BEFORE THE WASHINGTON

UTILITIES & TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

COMPLAINANT

V.

AVISTA CORPORATION, d/b/a AVISTA UTILITIES,

RESPONDENT

DOCKETS UE-150204 and UG-150205 (*Consolidated*)

DONN M. RAMAS ON BEHALF OF PUBLIC COUNSEL

EXHIBIT DMR-37

Brief of Respondent WUTC in Court of Appeals, 48982-1-II

September 13, 2019

NO. 48982-1-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

THE WASHINGTON STATE ATTORNEY GENERAL'S OFFICE, PUBLIC COUNSEL UNIT, Appellant,

v.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Respondent,

and

AVISTA CORPORATION d/b/a AVISTA UTILITIES, Intervenor-Respondent.

BRIEF OF RESPONDENT WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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I. INTRODUCTION

The Washington Utilities and Transportation Commission has a statutory duty to "secure for the public safe, adequate, and sufficient utility services at just, fair, reasonable, and sufficient rates." *People's Org. for Wash. Energy Res. v. Utils. & Transp. Comm'n*, 104 Wn.2d 798, 808, 711 P.2d 319 (1985); *see* RCW 80.01.040(3); RCW 80.28.010.

In this ratemaking case, the Commission executed its duty by reducing customer rates for Avista Utilities' electric service, and by increasing customer rates slightly for its natural gas service. The end result struck a fair balance between ratepayer and investor interests by allowing Avista to earn no more revenue than necessary to recover reasonable operating expenses and to pay investors a fair return on capital contributed toward the safe and reliable operation of the utility's system.

Economic regulatory agencies, like the Commission, have broad discretion to select appropriate methods when setting rates. Here, the Commission employed a method known as an "attrition adjustment" to forestall Avista's anticipated revenue shortfall. Public Counsel contends that the adjustment was the wrong method for this case. But "[u]nder the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. It is not theory but the impact of the rate order which counts." *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320

U.S. 591, 602, 64 S. Ct. 281, 88 L. Ed. 333 (1944). Here, the Commission had discretion to employ an attrition adjustment, as opposed to the more conventional methodology favored by Public Counsel.

Public Counsel also alleges that the Commission committed a "calculation error" when incorporating Avista's post-hearing "power cost update" into its final rate calculation. The Commission believes it would be beneficial to reopen the administrative record to clarify its decision on this issue. The Commission respectfully requests that this Court affirm the Commission's use of an attrition adjustment but remand for the limited purpose of reevaluating the implementation of Avista's power cost update.

II. RESTATEMENT OF THE ISSUES

From the Commission's perspective, the issues pertaining to Public Counsel's assignments of error are:

1.a Whether RCW 80.04.250(1)'s requirement that rate base assets be "used and useful" for service in Washington prohibits the Commission from calculating the value of a utility's rate base, for ratemaking purposes, by projecting capital spending during the rate-effective period based on historical trends (Assignment of Error 1);

1.b Whether this Court should review Issue 1.a after Public Counsel failed to raise it at the administrative level (Assignment of Error 1). *See* RCW 34.05.554.

2. Whether the Commission had discretion to set electric rates using an "attrition adjustment" in response to evidence that Avista will earn insufficient revenue during the rate-effective period to pay its investors a fair return (Assignments of Error 2 and 3).

3. Whether this Court should remand for the limited purpose of reopening the administrative record to clarify the proper implementation of Avista's post-hearing "power cost update" (Assignments of Error 4 and 5).

III. RESTATEMENT OF THE FACTS

A. Avista Sought Permission to Increase its Electric and Natural Gas Rates

In the ratemaking case below, Avista sought permission to increase electric rates by 6.7 percent (yielding $33.2 million in annual revenue beyond its authorized annual revenue of approximately $500 million) and to raise natural gas rates by 6.9 percent (yielding $12 million in annual revenue beyond its authorized annual revenue of approximately $170 million). AR 686, 772, 3835. As permitted by RCW 80.04.130(1), the Commission suspended the proposal for ten months to allow time for study, settlement negotiations, and public engagement. AR 691.

The parties reached a partial settlement before the evidentiary hearing. All parties agreed that Avista's investors should have the opportunity to earn an average return of 7.29 percent—a slight decrease

from the utility's previously approved rate of return. AR 693, 773. The parties also agreed that, two months before the new rates would take effect, Avista would provide an update of the utility's costs to procure electricity and natural gas for delivery to customers (i.e., a "power cost update"). AR 693, 789. The utility's operating expenses are a key variable in the Commission's basic ratemaking equation.

B. The Parties' Dispute Focused on the Method for Valuing Avista's "Rate Base"

The parties litigated the remaining issues. A major unresolved issue was the value of Avista's "rate base." The rate base is the utility's total investment in property used to provide electric or natural gas service. *People's Org. for Wash. Energy Res. v. Utils. & Transp. Comm'n*, 101 Wn.2d 425, 427, 679 P.2d 922 (1984) (*POWER 84*).[1] In a ratemaking case, the Commission must empower the utility to collect enough revenue from ratepayers to pay the utility's investors a fair return. *People's Org. for Wash. Energy Res. v. Utils. & Transp. Comm'n*, 104 Wn.2d 798, 810-11, 711 P.2d 319, 327 (1985) (*POWER 85*). The return is calculated by multiplying the Commission-authorized average rate of return (7.29 percent according to the partial settlement in this case) by the value of the utility's rate base.

[1] As noted by Public Counsel in its opening brief, the Washington Supreme Court decided two *POWER* cases in the 1980s. This brief follows Public Counsel's naming convention by referring to each case respectively as *POWER 84 and POWER 85*.

Rate base can be valued in a variety of ways. The Commission traditionally looks backward to the utility's actual level of investment during a historical "test year." AR 701. The test year may be updated to reflect significant post-test-year investments. AR 701, 3819. This approach is known as "modified historical test year" ratemaking. *Id.* A key assumption is that test-year relationships between revenue, operating expenses, and rate base will hold during the rate-effective period, thereby making the historical test year an accurate representation, or prediction, of the prospective period. AR 371-72.

