mr. Gorman's 2013 and 2014 cost of equity studies establish that PSE's ROE was 9.3% when Order 07 was issued, and remains at 9.3% through 2014.

23 In the initial phase of this docket, Mr. Gorman estimated a reasonable ROE for PSE of 9.3% for early 2013.^{57/} His estimate was based on: (1) two versions of a constant growth DCF analysis, using consensus analysts' growth rate projections and sustainable growth rate projections; (2) a multi-stage growth DCF model; (3) a risk premium study; and (4) a CAPM analysis.^{58/} The results of his DCF analyses produced reasonable ROEs in the range of 8.38% to 9.29%.^{59/} His risk premium model produced a reasonable ROE of 9.3%.^{60/} Finally, his CAPM

^{53/} Morin, Tr. 673:11-12.

^{54/} Exh. No.__(DCP-20CX) at 6:14-15; Ex. No.__(DCP-21CX) at 8:9.

^{55/} Parcell, Exh. No.__(DCP-1T) at 28:10-11.

^{56/} Docket Nos. UE-111048/UG-111049, Order 08 ¶ 89.

^{57/} Exh. No.__(MPG-3) at 31:15.

^{58/} Id. at 8:22-9:2.

^{59/} Id. at 21:6-8.

^{60/} Id. at 26:5-6.

analysis produced a reasonable ROE of 8.40%.^{61/} Accordingly, Mr. Gorman's recommended ROE for PSE in early 2013 of 9.30% was based on his highest results. Mr. Gorman's 2013 analysis is the only ROE study performed and defended contemporaneously with the proceedings that resulted in the Commission's Order 07. Given that Mr. Parcell indicated that he used a wider ROE range in this proceeding due to his need to perform a retrospective analysis,^{62/} the contemporaneous nature of Mr. Gorman's 2013 analysis gives it a precision the other experts' 2013 analyses lack.

24 Mr. Gorman performed a new analysis of PSE's ROE for this remand proceeding that looked at data through November 2014.^{63/} His analysis continues to show that a reasonable ROE for PSE is 9.30%, with a range of reasonable returns between 9.0% and 9.6%.^{64/} The results of his DCF analyses produce reasonable ROEs in the range of 8.64% to 9.36%.^{65/} His risk premium model produces a reasonable ROE of 9.6%, which is more heavily weighted toward the high end of his results.^{66/} Finally, his CAPM analysis produces a reasonable ROE of 9.18%.^{67/} Accordingly, Mr. Gorman's recommended ROE of 9.3% for the second half of 2014 represents the upper range of his DCF analyses, exceeds his CAPM results, and is only exceeded by his highest risk premium results. Furthermore, the consistency of Mr. Gorman's results from both 2013 and 2014 demonstrates that they are based on "strong fundamentals at this point in the marketplace."^{68/}

^{61/} Id. at 31:8-10.

^{62/} Parcell, Tr. 602:13-24.

^{63/} Gorman, Exh. No. __ (MPG-25T).

^{64/} Id. at 2:7-9.

^{65/} Id. at 24:1-2.

^{66/} Id. at 30:3-4.

^{67/} Id. at 35:13-15.

^{68/} Gorman, Tr. 657:11-12.

The Commission has previously approved of Mr. Gorman’s method for estimating a utility’s ROE. In PSE’s last rate case, the Commission stated that Mr. Gorman “provides a thorough and broad examination of equity return using three approaches to DCF analysis He checks these results for reasonableness using RP and CAPM analyses. His presentation is buttressed by more than 20 detailed exhibits including relevant financial information. His analytical approach is thoughtful and well-reasoned.”^{69/} Mr. Gorman’s method in this proceeding, both in the original phase and the remand phase, is substantially similar to his method in PSE’s last rate case.

2. Dr. Morin’s ROE results are inflated and unreliable.

Dr. Morin estimates PSE’s cost of equity for two separate periods: (1) the first half of 2013; and (2) the second half of 2014.^{70/} For both periods, Dr. Morin conducted two DCF analyses using *Value Line* growth projections and consensus analysts’ growth projections, traditional and empirical CAPM analyses, and historical and allowed risk premium analyses. In each of his analyses, Dr. Morin uses subjective, inconsistent, or unrealistic assumptions to derive his results. By modifying certain inputs to Dr. Morin’s models to reflect more accurate data, Mr. Gorman obtains ROE results for PSE between 8.7% and 9.7%.^{71/} The approximate mid-point of these results is a range of 9.0% to 9.3%. All of Mr. Gorman’s results using Dr. Morin’s models are below PSE’s currently authorized ROE of 9.8%.

^{69/} Docket Nos. UE-111048/UG-111049, Order 08 ¶ 88.

^{70/} Morin, Exh. No.__(RAM-1T) at 2:9-16.

^{71/} Gorman, Exh. No.__(MPG-25T) at 41 (Table 3).

a. *Dr. Morin's DCF Analyses rely on unrealistic growth projections.*

27 Dr. Morin's DCF analyses for the first half of 2013 produce ROEs between 9.8% and 10.0%.^{72/} These ROEs, however, are derived by excluding unrealistically low growth rates but not unrealistically high growth rates. While Dr. Morin excludes companies with negative projected growth rates on the basis that they do not reflect a rational estimate of long-term growth by investors, he includes companies with growth rates that far exceed what a rational investor would expect over the long term.^{73/} As an example, the growth projections for NV Energy in Dr. Morin's 2013 DCF analyses are many percentage points higher than the next highest proxy company's growth estimate – in his consensus analyst DCF model, it is more than *double* the next highest growth projection.^{74/}

28 The consequence of Dr. Morin's one-sided exclusion of proxy companies from his DCF models is that his overall growth rate used to derive his ultimate results exceeds the long-term maximum sustainable growth rate. As Mr. Gorman testifies:

A long-term sustainable growth rate for a utility stock cannot exceed the growth rate of the economy in which it sells its goods and services. Hence, a reasonable proxy for the long-term maximum sustainable growth rate for a utility investment is best proxied by the projected long-term Gross Domestic Product ("GDP").^{75/}

In fact, the "Energy Information Administration ("EIA") has observed that utility sales growth ... has lagged behind GDP growth for more than a decade Therefore, GDP growth is a

^{72/} Morin, Exh. No.__(RAM-1T) at 27 (table 1).

^{73/} Morin, Exh. No.__(RAM-1T) at 25:15-16 and 26:9-10; see also, Gorman, Exh. No.__(MPG-25T) at 55:8-11.

^{74/} Exh. Nos.__(RAM-4) and (RAM-5). Exh. No.__(RAM-5) shows a projected growth rate for NV Energy of 15.1%. The next highest growth rate is Northeast Utilities at 7.2%.

^{75/} Gorman, Exh. No.__(MPG-25T) at 16:21-24.

conservative proxy for the highest sustainable long-term growth rate of a utility.”^{76/} The publication that is “most influential on investors’ expectations of future growth outlooks” is *The Blue Chip Financial Forecasts’* consensus economists’ GDP growth projections.^{77/} “These analyst projections reflect all current outlooks for GDP, as reflected in analyst projections”^{78/} For early 2013, this projected GDP growth rate was between 4.7% and 5.0%.^{79/} Nevertheless, Dr. Morin’s overall average growth rates in his 2013 DCF analyses exceed the highest projected GDP growth rate by between 31 and 50 basis points.^{80/} Simply lowering this average growth rate to 5.0% would produce an ROE estimate from Dr. Morin’s 2013 DCF studies of approximately 9.5%.^{81/}

29 Similarly with Dr. Morin’s 2014 DCF analyses, the average projected growth rate for his proxy group is even more out of line with long-term GDP growth projections. *The Blue Chip Financial Forecasts’* late 2014 GDP growth projections were between 4.4% and 4.8%.^{82/} Nevertheless, Dr. Morin’s average growth rates for late 2014 are 5.38% and 5.51%, at least 58 basis points above the highest GDP growth projections.^{83/} These higher-than-expected growth rates likely occur because Dr. Morin uses only 3-5 year growth projections,^{84/} even though the constant growth DCF model requires an assumed growth rate that can be sustained indefinitely.^{85/} Accordingly, Mr. Gorman proposes implementing a multi-stage DCF model in

^{76/} Exh. No.__(MPG-3) at 18:11-17.

^{77/} Id. at 19:6-11.

^{78/} Id. at 19:9-10.

^{79/} Id. at 19:12-13.

^{80/} Exh. Nos.__(RAM-4) and (RAM-5).

^{81/} Id.

^{82/} Gorman, Exh. No.__(MPG-25T) at 16:24-26.

^{83/} Exh. Nos.__(RAM-10) and (RAM-11).

^{84/} Gorman, Exh. No.__(MPG-25T) at 57:2-5.

