BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Docket No. UE-132027

Puget Sound Energy, Inc.'s
Petition for an Accounting Order Approving the Allocation of Proceeds of the Sale of Certain Assets to Public Utility District #1 of Jefferson County

BENCH REQUEST NO. 001

BENCH REQUEST NO. 001:

What is the return on equity listed on page 33 of PSE’s 2013 10K?

Response:

Attached as Attachment A to Puget Sound Energy, Inc.’s (“PSE”) Response to Bench Request No. 001, please find pages 33-34 of PSE’s 2013 10K, which reconcile PSE’s return on equity (“ROE”) between GAAP and regulatory. The simple GAAP ROE was 10.4% and the regulatory ROE was 8.0%. On page 34 of the 10K, PSE explains why the regulatory ROE is less than the authorized ROE. Unrecovered depreciation expense is a significant contributor to under earnings.

Additionally, attached as Attachment B to PSE’s Response to Bench Request No. 001, please find pages 33-34 of PSE’s 2012 10K, which illustrate similar under earnings and unrecovered depreciation expense.

Attachment A to PSE's Response to Bench Request No. 001

2015 and no later than April 1, 2016. Upon implementation of the decoupling mechanism on July 1, 2013, electric and natural gas rates increased $21.4 million and $10.8 million, respectively, on an annual basis. The decoupling mechanism also allows for decoupling revenue on a per customer basis to subsequently increase by 3.0% for electric customers and 2.2% for natural gas customers on January 1 on each year, until the conclusion of PSE's next general rate case.

In October 2013, PSE completed a PCORC filing which allows PSE to recovery certain generation investments and updates PSE's overall normalized power supply costs. As a result, PSE decreased electric rates by $10.5 million, annually, effective November 1, 2013.

In October 2013, PSE received approval of its pipeline integrity program that would accelerate and enhance the safety of the natural gas system and ultimately reduce costs. Under the plan, PSE would be allowed to file a tariff revision to recover its costs associated with the acceleration of the replacement of natural gas pipelines with the Washington Commission.

Washington state law also requires PSE to pursue conservation initiatives that promote efficient use of energy. PSE's mandate to pursue conservation initiatives may have a negative impact on the electric business financial performance due to lost margins from lower sales volumes as power costs are not part of the decoupling mechanism. This mandate, however, will only have a slight negative impact on natural gas business financial performance due to the natural gas business being almost fully decoupled.

For the year ended December 31, 2013 as compared to the prior year, PSE's net income was affected by the following four factors: (1) an increase in electric margin; (2) implementation of a property tax tracker mechanism which lowered property tax expense by reducing regulatory lag, thus matching expense with revenues; (3) reduction in amortization expenses primarily due to an increase in regulatory credit related to amortization of Treasury Grant; and (4) a decrease in unrealized gain in derivatives instruments for energy contracts.

Further detail on each of these primary drivers, as well as other factors affecting performance, is set forth in this "Overview" section, as well as in other sections of the Management's Discussion & Analysis.

NON-GAAP FINANCIAL MEASURES

The following discussion includes financial information prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP), as well as return on equity excluding unrealized loss on derivative instruments (net income plus unrealized loss on derivative instruments divided by average common equity) that is considered a "non-GAAP financial measure." Generally, a non-GAAP financial measure is a numerical measure of a company's financial performance, financial position or cash flows that exclude (or include) amounts that are included in (or excluded from) the most directly comparable measure calculated and presented in accordance with GAAP. The presentation of return on equity excluding unrealized loss on derivative instruments is intended to supplement readers' understanding of the Company's operating performance. Return on equity excluding unrealized loss on derivative instrument is used by the Company to determine whether the Company is collecting the appropriate earnings from its customers to allow recovery of investor's capital. The return on average of monthly averages (AMA) equity is not intended to represent the regulated return on equity. PSE's return on equity may not be comparable to other companies return on equity measures. Furthermore, this measure is not intended to replace return on equity (net income divided by average common equity) as determined in accordance with GAAP as an indicator of operating performance.