In this case, the Commission Staff presented evidence that modified historical test year ratemaking would not yield just, fair, reasonable, and sufficient rates. Staff presented testimony that test-year relationships among revenue, operating expenses, and rate base were unlikely to hold during the rate-effective period. AR 3817, 3824-25, 3836; Tr. 436; *see* AR 3129. In particular, Staff established that Avista's revenue requirement calculated using a modified historical test year approach would not cover the average rate of return (7.29 percent) that all parties agreed should be available to Avista's investors. AR 3836.

Staff's Regulatory Analyst, Chris McGuire, identified the primary driver of Avista's anticipated revenue shortfall: "low load growth" (i.e., weaker-than-anticipated customer demand) set against a backdrop of

aggressive investment in utility infrastructure. AR 3824, 3826; *see* AR 297, 712, 1483; Tr. 438, 446-47. Stated differently, McGuire perceived that Avista was experiencing "earnings attrition" (an erosion in revenue growth) during a cycle of rapid rate base expansion (investment in utility infrastructure, including replacement of aging facilities).

To remedy the shortfall, Staff proposed a ratemaking tool known as an "attrition adjustment." AR 626, 3836. As the Commission later explained:

> [A]ttrition occurs when the test-period relationship between rate base, expenses and revenues does not hold under conditions in the rate effective period, such that a utility's expenses or rate base grows more quickly than revenues, and a utility would likely have no reasonable opportunity to earn its allowed rate of return. *An attrition adjustment is a discrete adjustment to the modified historical test year that the Commission may use when it determines attrition is present.*

AR 703-04 (Final Order 05) (emphasis added). Public Counsel agreed that an attrition adjustment "is one among several possible responses the Commission could make to address a demonstrated trend of under-earning due to circumstances beyond the Company's ability to control." AR 371 (internal quotation omitted).

McGuire calculated the attrition adjustment by performing a regression analysis. He used historical data to forecast Avista's investment in rate base during the prospective rate-effective period. AR 624, 722, 727,

3877-88. The goal was to capture trends in capital spending that were likely to develop between the historical test year and the rate-effective period—trends that might be neglected using the traditional modified historical test year approach. AR 3825. McGuire explained, "An attrition study is an acceptable basis upon which to calculate rates since historical data provide evidence of how fundamental ratemaking relationships are likely to behave over limited future time periods." AR 3825. Avista's Vice President of State and Federal Regulation similarly testified, "Through the attrition analysis, changes in rate base, operating expenses and revenues between the historical test period and the prospective rate year are all captured in the analysis, and provide for a matching during the prospective rate period." AR 1592 (testimony of Kelly O. Norwood).

By projecting rate base and operating expense levels through the rate-effective period, rather than relying exclusively on values derived using the modified historical test year approach, Staff determined that Avista should *reduce* its annual electric revenue by $6.5 million and increase its annual natural gas revenue by $10.3 million. AR 3816.

Public Counsel was skeptical that Avista was, in fact, suffering from earnings attrition. AR 368, 370-71. Its chief witness, Donna Ramas, asserted, "Avista is not experiencing the earnings attrition that it alleges in

its case." AR 6016. Ms. Ramas was convinced that Avista's equity investors (shareholders) were making too much money. AR 6016, 6031.

Public Counsel also questioned whether Staff's "trend analysis" was a reliable ratemaking tool. *E.g.*, AR 373. But Public Counsel offered absolutely nothing to counter Staff's calculations. *See* AR 1143. At the close of the adjudication, Staff observed, "No Party can or does legitimately dispute that regressions confirmed by correlation calculations are a credible, well-recognized statistical methodology for measuring historical data and issuing projections." AR 623. The mathematical underpinning of McGuire's regression analysis is undisputed in this appeal.

Despite acknowledging that an attrition adjustment is "among several responses" the Commission could make to forestall Avista's anticipated revenue shortfall, Public Counsel insisted that the Commission set rates using the modified historical test year approach. AR 370-71. Using a modified historical test year, it calculated that Avista should incur a drastic $29.7 million reduction in annual electric revenue, and that natural gas revenue should increase by only $3.3 million annually. AR 368.

After considering other parties' positions and the state of the post-hearing evidentiary record, Avista elected to reduce its rate request from $33.2 million to $3.6 million for its electric operation and from $12 million to $10 million for its natural gas operation. AR 290. One agent of change

was Avista's power cost update, which the utility agreed to provide under the partial settlement discussed above. The power cost update showed that Avista would save approximately $12 million due to a reduction in average natural gas and electricity market prices. AR 277.

C. The Commission Ultimately Set Rates Using a Modified Version of Staff's Attrition Study

When the evidentiary record closed, the Commission was faced with wildly divergent revenue requirement proposals.

Table 1: Final revenue requirement proposals

Party	Electric	Natural Gas	Citation
Avista	$3.6 million[2]	$10 million	AR 290
Staff	($6.5 million)[3]	$10.3 million	AR 3816
ICNU[4]	($24.8 million)	No proposal	AR 436
NWIGU[5]	No proposal	$6.7 million	AR 6776
Public Counsel	($29.7 million)	$3.3 million	AR 368

The Commission was required to apply its expertise and exercise its discretion to determine a just, fair, reasonable, and sufficient result.

The Commission found that a modified version of Staff's attrition proposal struck the proper balance. AR 726. Its primary modification

[2] As discussed above, Avista initially proposed to increase annual electric revenue by $33.2 million and to increase annual natural gas revenue by $12 million. AR 686.

[3] Parentheses indicate a negative number (i.e., a reduction in annual revenue).

[4] Industrial Customers of Northwest Utilities, an industry advocacy organization.