^{85/} Id. at 56:14-16; Docket Nos. UE-111048/UG-111049, Order 08 ¶ 69.

which Dr. Morin's dividend yields and growth rates are utilized for the first five years, while the out-year projections transition to the estimated long-term GDP growth rate of 4.6%.^{86/} Mr. Gorman's results show cost of equity estimates between 8.81% and 8.86% for PSE in late 2014.^{87/}

30 Notably, however, even Dr. Morin's own 2014 DCF analyses produce ROE results of 9.4% and 9.6%, at least 20 basis points below PSE's currently authorized ROE.^{88/} Moreover, Mr. Gorman points out in his testimony that Dr. Morin's 2014 DCF studies inappropriately include certain companies that were involved in merger and acquisition activity during the study period, which skews the investment metrics of these companies.^{89/} Removing these companies from Dr. Morin's analysis reduces his high-end 2014 results from 9.6% to 9.4%.^{90/} In his rebuttal testimony, Dr. Morin did not challenge Mr. Gorman's decision to remove these companies from the proxy group, and Dr. Morin himself removed NV Energy and UNS Energy from his 2014 proxy group because they were purchased in the intervening period between his 2013 and 2014 studies.^{91/}

^{86/} Gorman, Exh. No.__(MPG-25T) at 56:20-24.

^{87/} Id.

^{88/} Morin, Exh. No.__(RAM-1T) at 29:6.

^{89/} Gorman, Exh. No.__(MPG-25T) at 11:19-22. Mr. Gorman removed Duke Energy, Integrys, Pepco Holdings, UIL Holdings Corp., and Wisconsin Energy Corp. from Dr. Morin's 2014 proxy group. He also noted that Exelon Corp. was involved in merger activity at the time, though Dr. Morin had already excluded this company from his 2014 studies for other reasons.

^{90/} Exh. No.__(RAM-10) and (RAM-11).

^{91/} Morin, Exh. No.__(RAM-1T) at 27:14-20.

b. *Dr. Morin's traditional CAPM analyses rely on selective and inconsistent data, while his empirical CAPM studies are structurally flawed because they rely on adjusted, rather than raw, betas.*

31 Dr. Morin performed traditional and empirical CAPM analyses for PSE for both early 2013 and late 2014.^{92/} His CAPM analyses produce ROEs of 9.8% (traditional) and 10.3% (empirical) for 2013, and 10.3% (traditional) and 10.8% (empirical) for 2014.^{93/} That these CAPM results are significantly inflated is evident from their comparison with the CAPM results of the other cost-of-capital experts in this proceeding. Mr. Gorman's 2013 CAPM analysis produces an ROE of 8.40%,^{94/} while his 2014 CAPM analysis produces an ROE of 9.18%.^{95/} Meanwhile, Mr. Hill's CAPM study results in a 7.42% ROE,^{96/} while Mr. Parcell's CAPM studies produce an ROE range between 6.5% and 6.8%, approximately four percent lower than Dr. Morin's.^{97/}

32 Dr. Morin's results are so much higher than the other witnesses' in this proceeding for two reasons. First, Dr. Morin develops his market risk premium by averaging Ibbotson's published market risk premiums with a DCF estimate of market risk premiums that Dr. Morin himself made up.^{98/} This produces a market risk premium for both 2013 and 2014 of 7.2%.^{99/} Had Dr. Morin simply relied on the published data, which is the data available to

^{92/} Id. at 30:1-54:6.

^{93/} Id. at 49:6, 54:6.

^{94/} Exh. No.__(MPG-3) at 31:8-10.

^{95/} Gorman, Exh. No.__(MPG-25T) at 35:13-15.

^{96/} Hill, Exh. No.__(SGH-2T) at 34:20-35:1.

^{97/} Parcell, Exh. No.__(DCP-1T) at 22:12-14.

^{98/} Morin, Exh. No.__(RAM-1T) at 46:12-47:10, 51:12-52:9.

^{99/} Id. at 47:8, 52:6-7.

investors, this would reduce his market risk premium for 2013 by 60 basis points and his 2014 market risk premium by 20 basis points.^{100/}

33 The second reason is Dr. Morin’s choice of risk-free rates. As Dr. Morin testifies, “the yield on 30-year Treasury bonds[] is the best measure of the risk-free rate for use in the CAPM.”^{101/} Yet, Dr. Morin’s Treasury bond yield forecasts used to derive his risk-free rates in his traditional CAPM analyses are not transparent or consistent. For his 2013 study, Dr. Morin uses a risk-free rate of 4.6%.^{102/} To arrive at this rate, he uses 30-year Treasury bond yield forecasts from Global Insight, Value Line, and Consensus Economics, Inc.^{103/} He considers the four-year period from 2014-2017 and averages the forecasts for the 2015-2017 period.^{104/} Meanwhile, for his 2014 study, Dr. Morin uses a risk-free rate of 5.0% based on 30-year Treasury bond yield forecasts from Global Insight, Value Line, the Congressional Budget Office, and EIA Energy Outlook.^{105/} Dr. Morin considers a 6-year period from 2015-2020, then adopts his 5.0% rate from the average of the long-term forecasts from these sources.^{106/} Thus, Dr. Morin’s 2013 and 2014 traditional CAPM analyses use projections from different sources, over a different time period, with an average applied to different projections. As a consequence, Dr. Morin’s risk-free rates for both his 2013 and 2014 studies appear cherry-picked and their accuracy is difficult to assess.

34 Conversely, Mr. Gorman relies on the consensus economists’ projected 30-year Treasury bond yield, as published in *The Blue Chip Financial Forecasts*, for both his 2013 and

^{100/} Id. at 47:6-10, 52:5-9.

^{101/} Id. at 31:17-18.

^{102/} Id. at 45:1-2.

^{103/} Id. at 44 (table 4).

^{104/} Id. at 44:15-16.

^{105/} Id. at 50 (table 6).

^{106/} Id. at 50:1-13.

2014 analyses.^{107/} Dr. Morin criticizes Mr. Gorman’s 2014 CAPM analysis because he believes the risk-free rate Mr. Gorman uses is “far too low.”^{108/} Yet, his criticism boils down to the fact that Dr. Morin simply disagrees with Mr. Gorman’s reliance on *The Blue Chip Financial Forecasts*.^{109/} His reasons for this disagreement, however, are not apparent beyond the fact that they forecast a lower Treasury bond yield than Dr. Morin himself does. Yet, these forecasts constitute a consensus of analyst projections, rather than individual analyst projections, as Dr. Morin’s study does.^{110/} The consensus projections are, therefore, a far more reliable source than Dr. Morin’s selective and inconsistent data. Furthermore, by relying on the same information for all of his analyses, Mr. Gorman’s 2013 and 2014 CAPMs have a transparency Dr. Morin’s lacks. By using Dr. Morin’s betas, the Ibbotson published market risk premiums, and the *Blue Chip* forecasts in Dr. Morin’s traditional CAPMs, his ROE projections for PSE are 8.7% in early 2013 and 9.3% in late 2014.^{111/}

35 Even more flawed are Dr. Morin’s empirical CAPM analyses. These models produce ROEs for PSE of 10.3% in 2013 and 10.8% in 2014.^{112/} The reason these ROEs are so high is because they rely on inflated betas that double-count the increase in CAPM return estimates.^{113/} The beta in a CAPM analysis is intended to represent the systematic risk – the market risk that cannot be diversified away – embedded in a particular stock.^{114/} For his 2013 traditional CAPM study, Dr. Morin calculates a beta of 0.72 based on a group of proxy

^{107/} Exh. No.__(MPG-3) at 27:15-18; Gorman, Exh. No.__(MPG-25T) at 31:19-22.

^{108/} Morin, Exh. No.__(RAM-16T) at 58:9.

^{109/} *Id.* at 58:7-59:10.

^{110/} Gorman, Tr. 674:9-18.

^{111/} Gorman, Exh. No.__(MPG-25T) at 47:17-23.

^{112/} Morin, Exh. No.__(RAM-1T) at 49 (table 5), 54 (table 7).

^{113/} Gorman, Exh. No.__(MPG-25T) at 48:12-49:16.

