

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**DOCKETS UE-090704
and UG-090705 (consolidated)**

INITIAL BRIEF ON BEHALF OF COMMISSION STAFF

February 19, 2010

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I. INTRODUCTION

1 Puget Sound Energy, Inc. (“PSE” or “the Company”) seeks to increase electric and natural gas revenues by \$112.7 million (5.6 percent) and \$28.3 million (2.3 percent), respectively.¹ Commission Staff recommends an increase in electric revenues of \$10.4 million (.5 percent) and an increase in gas revenues of \$9.2 million (.8 percent).²

2 Three factors explain this significant disparity. First, Staff’s presentation is a straightforward application of ratemaking via an historic test year, with pro forma adjustments for known and measurable changes that are not offset by other factors. The Commission has recently reaffirmed that practice by adopting Staff adjustments that use verified, actual data rather than budget projections like those used by PSE in this case.³

3 Second, this proceeding comes in the wake of the 2008 financial crisis. Staff’s recommendation to reduce the Company’s authorized return on equity reflects the lower cost of capital that the crisis engendered. In contrast, PSE’s proposal to increase its authorized return on equity disregards the undisputed consequences of the crisis.

4 Finally, this proceeding is PSE’s first rate case since its 2008 acquisition by an Investor Consortium.⁴ Staff proposes a capital structure that satisfies the Commission’s standard to balance safety and economy, ensuring that the new owners are fairly compensated for their equity investment in PSE. PSE’s proposed capital structure requires customers to pay for an excessive equity ratio that violates that standard.

¹ Exhibit No. B-2 at Attachments C and D.

² Exhibit No. B-3 at Exhibit Nos. KHB-2 and KHB-3.

³ *WUTC v. Avista Corporation, d/b/a Avista Utilities*, Dockets UE-090134 and UG-090135, Order 10 (December 22, 2009) (“Avista Order”).

⁴ *In the Matter of the Joint Application of Puget Holdings LLC and Puget Sound Energy, Inc.*, Docket U-072375, Order 08 (December 30, 2008) (“2008 Acquisition”).

II. COST OF CAPITAL

5 The cost of capital for PSE is one of the most contentious issues in this proceeding. Three parties presented witnesses addressing the issue: Mr. David Parcell for Staff, Dr. Roger Morin and Mr. Donald Gaines for PSE, and Mr. Steven Hill for Public Counsel. In turn, there are three contested components of the cost of capital calculation:

<u>Issue</u>	<u>PSE</u>	<u>Staff</u>	<u>Public Counsel</u>
Common Equity Ratio	48.0%	45.0%	43.0%
Cost of Long-Term Debt	6.70%	6.48%	6.82%
Cost of Common Equity	10.7%	10.0%	9.5%
Total Cost of Capital	8.50%	7.91%	7.73%

6 For the reasons set forth below, the Commission should find that the total cost of capital for PSE is Mr. Parcell's 7.91 percent.⁵

A. Capital Structure

7 The Commission should reject the Company's proposed capital structure with a 48.0 percent common equity ratio. PSE has a long-history of seeking hypothetical capital structures that exceed its actual common equity ratios. PSE requested a 45 percent common equity ratio in its last five cases, despite year-end actual common equity ratios of 40.11 percent (2004), 43.84 percent (2005), 39.81 percent (2006), and 39.58 percent (2007).⁶

8 The Commission has also typically adopted a lower common equity ratio than the 45 percent PSE requested: 40.0% (Dockets UE-011570/UG-011571); 43.0% (Dockets UE-

⁵ Exhibit No. DCP-1T at 2:13-19. The parties agree to a 2.47 percent cost of short-term debt applied to a 3.95 percent short-term debt ratio. Mr. Parcell derived a long-term debt ratio of 51.05 percent by adding to the long-term debt level proposed by PSE the amount necessary for total capital to remain the same. Exhibit No. DCP-1T at 28:5-11 and Exhibit No. DCP-3.

⁶ Exhibit No. SGH-5C at 1.

040641/UG-040640); 44.0% (Dockets UE-060266/UG-060267); and 46.0% (Dockets UE-072300/UG-072301).⁷

9 More to the point, it is not proper to increase PSE's common equity ratio to 48 percent. This is in part due to the impact of the 2008 Acquisition on PSE's capital additions. PSE claims that its actual common equity ratio has increased since the transaction was completed.⁸ However, it is clear that the decision to infuse equity at PSE was driven by the interests of the new owners to maximize their profits by financing PSE equity with less expensive parent debt.⁹ It is unreasonable for PSE to expect ratepayers to support an excessive equity ratio for the benefit of the new owners.

10 Additionally, the adoption of a 48 percent equity ratio after the leveraged buy-out, compared to the 45 percent ratio PSE has requested before the buy-out, provides an appearance of manipulation of PSE's capital structure by the parent.¹⁰ This is also apparent from the significant debt at the parent level that is used as a source of equity for PSE.¹¹

11 Staff maintains that Mr. Parcell's recommended 45 percent common equity ratio is reasonable and proper. It is consistent with PSE requests in prior cases.¹² It is consistent with common equity ratios of publicly-traded electric utilities.¹³ And, it meets the Commission's long-standing policy that a proper capital structure should balance safety (the

⁷ Tr. 707:5-16 (Parcell).

⁸ Exhibit No. DEG-11CT at 3:13-18.

⁹ Tr. 723:5-22 (Hill), Exhibit No. DCP-1T at 26:18-27:2, and Exhibit No. SGH 1-HCT at 12-15.

¹⁰ Exhibit No. DCP-1T at 27:3-7 and Tr. 707:5 to 708:1 (Parcell).

¹¹ Exhibit No. SGH 1HCT at 9-17 and Tr. 703:10-704:2 (Parcell). PSE may dispute this claim given the ring-fencing provisions of the 2008 Acquisition. However, the issue here involves control of PSE's capital structure by its new owners who have the incentive to maximize the equity in PSE in order to maximize their returns. Ring fencing only protects PSE from the risks of leverage within the new ownership hierarchy.

¹² Exhibit No. DCP 1T at 25:11-12.

¹³ Exhibit No. DCP 1T at 25:13-15. PSE argues that these publicly-traded electric utilities provide an inappropriate comparison because they include holding companies that own unregulated utility subsidiaries. Exhibit No. DEG-11HCT at 4:8-15. This criticism is unfounded. The unregulated operations of the holding companies will be reflected in cost of equity models, which will then result in higher results than required for regulated operations. Exhibit No. DEG-12 (Staff Response to PSE Data Request No. 7).

preservation of investment quality credit ratings and access to capital) against economy (the lowest overall cost to attract and maintain capital).¹⁴ PSE does not even acknowledge that standard. Nor does it show how ratepayers benefit from increasing PSE's equity ratio.

B. Cost of Common Equity

12 The Company's current authorized return on equity is 10.15 percent.¹⁵ PSE now seeks to increase the return to 10.8 percent. This request exceeds the 10.7 percent proposal of the Company's own witness, Dr. Morin.¹⁶ PSE's request also far exceeds the 10.2 percent return on equity the Commission just authorized for Avista and PacifiCorp.¹⁷ In contrast, Mr. Parcell's 10.0 percent cost of equity represents the approximate mid-point between Dr. Morin's recommendation and Mr. Hill's return on equity of 9.5 percent.

13 Mr. Parcell's 10.0 percent return on equity is also supported by evidence of significant changes in the capital markets that have lowered PSE's cost of capital since the Commission last set PSE's return on equity.¹⁸ A decrease in the authorized return of equity is also supported by the analytical methods of all cost of capital witnesses in this case.

¹⁴ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-040641 and UG-040640, Order 06 at ¶27 (February 18, 2007).

¹⁵ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-072300 and UG-072301, Order 12 at ¶116 (October 8, 2008).

¹⁶ There is even good reason to presume that Dr. Morin's return on equity is upwardly biased. In the Company's 2006 rate case, Dr. Morin recommended a return on equity of 11.25 percent. The Commission authorized 10.4 percent. In PSE's 2007 rate case, Dr. Morin recommended a cost of equity of 10.8 percent to 11.25 percent. The Commission approved 10.15 percent. Exhibit No. RAM-22.

¹⁷ The Commission found the rates granted in those cases to be just, fair, reasonable and sufficient. Avista Order at ¶330; *WUTC v. PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-090205, Order 09 at ¶76 (December 16, 2009). Thus, it is irrelevant that the 10.2 percent return on equity resulted from a settlement.

¹⁸ Cost of capital witnesses must support any change in the authorized return on equity with evidence of changed circumstances in the capital markets and the particular company under consideration. *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267, Order 08 at ¶84 (January 5, 2007) ("Little of the extensive testimony offered on this subject focuses on what might have changed in the capital markets or at PSE in the last 18 months to justify a change in the ROE set by the Commission in February of 2005").

1. Changes in the capital markets support Staff's recommendation to reduce the company's cost of equity

14 As Mr. Parcell indicated, the cost of capital for utilities such as PSE has declined over the past two years.¹⁹ This is apparent from several perspectives.

15 First, beginning in September 2008 and lasting through March 2009, the U.S. and global economies and capital markets were highly volatile. Capital markets practically came to a halt, as investors shied away from stocks and corporate bonds, and invested in the safest of investments – U.S. Treasury securities. As a result of this “flight to safety,” rates on U.S. Treasuries fell to unprecedented lows. In turn, stock prices fell dramatically and corporate bond yields rose. The yield on Baa-rated utility bonds was about 7 percent in June to September 2008, the time-frame of PSE's last rate case.²⁰ Rates rose to nearly 9 percent in late 2008 and remained around 8 percent through April of 2009.