[5] Northwest Industrial Gas Users, another industry advocacy organization.

related to Staff's analysis of the growth trend for "distribution plant," a category of rate base. AR 736. It agreed that the trend existed but, citing its policy requiring utilities to "demonstrate persuasively that the attrition occurring is outside their control," exercised its discretion to disregard the trend. AR 728. It explained, "[Avista] has not met its burden to show that its proposed investments [in distribution plant] are based on circumstances beyond its control." AR 736. The Commission retained all other growth trends largely as proposed by Staff.

The Commission ultimately concluded that Avista should reduce its annual electric revenue by $8.1 million and increase its annual natural gas revenue by $10.8 million. AR 731, 737. This rate decision was comfortably within the range of alternatives presented by the parties.

Table 2: Commission's Final Decision Compared to Parties' Proposals

Party	Electric	Natural Gas[6]	Citation
Avista	$3.6 million	$10 million	AR 290
Staff	($6.5 million)	$10.3 million	AR 3816
Commission	**($8.1 million)**	**$10.8 million**	**AR 731**
ICNU	($24.8 million)	No proposal	AR 436
NWIGU	No proposal	$6.7 million	AR 6776
Public Counsel	($29.7 million)	$3.3 million	AR 368

[6] As this Court reads through the Commission's response brief, it is important to bear in mind that Public Counsel makes only one assignment of error (Assignment of Error 1) related to the final **natural gas** revenue requirement ($10.8 million). Public Counsel's claim is statutory and, as discussed below in Section IV.C.1., the Commission asserts that the issue is not properly before this Court. Public Counsel's remaining assignments of error (Assignments of Error 2-5) all relate to the Commission's final **electric** revenue requirement (negative $8.1 million). *See* Br. of Appellant at 3 ("The second and third errors [Assignments of Error 2-5] apply only to electric rates.").

Newly approved rates remain in effect until modified in a subsequent Commission order. Avista told the Commission that it intends to seek new rates "every year for the next five years." AR 737. With annual ratemaking cases on the horizon, the "rate-effective period" for the electric and natural gas rates approved below is a one-year period that roughly spans the 2016 calendar year.[7]

IV. ARGUMENT

A. Judicial Review of Ratemaking Cases Favors the Agency

An appellate court has three basic duties when reviewing the Commission's ratemaking decisions. First, it "'must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority.'" *POWER 85*, 104 Wn.2d at 811 (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92, 20 L. Ed. 2d 312, 88 S. Ct. 1344 (1968)). Next, the court considers whether "each of the order's essential elements is supported by substantial evidence." *Id.* Finally, the court considers whether the decision "may reasonably be expected to maintain financial integrity, attract

[7] Avista filed its subsequent rate case, as planned, in February 2016. It sought new rates effective in January 2017. *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Docket Nos. 160228 & 160229, Order 06, Final Order Rejecting Tariff Filing (Dec. 15., 2016), *available at* https://www.utc.wa.gov/docs/Pages/DocketLookup.aspx?FilingID=160228. The Commission rejected Avista's rate proposal, thereby leaving in place the rates approved in the order that is the subject of this appeal. Those rates officially took effect on January 11, 2016. AR 1144.

necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." *Id.* at 811-12.

"The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." *Id.* at 812 (italics removed). "The function of rate-making is legislative in character, and the judicial branch is not empowered to undertake the job of fixing rates." *PacifiCorp v. Wash. Utils. & Transp. Comm'n*, 194 Wn. App. 571, 587, 376 P.3d 389 (2016).

> [A]s the late Justice Frankfurter wrote: "[t]he determination of utility rates—what may fairly be exacted from the public and what is adequate to enlist enterprise—does not present questions of an essentially legal nature in the sense that legal education and lawyers' learning afford peculiar competence for their adjustment. These are matters for the application of whatever knowledge economics and finance may bring to the practicalities of business enterprise."

POWER 85, 104 Wn.2d at 807 (quoting *Driscoll v. Edison Light & Power Co.*, 307 U.S. 104, 122, 83 L. Ed. 1134, 59 S. Ct. 715 (1939).

Additionally, the Commission's decision is evaluated under the Administrative Procedure Act (APA). RCW 34.05.570. APA standards overlay the "classic" three-part test set forth above. *POWER 85*, 104 Wn.2d at 812. The APA does not, however, broaden the availability of judicial

relief. Although this Court's role is "modernly . . . delineated by the [APA]," it "remains the law that courts are not at liberty to substitute their judgment for that of the [Commission]." *Id.*

Whether the Commission exceeded its statutory authority is a legal question reviewed de novo. *Pub. Counsel v. Utils. & Transp. Comm'n*, 128 Wn. App. 818, 825, 116 P.3d 1064 (2005). "An agency's action is arbitrary and capricious only if it 'is willful and unreasoning and taken without regard to the attending facts or circumstances.'" *PacifiCorp*, 194 Wn. App. at 587 (quoting *Pub. Counsel*, 128 Wn. App. at 824). "Neither the existence of contradictory evidence nor the possibility of deriving conflicting conclusions from the evidence renders an agency decision arbitrary and capricious." *Id.*

Public Counsel observes that the Commission's findings are "reviewed under a substantial evidence standard." Br. of Appellant at 20. But it fails to identify any particular Commission finding that, in its opinion, lacks a substantial evidentiary basis. Its assignments of error and issue statements likewise fail to disclose a substantial evidence issue. Br. of Appellant at 4-6 (citing RCW 34.05.570(3)(b) and RCW 34.05.570(3)(i)).

Given the absence of any express substantial evidence argument, the Commission's findings are assumed to be supported by substantial evidence. *Cowiche Canyon Conservancy v. Bosley*, 118 Wn.2d 801, 808-

09, 828 P.2d 549 (1992) (court has no obligation to review unchallenged findings or inadequately briefed assignments of error). Such an assumption aligns with the principle that "the Commission's findings are prima facie correct." *PacifiCorp*, 194 Wn. App. at 589 (citing RCW 80.04.430); *see also* RCW 34.05.570(1)(a) (burden of demonstrating the invalidity of agency action is on the party asserting invalidity).