^{114/} Morin, Exh. No.__(RAM-1T) at 34:10-22.

utilities.^{115/} The beta for his 2014 traditional CAPM study is 0.74.^{116/} These betas are “adjusted” in that the *Value Line* data Dr. Morin relies upon constitutes a weighted average of a “raw” beta and a market beta of 1.0.^{117/} Yet, Dr. Morin “adjusts” these betas in his empirical CAPM analyses a second time by using a weighted average of these already adjusted betas and the market beta of 1.0.^{118/} This has the practical effect of assuming a higher level of market risk embedded in PSE’s stock than the proxy group results demonstrate is reasonable.^{119/} It also double-counts the increase in the CAPM return estimates for utility stocks like PSE’s.^{120/} Dr. Morin attempts to defend his use of adjusted betas in his empirical CAPM studies,^{121/} but as Mr. Gorman points out, this approach is simply not supported in the academic community.^{122/} Using raw, instead of adjusted betas, Mr. Gorman shows that a properly performed empirical CAPM study produces an ROE for PSE of 9.24%.^{123/}

c. *Dr. Morin’s risk premium studies also rely on selective and inconsistent data, and his allowed risk premium model is structurally flawed.*

36

Finally, Dr. Morin performed historical risk premium analyses and allowed risk premium analyses, each for early 2013 and late 2014.^{124/} His historical risk premium analyses measure the achieved return on electric utility stocks relative to that of long-term Treasury bonds going back to 1931.^{125/} Dr. Morin then takes the difference between these two returns and adds

^{115/} Id. at 45:7-13.

^{116/} Id. at 50:16-51:3.

^{117/} Gorman, Exh. No.__(MPG-25T) at 49:22-23.

^{118/} Morin, Exh. No.__(RAM-1T) at 48:18, 53:18; see also, Gorman, Exh. No.__(MPG-25T) at 48:12-49:16.

^{119/} Gorman, Exh. No.__(MPG-25T) at 48:12-16.

^{120/} Id. at 49:11-14.

^{121/} Morin, Exh. No.__(RAM-1T) at 43:1-20.

^{122/} Gorman, Exh. No.__(MPG-25T) at 49:6-10.

^{123/} Id. at 50:4-8.

^{124/} Morin, Exh. No.__(RAM-1T) at 54:7-63:16.

^{125/} Id. at 54:13-16, 56:21-57:1.

them to the same projected 30-year Treasury bond yields he uses in his CAPM analyses.^{126/} The results produce ROEs for PSE of 9.8% for 2013 and 10.3% for 2014.^{127/} Dr. Morin's allowed risk premium analyses allegedly measure the electric utility ROEs allowed by regulatory commissions relative to that of long-term Treasury bonds going back to 1986.^{128/} The results produce ROEs for PSE of 10.7% for 2013 and 11.0% for 2014.^{129/}

37 Because Dr. Morin's historical risk premium studies rely on the same risk free rates he developed for his CAPM analyses, they suffer from the same problems. Namely, those rates were developed from inconsistent data that is inconsistently interpreted, and is, therefore, subjective and not transparent.^{130/}

38 Moreover, Dr. Morin's allowed risk premium studies are structurally flawed. Dr. Morin calculates risk premiums for PSE of 6.1% in 2013 and 6.0% in 2014.^{131/} He then adds his subjectively derived projected 30-year Treasury bond yields to these numbers to arrive at his overall ROE results in his allowed risk premium studies.^{132/} Dr. Morin's risk premiums in these studies are derived using a regression formula based on the assumption that there is a direct inverse relationship between interest rates and allowed ROEs.^{133/} As Mr. Gorman testifies, however, there is no merit to Dr. Morin's simplistic use of an inverse relationship between interest rates and equity risk premiums.^{134/} This methodology ignores entirely investment risk

^{126/} Id. at 55:1-6, 57:6-11.

^{127/} Id. at 55:6, 57:11.

^{128/} Id. at 57:17-20.

^{129/} Id. at 59:9-10, 62:9-10.

^{130/} Supra at 18.

^{131/} Morin, Exh. No.__(RAM-1T) at 59:10, 62:10.

^{132/} Id.

^{133/} Id. at 59:1-10.

^{134/} Gorman, Exh. No.__(MPG-25T) at 52:15-53:17.

differentials, including inflation outlooks.^{135/} As Mr. Gorman shows, researchers have found that the relevant relationship is not between risk premiums and interest rates, but “the relative changes to the risk of equity versus debt securities investments.”^{136/}

39 Dr. Morin’s own findings support this criticism. Dr. Morin calculated the actual difference between allowed ROEs and contemporaneous Treasury bond yields going back to 1986 and found that this spread was 5.4% in 2013 and 5.6% in 2014.^{137/} This means that Dr. Morin’s regression formula produces risk premiums that are between 40 and 60 basis points higher than actual historical spreads. Dr. Morin makes no attempt to explain this discrepancy. Dr. Morin’s use of a linear regression study based on an inverse relationship between interest rates and allowed ROEs, therefore, is without merit and should be rejected outright.

3. Mr. Parcell’s High-End ROE Range is Unsupported.

40 In this proceeding, Staff’s witness, Mr. Parcell, recommends an ROE for PSE of 9.5%.^{138/} At most, this represents the high end of the range of reasonableness for the Company. Mr. Parcell performed a constant growth DCF analysis using three different proxy groups – Dr. Morin’s, Mr. Gorman’s, and his own – a CAPM analysis, and a CE analysis.^{139/} All of Mr. Parcell’s studies were performed based on data from the early 2013 period.^{140/} Mr. Parcell’s ultimate recommendation of a 9.5% ROE for PSE is based on his selection of the mid-point of his range of reasonableness, which he considers to be 9.0% to 10.0% based on the results of his

^{135/} Id. at 53:14-17.

^{136/} Id. at 53:11-12.

^{137/} Morin, Exh. No.__(RAM-1T) at 58:5-6, 61:3-4.

^{138/} Parcell, Exh. No.__(DCP-1T) at 28:1-2.

^{139/} Id. at 3:12-23.

^{140/} Id. at 3:10-12.

DCF and CE studies.^{141/} Mr. Parcell indicated at the hearing in this case that the fact that he was performing a retrospective ROE analysis for the Company in early 2013 contributed to a wider range of reasonableness than he usually recommends.^{142/} PSE did not respond to, nor challenge, any of Mr. Parcell's studies or results, including his 9.5% ROE recommendation.^{143/}

a. *The Commission should reject Mr. Parcell's CE analysis as a method of establishing a reasonable ROE for PSE and should only use it, if at all, to cross-check the reasonableness of other ROE recommendations.*

41 Of all of Mr. Parcell's studies, only his CE analysis produces ROEs that encompass PSE's currently authorized 9.8% ROE.^{144/} Notably, Mr. Parcell testified at the hearing in PacifiCorp's current general rate case that he would have recommended an ROE for PSE in this case *below 9%* if he only performed DCF and CAPM analyses.^{145/}

42 As Mr. Parcell describes the CE analysis, it is designed to allow one to:

[A]ssess the degree to which a given level of return equates to the cost of capital. It is generally recognized for utilities that market-to-book ratios of greater than one (i.e., 100 percent) reflect a situation where a company is able to attract new equity capital without dilution (i.e., above book value). As a result, one objective of a fair cost of equity is the maintenance of stock prices at or above book value. There is no regulatory obligation to set rates designed to maintain a market-to-book ratio significantly above one.^{146/}

^{141/} Id. at 4:1-4.

^{142/} Parcell, Tr. 602:13-24, 694:10-16.

^{143/} Nor, for that matter, did Staff respond to Dr. Morin's testimony despite nominally being filed in response to this testimony.

^{144/} Parcell, Exh. No.__(DCP-1T) at 27:15-17.

^{145/} Exh. No.__(DCP-19CX) at 286:10-16.

^{146/} Parcell, Exh. No.__(DCP-1T) at 23:18-24:2.

Thus, the CE analysis is nothing more than a test of what level of ROE ensures that a utility will maintain a market-to-book ratio of 100% or greater. This means that there is no ceiling to a range of reasonableness in the analysis, only a floor.

43 For this reason, Mr. Gorman testifies to his reservations about the usefulness of the CE methodology. Specifically, he notes that this methodology does not provide investors with a means of judging whether the utility in question produces an ROE that is similar to an investment in alternative companies with comparable risk.^{147/} Mr. Parcell’s CE results illustrate Mr. Gorman’s point. They indicate that an ROE for PSE between 8.3% and 10.3% is sufficient to maintain market-to-book ratios of 121% to 155%.^{148/} Any ROE within this range – and presumably even higher or lower ROEs – is, therefore, sufficient to maintain the necessary market-to-book ratio.

44 Mr. Parcell notes in his testimony that he focuses on the high-end results of both his DCF and CE analyses “in order to be conservative.”^{149/} Mr. Parcell does not explain, however, why ROE results that support market-to-book ratios over 140% are sufficiently “conservative” and ROEs that support market-to-book ratios over 120% are not. This is particularly questionable given Mr. Parcell’s testimony that authorized returns below an 8.7% ROE would still produce market-to-book ratios “well above” 100% and his testimony that “[t]here is no regulatory obligation to set rates designed to maintain a market-to-book ratio significantly above one.”^{150/} Thus, Mr. Parcell’s selection of a reasonable range of 9.0%-10.0%

^{147/} Gorman, Exh. No.__(MPG-44T) at 4:11-5:2.

