**EXHIBIT NO. \_\_\_(SLL-1T)  
DOCKET NO. UE-132027  
WITNESS:  STANFORD L. LEVIN**

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

|  |  |  |
| --- | --- | --- |
| **In the Matter of the Petition of**  **PUGET SOUND ENERGY, INC.**  **For an Accounting Order Approving the Allocation of Proceeds of the Sale of Certain Assets to Public Utility District #1 of Jefferson County.** |  | **Docket No. UE-132027** |

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF  
STANFORD L. LEVIN**

**ON BEHALF OF PUGET SOUND ENERGY, INC**

**APRIL 22, 2014**

****PUGET SOUND ENERGY, INC.****

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF  
STANFORD L. LEVIN

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****PUGET SOUND ENERGY, INC.****

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# I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Stanford L. Levin. I am Emeritus Professor of Economics at Southern Illinois University Edwardsville and President of The Resource Group, Inc., an economic consulting company in St. Louis. My business address is 133 S. 11th Street, Suite 500, St. Louis, Missouri, 63102.

Q. Please describe your qualifications.

A. I am an economist with over 40 years of experience both teaching and consulting. I have a B.A. in economics from Grinnell College and an M.A. and Ph.D. in economics from the University of Michigan. I have taught economics at Southern Illinois University Edwardsville and at other universities in the U. S. and abroad. From 1984-86, I served as a Commissioner on the Illinois Commerce Commission, the utility regulatory agency in Illinois. I have consulted for electric, natural gas, and telecommunications companies as well as regulatory agencies in the U. S. and abroad. Currently, in addition to Puget Sound Energy, Inc., I am consulting for the Alberta (Canada) Utilities Commission, the British Columbia (Canada) Utilities Commission, and TELUS, a Canadian telecommunications company. Please see Exhibit No. \_\_\_(SLL-2) for a summary of my education, experience, and qualifications.

Q. For whom are you testifying in this case?

A. I am testifying for Puget Sound Energy, Inc. (“PSE”).

Q. What is the purpose of your testimony?

A. I have been asked to review and respond to the following testimony in this proceeding:

(i) the Prefiled Testimony of Mr. Edward J. Keating, Exhibit No. \_\_\_(EJK-1T), on behalf of the Staff of the Washington Utilities and Transportation Commission (“Staff”);

(ii) the Prefiled Direct Testimony of Mr. James R. Dittmer, Exhibit No. JRD-1T, on behalf of the Public Counsel Section of the Washington Attorney General’s Office (“Public Counsel”); and

(iii) the Prefiled Response Testimony of Mr. Michael P. Gorman, Exhibit No. \_\_\_(MPG-1T), on behalf of the Industrial Customers of Northwest Utilities (“ICNU”).

Q. Please summarize your testimony.

A. The proposals made by Staff, the Public Counsel, and ICNU for the allocation of the proceeds from the sale of assets to the Jefferson County Public Utility District violate the regulatory compact and are, in fact, a confiscation of proceeds that belong to investors. Staff, the Public Counsel, and ICNU do not accurately state the function of depreciation, which is compensation to investors for the using up and decrease in the book value of the assets that investors own, and they confuse the risk associated with the provision of electric service with the risk of owning the assets. Because the remaining customers are not harmed as a result of the asset sale, all of the proceeds should be allocated to investors. In this context, PSE’s offer to allocate 25% of the gain on the sale to customers is a substantial offer that the Commission should accept.

# II. OVERVIEW OF THE REGULATORY COMPACT

Q. Do you agree with Public Counsel’s description of the regulatory compact?[[1]](#footnote-1)

A. Generally, I agree with Public Counsel’s description of the regulatory compact. Put simply, a privately owned company agrees to regulation of its rates and other terms and conditions of service in exchange for certain protections from the regulator. The most important aspects of regulation in this context are that the regulator sets prices and the company has an obligation to serve. In exchange, the regulator generally establishes a monopoly for the company in the service territory and promises the company’s stockholders the opportunity to earn a return on their investment that is comparable to what they might earn in an alternative, similar investment.

Q. Why is this regulatory compact important in this proceeding to determine the allocation of the proceeds from the asset sale?

A. There are, in my opinion, two reasons why the regulatory compact is important in this proceeding. One is that the regulatory compact provides a framework for determining the allocation of the proceeds from the asset sale. The other is that breaking or violating the regulatory compact in this case would have negative consequences for all customers of Washington utilities and for all stockholders in Washington utilities.