16 However, over the past several months, capital markets have largely stabilized such that the current yields on long-term corporate bonds have declined to levels below those that existed prior to the crisis. Rates declined to 6 percent in September-October 2009, nearly 100 basis points below the level that prevailed during PSE's last rate case. This reduction in utility bond rates is reflected in PSE's most recent sale of new debt at 5.757 percent, which was the “lowest coupon that PSE ever received on a 30-year senior unsecured note issue.”²¹

17 It is also apparent that the recent financial crisis affected virtually all sectors of the economy – households, small businesses, and larger commercial and industrial enterprises.

In most cases, the impact on those sectors was greater than for PSE because PSE is a

¹⁹ Exhibit No. DCP-1T at 5-8 and 12-17.

²⁰ Exhibit No. DCP-4 at 3-4.

²¹ Exhibit No. DEG-11HCT at 19:9-10. The stabilization of the capital markets and resulting lower cost of capital are shown graphically by Exhibit No. SGH-1HCT, page 24. The yield spread differential between corporate bonds and long-term Treasuries has declined to a level below that experienced prior to the crisis.

regulated utility that sells an essential product with few close substitutes. As such, PSE was partially, if not largely, insulated from the impacts of the depressed economic conditions.

18 Third, the major impact of the recession was to depress the profits of most enterprises. As a result, capital costs decreased in the wake of the recession. There is no justification to increase the profit level of a regulated utility such as PSE at the same time that other enterprises are experiencing lower profits and lower cost of capital.²²

19 Finally, the United States and other governments have taken, and are continuing to take, extraordinary measures to avoid a worsening of market conditions. The Federal Reserve reduced interest rates to historically low levels and is expected to keep them there.²³ PSE benefits from these measures. Likewise, PSE's ratepayers should pay rates recognizing the lower cost of capital resulting from these measures.

20 Given the fact that opportunity costs, as well as interest rates, have declined since PSE's current return on equity was set and are expected to continue their decline, the Commission should reduce the Company's cost of equity to 10.0 percent. This is consistent with the United States Supreme Court's decision that "[a] rate of return may be reasonable at one time, and becomes too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally."²⁴

2. Changes at the Company support Staff's recommendation to reduce PSE's cost of equity

21 Mr. Parcell's recommendation to reduce PSE's return on equity to 10.0 percent is also supported by substantial evidence of changes at PSE since its last general rate case.

²² Dr. Morin disputes this assertion on the theory that PSE must still compete for the capital and other goods and services it needs to provide utility service. Tr. 686:6-687:16 (Morin). Apparently, he chooses to single out PSE for increased profits despite other businesses whose profits have declined and customers who have no choice but to purchase PSE's products and services.

²³ Tr. 672:13-20 (Morin).

²⁴ *Bluefield Water Works and Improvement Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 693 (1923).

22

First, since the 2008 Acquisition, Standard & Poor's ("S&P") has removed all of PSE's ratings from Credit Watch with negative implications and has upgraded the PSE's corporate credit rating from BBB- to BBB and its senior secured credit rating from BBB+ to A-.²⁵ These upgrades occurred despite PSE claims of added risk due to significant needs to invest in and maintain its energy production and delivery systems, and despite earned returns on equity PSE says are significant and continually below authorized returns.²⁶

23

PSE's claims of higher relative construction risk are also unfounded. All utilities are in a building phase and must access capital markets to finance construction.²⁷ Thus, any risk associated with construction financing is reflected in the proxy companies used in cost of capital analysis.²⁸

24

In any event, PSE actually is not concerned with its ability to fund its capital construction budget.²⁹ There is good reason for that attitude. Credit facilities already are in place from the 2008 Acquisition to finance the \$1 billion of equity PSE needs to finance construction.³⁰ As stated above, PSE issued debt in September 2009 at a coupon rate of 5.757 percent, the lowest rate the Company has experienced in 30 years.³¹

It is true that, going forward, PSE will issue new debt and refinance maturing debt.³² However, there is agreement that capital markets have stabilized.³³ This will allow PSE to

²⁵ Tr. 312:5-10 (Markell) and Exhibit No. DCP-1T at 19:9-17.

²⁶ Exhibit No. EMM-5T at 17:10-14, and Exhibit Nos. BAV-3, BAV-4C and BAV-5C.

²⁷ Tr. 711:7-22 (Parcell).

²⁸ Tr. 711:24-712:1 (Parcell). Even Dr. Morin was only lukewarm to PSE's assertion of higher construction risk. He stated that PSE is only "slightly" more risky than other utilities. Tr. 682:8-13 (Morin).

²⁹ Exhibit No. EMM-11, Part a. The Company also admitted that its capital budget has not grown significantly over last year. Exhibit No. EMM-11, Part b.

³⁰ Tr. 726:21-727:3 (Hill).

³¹ Tr. 731:18-732:2 (Gaines) and Tr. 726:10-13 (Hill).

³² Tr. 305:19-306:8 (Markell).

³³ Tr. 678:22-679:18 (Morin).

issue and refinance debt under reasonable terms and conditions.³⁴

3. The analytical methods presented by all cost of capital witnesses support a reduction in the Company's return on equity

25 It is noteworthy that Mr. Parcell's conclusion that PSE's cost of equity has declined is a position with which Dr. Morin implicitly agrees. Dr. Morin's original cost of equity was in the upper portion of a range of 11.0 to 11.5 percent.³⁵ His rebuttal recommendation, however, appeared to be 10.95 percent, but actually had dropped to 10.7 percent.³⁶

26 That Dr. Morin agrees implicitly that PSE's cost of capital has declined is also evident by comparing his cost of equity results from his direct testimony with his results using the same analytical methods during the hearings (all numbers exclude flotation costs):

<u>Study</u>	<u>Direct</u> Exhibit No. RAM-1T at 37, 41 and 53	<u>Update</u> Bench Request No. 7	<u>Change</u>
CAPM	8.50%	9.30%	+0.8%
Empirical CAPM	8.90%	9.70%	+0.8%
Risk Premium Electric	11.10%	10.34%	-.76%
DCF Vert Int Value Line	12.10%	10.80%	-1.30%
DCF Vert Int Zacks	11.90%	10.80%	-1.30%
DCF S&P Value Line	11.90%	10.30%	-1.60%
DCF S&P Zacks	12.00%	11.30%	-.70%

Dr. Morin places little weight on Capital Asset Pricing Model ("CAPM") results,³⁷ so the Discounted Cash Flow ("DCF") and other methods he does advocate indicate significant equity cost declines since this case was first initiated.

27 It is also evident that the 10.0 percent equity cost proposed by Mr. Parcell properly reflects the current cost of equity for PSE. First, Mr. Parcell places primary reliance on the

³⁴ Tr. 727:5-9 (Hill).

³⁵ Exhibit No. RAM-1T at 3:11-20.

³⁶ Tr. 654:6-9 (Morin).

³⁷ Tr. 677:22- 678:4 (Morin).

DCF model, which reflects Commission historical preference.³⁸ The DCF model is also the preferred model of all other witnesses.³⁹

28

Mr. Parcell's DCF analyses employed the constant growth DCF model, which combines the current dividend yield for each group of proxy utility stocks with several indicators of expected dividend growth.⁴⁰ His dividend yield component used this formula:

$$Yield = \frac{D_o(1 + 0.5g)}{P_o}$$

This recognizes the timing of dividend payments and dividend increases. The P_o in his yield calculation is the average (of high and low) stock price for each proxy company in August-October 2009. The D_o is the current annualized dividend rate for each proxy company.⁴¹

Mr. Parcell then considered five indicators of growth in his DCF analyses:

1. 2004-2008 (5-year average) earnings retention, or fundamental growth (per Value Line)
2. 5-year average of historic growth in earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS") (per Value Line);
3. 2009, 2010, and 2012-2014 projections of earnings retention growth (per Value Line);
4. 2006-2008 to 2012-2014 projections of EPS, DPS, and BVPS (per Value Line); and,
5. 5-year projections of EPS growth as reported in First Call (Per Yahoo! Finance).

This combination of growth indicators is a representative set to estimate investor expectations for the proxy companies. They also reflect the types of information that investors consider in making their investment decisions.⁴²

³⁸ Exhibit No. DCP 1T at 4:20 and 44:17-18, and Tr. 696:4-23 (Parcell), citing, *WUTC v. Puget Sound Energy, Inc.*, Dockets UG-040641 and UG-040640, Order 06 at ¶73 (February 18, 2005).

³⁹ Tr. 677:677:5-10 (Morin) and Tr. 720:19-21 (Hill).

⁴⁰ Exhibit No. DCP-1T at 31:10-13. Mr. Parcell analyzed three groups of proxy utilities. Two groups were the same as chosen by Dr. Morin. Exhibit No. DCP-1T at 29:17-30:4 and Tr. 664:2-3 (Morin).

⁴¹ Exhibit No. DCP-1T at 32:1-3.

29 Mr. Parcell's DCF results indicated average (mean and median) cost rates of 9.6 percent to 11.3 percent.⁴³ Mr. Parcell concluded that the lower portion of this range reflects the proper equity cost for PSE.⁴⁴ He specifically recommends a 10.0 percent return on equity for the Company.