^{148/} Parcell, Exh. No.__(DCP-1T) at 25:14-16.

^{149/} Id. at 18:13-14,

^{150/} Id. at 24:1-2.

based on his CE analysis is, frankly, arbitrary. He could have just as easily selected a range of 8.3% to 9.3% and achieved similarly adequate market-to-book ratios.

45 The Commission, therefore, should reject Mr. Parcell's CE analysis as a means of establishing a reasonable ROE for PSE. To the extent it should be used at all, that is only as a cross-check for determining whether ROE results from the other models (DCF, CAPM, and RP) produce adequate market-to-book ratios. As Mr. Parcell's testimony shows, an ROE of 9.3% is more than adequate to accomplish this task.^{151/}

b. *Mr. Parcell's high-end DCF analyses are overstated.*

46 Mr. Parcell selects 9.1%-9.7% as a reasonable ROE range for PSE based on his DCF analysis.^{152/} This range represents the highest results his DCF studies produced.^{153/} Mr. Parcell testifies that he focuses on the high end of his range in order to be conservative in his estimates.^{154/} Yet, in his desire to be conservative, Mr. Parcell ignores his own principles for conducting a DCF analysis. Mr. Parcell testifies that "it is evident that no single indicator of growth is always used by all investors. It therefore is necessary to consider alternative indicators of dividend growth in deriving the growth component of the DCF model."^{155/} Yet, while Mr. Parcell nominally adheres to this principle by using five different growth rates in his DCF study, his ultimate recommended range of 9.1%-9.7% is based almost exclusively on *just one growth rate*, First Call EPS.^{156/}

^{151/} Id. at 25:9-13.

^{152/} Id. at 27:15.

^{153/} Id. at 17:14-16.

^{154/} Id. at 18:13-14.

^{155/} Id. at 16:7-9.

^{156/} Exh. No. (DCP-7) at 4-5. Two of Mr. Parcell's 42 DCF results include historic per share growth rates that produce ROEs within his recommended range. Otherwise, all results between 9.1% and 9.7% come from his First Call EPS growth rate.

47

His two highest results (9.6%-9.7%) are particular outliers. Mr. Parcell's DCF analyses produced 42 different ROE results for PSE based on iterations of different growth rates and dividend yields applied to three different proxy companies.^{157/} Of these results, precisely two establish an ROE for PSE between 9.6% and 9.7%.^{158/} Every other result is at least 20 basis points lower, and the vast majority is at least a full percentage point lower.^{159/} In fact, as Mr. Parcell notes, the simple average of all of his results is between 8.3% and 8.6%, also a full percentage point, or more, lower than his highest results.^{160/}

48

Mr. Parcell derives his highest results by applying the highest assumed dividend yields to the highest assumed growth rates in his model.^{161/} These growth rates in particular should be questioned because they are 30-40 basis points higher than the highest long-term GDP growth rate projected in early 2013 (5.0%).^{162/} As noted above, the projected long-term GDP growth rate is a reasonable proxy for utility stock growth rates because a utility cannot grow at a faster rate than the economy in which it sells its goods and services.^{163/} Accordingly, Mr. Parcell's most "conservative" DCF results do not reflect reasonable estimates of PSE's ROE. Indeed, Mr. Parcell himself testifies that "[h]ad I emphasized mean/median values [from his DCF results], *as other analysts might reasonably have done*, my recommended cost of equity for PSE would have been lower."^{164/}

^{157/} Exh. No.__(DCP-7) at 4-5.

^{158/} Id. at 4.

^{159/} Id. at 4-5.

^{160/} Parcell, Exh. No.__(DCP-1T) at 17:14-16.

^{161/} Exh. No.__(DCP-7) at 4-5.

^{162/} Exh. No.__(MPG-3) at 19:12-13.

^{163/} Gorman, Exh. No.__(MPG-25T) at 16:21-24.

^{164/} Exh. No.__(DCP-1T) at 18:14-15 (emphasis added).

c. *Mr. Parcell's decision to select the mid-point of his ROE range is unsupported.*

49 While Mr. Parcell makes questionable decisions in selecting his range of reasonable ROEs for PSE from his high-end DCF and CE analyses, he also fails to justify his decision to recommend an ROE for PSE at the mid-point of this range, 9.5%. This decision is particularly perplexing given his testimony in other proceedings.

50 For instance, in his testimony in PacifiCorp's currently pending general rate case, he recommended an ROE at the lowest point of his range because: (1) PacifiCorp has above average debt ratings; (2) his DCF and CE analyses focused on the highest results; and (3) the possible implementation of a power cost adjustment mechanism ("PCAM") for PacifiCorp.^{165/} These circumstances all apply to PSE as well.

51 In this case, while PSE's 2013 debt ratings were one notch below PacifiCorp's, according to Standard & Poor's,^{166/} Mr. Parcell still finds them to be "at or above [] the most common rating categories of most electric utilities in early 2013."^{167/} Additionally, as he did in his PacifiCorp testimony, Mr. Parcell selects the high end of his DCF and CE ranges to establish an ROE range for PSE.^{168/} If this was a justification for Mr. Parcell to select the low end of the range in his PacifiCorp testimony, it is unclear why it should be irrelevant here. With respect to PacifiCorp's potential PCAM, Mr. Parcell testified at the PacifiCorp hearing that this was relevant to his decision to recommend an ROE at the lowest end of his range because "it was

^{165/} Exh. No.__(DCP-21CX) at 13:1-6.

^{166/} Compare id. at 11:6 with Parcell, Exh. No.__(DCP-1T) at 9:21.

^{167/} Parcell, Exh. No.__(DCP-1T) at 10:1-2. Moreover, it is worth noting that PSE's long-term issuer ratings have been upgraded since the period covered in Mr. Parcell's testimony, largely due to the Commission's approval of decoupling and the rate plan. Exh. No.__(DCP-18CX).

^{168/} Compare Exh. No.__(DCP-21CX) at 13:4 with Parcell, Exh. No.__(DCP-1T) at 18:13-14.

something new” for the utility.^{169/} Of course, as Mr. Parcell agrees, PSE’s decoupling mechanism and rate plan were also “something new” for the Company in the original phase of this proceeding,^{170/} mechanisms that are at least as risk-mitigating in their effects as a PCAM given that they essentially guarantee a certain revenue level for the Company. That Mr. Parcell did not analyze the effects of these new mechanisms on the Company’s ROE is no reason to dismiss those effects. Rather, it indicates that Mr. Parcell was not as thorough in his analysis in this proceeding as he was in PacifiCorp’s rate case, which should go to the weight the Commission gives to his testimony in general.^{171/}

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Lastly, in his PacifiCorp testimony, Mr. Parcell noted his low CAPM results as further evidence that the utility’s ROE should be established at the lowest end of his range.^{172/} He gave two reasons for taking these results into account. First was that “risk premiums are lower currently than was the case in prior years,” which is “reflective of a decline in investor expectations of equity returns”^{173/} Second, he testified that “the level of interest rates on U.S. Treasury bonds ... has been lower in recent years,” which “also impacts investor expectations of return in a negative fashion.”^{174/} Crucially, these are not PacifiCorp-specific observations. They apply to the economy generally. Moreover, they are not endemic to the time period Mr. Parcell analyzed in his PacifiCorp testimony. He made *exactly the same* observations in his Delmarva

^{169/} Exh. No.__(DCP-19CX) at 22:7-8.

^{170/} Parcell, Tr. 597:7-23

^{171/} This conclusion is further bolstered by the fact that Mr. Parcell undertook no analysis of the general economic conditions that prevailed in early 2013, despite regularly testifying that such economic conditions are “important in determining the cost of capital for a public utility.” Ex. No.__(DCP-21CX) at 2:11-13.

^{172/} Exh. No.__(DCP-21CX) at 13:8-14:3.

^{173/} Id. at 13:11-13.

^{174/} Id. at 13:13-16.

testimony analyzing nearly the same period he analyzes for PSE in this case.^{175/} Thus, Mr. Parcell testified in this case that these economic conditions, and the associated investor expectations, were “true in 2013, and it’s true today.”^{176/} Indeed, Mr. Parcell’s CAPM results are even lower in this case than they were in his PacifiCorp testimony.^{177/} Yet, without any explanation, Mr. Parcell ignores entirely these results in recommending an ROE for PSE.

53 Mr. Parcell’s decision to recommend an ROE for PSE at the mid-point of his range is simply not credible. He does not justify this decision at any point in his testimony, and it is contradicted by all of the factors that he has considered in other cases when recommending an ROE. A reasonable ROE for PSE is, as Mr. Gorman testifies, 9.3%, which also is included within the low end of Mr. Parcell’s range. To the extent the Commission should consider Mr. Parcell’s recommendation of a 9.5% ROE for the Company, this should establish the upper bound of the range of reasonableness.