Q. How does the regulatory compact provide guidance for allocating the proceeds of the asset sale?

A. The regulatory compact is between investors in a privately owned utility and the regulator. Investors own the utility and its assets. In exchange, investors receive an opportunity to earn a competitive return, often referred to as a normal or allowed rate of return. Any allocation of the proceeds of an asset sale must be consistent with the regulatory compact. If the allocation confiscated proceeds belonging to stockholders or impaired the stockholders from having an opportunity to earn the allowed rate of return, it would contravene the regulatory compact.

Q. If a regulatory body were not to honor the regulatory compact in determining the allocation of the proceeds from the asset sale, what would be the consequences?

A. If investors believe that the Commission is not honoring the regulatory compact and that current stockholders did not have an opportunity to earn the allowed rate of return or had their assets confiscated, they would demand a higher return in order to invest in any regulated utility in Washington. This would increase costs and prices for all customers of Washington utilities. Even though each individual price increase might be small, the total for all Washington utility customers could be substantial.

# III. THE ALLOCATIONS PROPOSED BY STAFF, PUBLIC COUNSEL, AND ICNU VIOLATE THE REGULATORY COMPACT

Q. Can you summarize the proposals to allocate the proceeds from the asset sale provided by Staff, Public Counsel and ICNU?

A. Yes, Table 1 below summarizes the proposals of the responding parties to allocate the proceeds from the asset sale.

**Table 1. Summary of Parties’ Proposals to  
Allocate the Proceeds from the Asset Sale**

|  |  |  |  |
| --- | --- | --- | --- |
| **Party** | **Allocation to Investors** | **Allocation to Customers** | **Total Proceeds from Asset Sale** |
| Staff | $56,597,473 | $52,775,723 | $109,373,196 |
| Public Counsel | $52,407,099 | $56,966,097 | $109,373,196 |
| ICNU | $52,411,441 | $56,961,755 | $109,373,196 |

In each instance, the proposed allocation would return 100% of the net book value to investors and would allocate 100% of accumulated depreciation to customers. The responding parties have differing views regarding the allocation of the balance of the proceeds, and these differing views account for the relatively modest differences in actual dollars among these proposals.

Q. Can you summarize the proposals to allocate the net gain on sale provided by Staff, Public Counsel and ICNU?

A. Yes. The net gain on the sale of the Jefferson County assets is $59,864,313. This is documented in the testimony of Matthew R. Marcelia. Table 2 below provides a summary of the responding parties’ proposals to allocate the net gain on the sale of the Jefferson County assets:

**Table 2. Summary of Parties’ Proposals to  
Allocate Net Gain On Sale**

|  |  |  |  |
| --- | --- | --- | --- |
| **Party** | **Allocation to Investors** | **Allocation to Customers** | **Total Gain Sale[[2]](#footnote-2)** |
| Staff | $7,506,394 | $52,457,919 | $59,964,313 |
| Public Counsel | $2,998,216 | $56,966,097 | $59,964,313 |
| ICNU | $3,002,558 | $56,961,755 | $59,964,313 |

While there are some differing views among the responding parties regarding the allocation of the gain in actual dollars, these are small differences. The responding parties are therefore aligned in proposing that the vast majority of the gain realized on the sale of the Jefferson County assets be allocated to customers as opposed to the owner of these assets, the investors.

Q. What is your opinion of the allocations proposed by Staff, Public Counsel, and ICNU?

A. The Commission should reject the allocations proposed by Staff, Public Counsel, and ICNU because they violate the regulatory compact. The allocations proposed by Staff, Public Counsel, and ICNU demonstrate that the parties misunderstand accumulated depreciation and the risk that customers have borne regarding PSE’s assets. Moreover, there are no objective criteria to evaluate the allocations proposed by Staff, Public Counsel, and ICNU because they are arbitrary.

# IV. ANY RETURN TO CUSTOMERS OF ACCUMULATED DEPRECIATION WOULD BE A CONFISCATION OF PROCEEDS THAT RIGHTLY BELONG TO INVESTORS

Q. How do the allocations proposed by Staff, Public Counsel, and ICNU misunderstand accumulated depreciation?

A. Any customer of any business, whether regulated or not, pays a price that includes depreciation on the assets required to produce the good or service. In the context of an electric utility, customers pay for electricity that they purchase, and part of this payment is for depreciation to compensate the owners of the asset (i.e., the investors) for the decline in the book value of the asset. Once customers make this payment to the owners of the asset for its decline in book value, customers no longer have a claim on this payment. If owners sell any of these assets, customers do not receive a refund of the accumulated depreciation that they have paid.

Accumulated depreciation for the assets sold in this case represents money that PSE investors received in the past to compensate them for the decline in book value of the assets. In the context of regulated utilities, investors receive a return on and a return of their investment, and depreciation is the return of their investment.