B. Ratemaking 101: The Commission Seeks to Balance Competing Economic Interests

1. The Commission has Broad Authority to Regulate in the Public Interest

In every rate case, the Commission strives to establish "just, fair, reasonable and sufficient" rates. RCW 80.28.010(1). These rates are prospective: They remain in effect until modified by the Commission in a subsequent rate case. The time frame during which newly approved rates remain in effect is known as the "rate-effective" period.

The "just, fair, reasonable and sufficient" standard is flexible. It recognizes that the Commission must balance competing economic interests. *POWER 85*, 104 Wn.2d at 808. Ratepayers want reliable, low-priced power, but investors want an opportunity to earn a fair profit. Meanwhile, the utility must earn enough revenue to recover reasonable operating expenses. *See id.* at 808-09. Each of these interests "is as important in the eyes of the law as the other." *Id.* at 808.

The proper balance among ratepayer and investor interests is, at heart, a judgment call addressed to the Commission's discretion. *PacifiCorp*, 194 Wn. App. at 588 ("'We give substantial deference to a regulatory agency's judgment about how best to serve the public interest.'") (quoting *Pub. Counsel*, 128 Wn. App. at 824).

2. The Commission Relies on a Well-Known Formula to Ensure that the Utility Earns no More Revenue than is Necessary

Utility revenue must be "just, fair, reasonable and sufficient." RCW 80.28.010(1). That means that the level of annual revenue authorized by the Commission in a particular case must "'enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed.'" *POWER 85*, 104 Wn.2d at 811 (quoting *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 605, 88 L. Ed. 333, 64 S. Ct. 281 (1944). The level of revenue that satisfies this standard is known as the utility's "revenue requirement."

To calculate a utility's revenue requirement, the Commission generally relies on a formula that is "commonly accepted and used" by utility regulators across the nation. *POWER 85*, 104 Wn.2d at 809.

The basic ratemaking equation is:

$R = O + B(r)$

In this equation,

> R is the utility's allowed revenue requirement;
> O is its operating expenses;
> B is its rate base; and
> r is the rate of return allowed on its rate base.

POWER 85, 104 Wn.2d at 809.

> First, the B term is the "rate base" which represents the total investment in, or fair value of, the facilities of the utility employed in providing its service. Calculation of the rate base is of obvious importance since the product of the rate base (B) multiplied by the allowed rate of return (r) accrues to the utility's investors.

Id. at 809-10. Assets in a utility's "rate base" (e.g., power plants, wooden power poles, wires, meters, etc.) must be "used and useful for service in this state." RCW 80.04.250(1).

> Next, the *r* term is the rate of return that the utility is allowed to earn on its investment, i.e., on its rate base (B). In theory, r is the utility's cost of capital, or the amount of money it must spend to obtain the capital it uses to provide regulated products. Rate of return is the weighted average cost of the utility's various sources of capital (the interest it pays on its debt and the rate of return on its equity) that is necessary to permit it to continue to attract the capital required to provide the regulated product or service [for Avista, electricity or natural gas].

POWER 85, 104 Wn.2d at 810. In this case, pursuant to a partial settlement, all parties agreed that Avista's investors (shareholders and bondholders) should have the opportunity to earn an average return of 7.29 percent. AR 693. To ensure that rates are "sufficient,"

and "fair" to the utility, the Commission must empower Avista to earn enough revenue to cover the average rate of return.

> The O term in the equation refers to the operating expenses the utility incurs to provide the regulated product or service. Customarily, O is determined based on actual operating expenses in a recent past period referred to as the "test period" or "test year." A utility cannot include every expense it wishes in this operating expense category since the regulatory agency has the power to review operating expenses incurred by a utility and to disallow those which were not prudently incurred.

POWER 85, 104 Wn.2d at 810. Operating expenses include maintenance, power procurement, depreciation, taxes, and labor costs.

Putting it all together, a utility's "revenue requirement" is the amount of money the utility must collect through customer rates each year to recover reasonable operating expenses and to allow investors to earn a fair return on capital invested in assets that are "used and useful" in providing utility service in Washington.

This Court recently acknowledged that the "'economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result.'" *PacifiCorp*, 194 Wn. App. at 588 (quoting *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 313, 109 S. Ct. 609, 102 L. Ed. 2d 646 (1989)). In the same vein, what constitutes a "just, fair, reasonable and sufficient" rate is "'obviously incapable of precise judicial

definition.'" *Id.* (quoting *Morgan Stanley Capital Grp. Inc. v. Pub. Util. Dist. No. 1*, 554 U.S. 527, 532, 128 S. Ct. 2733, 171 L. Ed. 2d 607 (2008)).

3. The Commission has Particularly Wide Discretion to Choose an Appropriate Ratemaking Method

In practice, courts exercise deference by focusing on the total effect of the ratemaking order. In its landmark *Hope* decision (1944), the United States Supreme Court articulated the view that prevails today, commonly referred to as the "end results" test:

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. **It is not theory but the impact of the rate order which counts.** If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [federal Natural Gas Act of 1938] is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Fed. Power Com. v. Hope Nat. Gas Co., 320 U.S. 591, 602, 64 S. Ct. 281, 88 L. Ed. 333 (1944) (emphasis added). Washington courts have embraced the "end results" test. *POWER 85*, 104 Wn.2d at 812.

Many of Public Counsel's arguments in this appeal relate to the Commission's choice of ratemaking methods, rather than to the total effect of the final ratemaking order. In doing so, Public Counsel invites this Court to second-guess the Commission's expertise in selecting appropriate ratemaking "tools" to reconcile competing economic interests.

C. The Commission Justifiably Used a Ratemaking Tool Known as an "Attrition Adjustment" to Establish Rates

To establish a utility's "revenue requirement" in a ratemaking case, the Commission identifies the level of annual revenue the utility must earn to recover reasonable operating expenses and to provide investors an opportunity to earn a fair return on capital invested in "rate base" assets that are "used and useful" in providing utility service in Washington. RCW 80.04.250; *POWER 85*, 104 Wn.2d at 809-10. As discussed above, operating expenses (O) and rate base (B) are two variables in the Commission's basic ratemaking equation, $R = O + B(r)$.