30 It is clear that Mr. Parcell's DCF conclusions are more appropriate than Dr. Morin's DCF results of 10.8 to 11.3 percent. This is largely because Mr. Parcell considers multiple measures of growth whereas Dr. Morin uses only one: analysts' estimates of EPS. As Mr. Parcell indicated, it is not proper to rely exclusively on EPS growth forecasts since investors routinely consider other information, such as that provided by Value Line, regarding alternative measures of growth.⁴⁵

31 Mr. Parcell also noted that current DCF results are upwardly impacted by recent financial circumstances, in a similar manner that current CAPM results are downwardly impacted.⁴⁶ Thus, it is proper to set the equity return at the low portion of the DCF results.⁴⁷

32 Finally, Mr. Parcell's 10.0% cost of equity is supported by his Comparable Earnings cost of equity of 9.5 percent to 10.5 percent.⁴⁸ Mr. Parcell's recommendation is also supported by the 9.5 percent return on equity proposed by Mr. Hill.

4. Conclusion on the Cost of Equity

33 There is no dispute among the cost of capital witnesses that PSE's capital costs are declining. The issue for the Commission is to determine in that environment the degree to which the Company's new owners should be compensated for providing equity capital to

⁴² Exhibit No. DCP-1T at 33:10-16.

⁴³ Exhibit No. DCP-1T at 34:7-11.

⁴⁴ Exhibit No. DCP-1T at 34:20-21.

⁴⁵ Exhibit No. DCP-1T at 50:1-12.

⁴⁶ Exhibit No. DCP-1T at 34:20-35:16 and Tr. 697:11-689:17 (Parcell).

⁴⁷ Exhibit No. DCP-1T at 35:2-16.

⁴⁸ Exhibit No. DCP-1T at 43:2-4.

PSE. Staff submits that sufficient compensation will be paid to the new owners using a 10.0 percent return on equity. The record clearly supports Staff's conclusion.

C. Cost of Long-Term Debt

34 In its original filing, PSE proposed a cost of long-term debt of 6.82 percent. That rate was an estimate based upon projected costs for three issuances in September 2009 (6.90 percent), March 2010 (6.72 percent), and September 2010 (6.86 percent).⁴⁹

35 PSE recognized in rebuttal that its estimate was excessive in light of its September 2009 issuance of 30-year bonds at 5.757 percent, significantly below the 6.90 percent PSE first assumed for that issue.⁵⁰ The Company did not, however, reduce its estimate for the future debt issuances it expects to sell in March and September 2010.⁵¹

36 This omission is baseless. Mr. Parcell corrected that error by re-pricing the two 2010 debt issuances at the 5.757 percent cost PSE actually paid in September 2009. The resulting cost of debt recommended by Mr. Parcell is 6.48 percent.⁵²

37 Mr. Parcell's cost of debt is fair to ratepayers and PSE because it incorporates a reduction in interest rates that has occurred and is likely to occur in the rate year. In contrast, the PSE's proposal inflates the cost of debt in a manner that is unfair to ratepayers.

D. Staff's Overall Cost of Capital Will Maintain the Company's Financial Integrity

38 Mr. Parcell's recommendations result in a total cost of capital for PSE of 7.91 percent. A total cost of capital of 7.91 percent will maintain PSE's financial integrity. It

⁴⁹ Exhibit No. DEG-5C at 5:31-33.

⁵⁰ Exhibit No. DEG-12:18-13:8.

⁵¹ Exhibit No. DEG-9CT at 14:2-6 and Exhibit No. DEG-10C at 5:31-33.

⁵² Exhibit No. DCP-1T at 28:22-29:2 and Exhibit No. DCP-3 at 2. Mr. Parcell used the same 5.757 percent cost rate to price the 3 percent differential between PSE and Staff recommended equity ratios.

produces a pre-tax interest coverage of 3.03,⁵³ which falls within the S&P benchmark for a BBB utility like PSE.⁵⁴ The 51.05 percent debt ratio recommended by Mr. Parcell is also within S&P's benchmark for a BBB utility like PSE.⁵⁵

39 The Company challenges this conclusion by offering its perception of what S&P's credit matrices would be if all of Staff's revenue requirement recommendations were adopted. PSE then compares its portrayal with S&P's "Expectation" for each metric to imply that adoption of the Staff case would threaten PSE's current credit rating.⁵⁶

40 By this logic, PSE's own case should be rejected since it also does not meet S&P's Expectations.⁵⁷ More to the point, the assignment of credit ratings is not the mechanical exercise PSE implies. S&P also considers qualitative factors. The qualitative factors S&P considered when it increased PSE's credit rating were PSE's "excellent" business risk profile and its many, significant cost recovery mechanisms.⁵⁸ PSE ignores these qualitative attributes. Its conclusion regarding the impacts of the Staff case is pure speculation.

III. RATEMAKING ADJUSTMENTS

A. Actual Results of Operations for the 2008 Test Year

41 Staff and PSE agree on the electric and gas per books amounts for the 2008 test year.⁵⁹ This includes an allowance for working capital to: (1) reclassify certain accounts

⁵³ Exhibit No. DCP-17. A 3.03 coverage exceeds levels experienced by PSE over the last 5 years. Tr. 722:9-16 (Hill). Thus, Mr. Parcell's recommendation will allow PSE to improve its pre-tax interest coverage.

⁵⁴ Exhibit No. DCP-17.

⁵⁵ *Id.*

⁵⁶ Exhibit No. DEG-11HCT at 23:7-28:12 and Exhibit No. DEG-19.

⁵⁷ Exhibit No. DEG-19 at 1.

⁵⁸ Exhibit No. DCP-1T at 20:10-42 and Exhibit No. DEG-20.

⁵⁹ Exhibit No. B-3 at Exhibit Nos. KHB-2 and KHB-3, columns entitled "Actual Results of Operations", and Exhibit No. B-2, Attachments C and D, columns entitled "Actual Results of Operations".

related to an oil spill at Crystal Mountain; (2) include combined CWIP balances in the working capital ratios; and (3) treat gas customer deposits as a rate base reduction.⁶⁰

B. Uncontested Ratemaking Adjustments

42 The following electricity and natural gas ratemaking adjustments are uncontested as between PSE and Staff and should be adopted by the Commission:

<u>Electricity Adjustments</u>	<u>Natural Gas Adjustments</u>
10.01 Temperature Normalization	9.01 Temperature Normalization
10.04 Federal Income Tax	9.04 Federal Income Tax
10.12 Pass-Through Rev & Expense	9.06 Depreciation Study
10.13 Bad Debt	9.07 Pass-Through Rev & Expense
10.14 Miscellaneous Operating Exp.	9.08 Bad Debt
10.16 Excise Tax & Filing Fee	9.09 Miscellaneous Operating Exp.
10.18 Montana Electric Energy Tax	9.11 Excise Tax & Filing Fee
10.19 Interest on Customer Deposits	9.13 Interest on Customer Deposits
10.20 SFAS 133	9.14 Rate Case Expense
10.21 Rate Case Expense	9.15 Deferred G/L on Property Sales
10.22 Deferred G/L on Property Sales	9.16 Property & Liability Insurance
10.23 Property & Liability Insurance	9.17 Pension Expense
10.24 Pension Expense	9.21 Incentive Pay
10.28 Incentive Pay	9.22 Merger Savings
10.29 Merger Savings	9.23 Fleet Vehicles
10.30 Storm Damage	
10.32 Depreciation Study	
10.35 Fleet Vehicles	
10.39 Wild Horse Solar Removal	

43 With respect to Adjustments 10.04 and 9.04, Federal Income Tax, PSE accepted proposals from Public Counsel for non-tax deductible executive compensation and flow-through treatment for injuries and damages.⁶¹ Staff concurs with this approach.⁶²

44 Adjustments 10.14 and 9.09, Miscellaneous Operating Expenses, were contested in Staff's response case because PSE proposed to recover increases in service contracts even

⁶⁰ Exhibit No. RCM-1T at 8:7-22, Exhibit No. DPK-1T at 8:5-15 and 10:20-11:12, Exhibit No. DPK-3T, and Exhibit No. MJS-12T at 9:3-24. The agreement to reduce gas rate base by the customer deposit balance is also reflected in uncontested Adjustments 10.19 and 9.13.

⁶¹ Exhibit No. JHS-14T at 27:1-6 and Exhibit No. MRM-4T at 20-25:10.

⁶² Exhibit No. B-3 at Exhibit No. KHB-2, page 2.11 and Exhibit No. KHB-3, page 3.9.

though it had not signed new contracts with its service providers.⁶³ PSE has now finalized new contracts.⁶⁴ This allows Staff to include the contract increases in its adjustments.⁶⁵

45 For Adjustments 10.22 and 9.15, Deferred G/L on Property Sales, Staff includes the additional gain on property noted by the Company in rebuttal.⁶⁶

46 Finally, at hearing, PSE noted that it had inadvertently included without justification a small solar facility serving the Wild Horse visitor center.⁶⁷ Adjustment 10.39, Wild Horse Solar Removal, removes the facility using data provided by PSE after the hearings. Staff accepts the data as a fair representation of facility costs and rate base, but reserves the right to further review these amounts and contest their recovery in any later case.

C. Contested Ratemaking Adjustments⁶⁸

47 As the Commission is well aware, ratemaking begins with an historical test year because an historical test year provides cost, revenue and rate base data that can be audited, and the test year captures the relationships among costs, revenues, and rate base over a uniform period of time. There are expenses or investments that take place during or after the test year. Thus, pro forma adjustments are permitted, but only if they are “known and measurable” and “not offset by other factors.”⁶⁹ Pro forma adjustments that meet these requirements preserve the test year matching of revenues, costs and rate base.