The following table presents PSE's return on equity for 2013 and 2012:

	2013			2012		
(Dollars in Thousands)	Earnings	Average Common Equity	Return On Equity	Earnings	Average Common Equity	Return On Equity
Return on equity - GAAP	$ 356,129	$ 3,422,251	10.4%	$ 356,170	$ 3,313,183	10.8%
Less/Plus: Unrealized gains and losses on derivative instruments, after-tax	(64,272)	—	*	(77,428)	—	*
Less: Equity adjustments [1]	—	113,985	*	—	268,610	*
Plus: Impact of average of monthly average (AMA)	—	111,598	*	—	32,131	*
Return on AMA equity	$ 291,857	$ 3,647,834	8.0%	$ 278,742	$ 3,613,924	7.7%
Authorized regulated return on equity			9.8%			9.8%

[1] *Equity adjustments are related to removing the impacts of accumulated other comprehensive income (OCI), subsidiary retained earnings and retained earnings of derivative instruments.*

* *Not meaningful.*

The Company's 2013 return on equity, excluding derivative instruments, was 8.0%, which is lower than the authorized return on equity primarily due to the following:

- Utility operations and maintenance expense was $15.6 million higher than the amount allowed in rates for the year ended December 31, 2013. The increase was driven by an increase in costs in electric production, administration and general expenses and customer service expense.
- Depreciation expense was $36.4 million higher than the amount allowed in rates for the year ended December 31, 2013. The increase was primarily due to additional electric expenditures placed into service.

The Company's 2012 return on equity, excluding derivative instruments, was 7.7%, which is lower than the authorized return on equity primarily due to the following:

- Operating revenue was $124.2 million lower than the amount allowed in rates for the year ended December 31, 2012. However, margins increased $27.6 million due to significantly lower power costs.
- Utility operations and maintenance expense was $18.7 million higher than the amount allowed in rates for the year ended December 31, 2012. The increase was driven by an increase in costs in electric production, administration and general expenses and customer service expense.
- Depreciation expense was $38.2 million higher than the amount allowed in rates for the year ended December 31, 2012. The increase was primarily due to additional electric expenditures placed into service.
- Utility rate making process has a delay between incurring expenses and their recovery in rate base. PSE increased ratebase by $416.7 million since its last general rate increase effective May 14, 2012.

Factors and Trends Affecting PSE's Performance

PSE's regulatory requirements and operational needs require the investment of substantial capital in 2013 and future years. Because PSE intends to seek recovery of such investments through the regulatory process, its financial results depend heavily upon favorable outcomes from that process. Further, PSE's financial performance is heavily influenced by general economic conditions in its service territory, which affect customer growth and use-per-customer and thus utility sales, as well as by its customers' conservation investments, which also tend to reduce energy sales. The principal business, economic and other factors that affect PSE's operations and financial performance include:

- The rates PSE is allowed to charge for its services;
- PSE's ability to recover fixed costs that are included in rates which are based on volume;
- PSE's ability to manage costs during the rate stay out period through March 31, 2016;
- Weather conditions, including snow-pack affecting hydrological conditions;
- Demand for electricity and natural gas among customers in PSE's service territory;
- Regulatory decisions allowing PSE to recover costs, including purchased power and fuel costs, on a timely basis;
- PSE's ability to supply electricity and natural gas, either through company-owned generation, purchase power contracts or by procuring natural gas or electricity in wholesale markets;
- Availability and access to capital and the cost of capital;
- Regulatory compliance costs, including those related to new and developing federal regulations of electric system reliability, state regulations of natural gas pipelines and federal, state and local environmental laws and regulations;
- The impact of energy efficiency programs on sales;
- Wholesale commodity prices of electricity and natural gas;
- Increasing depreciation; and
- Federal, state, and local taxes.