To calculate operating expenses and rate base values for ratemaking purposes, the Commission has traditionally employed the "modified historical test year" approach. AR 3819. Under this method, the Commission derives values for O and B from data collected during a recent "test year." The test year may be modified through "pro forma adjustments" that reflect significant post-test-year operating expenses and/or rate base additions. AR 698-700, 3819; *see* WAC 480-07-510(3)(e). A key assumption underlying this approach is that test-year relationships among revenue, operating expenses, and rate base will hold during the rate-effective period, thereby making the historical test year an accurate representation of the rate-effective period. AR 371-72. If all relationships

hold, the utility will have a fair opportunity to recover all expenses and earn a limited profit.

In this case, Staff presented evidence that modified historical test year ratemaking would not yield just, fair, reasonable, and sufficient rates, because test-year relationships among revenue, operating expenses, and rate base were unlikely to hold during the rate-effective period. AR 3817, 3824-25, 3836; Tr. 436; *see* AR 3129. Staff specifically established that Avista's revenue requirement calculated using a modified historical test year approach would not cover the average rate of return (7.29 percent) that all parties agreed should be available to Avista's investors. AR 3836.

The Commission addressed Avista's anticipated revenue shortfall by applying a supplementary ratemaking method known as an "attrition adjustment." AR 722-37. Application of this method results in a temporary adjustment of the utility's revenue requirement beyond the revenue requirement determined through the modified historical test year approach. AR 609; *see POWER 84*, 101 Wn.2d at 428. The temporary adjustment (measured as the difference between the attrition-adjusted revenue requirement and the modified historical test year revenue requirement) is known as an "attrition adjustment." AR 704.

The Commission may rely on an attrition adjustment to forestall an anticipated revenue shortfall created by a condition that is outside the

utility's control. AR 703, 726-28. Due to the external condition (e.g., high inflation), the utility's operating expenses and/or rate base grow more rapidly than would be predicted using the modified historical test year approach. AR 371, 3836-37; Tr. 441-42. Our Supreme Court has recognized that "increased expenses and inflation can erode a rate of return established on the basis of a historic test year." *POWER 84*, 101 Wn.2d at 428.

When costs grow at an escalating rate, the modified historical test year approach may inaccurately forecast the relationship among revenue, operating expenses, and rate base during the rate-effective period. AR 3824-25. Stated differently, the modified historical test year approach may fail to capture trends that develop between the test year and the rate-effective period. In that case, the key assumption underpinning the modified historical test year approach becomes invalid.

When the modified historical test year approach produces an inaccurate forecast of the utility's revenue requirement during the rate-effective period, the utility needs an attrition adjustment (i.e., revenue boost) to provide investors a fair chance to earn their authorized return. AR 3823. If investors have no opportunity to earn a fair return, the final rate will not be "just, fair, reasonable and sufficient." RCW 80.28.010(1); *see POWER 85*, 104 Wn.2d at 808 (sufficiency of rates from the utility's perspective is "as important in the eyes of the law" as is respect for

ratepayers' desire for low-priced power). Public Counsel acknowledges that attrition adjustments "are one tool available to regulators to address a utility's ability to earn a reasonable return." Br. of Appellant at 31; *see also* AR 371. Ultimately, by ensuring the sufficiency of rates, the attrition adjustment safeguards the utility's capacity to invest in infrastructure that improves safety and enhances reliability. AR 729, 1482, Tr. 447-48.

Attrition adjustments are "not a new idea." AR 611; *see also* AR 293. Staff's research demonstrated that "use of an attrition allowance extends across multiple states and decades, and well-respected treatises on utility ratemaking include definitions and discussions of the concept." AR 611. Public Counsel acknowledges that the Commission "has used attrition adjustments in past rate cases." Br. of Appellant at 30.

To calculate Avista's attrition adjustment in this case, the Commission relied on a "detailed and rigorous attrition analysis" performed by Staff analyst Chris McGuire. AR 722; *see* AR 727; 3877-88 ("Staff Electric Attrition Study"). McGuire performed a statistical analysis that evaluated "historical rates of growth in revenues, expenses and rate base to assess how the relationships of these elements are likely to evolve between the test year and the rate-effective period [i.e., the one-year period during which newly approved rates will remain in effect]." AR 3825. At the evidentiary hearing, McGuire explained, "I'm using the historic rates of

growth, which contain multiple years of data in those categories to make an assessment of how the business has grown over that time period." Tr. 444. Ultimately, McGuire concluded that "rates calculated using a modified historical test year approach will likely be insufficient to provide the Company with a fair opportunity to earn the Settlement rate of return [7.29 percent]." AR 3813, 3836; *see also* Tr. 436.

McGuire identified the external conditions causing Avista's earnings attrition: "low load growth" (i.e., weaker-than-anticipated customer demand) set against a backdrop of rapid investment in utility infrastructure. AR 3824, 3826; *see* AR 712, 1483; Tr. 438, 446-47. He explained, "[I]f load growth is insufficient to generate the revenues necessary to cover growth in expenditures (including return on rate base) between the historical test year and the rate year [i.e., the period during which newly approved rates are in effect], attrition is likely to occur." AR 3837; *see* Tr. 438. The Commission found, "The evidence in this case demonstrates that Avista is making increased capital investments in non-revenue generating plant (primarily on the distribution system) in an environment of low load growth." AR 725.

McGuire also described the math underlying his attrition study. He explained that his analysis was "an exercise in inferential statistics, whereby inferences regarding rates of growth are made through empirical analysis of

recorded observations." AR 3841. First, "growth factors" are calculated based on historical rates of growth. AR 3842; *see also* Tr. 449-50. Next, growth factors are applied to historical test year levels of revenue, operating expenses, and rate base to estimate the revenue requirement that will allow the utility "a reasonable opportunity to earn the Settlement rate of return [7.29 percent]." AR 3842. Finally, this attrition-adjusted revenue requirement is "compared to the revenue requirement calculated using a modified historical test period approach to determine if those rates are sufficient to cover attrition adjusted rate year expenses." AR 3842.