Q. Do you agree with Staff’s characterization that PSE’s proposal “has the effect of compensating shareholders twice for their initial investment, once through depreciation expense already included in rates, and again by the allocation of accumulated depreciation to shareholders”?[[3]](#footnote-3)

A. No. Staff’s claim that PSE’s proposal “has the effect of compensating shareholders twice for their initial investment” is incorrect. Staff’s proposal for the allocation of the proceeds from the sale, as well as the proposals of Public Counsel and ICNU, have the effect of not compensating investors at all for the accumulated depreciation, denying them the recovery of their investment and breaking the regulatory compact. If the Commission were to take proceeds equivalent to accumulated depreciation from the proceeds that belong to investors and allocate those proceeds to customers, then investors, rather than being compensated twice for depreciation, would not be compensated at all. Such an allocation would mean that customers would have purchased electricity without paying for the depreciation of the assets that produced and delivered this electricity. Investors will have been denied the return of their investment. Any return to customers of accumulated depreciation would be a confiscation of proceeds that rightly belong to investors and would be a clear violation of the regulatory compact.

# V. THE STAFF, PUBLIC COUNSEL, AND ICNU PROPOSALS WOULD INADEQUATELY COMPENSATE PSE INVESTORS FOR THE RISK OF OWNING THE ASSETS

Q. Do you agree with Staff’s assertion that “(t)he Risk-Reward principles states that reward should follow risk. In other words, the reward should be provided to the entity that assumes the risk . . .”?[[4]](#footnote-4)

A. Yes. As a general observation, I agree that reward should follow risk and that the reward should be provided to the entity that assumes the risk. Staff, however, fundamentally misunderstands who bears the risk associated with the ownership of PSE’s assets. Indeed, Staff’s proposal actually violates the risk-reward principle that it espouses.

Q. How does Staff fundamentally misunderstand the risk associated with the ownership of PSE’s assets?

A. In order to understand the risk associated with the ownership of PSE’s assets, or any assets involved in the production of a good or service, it is necessary to separate risk into two components: 1) risk associated with doing business, and 2) risk associated with the ownership of the assets.

Q. What is the risk associated with doing business?

A. The operation of any business, including an electricity business like PSE’s, involves some risk. Assets may be damaged in a storm, assets may need to be repaired, there may be vandalism, and there can be any other number of unforeseen events. Businesses must be compensated for this risk, though, or they would not be able to remain in business because they would not earn an adequate return comparable to equivalent opportunities, what economists call a normal profit. Businesses either (i) purchase insurance so that they know with more certainty what their cost will be and set their prices to recover the cost of the insurance, or (ii) they make an estimate of the risk and include the expected cost of the risk in their prices. In either case, the price is set high enough to cover this risk, which is just another cost of doing business.

Q. How do regulated utilities such as PSE recover this risk?

A. Regulators have a great deal of control over how regulated utilities recover this risk. Typically, utilities carry some insurance. At the same time, utilities may not insure some risks but recover the costs of those risks through rates when those costs occur. Regulators in this case have made either an explicit or an implicit decision that customers are better off paying for such costs as they occur rather than paying for insurance premiums or paying a higher price to include the expected cost of these anticipated events as would be the case in a competitive market. In any case, though, customers do and should pay for this cost of business.

It is important to understand in the context of this asset sale that this does not mean that customers have done any more than pay for another cost of doing business. Customers have not accepted any risk associated with the ownership of the assets, and they do not have any claim on any profit from the sale of these assets under the regulatory compact.

Q. Does ICNU also confuse the types of risk when it suggests that customers bear risk?[[5]](#footnote-5)

A. Yes. In suggesting that customers bear risk, ICNU confuses the risk of doing business with the risk of owning an asset. ICNU uses the example of customers paying for the cost of natural disasters, but, as explained above, this does not mean that customers have an ownership interest in the assets and are entitled to share in any gain from their sale.

Q. What is the risk associated with the ownership of assets?

A. The value of assets may change in unforeseen ways. This might be due to various market conditions, including technology. This risk of ownership falls onto the investors, and any gain or loss accrues to them. That is why, in the case of the asset sale by PSE, the regulatory compact requires that the net gains from the sale (i.e., any proceeds remaining above net book value and transaction costs) belong to investors. Customers have not borne the risk of owning the assets; therefore, they have no claim on the proceeds.