Regulation of PSE Rates and Recovery of PSE Costs

The rates that PSE is allowed to charge for its services influence its financial condition, results of operations and liquidity. PSE is highly regulated and the rates that it charges its retail customers are approved by the Washington Utilities and Transportation Commission (Washington Commission). The Washington Commission has traditionally required that these rates be determined based, to a large extent, on historic test year costs plus weather normalized assumptions about hydroelectric conditions and power costs in the relevant rate year. Incremental customer growth and sales typically have not provided sufficient revenue to cover year-to-year cost growth, thus rate increases are required. If, in a particular year, PSE's costs are higher than what is currently allowed to be recovered in rates, revenue may not be sufficient to permit PSE to earn its allowed return. In addition, the Washington

Attachment B to PSE's Response to Bench Request No. 001

For the year ended December 31, 2012 as compared to the prior year, PSE's net income was positively affected by the following two factors: (1) an unrealized gain in derivatives instruments for energy contracts compared to an unrealized loss for the same periods in the prior year; and (2) increased electric margins driven by lower power costs.

Further detail on each of these primary drivers, as well as other factors affecting performance, is set forth in this "Overview" section, as well as in other sections of the Management's Discussion & Analysis.

NON-GAAP FINANCIAL MEASURES

The following discussion includes financial information prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP), as well as return on equity excluding unrealized loss on derivative instruments (net income plus unrealized loss on derivative instruments divided by average common equity) that is considered a "non-GAAP financial measure." Generally, a non-GAAP financial measure is a numerical measure of a company's financial performance, financial position or cash flows that exclude (or include) amounts that are included in (or excluded from) the most directly comparable measure calculated and presented in accordance with GAAP. The presentation of return on equity excluding unrealized loss on derivative instruments is intended to supplement readers' understanding of the Company's operating performance. Return on equity excluding unrealized loss on derivative instrument is used by the Company to determine whether the Company is collecting the appropriate earnings from its customers to allow recovery of investor's capital. PSE's return on equity may not be comparable to other companies return on equity measures. Furthermore, this measure is not intended to replace return on equity (net income divided by average common equity) as determined in accordance with GAAP as an indicator of operating performance.

The Company has faced certain challenges which caused a significant reduction in the return on equity as compared to other years. The following table presents PSE's return on equity for 2012 and 2011:

	2012			2011		
(Dollars in Thousands)	Earnings	Average Common Equity	Return On Equity	Earnings	Average Common Equity	Return On Equity
Return on equity - GAAP	$ 356,170	$ 3,313,183	10.8%	$ 204,120	$ 3,098,564	6.6%
Less/Plus: Unrealized gains and losses on derivative instruments, after-tax	(77,428)	—	*	35,195	—	*
Less: Equity adjustments [1]	—	268,610	*	—	341,231	*
Plus: Impact of average of monthly average (AMA)	—	32,131	*	—	36,242	*
AMA regulated return on equity	$ 278,742	$ 3,613,924	7.7%	$ 239,315	$ 3,476,037	6.9%
Authorized regulated return on equity [2]			9.8%			10.1%

[1] *Equity adjustments are related to removing the impacts of accumulated other comprehensive income (OCI), subsidiary retained earnings and retained earnings of derivative instruments.*

[2] *The authorized regulated return on equity was approved by the Washington Commission in its general rate case order which became effective May 14, 2012 and April 8, 2010 for the years ended December 31, 2012 and December 31, 2011, respectively.*

* *Not meaningful*

The Company's 2012 return on equity, excluding derivative instruments, was 7.7%, which is lower than the authorized return on equity due to the following:

- Operating revenue was $124.2 million lower than the amount allowed in rates for the year ended December 31, 2012. However, margins increased $27.6 million due to significantly lower power costs.
- Utility operations and maintenance expense was $18.7 million higher than the amount allowed in rates for the year ended December 31, 2012. The increase was driven by an increase in costs in electric production, administration and general expenses and customer service expense.
- Depreciation expense was $38.2 million higher than the amount allowed in rates for the year ended December 31, 2012. The increase was primarily due to additional electric expenditures placed into service.
- Utility rate making process has a delay between incurring expenses and their recovery in rate base. PSE increased ratebase by $416.7 million since its last general rate increase effective May 14, 2012.