48 Staff’s approach applies these fundamental principles. This required Staff to revise many of PSE’s expense adjustments because those adjustments used budget forecasts of

⁶³ Exhibit No. MDF-1T at 5:8-7:25.

⁶⁴ Tr. 173:21-174:3 (Valdman).

⁶⁵ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.21 and Exhibit No. KHB-3, page 3.14.

⁶⁶ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.29 and Exhibit No. KHB-3, page 3.20.

⁶⁷ Tr. 600:14-601:17 (Story).

⁶⁸ Public Counsel and the Federal Executive Agencies propose other adjustments not discussed in the Staff Brief. Staff takes no position on those adjustments.

⁶⁹ WAC 480-07-510(3)(iii).

future expenses that were shown to be inherently unreliable.⁷⁰ Likewise, Staff revised many of PSE's adjustments for plant added during or after the test year, based generally on verified expenditures at August 2009, rather than the projections used by PSE.⁷¹

49 PSE does not dispute that its adjustments rest on budget projections and that those projections changed during this case. It states, however, that its approach is consistent with Commission precedent and prior Staff practice.⁷² PSE also argues that Staff's current approach is incompatible with its increasingly expensive efforts to maintain and operate a safe and reliable energy delivery system, and provide a reliable and adequate energy supply.⁷³ The Commission has heard these challenges before and has not been persuaded.⁷⁴

50 First, the Commission affirmed Staff's approach to reject budget forecasts of rate year expenses even when those projections reflect the sound opinion of management:

The known and measurable concept requires that an event that causes a change in revenue, expense or rate base must be *known* to have occurred during or after the historical 12 months of actual results of operations. It must also be demonstrated (*i.e., known*) that the effect of the event will be in place during the 12-month period when rates will likely be in effect. The actual amount of the change must be *measurable*. This means the amount cannot be an estimate, a projection, the product of a budget forecast, or some similar exercise of judgment—even informed judgment—concerning future revenue, expense or rate base. Costs that are documented by actual expenditure, invoice, contract, or other specific obligation usually meet this test. Costs that are the product of forecasts, projections, or budgets generally will not qualify.⁷⁵ (Emphasis in original; Footnotes omitted.)

⁷⁰ Exhibit No. MPP-1T at 4:26-11:28 and Exhibit No. KHB-1TC at 20:8-22:12.

⁷¹ Exhibit No. MPP-1T at 11:30-12:8 and Exhibit No. KHB-1TC at 26:7-20.

⁷² Exhibit No. JHS-14T at 4:14-12:4.

⁷³ Exhibit No. EMM-5T at 4:12-18 and 21:19-22.

⁷⁴ Avista Order at ¶57 ("Explaining the factors driving its need to make new plant investments, Avista points to the need to strengthen [its] transmission and distribution systems, aging infrastructure, physical degradation and to meet the costs of municipal compliance including street relocations. [Avista] asserts that these necessary plant investments are increasingly expensive and exceed depreciation revenue due to increased construction materials in the range of 55 percent to 170 percent since 2003."). *Id.* at ¶62 ("[Avista] counters that Commission precedent treats many costs as known and measurable for purposes of pro forma adjustment even though they are estimates and not precisely known.").

⁷⁵ Avista Order at ¶45 and Exhibit No. MPP-1T at 10:1-4. The Commission did state that power cost and production plant adjustments are allowed despite their use of estimates or forecasts, because they use well-established mechanisms accompanied by rigorous and specific analysis. Avista Order at ¶¶49-50. PSE's projections of power cost O&M expense do not meet such exacting standards and, thus, should not be allowed,

Second, the Commission affirmed the importance Staff attributes to identifying all offsetting factors across a utility's entire operations in order to preserve test year relationships among revenues, costs and rate base:

The Company provides estimates of the revenue or cost savings it believes could be attributable to each of the projects during the rate year. While these estimates may be accurate, this approach misconstrues the principle of matching. It implies that the necessary matching is limited solely to offsetting factors caused by the project in question. The principle of matching requires that all cost of service components – revenue, investment, expenses and cost of capital – be evaluated at a similar point in time. Staff is correct to point out that this requires consideration of all of the Company's costs and revenues.⁷⁶ (Emphasis in original.)

Finally, the Commission confirmed Staff's concern that injury to the matching principle could result if projected costs for plant additions are used rather than audited, verified results:

Staff is correct to focus on audited results to ensure that the costs it proposes to include in rates comply with both the known and measurable principle and the used and useful principle. Budgeted figures representing the Company's projected and planned costs for capital programs may prove to be inaccurate. While we do not question the rigor of the Company's management and planning processes, planned expenditures are not certain expenditures.

* * *

... The Company's proposal to include all planned 2009 capital additions is tantamount to requiring either a continuous audit during the pendency of a rate proceeding or acceptance of budgeted or forecast data as known and measurable. Staff correctly points out that for it to verify that costs are sufficiently documented and appropriate to include in rates, the dictates of practicality require its audit must conclude at some point in time before the conclusion of the rate review.⁷⁷ (Emphasis in original.)

as we discuss below in Section III, C, 2, a. In Section III, C, 2, j below, Staff addresses why the production plant adjustment also should not be allowed in this case in light of Company forecasts for a reduction in load.

⁷⁶ Avista Order at ¶94, and Exhibit No. MPP-1T at 6:14-21 and 8:20-9:3.

⁷⁷ Avista Order at ¶¶71 and 78, and Exhibit No. MPP-1T at 11:31-12:5.

Thus, Staff's use of audited results struck a fair balance preserving the integrity of the test year, while allowing recovery of capital expenses that occur during or after the test year.⁷⁸

53 Each of these principles was applied by Staff in the ratemaking adjustments it recommends in this proceeding. In contrast, PSE's approach is tantamount to future test year ratemaking which this Commission has not adopted by order or by rule.

1. Contested Electricity and Natural Gas Adjustments

54 The following parallel electricity and natural gas adjustments are contested as between the Company and Staff:

a. 10.02 and 9.02, Revenues and Expenses

55 These adjustments are contested only for PSE's Conservation Phase-In proposal, which removes energy sales intended to represent the amount of conservation not captured by actual sales during the test year. The adjustment is based upon the difference between total savings estimated by PSE for Company-sponsored conservation by the end of test year and year-to-date estimated savings for each month of the test year.⁷⁹

56 The Conservation Phase-In adjustment should be rejected. It is not a proper pro forma adjustment. Nor has PSE demonstrated material harm absent the adjustment.

i. The Conservation Phase-in adjustment fails to properly annualize the effects of energy savings

57 PSE's Conservation Phase-In adjustment annualizes estimated changes in energy sales from Company-sponsored conservation. In doing so, the adjustment pro forms changes in units during the test year, rather than changes in the rate applied to test year units. This creates an inappropriate mismatch with other test year components.⁸⁰

⁷⁸ Avista Order at ¶70.

⁷⁹ Exhibit No. JAP-1T at 18:12-14.

⁸⁰ Exhibit No. MPP-1T at 13:19-22.

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The Company states that its adjustment annualizes conservation savings in accordance with established accounting practice.⁸¹ The support it cites, however, states:

The key ingredient in the annualizing adjustment considerations is the changing level of costs (or revenues) for the same level of operations.⁸²

The proposal to annualize reduced energy sales from Company-sponsored conservation changes the level of operations, in violation of this provision.

59

PSE argues that its proposal is similar to weather normalization adjustments that adjust units of energy sales based upon temperature.⁸³ However, temperature normalization adjustments are symmetrical. They increase or decrease load when weather is either warmer or colder than normal. In contrast, PSE's proposal is one-sided: it only requires ratepayers to make the Company whole for lost margins alleged to result from decreased sales.⁸⁴ Indeed, the proposal is doubly unfair to ratepayers who already fully reimburse PSE to install conservation measures.⁸⁵

ii. The Conservation Phase-In proposal is not a proper pro forma adjustment because it uses unverified savings

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PSE's Conservation Phase-In adjustment uses reported energy savings that have not been independently verified through post-installation analysis.⁸⁶ Thus, it is unproven that the reported savings represent savings that actually result from PSE-sponsored conservation.

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This is a deficiency that fails to meet the "known and measureable" standard for ratemaking and, therefore, requires that PSE's proposal be rejected.⁸⁷ Staff's position has been validated by the Commission in finding that bill verification analyses must be included

⁸¹ Exhibit No. JAP-1T at 19:18-20:13.

⁸² Exhibit No. MPP-1T at 14:3-13 citing Robert L. Hahne and Gregory E. Aliff, *Accounting for Public Utilities*, §7.05 (2006).

⁸³ Exhibit JAP-5T at 3:13-5:14.

⁸⁴ Tr. 546:14-547:24 (Piliaris).

⁸⁵ Tr. 563:9-25 (Piliaris) and Tr. 564:8-17 (Piliaris).

⁸⁶ Exhibit No. JAP-5T at 10:4-5 and Tr. 555:15-18 (Piliaris).