4. An objective measure of PSE’s early 2013 cost of equity indicates 9.3% is reasonable and 9.8% is unreasonable.

54 The Commission has, in the past, noted the opacity and subjectivity of the various ROE analyses performed by cost of capital experts.^{178/} It is perhaps helpful, therefore, to consider an objective analysis that takes account of all of the experts’ assumptions and data. At the hearing in this proceeding, the cost of capital experts generally agreed that the early 2013 period should be the primary focus in this case.^{179/} Because the DCF analysis is the “most

^{175/} Exh. No. __ (DCP-20CX) at 10:5-10; Parcell, Tr. 593:1-6.

^{176/} Parcell, Tr. 594:1-8.

^{177/} Mr. Parcell developed a range of 7.2%-7.4% from his CAPM analysis for PacifiCorp, which compares to a range of 6.5%-6.8% for PSE.

^{178/} WUTC v. PSE, Docket Nos. UE-090704/UG-090705, Order 11 ¶¶ 290-93 (Apr. 2, 2010).

^{179/} Morin, Hill, Parcell, Gorman, Tr. 649:19-652:13.

widely accepted approach” for determining a utility’s cost of equity,^{180/} the Commission can determine a reasonable ROE for PSE by comparing the experts’ early 2013 DCF analyses on an apples-to-apples basis.

55 As Commissioner Jones recognized at the hearing, the selection of proxy companies is critical to the results derived from a DCF study.^{181/} Although Mr. Gorman generally uses the group of proxy companies selected by the utility’s cost-of-capital witness, with appropriate exclusions, he did not do that for his 2013 DCF study in this case because PSE did not put on a cost of capital case in the original proceeding.^{182/} Accordingly, Mr. Gorman and Dr. Morin apply their 2013 DCF analyses to different proxy groups. Nevertheless, 13 companies overlap Mr. Gorman’s and Dr. Morin’s 2013 proxy groups.^{183/} In PSE’s last rate case, the Commission adopted a 9.8% ROE for PSE based primarily DCF analyses that relied on a proxy group of nine companies.^{184/} Accordingly, a proxy group comprised of the 13 companies that overlap Mr. Gorman’s and Dr. Morin’s 2013 DCF studies is sufficient to generate a reasonable ROE for PSE.

56 If one applies the dividend yields and growth rates assumed in Mr. Gorman’s 2013 constant growth analyses to these 13 companies, they generate ROE results for PSE between 8.48% and 9.06%, or an average ROE of 8.77%.^{185/} If one applies the dividend yields and growth rates assumed in Dr. Morin’s analyses to these 13 companies, they generate ROE

^{180/} Docket No. UE-130043, Order 05 ¶¶ 44.

^{181/} Comm’r Jones, Tr. 663:9-15.

^{182/} Compare Exh. Nos.__(MPG-10) & (MPG-13) with Exh. Nos.__(RAM-4) & (RAM-5).

^{183/} These companies are: (1) Alliant Energy Corporation; (2) Avista Corporation; (3) CMS Energy Corporation; (4) Consolidated Edison, Inc.; (5) DTE Energy Company; (6) Integrys Energy Group, Inc.; (7) Northeast Utilities; (8) NorthWestern Corporation; (9) PG&E Corporation; (10) TECO Energy, Inc.; (11) UIL Holdings Corporation; (12) Wisconsin Energy Corporation; and (13) Xcel Energy, Inc.

^{184/} Docket Nos. UE-111048/UG-111049, Order 08 ¶¶ 66-67, 89.

^{185/} Exh. Nos.__(MPG-10) & (MPG-13).

results for PSE between 9.36% and 9.96%, or an average ROE of 9.66%.^{186/} *The average of Mr. Gorman's and Dr. Morin's results is 9.22%*, slightly below Mr. Gorman's recommended ROE of 9.3%.^{187/} Moreover, applying Mr. Gorman's 2013 multi-stage DCF analysis to these 13 proxy companies, it shows an ROE for PSE of 9.14%.^{188/} Finally, if one includes Mr. Parcell's constant growth DCF analysis in this exercise, applied to the same proxy group, it generates an ROE for PSE of 9.1%.^{189/} *The average ROE from all three experts' constant growth DCF studies is 9.18%.*^{190/}

57 This number represents the average of constant growth DCF studies performed by cost of capital experts for three different parties in this proceeding applied to the same proxy group. It incorporates five different dividend yield assumptions and nine different growth rate assumptions.^{191/} Notably, the average growth rate for this proxy group, applied to all of Mr. Gorman's and Dr. Morin's assumed growth rates, is 4.77%,^{192/} which is within *The Blue Chip Economic Indicators'* long-term GDP growth rate projections from both early 2013 and late 2014.^{193/} A consistent, comprehensive, and objective DCF analysis for PSE in early 2013, therefore, establishes that a 9.3% ROE for the Company is reasonable, and 9.8% is unreasonable.

^{186/} Exh. Nos.__(RAM-4) & (RAM-5).

^{187/} (8.77% + 9.66%) / 2.

^{188/} Exh. No.__(MPG-15).

^{189/} Exh. No.__(DCP-7) at 4 (using "Composite – Mean" row of Gorman Proxy Group; applying the same analysis to Mr. Parcell's assumptions in Morin Proxy Group on page 5 of the exhibit yields a "Composite – Mean" of 9.0%).

^{190/} (8.77% + 9.66% + 9.1%) / 3. Excluding Mr. Hill's lower DCF results from this exercise arguably makes the results conservatively high.

^{191/} Both Mr. Gorman and Dr. Morin used two different yield and growth assumptions for each of their 2013 constant growth analyses; Mr. Parcell used one yield assumption and 5 different growth assumptions for his 2013 constant growth analysis. Exh. Nos.__(MPG-10), (MPG-13), (RAM-4), (RAM-5), (DCP-7) at 4-5.

^{192/} Mr. Gorman's average growth rates for the consensus proxy group are 4.8% and 4.24%; Dr. Morin's average growth rates are 4.74% and 5.31%. Exh. Nos.__(MPG-10), (MPG-13), (RAM-4), (RAM-5).

^{193/} Exh. No.__(MPG-3) at 19:12-13; Gorman, Exh. No.__(MPG-25T) at 16:24-26.

This exercise also demonstrates that Mr. Parcell’s recommended 9.5% ROE, far from being the midpoint of the range of reasonableness, lies, at best, at the upper end of this range.

5. A 9.3% ROE applied to PSE’s current capital structure is sufficient to maintain the Company’s financial integrity.

58 Mr. Gorman shows that a 9.3% ROE is sufficient to place the financial risk profile of PSE’s regulated operations well within Standard & Poor’s “intermediate” category.^{194/} This is above PSE’s current “significant” financial risk profile, which itself is higher than the “aggressive” financial risk profile of most utilities.^{195/} Furthermore, Mr. Parcell’s CE analysis demonstrates that a 9.3% ROE is sufficient to maintain a market-to-book ratio over 120% – well above the requisite 100%.^{196/} Accordingly, a 9.3% ROE is sufficient to maintain the financial integrity of PSE’s regulated operations.

59 PSE’s witness, Mr. Doyle, recommends that if the Commission reduces PSE’s ROE in this proceeding it should increase the equity in its allowed capital structure to maintain the same overall rate of return (“ROR”) it was awarded in Order 07: 7.77%.^{197/} Mr. Doyle’s rationale for this recommendation is that this rate of return “should maintain PSE’s financial profile and ability to raise capital during the remainder of the rate plan.”^{198/} Mr. Doyle provides no support for what this ROR “should” do and, in fact, his true rationale for arguing that the Commission should maintain this ROR appears to be that it was a necessary component of the Company’s willingness to agree to the rate plan.^{199/} Simply put, this justification has nothing to

^{194/} Gorman, Exh. No.__(MPG-25T) at 39:7-16.

^{195/} Id. at 37:10-13.

^{196/} Parcell, Exh. No.__(DCP-1T) at 25:5-19.

^{197/} Doyle, Exh. No.__(DAD-4T) at 14:25-28.

^{198/} Id. at 14:28-15:2.

^{199/} Id. at 14:18-22, 15:2-4.

do with the Commission’s statutory obligation to set “just, fair, reasonable and sufficient” rates.^{200/}

60 In addition to ensuring PSE’s regulated operations would be well positioned within S&P’s financial metrics, Mr. Gorman’s recommended 9.3% ROE, in conjunction with PSE’s currently authorized capital structure, would yield an overall ROR of 7.53%.^{201/} This would *still* be the highest ROR for any electric utility in the State.^{202/} There is no merit to Mr. Doyle’s unsubstantiated suggestion that a 7.77% ROR is necessary for PSE to maintain its financial integrity.

C. PSE-specific rate mechanisms are relevant in developing an ROE that is commensurate with returns in enterprises having corresponding risk.