No party questioned the accuracy of McGuire's regression analysis and correlation calculations. AR 612, 623. The Commission found that his attrition study employed "a sound methodology for developing an escalation rate from historical data." AR 727. On appeal, Public Counsel makes no claim that the trends identified by McGuire are unsupported by substantial evidence. From a mathematical perspective, the validity of McGuire's attrition study is undisputed.

Ultimately, the Commission used a modified version of McGuire's attrition study to calculate Avista's final attrition adjustment. AR 736. Most significantly, it declined to adopt Staff's proposed growth trend for "distribution plant," a category of rate base. AR 736. The trend itself was not in question. Nevertheless, the Commission invoked its policy requiring

"utilities to demonstrate persuasively that the attrition occurring is outside their control." AR 728. After reviewing the evidence, it found that Avista failed to establish that it was ramping up distribution plant investment in response to conditions outside its control. AR 736. All other growth trends were maintained largely as proposed by Staff.

The Commission's final analysis showed that Avista was entitled to a $28.3 million attrition adjustment for its electric operation and a $6.8 million attrition adjustment for its natural gas operation. AR 731, 737. These adjustments, when added to the gas and electric revenue requirements calculated using the modified historical test year approach, resulted in an overall revenue requirement reduction of $8.1 million for Avista's electric operation and an overall revenue requirement increase of $10.8 million for the utility's natural gas operation. AR 731, 737.

1. Public Counsel's Statutory Challenge to the Commission's Attrition Adjustment is Untimely

Public Counsel makes two arguments against the Commission's $28.3 million electric attrition adjustment: (1) a broad statutory challenge that, if successful, might preclude all future attrition adjustments (Assignment of Error 1); and (2) a narrow factual challenge that, if successful, would merely invalidate the result in this case (Assignments of

Error 2 and 3). This Court should not review the statutory challenge because it was never presented to the Commission for resolution.

Under the APA, a party seeking judicial review may not raise new issues on appeal. RCW 34.05.554. "This rule is more than simply a technical rule of appellate procedure; instead, it serves an important policy purpose in protecting the integrity of administrative decisionmaking." *King County v. Wash. State Boundary Review Bd. for King County*, 122 Wn.2d 648, 668, 860 P.2d 1024 (1993). Policies furthered by the rule include:

> (1) discouraging the frequent and deliberate flouting of administrative processes; (2) protecting agency autonomy by allowing an agency the first opportunity to apply its expertise, exercise its discretion, and correct its errors; (3) aiding judicial review by promoting the development of facts during the administrative proceeding; and (4) promoting judicial economy by reducing duplication, and perhaps even obviating judicial involvement.

King County, 122 Wn.2d at 669 (quoting *Fertilizer Inst. v. United States Envtl. Prot. Agency*, 935 F.2d 1303, 1312-13 (D.C. Cir. 1991)).

"In order for an issue to be properly raised before an administrative agency, there must be more than simply a hint or a slight reference to the issue in the record." *Citizens for Mount Vernon v. City of Mount Vernon*, 133 Wn.2d 861, 869, 947 P.2d 1208 (1997); *see, e.g.*, *Edelman v. State*, 160 Wn. App. 294, 310, 248 P.3d 581 (2011) (declining to review a statutory issue where the appellant failed to mention the relevant statutes to the

decision-maker); *ZDI Gaming, Inc. v. State ex rel. Wash. State Gambling Comm'n*, 151 Wn. App. 788, 811, 214 P.3d 938 (2009) (declining to review an issue involving a regulatory definition where the appellant failed to seek declaratory relief from the agency and neither the ALJ nor the agency head considered the issue or discussed it in their respective orders).

Public Counsel argues for the first time on appeal that attrition adjustments are *never* lawful, since they incorporate the value of rate base assets that are not "used and useful for service in this state" within the meaning of RCW 80.04.250(1). Br. of Appellant at 4 (Assignment of Error 1). At the agency level, it acknowledged that attrition adjustments are appropriate "on a case-by-case basis." AR 371. It then argued that the "fundamental defect" in Staff's attrition analysis was factual—namely, Avista's failure to prove its claim of "earnings erosion"—not legal. AR 373.

The Commission never analyzed whether attrition adjustments are lawful under RCW 80.04.250(1). It believed that the primary question was whether Avista met its *evidentiary burden* to justify an attrition adjustment in this case. AR 725. It wrote, "The parties' positions vary wildly. Public Counsel and [intervenor] ICNU oppose the use of an attrition adjustment, contending it is *simply unnecessary*." AR 725 (emphasis added). Public Counsel's current stance is quite different. For the first time on appeal, Public Counsel seeks to outlaw *all* attrition adjustments—necessary or not.

After the Commission issued its final order, Public Counsel filed a motion that sought "technical changes" to the calculation of the attrition adjustment. AR 881. This motion made no mention of "used and useful." Instead, Public Counsel represented that it did not "seek to change the outcome of any issues resolved in [the Commission's final order]," and accordingly would not "challenge the factual findings or *legal conclusions* in support of the Commission['s] decision to approve an electric attrition adjustment for Avista, as a matter of principle." AR 882 (emphasis added). To all appearances, Public Counsel disapproved of how the attrition adjustment "tool" was used in this case. But it did not seek to *eliminate* the tool from the Commission's ratemaking "toolbox."

Public Counsel should not be permitted to advance its current statutory challenge after offering no more than a hint of that stance at the agency level. RCW 34.05.554; *King County*, 122 Wn.2d at 669. The Commission respectfully requests that this Court decline to address Public Counsel's Assignment of Error 1.