⁸⁷ Exhibit No. MPP-1T at 16:12-23.

in the analysis of energy efficiency programs.⁸⁸ Staff's position is particularly relevant as budgets for conservation have increased dramatically.⁸⁹

62 PSE argues that reported conservation savings were used to implement its performance incentive mechanisms from 2003 to 2008 without independent, post-installation evaluation and verification.⁹⁰ However, the Conservation Phase-In proposal has the potential to significantly impact rates because it changes billing determinants.⁹¹ The prior incentive mechanisms did not change billing determinants and, therefore, could be implemented without independent, post-installation analysis.⁹²

63 PSE argues that its reported conservation savings and process for their development have been reviewed by an independent third-party, Blue Ridge Consulting.⁹³ Actually, Blue Ridge questioned PSE's analysis of cost-effectiveness, which is used to determine energy savings. Blue Ridge urged the use of additional tests beyond the total resource cost test, and recommended that PSE's planning and modeling techniques be further investigated.⁹⁴

64 Moreover, the Blue Ridge report is only a preliminary assessment prepared over a very short time frame.⁹⁵ Further evaluation is expected in a second report to come.⁹⁶ Indeed, Blue Ridge itself acknowledges the limits of its initial report. It states that it "has not made an analysis, verified, or rendered an independent judgment of the validity of the

⁸⁸ Avista Order at ¶350.

⁸⁹ PSE's overall expenditures for conservation have more than doubled since 2004. Exhibit No. JAP-6 at 15.

⁹⁰ Exhibit No. JAP-5T at 10:1-14. A penalty-only mechanism was in place from 2003 to 2006. It was replaced in 2007 with the reward/penalty Electric Conservation Incentive Mechanism.

⁹¹ Exhibit No. TES-1T at 3:22-4:2.

⁹² Exhibit No. JAP-11.

⁹³ Exhibit No. JAP-5T at 10:14-11:9, citing Exhibit No. JAP-6.

⁹⁴ Exhibit No. JAP-6 at 62-63.

⁹⁵ The Request for Proposal through which Blue Ridge was selected was issued on June 5, 2009 and contract completion did not occur until July 31, 2009. Tr. 529:19-20 and 530:16-22 (Piliaris). Thereafter, data collection, analysis and report drafting all had to be completed by the submission date of October 24, 2009. Exhibit No. JAP-6 at 1.

⁹⁶ Exhibit No. JAP-6 and Tr. 531:1-24 (Piliaris).

information provided by others.”⁹⁷ It also states that it was endeavoring only to determine, “What assumptions or methods were used to calculate the energy savings reported by PSE?”⁹⁸ Thus, the report did not analyze the energy savings that the Company estimated.

iii. The Conservation Phase-In Proposal is not a proper pro forma adjustment because it does not address other factors that affect energy sales

65 Company-sponsored conservation is only one of many factors that influence electricity and natural gas sales. Other factors include the number of customers served and the average use per customer which can be impacted by selected end-uses (such as heat, water heat, air conditioning and other appliance/device choices), home size, building codes, economic conditions, and customer-financed measures.⁹⁹

66 PSE’s Conservation Phase-In adjustment selects only one cause for changing sales volumes, without accounting for other variables that influence sales. Indeed, PSE acknowledged that its proposal will allow it to recover lost margins from conservation even when total household use increases or remains unchanged due to new end uses.¹⁰⁰ This, again, is unfair, and one-sided in PSE’s favor.

67 Finally, even if the conservation savings occur exactly as PSE predicts, the Company has not accounted for other offsetting factors, such as reduced labor and maintenance costs, that may have occurred during the test year as a result of decreased load.¹⁰¹ Until all offsetting factors have been assessed, the adjustment has not been shown to preserve the matching principle of historical test year ratemaking.

⁹⁷ Exhibit No. JAP-6 at 3.

⁹⁸ Exhibit No. JAP-6 at 37.

⁹⁹ Exhibit No. JRD-1CT at 37:7-38:2.

¹⁰⁰ Tr. 560:1-25 and Tr. 561:9-12 (Piliaris).

¹⁰¹ Exhibit No. MPP-1T at 14:20-15:6.

iv. The Conservation Phase-In Proposal attempts to address an issue that has not been shown to be material

68 The Company agreed that annualizing adjustments should capture significant changes in use by customers.¹⁰² Changes in use from conservation changed PSE's original revenue requirement by only 0.25 percent.¹⁰³ Therefore, the Conservation Phase-In adjustment is not necessary under PSE's own standard.

69 PSE also admitted that the adjustment will not cure its disincentive to invest in conservation because the proposal does not break the link between revenues and retail sales.¹⁰⁴ That admission renders irrelevant Company testimony that this case provides a "perfect opportunity" for the Commission to formulate policy and approve mechanisms that remove utility disincentives to invest in conservation.¹⁰⁵

70 PSE now argues that the Conservation Phase-In adjustment is "material" to the Company's finances.¹⁰⁶ However, it provided no analysis to support that allegation.

71 The Company argues that conservation in 2007 and 2008 was projected to result in lost margins of \$34 million and lost revenues of \$46 million.¹⁰⁷ However, PSE provided no support for those amounts.¹⁰⁸ Its first attempt to explain the derivation did not occur until the hearing.¹⁰⁹ Even then, the Company's explanation proved ineffective.¹¹⁰

¹⁰² Exhibit No. JAP-1T at 20:18.

¹⁰³ Exhibit No. MPP-1T at 15:17-19, citing PSE's Response to Staff Data Request No. 190.

¹⁰⁴ Tr. 565:14-24 (Piliaris). The question arose at hearing whether the Conservation Phase-In proposal is a decoupling mechanism that violates commitments in the 2008 Acquisition. Tr. 565:8-566:1 (Piliaris). Decoupling is a mechanism that breaks the link between revenues and retail sales. Avista Order at ¶242. Because PSE's proposal does not meet that standard, it does not violate 2008 Acquisition commitments.

¹⁰⁵ Exhibit No. JAP-5T at 20:6-18.

¹⁰⁶ Exhibit No. JAP-5T at 8:6-10.

¹⁰⁷ Exhibit No. JAP-5T at 15:5-12.

¹⁰⁸ Tr. 549:20-22 and 552:19-22 (Piliaris).

¹⁰⁹ Tr. 572:1-576:18 (Piliaris).

¹¹⁰ Tr. 576:16-18 (Piliaris).

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Finally, PSE states that Blue Ridge “confirmed” the lost margin and lost revenue amounts alleged for 2007 and 2008. It became clear, however, that Blue Ridge confirmed nothing. It merely accepted without objection or analysis the same amounts provided by PSE that have been shown on this record to have no support.¹¹¹

b. 10.05 and 9.05, Tax Benefits of Pro Forma Interest

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The difference between Staff and PSE relates to other contested adjustments that affect rate base and the weighted cost of debt. No further discussion is included here.

c. 10.15 and 9.10, Property Tax

74

The Commission has stated that the adjustment for property taxes illustrates the basic principles of historical test year ratemaking:

Property taxes are an annual expense that is consistently known and must be planned for every year. However, the exact amount of these taxes remains unmeasurable until the taxing authorities announce rates and property valuations for any given tax year. It is wholly appropriate to pro form new tax rates and assessments once they become measurable.¹¹²

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Staff’s adjustments meet this test. They represent PSE’s actual tax liability for all property for the 2008 test year, based on the actual, centrally-assessed valuation of the Department of Revenue (“DOR”) and the actual levy rates announced by taxing districts.¹¹³

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In contrast, PSE’s adjustments are forecasts of 2009 property taxes that rely on levy rates that have not yet been announced by the taxing authorities.¹¹⁴ That approach violates

¹¹¹ Tr. 551:24-552:18 (Piliaris). In fact, Blue Ridge suggested that PSE’s lack of awareness concerning conservation-related lost revenues and lost margins may indicate “the lack of impact of these disincentives in terms of harm to the financial health of the Company.” Exhibit No. JAP-6 at 78.

¹¹² Avista Order at ¶154.

¹¹³ Exhibit No. B-2 at Exhibit No. KHB-2, page 2.22 and Exhibit No. KHB-3, page 3.15, Exhibit No. MRM-9, and Tr. 465:7-466:16 and Tr. 519:10-19 (Marcelia). The Company’s operating properties are assessed en masse by DOR. Exhibit No. MRM-5 at 1. DOR determines the total value of all property regardless of location. Assets, including energy producing facilities, are not individually assessed.

¹¹⁴ Exhibit No. MRM-4T at 9:17-18 and Exhibit No. MRM-5.

the Commission's test that new tax rates can be pro formed only when they are fixed by the taxing authorities and, thereby, become measurable.

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PSE states that its use of estimated levy rates does not disqualify its adjustments because estimating property taxes is a common practice that becomes more precise over time.¹¹⁵ That is precisely the point: the 2009 property tax estimates used by PSE for its adjustment have changed and will continue to change until PSE's actual tax liability is finally determined. PSE's initial forecasted change in property taxes for its electric operations was \$2,467,222.¹¹⁶ The forecast later decreased 187 percent to (\$2,139,835).¹¹⁷ Similarly, PSE's projection of property taxes for its gas operations changed from \$1,308,384 to \$1,620,627, a 24 percent increase.¹¹⁸ It is wholly inappropriate to pro form estimates of property taxes that have so significantly changed and can be expected to change again.

d. 10.17 and 9.12, D&O Insurance

78

Staff proposes that 50 percent of D&O insurance be allocated to shareholders because shareholders benefit equally with ratepayers when directors and officers are protected from legal claims while performing their official duties.¹¹⁹ The Commission has accepted the premise that shareholders benefit.¹²⁰ Other jurisdictions agree.¹²¹

¹¹⁵ Exhibit No. MRM-4T at 8:13-20 and 9:17-10:2.

¹¹⁶ Exhibit No. JHS-10 at 21.