The Company's 2011 return on equity, excluding derivative instruments, was 6.9%, which is lower than the authorized return on equity due to the following:

- Utility operations and maintenance expense was $21 million higher than the amount allowed in rates for the year ended December 31, 2011. The increase was driven by an increase in costs in electric production, administration and general expenses and gas operations costs.
- Depreciation expense was $30 million higher than the amount allowed in rates for the year ended December 31, 2011. The increase was primarily due to additional electric and common utility capital expenditures placed into service.
- Utility rate making process has a delay between incurring expenses and their recovery in ratebase. PSE increased ratebase by $484 million since its last general rate increase effective April 8, 2010.
- These negative impacts were offset by favorable load which increased natural gas therm sales 7.0% for the year ended December 31, 2011, due to cooler temperatures in 2011 as compared to the same period in 2010. Also, favorable electric power costs had a positive impact on net income.

Factors and Trends Affecting PSE's Performance. PSE's regulatory requirements and operational needs require the investment of substantial capital in 2012 and future years. Because PSE intends to seek recovery of such investments through the regulatory process, its financial results depend heavily upon favorable outcomes from that process. Further, PSE's financial performance is heavily influenced by general economic conditions in its service territory, which affect customer growth and use-per-customer and thus utility sales, as well as by its customers' conservation investments, which also tend to reduce energy sales. The principal business, economic and other factors that affect PSE's operations and financial performance include:

- The rates PSE is allowed to charge for its services;
- PSE's ability to recover fixed costs that are included in rates which are based on volume;
- Weather conditions, including snow-pack affecting hydrological conditions;
- Demand for electricity and natural gas among customers in PSE's service territory;
- Regulatory decisions allowing PSE to recover costs, including purchased power and fuel costs, on a timely basis;
- PSE's ability to supply electricity and natural gas, either through company-owned generation, purchase power contracts or by procuring natural gas or electricity in wholesale markets;
- Availability and access to capital and the cost of capital;
- Regulatory compliance costs, including those related to new and developing federal regulations of electric system reliability, state regulations of natural gas pipelines and federal, state and local environmental laws and regulations;
- The impact of energy efficiency programs on sales and margins;
- Wholesale commodity prices of electricity and natural gas;
- Increasing depreciation and related property taxes; and
- Federal, state, and local taxes.

Regulation of PSE Rates and Recovery of PSE Costs. The rates that PSE is allowed to charge for its services influence its financial condition, results of operations and liquidity. PSE is highly regulated and the rates that it charges its retail customers are approved by the Washington Commission. The Washington Commission requires these rates be determined based, to a large extent, on historic test year costs plus weather normalized assumptions about hydroelectric conditions and power costs in the relevant rate year. Incremental customer growth and sales typically do not provide sufficient revenue to cover year-to-year cost growth, thus rate increases are required. If, in a particular year, PSE's costs are higher than what is allowed to be recovered in rates, revenue may not be sufficient to permit PSE to earn its allowed return. In addition, the Washington Commission determines whether expenses and investments are reasonable and prudent in providing electric and natural gas service. If the Washington Commission determines that part of PSE's costs do not meet the standard applied, those costs may be disallowed partially or entirely and not recovered in rates.

Electric Rates

PSE has a PCA mechanism that provides for the recovery of power costs from customers or refunding of power cost savings to customers in the event those costs vary from the "power cost baseline" level of power costs. The "power cost baseline" levels are set, in part, based on normalized assumptions about weather and hydroelectric conditions. Excess power costs or power cost savings are apportioned between PSE and its customers pursuant to the graduated scale set forth in the PCA mechanism.