61 Both Staff and PSE have urged the Commission to disregard any ROE impact of PSE-specific rate mechanisms, like decoupling, because, as Mr. Schooley testifies, “any potential effect from decoupling on ROE is never mentioned in the Order on Review or Judge Murphy’s letter ruling”^{203/} What is mentioned in the Court’s Order, however, is a directive to the Commission to establish a reasonable ROE for PSE based on substantial evidence in the record, with PSE carrying the burden of proof.^{204/} The Commission has chosen to comply with the Court’s Order by undertaking a full evaluation of PSE’s ROE: “As in the context of a general

^{200/} RCW § 80.28.010(1).

^{201/} Doyle, Exh. No.__(DAD-4T) at 10 (table 1) (replacing 9.8% with 9.3%).

^{202/} PacifiCorp currently operates with a 9.5% ROE and a 7.36% overall rate of return. Docket No. UE-130043, Order 05 ¶ 73. Avista Corp.’s last rate case was settled without establishing a specific ROE, but the settlement provided for an overall rate of return of 7.32% for certain purposes. Docket Nos. UE-140188/UG-140189, Order 05 ¶¶ 52-53 (Nov. 25, 2014). This return is less than its previously authorized return of 7.64%, which included a 9.8% ROE. Docket Nos. UE-120436/UG-120437, Order 09 ¶ 32 (Dec. 26, 2012). In that decision, the Commission stated that “[i]f this case had been litigated, we may very well have decided that an ROE of less than 9.8 would be warranted Part of our motivation for setting the 2014 rate increase as temporary is our anticipation of revisiting the appropriate level of ROE, if [Avista] files a new general rate case in the early part of 2014.” *Id.* ¶ 74.

^{203/} Schooley, Exh. No.__(TES-6T) at 3:12-13; see also, Doyle, Exh. No.__(DAD-4T) at 6:4-6.

^{204/} Court Order at 2-3.

rate proceeding, the Commission will consider *all relevant evidence* admitted on the question of return on equity, weigh the evidence, determine a range of reasonable returns, and set a return on equity that falls within that range.”^{205/}

62 The Commission’s task in establishing an ROE for PSE is to effectuate the age-old Supreme Court pronouncements in Bluefield Water Works, Hope Natural Gas, and Permian Basin Area Rate Cases.^{206/} As Dr. Morin has distilled these decisions:

[The] Commission’s decision should be to allow PSE the opportunity to earn a return on equity that is: (i) commensurate with returns on investments in other firms having corresponding risks; (ii) sufficient to assure confidence in PSE’s financial integrity; and (iii) sufficient to maintain PSE’s creditworthiness and ability to attract capital on reasonable terms.^{207/}

This is generally consistent with how the Commission has previously observed its task in establishing an ROE for PSE: “the Commission establishes a reasonable range for allowed equity return vis-à-vis what would be expected for businesses of *comparable risk*. Once a reasonable range is determined, the Commission considers additional factors affecting the balance between maintenance of the Company’s financial integrity and strength, and cost to ratepayers.”^{208/}

63 The reason decoupling and other risk-mitigating mechanisms are often considered to impact the cost of capital for a utility, therefore, is because they make the utility less risky relative to its counterparts, and a utility is supposed to have an ROE that is similar to enterprises

^{205/} Order 10 ¶ 25 (emphasis added).

^{206/} Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm’n, 262 U.S. 679, 692 (1923); Hope, 320 U.S. at 603; Permian Basin Area Rate Cases, 390 U.S. 747, 791-92 (1968).

^{207/} Morin, Exh. No.__(RAM-1T) at 5:27-6:6.

^{208/} Docket Nos. UE-111048/UG-111049, Order 08 ¶ 37 (emphasis added).

with *corresponding* risks.^{209/} Because PSE is not publicly traded, its cost of equity must be estimated by reference to a proxy group of companies comparable to PSE.^{210/} Therefore, to the extent the proxy group does not have risk-mitigating regulatory mechanisms like decoupling, a rate plan, a k-factor, or others that would impute such risk-mitigation into the market-derived cost of equity, those mechanisms should be factors in determining an ROE for PSE that is comparable to enterprises with corresponding risk.

64 Thus, the notion that PSE-specific risk-mitigating mechanisms are irrelevant to a determination of a reasonable ROE for the Company simply because the Court did not specifically order such an evaluation is without merit. Every cost of capital witness in this proceeding is aligned on the idea that decoupling is, in Dr. Morin’s words, a “risk-mitigating mechanism[.]”^{211/} Indeed, although they did not consider decoupling in this case, in prior proceedings both Mr. Parcell and Dr. Morin recognized significant risk-mitigating impacts from decoupling. Mr. Parcell has testified that implementation of a decoupling mechanism “would have the effect of reducing the common equity risk to approximately that of the cost of debt.”^{212/} Meanwhile, Dr. Morin has testified that “a gesture like approval of [decoupling] *would precipitate an avalanche* in a sense, over the next several years of [rating] upgrades, one notch at

^{209/} Hope, 320 U.S. at 603; see also, Docket No. UE-100749, Order 07 ¶ 27 (“[r]isk, of course, is one factor that affects the cost of equity because, generally speaking, as risk increases so does the rate an investor requires to undertake that risk”); WUTC v. PSE, Docket Nos. UE-040640/UG-040641, UE-031471, UE-032043, Order 06 ¶ 53 n. 69 (Feb. 18, 2005) (“[i]t is axiomatic that investors in lower risk companies tend to require less return than do investors who seek out higher risk companies”).

^{210/} Docket Nos. UE-111048/UG-111049, Order 08 ¶ 66.

^{211/} Morin, Exh. No.__(RAM-16T) at 29:8-9; Morin, Tr. 686:8-12.

^{212/} Exh. No.__(SGH-23CX) at 4:15-16.

a time, provided that the other pieces of the equation, for example, the ROE and the allowed capital structure, would be fair and reasonable as well.”^{213/}

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The question for the Commission, therefore, is not whether decoupling and other risk-mitigating mechanisms are within the scope of this proceeding, it is whether the ROE impact from these mechanisms has already been accounted for in the market cost of equity derived from the proxy groups. Dismissing the effects of such mechanisms based on relevancy grounds would be contrary to the testimony of every cost of capital expert in this case, and contrary to the legal requirements for establishing a regulated utility’s equity return.

1. PSE’s currently authorized 9.8% ROE is not a return commensurate with enterprises having corresponding risk.

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PSE was awarded its current 9.8% ROE before it implemented full decoupling and the rate plan. Over a period of consistently low capital costs, this fact alone should indicate that a 9.8% ROE does not account for the reduced risk the Company enjoys today relative to 2012. As Mr. Gorman testified, “if [PSE], regardless of what was going on in the industry, didn’t have a decoupling mechanism at the time the 9.8 percent return on equity was found to be appropriate for its risk at that time, that 9.8 [] is no longer reasonable if regulatory mechanisms have reduced their operating risk since that time. And that’s what’s happened.”^{214/} Mr. Gorman testified that his recommended 9.3% ROE, which he originally proposed contemporaneously, and with knowledge of, the Commission’s consideration of decoupling and the rate plan, does reflect PSE’s current risk.^{215/} His 2014 ROE study confirms these findings.

^{213/} Exh. No.__(RAM-24CX) at 8 ¶ 28 (emphasis added).

^{214/} Gorman, Tr. 667:11-16.

^{215/} Gorman, Tr. 661:7-15, 666:23-668:19.

67 PSE's change in circumstance relative to 2012, therefore, undercuts Dr. Morin's argument that, while rate mechanisms like decoupling reduce risk, that risk is already accounted for in the market-derived cost of equity for PSE and merely offsets increased risks PSE faces. Dr. Morin supports his argument through generalities that do not hold up under a close examination of the evidence.

68 Dr. Morin testifies that the "approval of adjustment clauses, ROE incentives riders, trackers, forward test years, and cost recovery mechanisms by regulatory commissions is widespread in the utility business and is already largely embedded in financial data."^{216/} This may be true. Certainly PSE has many such mechanisms, including a power cost adjustment mechanism, a power cost only rate case, numerous deferrals and regulatory assets, and an automatic storm damage deferral.^{217/} But, unlike other utilities, it has decoupling and a multi-year rate plan with fixed automatic rate increases in addition to these.

69 Meanwhile, the "risks" PSE faces that Dr. Morin claims offset the risk reduction the Company enjoys from decoupling and the rate plan are the Company's requirement to comply with a renewable portfolio standard ("RPS"), declining sales due to energy efficiency, a sluggish economy, and a capital investment program to replace aging infrastructure.^{218/} Needless to say, not only are these examples of "risks" that are common in the utility industry, much of the risk associated with them is, at least in Washington, borne by customers. Washington utilities,

^{216/} Morin, Exh. No.__(RAM-16T) at 29:13-16.