¹¹⁷ Exhibit No. B-2 at Attachment C, page 2.22.

¹¹⁸ Exhibit No. MJS-9 at 9.10 and Exhibit B-2 at Attachment D, page 3.15.

¹¹⁹ Exhibit No. AMCL-1T at 4:7-14.

¹²⁰ Avista Order at ¶136.

¹²¹ For example, *See Re Connecticut Light and Power Co.*, 124 P.U.R. 4th 532, 560 (Conn. D.P.U.C. 1991) ("Given the fact that the majority of the lawsuits would be initiated by shareholders, the Authority [Commission] agrees . . . that the costs should be borne equally between shareholders and ratepayers."). More recently, the Connecticut commission has noted that while it historically has allowed a portion of D&O insurance to be charged in rates, to assure some level of ratepayer protection from catastrophic lawsuits, the Department "agrees . . . that the shareholders should bear the weight of their decisions in appointing directors (who appoint the officers of the Company)." *In re The United Illuminating Co.*, 246 P.U.R. 4th 357, 403 (Conn. D.P.U.C. 2006). See also, *Re CenterPoint Arkla, a Division of CenterPoint Energy Resources Corp.*, 245 P.U.R. 4th 384, 409 (Ark. P.S.C. 2005) ("The Commission agrees with AG that more often than not it is the

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It is true that the cases cited by Staff have not persuaded the Commission to adopt an equal sharing of D&O insurance costs.¹²² However, PSE did not directly dispute the Staff allocation. It states merely that its adjustments are consistent with those accepted in prior cases.¹²³ Therefore, it is reasonable for the Commission to accept Staff's proposal to share the cost of D&O insurance equally between ratepayers and shareholders.¹²⁴

e. 10.25 and 9.18, Wage Increase

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PSE proposes wage increases for both union and non-union employees. With respect to union employees, PSE agrees to include only contractual increases.¹²⁵ The effective date of IBEW's 3 percent contract increase is January 1, 2010.¹²⁶ Therefore, PSE has included that increase from January 1, 2010 to December 31, 2010.¹²⁷ Staff concurs and has updated its adjustment accordingly.¹²⁸ Likewise, Staff and PSE include only wage increases for UA employees through September 30, 2010, the end of the current UA contract.¹²⁹

81

Staff and the Company, however, do not agree on the adjustment for non-union employee wage increases. PSE includes a 3 percent increase from March 1, 2010, based on a 2010 budget forecast.¹³⁰ Staff removes that increase because any such budget estimate is uncertain and, thus, not "known and measurable".¹³¹

current shareholders who sue management and who receive a large portion of the proceeds from the D&O insurance payouts.").

¹²² Avista Order at ¶136.

¹²³ Exhibit No. MJS-12T at 21:1-8.

¹²⁴ In the Avista Order, the Commission allocated D&O insurance based on the allocation of executive compensation. Avista Order at ¶137. A similar approach would allocate 92.5 percent of D&O insurance to ratepayers and 7.5 percent to shareholders. Exhibit No. JHS-28 and Tr. 386:17-21 (Stranik).

¹²⁵ Exhibit No. MJS-12T at 26:9-10.

¹²⁶ Exhibit No. MJS-12T at 26: 9-16 and Exhibit No. TMH-9CT at 27:20-28:1.

¹²⁷ Exhibit No. MJS-20.

¹²⁸ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.32 and Exhibit No. KHB-3, page 3.23.

¹²⁹ Exhibit No. JH-3 at 4:21-23 and Exhibit No. MJS-20 at 1.

¹³⁰ Exhibit No. TMH-20.

¹³¹ Avista Order at ¶110.

82 PSE states that the 2010 budget was approved by the Board of Directors in
November 2009.¹³² However, PSE could not support the budgeted wage increases with
specific documents. It admitted that no documents were part of the Board's approval.¹³³

83 PSE also acknowledged that the Board has authority to rescind prior actions or make
changes to budget projections after they are approved.¹³⁴ It is inappropriate to pro form
budgeted wage increases that the Company is not yet obligated to pay.

f. 10.26 and 9.19, Investment Plan

84 These adjustments adjust PSE's portion of the investment plan expense to reflect
additional expenses for wage increases. Staff and Company adjustments differ only because
of differences in their Wage Increase adjustments.

g. 10.27 and 9.20, Employee Insurance

85 Staff and PSE agree that these adjustments should reflect actual Flex Credit benefit
increases of 4.75 percent per employee that is set by contract.¹³⁵ Staff and Company
disagree on the employee counts used to calculate the adjustments.

86 Staff used the employee count from PSE's direct case, which was based on a system
report run at the start of each month in the test year for active employees covered at that
time.¹³⁶ Staff's adjustment, therefore, includes only actual costs incurred in the test period.

87 By contrast, PSE revised its employee count to include new employees who must
wait 30 days before they can sign up and qualify for coverage.¹³⁷ Consequently, PSE
includes employees who were hired at the end of the test period, but who did not qualify for

¹³² Exhibit No. TMH-20.

¹³³ Exhibit No. TMH-20; Tr. 449:23-25 and 458:10- 459:12 (Hunt).

¹³⁴ Tr. 454:15-23 (Hunt)

¹³⁵ Exhibit JH-1T at 7:14-16 and Exhibit No. MJS-12T at 27:12-14.

¹³⁶ Exhibit No. MJS-12T at 27:15-18.

¹³⁷ Exhibit No. MJS-12T at 27:18-19.

coverage until after the test period. It is inappropriate to include insurance costs for these employees because the costs were incurred outside the test period.

h. 10.36 and 9.03, Net Interest Paid to IRS

88 PSE proposes to recover net interest paid to the Internal Revenue Service (“IRS”), including carrying costs, which the Company incurred in connection with its use of a simplified service cost accounting method that later was disallowed by the IRS. As a result of a settlement, the IRS required PSE to pay interest on back taxes net of tax refunds. The thrust of PSE’s argument is that this adjustment is necessary to make the Company whole. This argument fails. Staff recommends that the Commission reject this adjustment.

89 Staff’s specific and detailed analysis shows clearly that PSE has already been the net beneficiary of the use and subsequent disallowance of the tax method. Therefore, any additional recovery would be an unwarranted and unreasonable windfall to PSE.¹³⁸

90 PSE does not challenge Staff’s analysis showing net benefits already received by the Company. As a result of deductions taken by PSE in 2002 through the simplified service cost method, PSE gained a \$72 million tax benefit. PSE enjoyed those benefits for a number of years, but ratepayers were deprived until March 2005 when the \$72 million tax benefit was used to reduce rate base in a general rate case.¹³⁹

91 PSE argues that customers received benefits since September 2002, when the deferred tax was recorded. Its argument relies upon “ratemaking principles” that support a “theory” that the tax benefits offset other utility-related costs that customers should bear.¹⁴⁰

¹³⁸ Exhibit No. RCM-1T at 12:6-16:17 and Exhibit No. RCM-2.

¹³⁹ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-040641 and UG-040640, Order 06 at ¶27 (February 18, 2007).

¹⁴⁰ Exhibit No. MRM-4T at 37:16-38:2 and Tr. 462:12-22 (Marcelia).

However, PSE provides no support for its theory or ratemaking principles.¹⁴¹ Nor did PSE present any evidence showing that the tax benefits it references were not instead used to offset below the line (non-utility) costs.¹⁴²

92 Moreover, ratepayers have already given back to PSE the benefits they eventually derived from lower rates.¹⁴³ When the IRS disallowed all of the tax deductions that gave rise to the rate base reduction, PSE incurred financing costs associated with repayment of the tax benefit. The Commission recognized the potential repayment of tax benefits with interest if the deductions associated with PSE's accounting method were disallowed:

We cannot lawfully prejudge future rates. However, we do find it appropriate to recognize in principle that if the IRS successfully challenges in court the adjustment PSE and other utilities have taken, and requires future repayment of the current benefits taken, presumably with interest, PSE should file an accounting petition asking for appropriate treatment of any back taxes and interest assessed.¹⁴⁴

The Commission allowed PSE to defer and accumulate financing costs necessary to repay the disallowed benefits,¹⁴⁵ and subsequently authorized rate recovery of the deferred financing costs.¹⁴⁶

93 Finally, PSE's proposed adjustment departs from the traditional ratemaking treatment of income taxes where the Commission sets rates by looking at the whole income of a company, rather than the taxability of a single item.¹⁴⁷ PSE fails to justify the "unique" treatment it proposes in this adjustment.

¹⁴¹ Exhibit No. MRM-8.

¹⁴² Tr. 462:23-463:12 (Marcelia).

¹⁴³ Exhibit No. RCM-2.

¹⁴⁴ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-040641 and UG-040640, Order No. 06 at ¶159 (February 18, 2005).

¹⁴⁵ *In the Matter of the Petition of Puget Sound Energy*, Dockets UE-051527 and UG-051528, Order No. 01 (October 26, 2005).

¹⁴⁶ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267, Order No. 08 (January 5, 2007).

¹⁴⁷ Tr. 512:9-24 (Marcelia).

2. Contested Electricity-Only Adjustments

94 The following electricity adjustments are contested as between Staff and PSE.

a. 10.03, Power Costs

95 This section is limited to the appropriate operations and maintenance (“O&M”) expense to be allowed for production facilities. The Industrial Customers of Northwest Utilities (“ICNU”) presented testimony on other power cost issues. Staff concurred with ICNU and defers to their brief on those matters. Issues related to other expenditures for new plant additions are addressed below in the individual plant adjustments.