Q. What does Staff’s home loan analogy demonstrate?[[6]](#footnote-6)

A. Staff’s home loan analogy clearly demonstrates that the proceeds from the sale of PSE’s assets belong to the investors. The homeowner in its analogy is the person who buys the house, and the bank has simply made a loan to the owner using the house as collateral. In the case of a sale for more than the remaining balance due on the loan, the bank must be paid for the remaining balance on the loan, but the owner, i.e., the homeowner, keeps all of the gain from the sale. This is exactly the position of PSE’s investors. They are the owners of the assets, and they are entitled to keep all of the gain from the sale. Anyone who has loaned money to the investors, such as bondholders, does not share in any gains from the sale, just as in Staff’s example, the bank holding the mortgage does not share in any gain from the sale.

Q. What if the house were rented?

A. Adding a renter to this analogy makes the example even clearer. Suppose the homeowner had rented out his house for a number of years and then sold it at a profit. The renter does not share in the gain, and the renter does not have any claim to a refund of a portion of his rent to recover the amount that he paid to cover the homeowner’s accumulated depreciation expense. All of the gain, over any amount owed to the bank for a mortgage, would accrue to the homeowner. The renter would have no claim on any profit and no claim to any refund of rent.

Customers are like renters. They pay for the use of the electric facilities when they buy electricity, much as the renter pays for the use of the house including all of the homeowner’s expenses. However, the house belongs to the homeowner, who captures all of the gain from the sale, and the utility assets belong to the investors who similarly are entitled to all of the gain from the asset sale.

Q. How does this relate to rate-base rate-of-return regulation discussed by Staff?

A. If the Commission denies investors the net gain of the asset sale, the regulatory compact is broken. Additionally, the denial of the net gain to investors is contrary to rate-base rate-of-return regulation. Investors would be denied a return of their investment, and they would be denied the appreciation on the assets resulting from their ownership. In this regard, Staff mischaracterizes rate-base rate-of-return regulation when it states that its proposal is consistent with such regulation.[[7]](#footnote-7) It is not. It is inconsistent with rate-base rate-of-return regulation and violates the regulatory compact.

Q. Is Staff’s correct in its argument that PSE’s proposal for the allocation of the proceeds from the asset sale would lower its risk profile?[[8]](#footnote-8)

A. No. Staff’s argument that PSE’s proposal for the allocation of the proceeds from the asset sale would lower its risk profile is incorrect. Staff’s proposal, by breaking the regulatory compact, would raise the risk profile for PSE and for all other utilities regulated by the Commission. PSE’s proposal, on the other hand, by being consistent with the regulatory compact, would maintain PSE’s risk profile.

Q. Is ICNU correct in its conclusion that “[t]he risks PSE faces from this transaction are nothing more than risks inherent in the utility business for which PSE is compensated through its return on equity and overall rate of return?”[[9]](#footnote-9)

A. No. ICNU is incorrect that the risks PSE faces from this transaction are nothing more than risks inherent in the utility business for which PSE is compensated through its return on equity and overall rate of return. As discussed above, the Staff, Public Counsel, and ICNU proposals for allocating the proceeds of the asset sale would violate the regulatory compact and are inconsistent with the ownership of the assets and the concept of risk and reward. Therefore, the Staff, Public Counsel, and ICNU proposals would inadequately compensate PSE investors for the risk of owning the assets.

# VI. REMAINING PSE CUSTOMERS HAVE NOT BEEN AND WILL NOT BE HARMED BY THE ASSET SALE

Q. How would any harm to remaining customers affect your analysis of the allocation of the proceeds of the asset sale consistent with the regulatory compact?

A. If remaining customers were harmed as a result of the asset sale, then it might be appropriate to compensate them out of any gain from the sale. In this case, though, the evidence that I have seen shows that the remaining PSE customers are not and will not be harmed by the asset sale. These issues are addressed, in detail, by Mr. Piliaris, in his direct testimony and in rebuttal to the responding parties.

Q. Why do you say that the remaining PSE customers are not and will not be harmed by the asset sale?

A. The remaining PSE customers are not and will not be harmed by the asset sale because the harm, if any, to the remaining customers from the recovery of fixed delivery system costs is more than offset by their benefits from power cost savings.

Q. Please explain the issue of fixed cost recovery.

A. To the extent that they exist at all, PSE will have to recover remaining fixed delivery system costs previously allocated to former PSE customers that are now customers of Public Utility District No. 1 of Jefferson County from PSE’s remaining customers. In theory, the correct way to quantify the effect of any remaining fixed costs would be to calculate the net present value of the fixed costs over a typical utility planning horizon (e.g., twenty years). For a regulated utility, it is common to use the allowed rate of return as the discount rate.