^{217/} Comm'r Jones, Tr. 665:11-18.

^{218/} Morin, Tr. 583:11-23, 666:8-12.

for instance, are statutorily allowed to recover their full costs of RPS compliance and energy efficiency from customers.^{219/}

70 The evidence in this case shows that PSE faces risks that are common in the utility industry and the risk reduction it enjoys from decoupling and the rate plan is decidedly uncommon. Indeed, an examination of Dr. Morin’s proxy group used to derive the cost of equity for PSE demonstrates that the Company is unique in its enjoyment of this combination of all of these mechanisms.

71 In exhibits attached to his testimony, Dr. Vilbert lists, among other things, holding companies in Dr. Morin’s proxy group that have a full decoupling mechanism with a true-up comparable to PSE’s, and a “multi-year revenue cap possibly with [revenue adjustment mechanism (“RAM”)],^{220/} which is comparable to PSE’s rate plan.^{221/}

72 Among the holding companies Dr. Vilbert lists as having utility subsidiaries with a full decoupling mechanism with revenue true-up are Avista Corp., CenterPoint Energy, Integrys Energy, and Vectren Corp.^{222/} With respect to Integrys Energy, the Wisconsin Public Service Commission discontinued the decoupling mechanism in place for the company’s electric and gas subsidiary, Wisconsin Public Service Corporation (“WPSC”), at the end of 2013. In that decision, the Wisconsin Public Service Commission found:

WPSC has not offered ratepayers anything in return for the risk reduction that the utility would realize if the [decoupling mechanisms] were continued The Commission is also persuaded by the unwillingness of [the Citizens’ Utility Board] and [Wisconsin Industrial Energy Group], representatives of the

^{219/} RCW § 19.285.050(2).

^{220/} Exh. Nos.__(MJV-15) and (MJV-16).

^{221/} Exh. No.__(MJV-49CX).

^{222/} Exh. No.__(MJV-15).

customer classes who are primarily affected by continuation of the [decoupling mechanisms], to continue to embrace the decoupling pilot.^{223/}

Regarding Avista, CenterPoint, and Vectren, the only utility subsidiaries that were fully decoupled during the study period in this case were gas subsidiaries.^{224/} While this may relate to the risk of PSE's gas business relative to its gas counterparts, it is difficult to understand how it would impact the risk embedded in PSE's electric operations. In fact, Vectren's combination gas and electric subsidiary, Southern Indiana Gas and Electric Company ("Vectren South"), requested a full decoupling mechanism for its electric operations and was denied by the Indiana Utility Regulatory Commission ("IURC").^{225/} The IURC found that "a decoupling mechanism is not well suited for use by a vertically integrated fully regulated electric utility," and that "Vectren South's decoupling proposal would allow the Company to recover revenues for reductions in energy consumption that were not caused by its conservation efforts."^{226/}

73 Furthermore, Dr. Vilbert's study merely counts the number of holding companies that have a utility subsidiary with decoupling; it makes no effort to determine how much of the holding companies' revenues are impacted by decoupling.^{227/} For instance, Duke Energy has a utility subsidiary with a full decoupling mechanism, so Dr. Vilbert counts the entire holding company. That utility subsidiary, however, is Duke Energy Ohio, a utility that makes up a mere 13% of the holding company's operating revenues.^{228/} Northeast Utilities offers another example. Its fully decoupled utility subsidiary is Western Massachusetts Electric Company,

^{223/} Exh. No.__(MJV-43CX) at 8.

^{224/} Vilbert, Tr. 727:24-730:18; Exh. Nos.__(MJV-40CX), (MJV-41CX).

^{225/} Exh. No.__(MJV-42CX).

^{226/} Id. at 12.

^{227/} Vilbert, Tr. 727:5-8.

^{228/} Exh. No.__(MJV-50CX) at 2 (row 20); Exh. No.__(MJV-44CX) at 2, 5 (showing total revenues for Duke Energy of \$24.6 billion and revenues from Duke Energy Ohio of \$3.2 billion).

which comprises only 6.5% of the holding company's operating revenues.^{229/} Thus, the percentage of total revenues in Dr. Morin's proxy group that are affected by a full decoupling mechanism is far less than the number of holding companies that have an electric utility subsidiary with such a mechanism.

74 Finally, PSE transitions from unusual to unique in terms of risk-mitigation when the rate plan is considered. Dr. Vilbert shows that there are four holding companies in Dr. Morin's proxy group that have a utility subsidiary with a mechanism similar to the rate plan.^{230/} Only two of Dr. Morin's proxy group holding companies have both a full decoupling mechanism and a rate plan among their utility subsidiaries: Duke Energy and Northeast Utilities.^{231/} However, in both of these holding companies, the utility subsidiary that has full decoupling is not the same subsidiary that has a rate plan.^{232/} Consequently, *not a single utility subsidiary of any holding company in Dr. Morin's proxy group has both a full decoupling mechanism and a multi-year rate plan, as PSE does.* Dr. Morin's assertion, then, that PSE-specific risk-mitigating mechanisms are already reflected in the capital market data from his proxy group is contradicted by the evidence, and consequently, his recommended ROE of 9.8% does not reflect the return investors would expect in investments having corresponding risk.

^{229/} Exh. No.__(MJV-50CX) at 1 (row 11); Exh. No.__(MJV-45CX) at 2, 5 (showing total revenues for Northeast Utilities of \$7.3 billion and revenues from Western Massachusetts Electric Company of \$473 million).

^{230/} Id. Note that NV Energy was removed from this list in a revised version of MJV-16.

^{231/} Compare Exh. No.__(MJV-15) with Exh. No.__(MJV-16).

^{232/} Exh. No.__(MJV-50CX) identifies Duke Energy Ohio and Western Massachusetts Electric as the utility subsidiaries of Duke Energy and Northeast Utilities, respectively, that have full decoupling. Exh. No.__(MJV-49CX) identifies Progress Energy Florida and Public Service Company of New Hampshire as the utility subsidiaries of Duke Energy and Northeast Utilities, respectively, that have "multi-year revenue cap possibly with RAM."

2. The Brattle studies are flawed, but nevertheless, do more to support the idea that decoupling reduces the cost of capital than vice versa.

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There is universal agreement of the cost-of-capital experts in this case that the PSE-specific rate-mechanisms the Commission approved in Order 07 – and decoupling in particular – are “risk-mitigating,” and the evidence shows that such risk-mitigation is not reflected in the market-derived cost of equity that supports a 9.8% ROE. This should be sufficient, under the Hope standard, to account for such risk-mitigating mechanisms in establishing an ROE for the Company. Nevertheless, PSE and Staff continue to maintain in this phase of the proceeding that the Commission should not reduce the Company’s ROE to account for decoupling unless and until decoupling’s effect on the ROE is demonstrated through “empirical evidence,” whatever that is supposed to mean.^{233/}

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NWEC’s witness, Ralph Cavanaugh, provides the justification for requiring such “empirical evidence” when he testifies that the Commission should be “demanding” in its search for evidence of decoupling’s impact on the ROE before including with this mechanism “an automatic upfront penalty for PSE.”^{234/} To be clear, the only ones being penalized in the current situation are customers who are forced to pay investors in the State’s least risky electric utility its highest return.^{235/} Indeed, one of the great ironies of decoupling is its proponents’ willingness to spend significant time and resources attempting to disprove the otherwise self-evident proposition that this mechanism reduces a utility’s risk, and therefore, should reduce the allowed

^{233/} These parties do not, of course, argue that the Company’s ROE itself should be demonstrated as reasonable through “empirical evidence,” as a reasonable ROE must be “estimated.” Docket Nos. UE-111048/UG-111049, Order 08 ¶ 58.

^{234/} Cavanaugh, Exh. No. __ (RCC-6T) at 2:16.

^{235/} Supra n. 202.

equity return, while simultaneously being willing to assume, without any evidence, that decoupling increases energy efficiency simply because it removes the throughput incentive.^{236/}

77 For its part, Staff appears to be at a loss as to what “empirical evidence” of decoupling’s impact on the cost of capital would look like.^{237/} Meanwhile, PSE has proffered the testimony and studies of Dr. Vilbert of the Brattle Group (the “Brattle studies”) in an apparent attempt to demonstrate that there is empirical evidence that decoupling does not reduce the cost of capital.^{238/} In fact, these studies do no such thing, and do more to *support* the argument that decoupling reduces the cost of capital than vice versa.