2. If this Court Addresses Public Counsel's Statutory Challenge, it Should Hold that Attrition-Adjusted Rate Base Valuations Satisfy RCW 80.04.250(1)'s "Used and Useful" Standard

If this Court reviews Public Counsel's untimely statutory challenge, it should hold that the Commission acted within its statutory authority.

Contrary to Public Counsel's claim, capital assets added to a utility's "rate base" through an attrition adjustment are "used and useful for service in this state" within the meaning of RCW 80.04.250(1).

"Used and useful" is a ratemaking principle that guides the Commission's discretion when it values utility property for ratemaking purposes. The principle is neither new nor unique to our state. *See* James J. Hoecker, *"Used and Useful": Autopsy of a Ratemaking Policy*, 8 Energy L. J. 303 (1987) (observing that the principle "emerged from the primordial ooze of public regulation of private enterprise"). As early as 1898, the United States Supreme Court concluded that investors, though protected by the Fourteenth Amendment from illegal takings, should not earn a state-sanctioned return on utility property that provides no public benefit:

> What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience; and on the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.

Smyth v. Ames, 169 U.S. 466, 515, 18 S. Ct. 418, 42 L. Ed. 819 (1898).

Today, Washington follows other jurisdictions in requiring that rate base assets must be "used and useful for service in this state" before investors may earn a Commission-authorized return. RCW 80.04.250(1). "Used and useful" means the assets must be "employed for service in

Washington *and* capable of being put to use for service in Washington." *POWER 84*, 101 Wn.2d at 430 (emphasis in original).[8]

In *POWER 84*, the Washington Supreme Court held that certain partially completed power plants were not "used and useful" within the meaning of RCW 80.04.250. "Obviously," the Court wrote, "an uncompleted utility plant is neither employed for service nor capable of being put to use for service . . . ." *POWER 84*, 101 Wn.2d at 430.[9]

Unlike a partially completed power plant, rate base assets that are valued through an attrition adjustment are "used and useful" within the meaning of RCW 80.04.250. The asset values are derived through a process that predicts, with a high degree of certainty, capital investments that will improve or maintain the utility's system during the period in which the newly approved rates will remain in effect (the "rate-effective period"). AR 612, 3825. Because the spending will occur during the rate-effective period, the Commission reasonably assumes that the associated investments will benefit current ratepayers. Staff's attrition model properly excluded "[s]peculative future expenses and plant balances." AR 3841.

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[8] "Used and useful" applies only to valuation of rate base for ratemaking purposes. *POWER 85*, 104 Wn.2d at 815-16. It does not apply to operating expenses, which are recognized, but not "valued," during the ratemaking process. *Id.*

[9] Subsequently, the legislature amended RCW 80.04.250 to allow inclusion of "the reasonable costs of construction work in progress." Laws of 1991, ch. 122, § 2.

Because the model focuses on the rate-effective period, there is no question that attrition-based ratemaking yields an end result that fairly balances current costs and benefits. Today's ratepayers will pay no more than is necessary to keep the utility's system in good working order, while adequately compensating the system's owners. Likewise, investors will earn no more than is fair, judged by the level of investment that is used and useful to ratepayers according to reasonably accurate forecasting. The end result is "just, fair, reasonable and sufficient." RCW 80.28.010(1).

Public Counsel argues that a utility's financial condition is irrelevant when deciding whether particular assets should be included in the utility's rate base. Br. of Appellant at 29 (citing *POWER 84*, 101 Wn.2d at 434). The premise is valid. But in making the argument, Public Counsel confuses two issues: (1) calculating the value of a utility's rate base for ratemaking purposes; and (2) deciding whether to grant an attrition adjustment—at heart, a judgment call. Here, the Commission considered Avista's anticipated financial condition only with respect to the latter issue. With respect to the former issue, the Commission properly valued Avista's rate base using "historic rates of [rate base] growth," with no regard for the company's past "over-earning." Tr. 445; *see* AR 3841-42.

Public Counsel also wrongly criticizes the Commission for relying on "projections." *E.g.*, Brief of Appellant at 28. "Generally speaking, the

case law regards costs incurred and investments made used and useful if . . . there is a direct and immediate benefit to customers; traditionally, the investment is made in plant that is operational now or in a future test year or *in the period during which the rates may reasonably be expected to be in effect* . . . ." James J. Hoecker, *"Used and Useful": Autopsy of a Ratemaking Policy*, 8 Energy L. J. 303, 312 (1987) (emphasis added).

Public Counsel appears to worry that the predicted level of capital spending will fail to materialize. *See* Br. of Appellant at 26. But Avista presented undisputed historical evidence establishing that, in recent years, Avista has often expended *more* capital than predicted. AR 1579. Avista's witness explained, "These data demonstrate that, although individual project timing and dollar amounts will vary within a year, and will sometimes carry over from one year to the next, the Company manages its overall spend[ing] to be close to the overall planned amount." AR 1579.

In any event, the "used and useful" principle is not a *guarantee* that a utility's rate base will include any particular collection of physical assets during the rate-effective period. It is merely a tool that helps "determine what can *reasonably* be done now with the fruits of investment." *Appeal of Conservation Law Found.*, 127 N.H. 606, 638, 507 A.2d 652 (1986) (emphasis added). The goal is to value the utility's property "for rate making

purposes," not to declare with absolute certainty which assets will comprise the utility's rate base during the rate-effective period. RCW 80.04.250(1).

In this case, the Commission had discretion to determine that Avista's attrition-adjusted rate base reasonably represented the value of property that will be used and useful for service in Washington during the rate-effective period. Stated differently, it was for the Commission to decide that attrition-based ratemaking was more likely to yield "just, fair, reasonable and sufficient" rates than would Public Counsel's approach, which depended strictly on the modified historical test-year approach. RCW 80.28.010(1); *see POWER 85*, 104 Wn.2d at 812 ("[W]ithin a fairly broad range, regulatory agencies exercise substantial discretion in selecting the appropriate ratemaking methodology"); *see also Consol. Gas Supply Corp. v. Fed. Power Comm'n*, 520 F.2d 1176 (D.C. Cir. 1975) ("The legal system does not compel rigidity, or bureaucratic inflexibility, least of all in an area like energy policy where flexibility may be essential in the public interest."). This Court should hold that the Commission acted within its statutory authority.