96 The bottom line difference between Staff and PSE power cost O&M adjustments is minimal: about \$500,000.¹⁴⁸ However, significant differences of policy and methodology exist. PSE seeks Commission approval to establish a regulatory asset for the cost of each event of major maintenance. The O&M expense PSE does seek to recover in this case reflects budget projections of rate year expense that have been shown to be inherently unreliable, in violation of the threshold requirements for a proper pro forma adjustment.

i. **The Commission should reject PSE’s proposal to establish a regulatory asset for the expense of each event of major maintenance**

97 Currently, PSE accounts for the cost of “major maintenance” under the American Institute of Certified Public Accountants (“AICPA”) Audit and Accounting Guide for Airlines.¹⁴⁹ For facilities with long-term service contracts, the deferral method applies: the cost is amortized until the next planned major maintenance event. For peaking plants or

¹⁴⁸ Compare Exhibit No. B-2 at Attachment C, page 2.10(A), line 18 with Exhibit No. B-3 at Exhibit No. KHB-2, page 2.10, line 18.

¹⁴⁹ Exhibit No. JHS-29, part a. The AICPA Guide for Airlines is incorporated into the Financial Accounting Standards Board Accounting Standards Codification Section 908, Airlines. Exhibit No. KHB-1TC at 9:19-21. The AICPA Guide for Airlines defines “major maintenance” as a significant overhaul or maintenance of plant and equipment. Exhibit No. KHB-1TC at 10:1-3.

plants without long-term service agreements, the unpredictable timing of the cost prohibits the deferral method; therefore, the cost is recognized as incurred under the direct expense method. These procedures comply with Generally Accepted Accounting Principles (“GAAP”) and have been approved by PSE’s external auditors.

98 Staff recommends that, for ratemaking, PSE continue its current accounting for major maintenance under the AICPA Guide for Airlines and GAAP.¹⁵⁰ PSE states that its proposal to recover major maintenance is “consistent” with Staff’s recommendation.¹⁵¹ In reality, however, PSE proposes to depart from current accounting and, instead, through repeated accounting petitions, seek Commission authority to establish a regulatory asset for each major maintenance event.¹⁵² The Commission should reject the Company’s proposal.

99 First, the creation of a regulatory asset is considered only for unusual or extraordinary circumstances, and requires Commission approval.¹⁵³ Major maintenance does not fit that category. Rather, it is an ongoing, expected cost of business for any utility. Major maintenance may even increase for PSE, given the Company’s recent acquisition of significant generation facilities.¹⁵⁴

100 Second, the Company cannot capitalize costs that would otherwise be charged to expense unless it is “probable” that PSE will receive future recovery.¹⁵⁵ Therefore, Commission orders authorizing PSE to establish regulatory assets for major maintenance

¹⁵⁰ Exhibit No. KHB-1TC at 14:15-19 and 16:21-17:1.

¹⁵¹ Exhibit No. LEO-13CT at 4:3-9 and Tr. 789:1-14 (Odom).

¹⁵² Tr. 794:16-23 (Odom) and Tr. 795:15-796:1 (Odom), and Exhibit No. LEO-16, part d.

¹⁵³ *Re Puget Sound Power & Light Co.*, Dockets UE-920433, 920499 and 921262, 11th Supp. Order at 53 (September 21, 1993) (rejecting deferred accounting of costs without a Commission order approving same) and *Re Pacific Power & Light Co.*, Cause Nos. U-82-12 and U-82-35, 4th Supp. Order at 23-24 (February 1, 1983) (rejecting deferred accounting of expenses into capital accounts to the extent the company failed to achieve its authorized return).

¹⁵⁴ Exhibit No. KHB-1TC at 17:16-20.

¹⁵⁵ Financial Accounting Standards Board, Accounting Standards Codification Section 980, Regulated Operations (previously, Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation).

burden ratepayers with virtually certain cost responsibility. That cost responsibility can be exasperated with the addition of carrying charges that can become excessive over time.

101 The establishment of a regulatory asset for major maintenance also burdens Staff. Given the expectation that future recovery is probable, the responsibility shifts to Staff to prove in a rate case that an expense is imprudent or unreasonable. Staff and the Commission will also be required to process PSE's many accounting petitions, and determine and track for every facility the appropriate maintenance intervals and resulting expense recovery.¹⁵⁶

102 Finally, historical test year ratemaking can accommodate the recovery of major maintenance expense. Major maintenance for plant under service agreements is currently normalized over time through the deferral method. All other major maintenance is expensed as incurred. If test year maintenance cost is abnormal, an average of historical data can be used to achieve a representative level. That is precisely the method employed by Staff to determine the appropriate level of recovery of *all* production O&M expense.

ii. Staff's adjustment for production O&M expense is based upon fundamental principles of historical test year ratemaking

103 The Company states it is basing its O&M adjustment on the most current test year expense because that is a "more accurate historical basis" for determining those expenses.¹⁵⁷

104 Staff agrees that test year O&M expense can provide an appropriate basis for ratemaking. However, because all costs can fluctuate, one must examine an average level of expense over time to determine if the test year represents a normal level of expense.¹⁵⁸

¹⁵⁶ This administrative burden results from the specific process contemplated by PSE. Exhibit No. LEO-16, part d. PSE will determine an amortization period for each major maintenance event for each facility. This will require the Commission to set new accounting guidelines because the process is otherwise prohibited by the AICPA Guide for Airlines and GAAP for peaking plants and other facilities without service agreements where the timing of the expense is unpredictable. PSE will then file an accounting petition for Commission approval to defer and amortize costs over the time period it selects. Approval of each petition will allow PSE to transfer the associated account to a regulatory asset.

¹⁵⁷ Exhibit No. LEO-13CT at 6:16-17.

105

Staff's examination in this case revealed abnormalities in test year O&M expense that made the test year unrepresentative.¹⁵⁹ Therefore, Staff relied upon verified historical data available at the time Staff prepared its response case. For established facilities, Staff used a 5-year historical average of actual O&M expense (Colstrip 1/2 and 3/4, Encogen, Frederickson 1 and 2, Fredonia 1-4, Whitehorn, and Freddy 1).¹⁶⁰ For new facilities added during the test year, Staff determined an annual expense level based either on January through August 2009 actual expense (Mint Farm and Hopkins Ridge Infill), monthly average actual expense from August 2008 through August 2009 (Sumas), or actual construction costs through October 2009 (Wild Horse Expansion).¹⁶¹ For Goldendale, Staff used the monthly average actual expense from March 2007 to August 2009.¹⁶² Finally, Staff included all fixed costs required by the Baker River Project license and Vestas turbine maintenance contracts for Hopkins Ridge and Wild Horse.¹⁶³

106

Staff did remove *all* budget projections for *all* plants included by PSE in its O&M expense adjustment.¹⁶⁴ This brings us to the heart of the matter. PSE states that it has used "recent [test year] historical maintenance expense to determine maintenance expense."¹⁶⁵ The evidence, however, proves otherwise. PSE adjusts test year actual expense with budget projections totaling \$16,285,069 for Mint Farm (based on Goldendale as a proxy), Colstrip Units 1/2 and 3/4, the Baker River Project and Snoqualmie River Project relicensing,

¹⁵⁸ Exhibit No. KHB-1TC at 24:1-2.

¹⁵⁹ The test year average for Whitehorn was more than twice the 5-year average. Exhibit No. KHB-6C at 6.2, line 14, column (b) versus column (k).

¹⁶⁰ Exhibit No. KHB-1TC at 24:15-17 and Exhibit No. KHB-6C at lines 1, 2, 4, 10, 14, 15 and 16.

¹⁶¹ Exhibit No. KHB-1TC at 25:1-5 and Exhibit No. KHB-6C at lines 13, 17, 19 and 20.

¹⁶² Exhibit No. KHB-6C at line 12.

¹⁶³ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.10.

¹⁶⁴ Exhibit No. KHB-1TC at 24:5 and 25:1-16.

¹⁶⁵ Exhibit No. LEO-13CT at 7:3-4.

Freddy 1, Hopkins Ridge Infill and the Wild Horse Expansion.¹⁶⁶ PSE then makes further unexplained adjustments to test year actual expense to remove major maintenance expense of \$6,197,058.¹⁶⁷ If that is not enough, again without explanation, PSE also adjusts actual test year expense with adjustments related to 2009 totaling \$1,031,427.¹⁶⁸ PSE's Sumas adjustment is based on the twelve months ended October 2009, which includes expenses beyond August 2009 that Staff could not verify.¹⁶⁹

107 The Company devotes entire witnesses to defending its budget projections as the product of reasoned and informed judgment based on rigorous and detailed analysis. Mr. Kim Lane addresses the budget underlying PSE's adjustment for the Baker River Project and Snoqualmie River Project relicensing.¹⁷⁰ Mr. Michael Jones addresses the budget underlying PSE's adjustment for Colstrip O&M.¹⁷¹ Mr. Louis Odom addresses the budget underlying PSE's adjustments for Hopkins Ridge and Wild Horse O&M, including the future escalation of turbine maintenance fees under Vestas service agreements.¹⁷²

108 PSE's defense is unpersuasive. Regardless of the care PSE devotes to its budget process, the fact remains that budgets rely upon projections that are inherently unreliable and fluctuate over time, up or down. PSE's O&M expense adjustment proves the point. In

¹⁶⁶ Exhibit No. DEM-15, column entitled "Adjustment", Tr. 784:6-12 (Odom), and PSE Response to Bench Request No. 6.