78 The Brattle studies are those included in a “published report” from March 20, 2014, and an update to those results through the second quarter of 2014.^{239/} To determine the impact of decoupling on the cost of capital, Dr. Vilbert first estimated the cost of capital for each sample company using a DCF analysis, then performed a regression analysis, which included a number of assumptions and variables and was intended to isolate the impact of what he terms the “decoupling index variable.”^{240/} Thus, fundamentally, it is difficult to understand how the Brattle studies could be characterized as the type of “empirical evidence” the Commission

^{236/} In discovery, Dr. Vilbert noted that he is “not aware of any published, multi-state, empirical studies on the relationship between decoupling and the size and effectiveness of energy efficiency programs.” Exh. No.__(MJV-48CX) at 2. In fact, the only study evaluating the effectiveness of decoupling that Dr. Vilbert appears to be aware of anywhere in the country is one from 2011 on Cascade Natural Gas’ decoupling mechanism in this State, which the Commission required be performed. This study found that decoupling worked as intended based on nothing more than the fact that Cascade met its energy efficiency goals during the pilot period. Id. at 29-32.

^{237/} Exh. No.__(TES-9CX).

^{238/} Vilbert, Exh. No.__(MJV-1T).

^{239/} Id. at 23:12-16.

^{240/} Id. at 24:11-27:22.

referred to in Order 07 when they are based on cost of capital *estimates* and subject to a number of other assumptions.^{241/}

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Furthermore, the Brattle studies' selection of its "null hypothesis" has the effect of essentially shifting the burden of proving a decoupling impact from PSE to other parties.^{242/} By allegedly attempting to discern whether decoupling lowers the cost of capital, the studies begin with the hypothesis that "there is no negative impact of decoupling" on the cost of capital.^{243/} While Dr. Vilbert characterizes this as a "neutral" hypothesis,^{244/} ICNU's and Public Counsel's witness, Dr. Christopher Adolph, demonstrates that it is anything but that.^{245/} This is because the Brattle studies use a "one-tailed test," which is, by definition, not neutral.^{246/} Under the Brattle Group's framework, one would have to be able to reject the studies' hypothesis with 95% confidence in order to conclude that decoupling does negatively impact the cost of capital.^{247/} On the other hand, if the Brattle Group started with the hypothesis that there *is* a negative impact of decoupling, Dr. Vilbert's conclusion would be very different. While his conclusion in this case is that the "statistical results do not reject the neutral hypothesis that there is no impact on the cost of capital from adoption of decoupling,"^{248/} if Dr. Vilbert's "neutral" hypothesis were reversed, his conclusion would presumably be that the statistical results do not disprove the "neutral" hypothesis that decoupling does negatively impact the cost of capital. In

^{241/} Order 07 ¶ 104.

^{242/} Adolph, Exh. No.__(CAA-1T) at 23:10-14.

^{243/} Vilbert, Exh. No.__(MJV-1T) at 27:20.

^{244/} Id. at 28:2-3.

^{245/} Adolph, Exh. No.__(CAA-1T) at 22:15-24:2.

^{246/} Id. at 11:7-12. In a one-tailed test, the hypothesis goes in either one direction or the other, rather than selecting a specific value, as a two-tailed test does.

^{247/} Vilbert, Exh. No.__(MJV-1T) at 27:20-22.

^{248/} Id. at 28:2-3.

other words, Dr. Vilbert has “stack[ed] the deck in favor of [his] preferred conclusion by making that preferred conclusion the null hypothesis.”^{249/}

80 Importantly, while the use of a one-tailed hypothesis necessarily creates an asymmetrical burden of proof,^{250/} the results of its application in this case unambiguously favor the conclusion that decoupling negatively impacts the ROE. Under Dr. Vilbert’s formulation of the study, the results demonstrate that decoupling *does* reduce the cost of capital, between 25 and 49 basis points, if one is willing to accept a confidence level of between 83% and 93%.^{251/} This result is consistent across every study the Brattle Group performed – “the estimated effect of decoupling is *always negative*.”^{252/} If, however, Dr. Vilbert had used the opposite hypothesis – that decoupling does negatively impact the cost of capital – he could disprove this hypothesis with confidence levels ranging only between 7% and 17%.^{253/}

81 PSE’s witness, Dr. Jeffrey Dubin, criticizes Dr. Adolph because he believes “Dr. Adolph’s primary argument is that Dr. Vilbert should have used different statistical procedures” and reached a different conclusion.^{254/} Dr. Dubin, however, proceeds upon a fundamental misreading of Dr. Adolph’s testimony. Rather than advocating for a particular confidence level or a particular conclusion, the overarching lesson to be drawn from Dr. Adolph’s testimony is that the Commission can reach its own determination about what, if anything, the Brattle studies show. While Dr. Vilbert insists on a 95% confidence level before drawing conclusions from

^{249/} Adolph, Exh. No.__(CAA-1T) at 23:11-12.

^{250/} Id. at 11:9-12.

^{251/} Id. at 9:19-10:3, 30:7-19

^{252/} Id. at 30:3-4 (emphasis in original).

^{253/} Id. at 29 (figure 4).

^{254/} Dubin, Exh. No.__(JAD-1T) at 5:7-11.

these studies, Dr. Adolph shows that this is not statistically required.^{255/} The Sixth Circuit Court of Appeals, for instance, has stated that, while the confidence interval percentage is frequently “set at 95 percent, [] that value is somewhat arbitrary and 85 to 90 percent figures are also used.”^{256/} Notably, both Dr. Adolph and Dr. Dubin agree that “[t]here is nothing sacred about a 95% confidence level.”^{257/} Thus, Dr. Adolph’s testimony is not that, as Dr. Dubin misstates, the Commission should interpret the Brattle studies one way or the other, just that it is not *necessary* to interpret them as Dr. Vilbert does.

82 Importantly, depending on what level of statistical confidence the Commission is willing to apply, the Brattle studies support one of only two conclusions: (1) decoupling reduces the cost of capital; or (2) one cannot conclude with sufficient confidence that decoupling reduces the cost of capital.^{258/} Under no circumstance do the Brattle studies demonstrate that decoupling does *not* reduce the cost of capital.^{259/} Dr. Dubin does not disagree with this.^{260/}

83 The problem with requiring “empirical evidence” of decoupling’s impact on the cost of capital before adjusting the ROE is that there is no consensus – or even an idea – of what such evidence would look like. As noted above, the Brattle studies are flawed in significant ways. Future attempts to provide empirical evidence of decoupling’s impact on the ROE are likely to run into similar disputes from one party or another about its reliability. Presumably, PSE is happy to continue this paradigm for as long as possible. Meanwhile, customers are left holding the bag.

^{255/} Adolph, Exh. No.__(CAA-1T) at 21:14-22:12.

^{256/} Turpin v. Merrel Dow Pharmaceuticals, Inc., 959 F.2d 1349, 1353 n. 1 (6th Cir. 1992).

^{257/} Dubin, Exh. No.__(JAD-1T) at 14:3; Adolph, Exh. No.__(CAA-1T) at 21:10-13.

^{258/} Adolph, Exh. No.__(CAA-1T) at 6:17-8:15.

^{259/} Id. at 8:9-10.

^{260/} Dubin, Exh. No.__(JAD-1T) at 16:19-17:13 (arguing only that Commission should use a 95% confidence level).

D. The Commission should refund to customers excess amounts PSE has collected, and continues to collect, under its illegal rates.

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Because PSE has operated with an unlawfully high ROE, which has contributed to unlawfully high rates since the date Order 07 became effective, the Commission should order PSE to refund all amounts that have been collected, and continue to be collected, in excess of amounts necessary for it to be allowed to earn a reasonable ROE since the start of the rate plan.

In Order 11 in these dockets, the Commission made clear that:

It will best preserve the parties' and the Commission's resources to phase these proceedings. There is no need for parties to develop evidence concerning the impact of possible outcomes [regarding PSE's ROE]. Such analyses should be performed and presented, if appropriate, once the outcome of this initial phase is known. The Commission will set a schedule for any subsequent phase of these proceedings as necessary.^{261/}

In accordance with Order 11, ICNU reserves until such later proceeding any arguments necessary to support a Commission determination to order refunds to customers that have paid, and continue to pay, illegally high rates.

IV. CONCLUSION

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For the foregoing reasons, the Commission should set PSE's ROE for the full term of the Company's rate plan at 9.3%, and in no circumstance should PSE's ROE be higher than 9.5%. PSE should be ordered to refund to customers amounts it has collected in excess of amounts it would have collected with a reasonable ROE in place since Order 07 took effect.

^{261/} Order 11 ¶ 17 (Oct. 24, 2014).

Dated in Portland, Oregon, this 6th day of March, 2015.

Respectfully submitted,

DAVISON VAN CLEVE, P.C.



Melinda J. Davison

Tyler C. Pepple

333 S.W. Taylor, Suite 400

Portland, Oregon 97204

(503) 241-7242 telephone

(503) 241-8160 facsimile

mjd@dvclaw.com

tcp@dvclaw.com

Of Attorneys for Industrial Customers
of Northwest Utilities