Q. If fixed costs are so quantified, can they be meaningfully compared to benefits?

A. Yes. The most conservative approach would be to calculate the net present value of the least favorable (highest) estimate of the fixed costs theoretically transferred to the remaining customers and compare that to the least favorable (lowest) estimate of the net present value of the benefits theoretically transferred to the remaining customers. Such a comparison would be an indication of whether the remaining customers have been harmed or benefited by this transaction.

Q. Have you undertaken such an assessment of these costs and benefits?

A. Yes, although I have relied on the testimony of other witnesses to quantify costs and benefits, and there is disagreement among the witnesses as to what constitutes the least favorable estimate of such costs and benefits. I have not attempted to resolve these differences.

As a point of reference for the least favorable estimate of benefits, I refer to Mr. Piliaris' assessment of significant power cost benefit. Specifically, I refer to Exhibit No. \_\_\_(JAP-14), which takes Public Counsel's conservative assumptions regarding projected PSE’s PCA fixed cost rate and makes corrections for certain load growth issues raised by Staff, and then calculates the net power cost benefit over the 20 year forecast horizon. So calculated, the net benefit to customers is approximately $79 million.[[10]](#footnote-10)

Similarly, a point of reference for the least favorable estimate of costs can also be derived from Mr. Piliaris' rebuttal testimony. While not agreeing with Public Counsel, Mr. Piliaris makes reference to Public Counsel's reliance on a $3.2 million increase in delivery costs allegedly incurred by PSE’s remaining customers as a result of this transaction. If the net present value of this number is used as a basis for comparison, it can then be compared to the power cost benefit referenced above to provide an indication of whether the remaining customers have been harmed or benefited by this transaction.[[11]](#footnote-11) Using PSE’s authorized rate of return of 7.77 percent, the net present value of the $3.2 million cost over the same twenty year period is approximately $32 million

The resulting comparison is a net benefit of approximately $47 million.[[12]](#footnote-12) This suggests that remaining customers have not been harmed but will in fact benefit, from this transaction.

# VII. CONCLUSION

Q. What is your recommendation to the Commission?

A. The Commission should allocate all of the net gain of the asset sale to PSE’s investors. Any other allocation of the proceeds contravenes the regulatory compact and would raise the risk for PSE’s investors and, indeed, for all other stockholders of utilities regulated by the Commission. The consequence of this would be to raise prices for the customers of these utilities. Nonetheless, PSE has made a substantial offer to share 25% of the net gain of the asset sale with customers, and the Commission should adopt the PSE proposal.

Furthermore, in allocating the gains of the sale, the Commission should acknowledge the consequences of the allocation on PSE and other companies to negotiate the best possible price for an asset sale. If some of the proceeds are confiscated from investors, it certainly dulls a company’s incentives to negotiate the most favorable possible sale price. In addition, the Commission should take into account that this was, in effect, a forced sale, even though PSE was able to negotiate a sale price.

Q. Does this conclude your rebuttal testimony?

A. Yes.

1. *See* Exhibit No. JRD-1T at 6:24-8:2. [↑](#footnote-ref-1)
2. Please note that the $59,964,313 is the net gain initially calculated by Mr. Marcelia in his direct testimony, and was the number available to the responding parties when they prepared their testimony. Mr. Marcelia has subsequently revised his calculation to reflect a $100,000 post closing adjustment to the purchase price, such that the net gain on sale is $59,864,313. [↑](#footnote-ref-2)
3. Exhibit No. \_\_\_(EJK-1T) at 12:9-11. [↑](#footnote-ref-3)
4. Exhibit No. \_\_\_(EJK-1T) at 13:17-18. [↑](#footnote-ref-4)
5. *See, e.g.*, Exhibit No. \_\_\_(MPG-1T) at 13:13-14:5. [↑](#footnote-ref-5)
6. *See* Exhibit No. \_\_\_(EJK-1T) at 12:13-23. [↑](#footnote-ref-6)
7. *See id.* at 13:2-12. [↑](#footnote-ref-7)
8. *See id.* at 17:16-18:3. [↑](#footnote-ref-8)
9. Exhibit No. \_\_\_(MPG-1T) at 11:8-10. [↑](#footnote-ref-9)
10. *See,* Exhibit No. \_\_\_(JAP-9T) at 20:3-5. [↑](#footnote-ref-10)
11. *See id.* at 27-28. [↑](#footnote-ref-11)
12. Even if Public Counsel's initial calculation of the power cost benefit ($58 million) is not adjusted, as proposed by Mr. Piliaris, to reflect the load growth issues raised by Staff, there is still a positive net benefit of $26 million. [↑](#footnote-ref-12)