3. The Commission's Attrition Adjustment was Based on an Undisputed Regression Analysis

Public Counsel's second challenge to the Commission's attrition adjustment is factual, rather than legal. The dispute is whether the

Commission's electric attrition adjustment was arbitrary or capricious because the Commission allegedly disregarded evidence opposing the adjustment. Br. of Appellant at 4-6 (Assignments of Error 2 and 3). This dispute should be resolved in the Commission's favor out of deference to the Commission's prerogative, as the fact-finder, to weigh the evidence. The record contains sufficient undisputed evidence supporting the attrition adjustment. Public Counsel's opinion about the strength of that evidence is immaterial to the validity of the Commission's final order under APA standards of review. "Neither the existence of contradictory evidence nor the possibility of deriving conflicting conclusions from the evidence renders an agency decision arbitrary and capricious." *PacifiCorp*, 194 Wn. App. at 587 (quoting *Pub. Counsel*, 128 Wn. App. at 824).

Public Counsel first argues that the Commission arbitrarily ignored its own finding that Avista failed to prove that its "'electric distribution investments are entirely outside its control, or required for the safe and efficient operation of its system.'" Br. of Appellant at 34. This claim is simply erroneous. The Commission accounted for the finding by declining to include "distribution plant" (a particular category of rate base) in Avista's attrition-adjusted rate base:

> The Company [Avista] has not met its burden to show that its proposed investments are based on circumstances beyond its control. Thus, while we authorize rates based on the

> attrition methodology proposed by Staff, we modify Staff's method to remove all escalation of distribution plant rate base.

AR 736. Public Counsel acknowledges that the Commission "removed escalation of distribution plant from the attrition calculation." Br. of Appellant at 36. The claimed error is nonexistent.

Public Counsel next argues that the Commission arbitrarily ignored evidence that Avista "'earned at or above its approved rate of return in 2013 and 2014, and may possibly do so in 2015.'" Br. of Appellant at 34. To the contrary, the record established that Avista was at risk of future earnings attrition despite its past financial success. Using growth factors derived from historical data, the Commission predicted that rate-effective-period levels of operating expenses (O) and rate base (B) would outpace the revenue requirement (R) derived through the modified historical test year approach, thereby denying investors a fair chance to earn the settlement rate of return (r) of 7.29 percent (an overall rate of return that all parties, including Public Counsel, agreed was fair).[10] AR 787. Under this analysis, Avista's past "over-earning" has no bearing on whether the utility's attrition-adjusted revenue will be sufficient during the upcoming rate-

[10] As discussed above, the basic ratemaking equation is R = O + B(r). "In this equation, R is the utility's allowed revenue requirement; O is its operating expenses; B is its rate base; and r is the rate of return allowed on its rate base." *POWER 85*, 104 Wn.2d at 809.

effective period. Tr. 441 (McGuire: "We're calculating rates to be effective in 2016, so what I'm attempting to do in my [attrition] analysis is provide revenues sufficient for costs in 2016, not 2014").

Public Counsel lastly argues that the Commission arbitrarily relied on the "end results" test to contrive an attrition-adjusted revenue requirement that was otherwise unsupported by record evidence. Br. of Appellant at 35-38. But as discussed in detail above, the Commission relied on Staff's empirical attrition study to set rates. AR 727 ("Mr. McGuire's attrition study uses a sound methodology for developing an escalation rate from historical data"); *see* AR 3877-88 ("Staff Electric Attrition Study"). Public Counsel's claim that the Commission invoked "limitless discretion" to arrive at an arbitrary result is baseless. Br. of Appellant at 38. Public Counsel knows this, because it acknowledges that the final rates are "based on calculations from historical trends." Br. of Appellant at 28.

D. The Commission Requests Partial Remand to Reevaluate the Implementation of Avista's Post-Hearing Power Cost Update

When calculating Avista's electric attrition adjustment, the Commission incorporated a "power cost update" supplied by Avista after the evidentiary hearing. *See* AR 1145. On appeal, Public Counsel alleges that the Commission made a "calculation error" when feeding the update through the Excel spreadsheets that comprised Staff's attrition study. Br. of

Appellant at 39-48 (Assignments of Error 4 and 5). If the error exists, the power cost update may be incompletely reflected in the Commission's final electric revenue requirement calculation.

The Commission agrees with Public Counsel that this Court should partially remand the matter for a supplementary evidentiary hearing on the power cost update. Staff's attrition study was a complex Excel model "populated by myriad data" that seems to have confused Public Counsel and other parties. AR 1143; *see* AR 1145-51 (summary of various post-order motions seeking clarification of the Commission's final revenue requirement calculation). Because the parties may not have understood the model's proper functioning, the Commission believes it would be beneficial to reopen the administrative record to reevaluate the implementation of the power cost update. It therefore respectfully requests that this Court remand for that limited purpose. RCW 34.05.574(1) (court has authority to "remand the matter for further proceedings").

V. CONCLUSION

Ratemaking is a complex legislative undertaking. The primary goal is to balance competing economic interests. In this case, the Commission struck an appropriate balance when it set rates using an "attrition adjustment," as opposed to the traditional modified historical test year

approach. The impact of this decision on ratepayers and investors was "just, fair, reasonable, and sufficient" within the meaning of RCW 80.28.010(1).

The only outstanding issue is whether Avista's post-hearing "power cost update" was properly reflected in the Commission's final electric revenue requirement (Assignments of Error 4 and 5). The Commission respectfully requests that this Court affirm with respect to Assignments of Error 1-3 but remand Assignments of Error 4 and 5 for a supplementary evidentiary proceeding. On remand, the Commission will reopen the administrative record for the limited purpose of clarifying the proper implementation of the power cost update.

RESPECTFULLY SUBMITTED on March 29, 2017.

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