¹⁶⁷ Exhibit Nos. LEO-14C, column D and LEO-16, part a).

¹⁶⁸ Exhibit No. LEO-14C, Note C.

¹⁶⁹ Exhibit No. LEO-13CT at 9:10-12.

¹⁷⁰ Exhibit No. KWL-1T.

¹⁷¹ Exhibit No. MLJ-5CT.

¹⁷² Exhibit No. LEO-13CT at 16-29. PSE assumed a 3 percent escalation rate for the Hopkins Ridge Vestas contract even though the rate varied from 4.3 percent to 0.00 percent since 2006. Exhibit No. LEO-13CT at 17:14-18:2. PSE used a 3 percent escalation rate for the Wild Horse Vestas contract even though the rate varied from 3.2 percent to .6 percent since 2005. Exhibit No. LEO-13CT at 24:5-15.

the short 3-month period between PSE's supplemental and rebuttal filings, the Company's projections for total production O&M expense decreased 23 percent (\$4,770,594).¹⁷³

109 The underlying goal in all adjustments is to preserve the integrity of historical test-year ratemaking. Staff's adjustment achieves that goal by removing the Company's O&M budget projections in favor of actual, verified results.

b. 10.06, Hopkins Ridge Infill; 10.09, Sumas; and 10.10, Whitehorn

110 Adjustment 10.06 involves the August 2008 addition of four turbines at Hopkins Ridge. Adjustment 10.09 involves the addition of the Sumas Cogeneration facility in July 2008. Adjustment 10.10 involves the purchase of Whitehorn in February 2009.

111 These three adjustments are grouped together because the only difference between PSE and Staff is the treatment of property taxes.¹⁷⁴ In Adjustment 10.15, Staff updated taxes for all PSE property from the test period accrued expense to the actual tax paid in 2008. In contrast, PSE includes estimates of property taxes for 2009 in the individual plant adjustments, despite the fact that the plants are not assessed individually and despite the fact that levy rates have yet to be announced by the taxing authorities.¹⁷⁵

112 For the reasons stated for Adjustment 10.15, the Company's adjustments are not known and measurable. They should be rejected by the Commission.

c. 10.07, Wild Horse Expansion

113 This adjustment relates to a 22 turbine expansion at Wild Horse that went into service on November 9, 2009. On rebuttal, the PSE revised its budget forecasts of plant and

¹⁷³ Exhibit No. DEM-15, column entitled "Difference From 9.28 Update", lines for Colstrip 1/2, Colstrip 3/4, Upper Baker & Baker Licensing, Snoqualmie 1/2, incl Licensing, Freddie 1, Mint Farm, Hopkins Ridge + Expansion, and Wild Horse and Wild Horse Expansion.

¹⁷⁴ A comparison of Exhibit Nos. B-2 and B-3 demonstrate that PSE has otherwise accepted Staff's calculation of these adjustments based on actual August 2009 plant balances.

¹⁷⁵ Exhibit No. MRM-4T at 9:17-18 and Exhibit No. MRM-5.

rate year costs.¹⁷⁶ PSE's forecast decreased \$5,469,920 (5.3 percent) for plant investment, increased \$1,295,256 (5630.1 percent) for wheeling, decreased \$82,056 (100.0 percent) for property insurance, and decreased \$274,947 (61.4 percent) for property taxes.¹⁷⁷

114 Staff's adjustment substitutes all of PSE's rate year projections with actual plant balances, and includes O&M expense based on the current service agreement with Vestas.¹⁷⁸ Staff's adjustment also reflects the land value of the project included in the test year and the depreciation calculation reflects an in-service date of November 9, 2009.¹⁷⁹ PSE's projections for Wild Horse property tax were also removed. Staff Adjustment 10.15 pro forms taxes for all property based on the 2008 actual tax liability.

115 Staff's adjustment meets the requirements of a pro forma adjustment used in historic test year ratemaking. In contrast, PSE's adjustment demonstrates that the judgment of management, even if informed through detailed analysis, can result in forecasts that fluctuate, in some cases significantly, in violation of those requirements.

d. 10.08, Mint Farm

116 This adjustment relates to the acquisition of the Mint Farm Energy Center on December 5, 2008. In Section IV, Staff explains why the acquisition was prudent and should be recovered in rates. Staff and PSE disagree on the manner to implement recovery.

117 PSE's adjustment demonstrates, again, that projections based on management judgment, even when informed, are an improper basis for ratemaking. On rebuttal, PSE revised its adjustment to include new estimates of plant additions through December

¹⁷⁶ Exhibit No. JHS-14T at 30:6-14.

¹⁷⁷ Compare Exhibit No. JHS-10 at 13 with Exhibit No. B-2 at Attachment C, page 2.14.

¹⁷⁸ Exhibit No. KHB-1TC at 28:14-17.

¹⁷⁹ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.14.

2009.¹⁸⁰ PSE's adjustment decreased \$3,922,732 (1.6 percent) for plant including acquisition costs, decreased \$401,950 (52.1 percent) for property insurance, decreased \$475,252 (36.7 percent) for property tax, decreased \$2,864,717 (4.6 percent) for fuel expense, and decreased \$4,148,029 (44.30 percent) for O&M expense.¹⁸¹

118 In contrast, Staff's adjustment substitutes all rate year projections with verified, actual plant balances and expense through August 2009. Staff also includes the latest premiums for property insurance. PSE's projections for Mint Farm property tax were also removed. Staff Adjustment 10.15 includes the 2008 actual tax liability for all property.¹⁸²

119 Staff's adjustment meets the requirements of a pro forma adjustment used in historic test year ratemaking. It should be adopted by the Commission.

e. 10.11, Baker Hydro Relicense

120 This adjustment relates to the cost of obtaining a new license for the Baker River Project. PSE adopted Staff's adjustment for actual plant additions and related amortization expense through August 2009.¹⁸³ The only remaining difference is the basis for federal land use fees.¹⁸⁴ Staff excludes PSE's rate year estimate of these costs.¹⁸⁵

121 PSE's adjustment is based on the "expectation" that its federal land use fees will increase over 400 percent from \$230,670 to \$1,109,030 in 2010.¹⁸⁶ One would expect, then, that the Company's prediction, if valid, would have been vindicated by now with the actual land use fees for 2010. However, PSE did not supplement its presentation with that

¹⁸⁰ Exhibit No. JHS-14T at 33:9-11.

¹⁸¹ Compare Exhibit No. B-2 at Attachment C, page 2.15 with Exhibit No. JHS-10 at 14.

¹⁸² Exhibit No. KHB-1TC at 29:16-22.

¹⁸³ Exhibit No. JHS-14T at 40:3-4.

¹⁸⁴ Exhibit No. B-3 at KHB-2, page 2.18. Staff corrected the amortization rate and accumulated deferred income tax to conform to the Company's adjustment. See Exhibit No. JHS-14T at 41:3-20.

¹⁸⁵ Exhibit No. KHB-1TC at 32:17.

¹⁸⁶ Exhibit No. B-2 at Attachment C, page 2.18 and Exhibit No KWL-1T at 9:4-21.

information. The Commission should adopt the Staff recommendation to exclude rate year estimates of those costs.

f. 10.31, Regulatory Assets & Liabilities

122 There are three contested elements of this adjustment.¹⁸⁷

i. West Coast Pipeline Capacity Payment

123 This element relates to a regulatory credit received from FB Energy Canada Corporation for PSE's assumption of transportation capacity on West Coast Pipeline. The payment was received on October 24, 2008. Assumption of the pipeline capacity occurred on November 1, 2009.¹⁸⁸

124 The payment offsets the cost of the capacity charge, which is a variable cost under the Power Cost Adjustment ("PCA"). Therefore, Staff treated the credit as an offset to power-related regulatory assets as of October 24, 2008 when PSE received payment.¹⁸⁹

125 PSE accepts Staff's proposal subject to not having to restate prior period PCA reports and financial impacts in previous periods. PSE states that these impacts should, instead, be reflected at the time an order issues in this proceeding.¹⁹⁰

126 However, PSE ignores the fact that adjustments to prior PCA periods are addressed by approved procedures.¹⁹¹ Adjustments for previous PCA periods of \$1 million or less (debit or credit) flow through the current month's calculation. Adjustments above \$1 million (debit or credit) flow through the recalculation of the prior PCA period. PSE has provided no justification to diverge from these established procedures.

¹⁸⁷ The Company accepted Staff's proposal to remove a regulatory liability related to an over-collection of maintenance expense. Exhibit No. KHB-1TC at 34:17-35:15 and Exhibit No. JHS-14T at 47:19-24.

¹⁸⁸ Exhibit No. RCM-1T at 9:15-20.

¹⁸⁹ Exhibit No. RCM-1T at 10:1-8.

¹⁹⁰ Exhibit No. JHS-14T at 48:2-9.

¹⁹¹ *In the Matter of the Petition of Puget Sound Energy, Inc.*, Docket UE-031389, Order 04, Attachment A, Exhibit A, Section C (January 14, 2004).

ii. White River Proceeds

127 PSE's adjustment reduces rate base by \$25,000,000, representing gross proceeds from the anticipated White River sale of assets and water rights to Cascade Water Alliance.¹⁹² This is a change from PSE's direct case, which reduced rate base by \$16,250,000. That amount was calculated by reducing the gross proceeds by an expected tax liability of \$8,750,000, based on the assumption that all proceeds would be taxable.¹⁹³

128 However, Public Counsel notes that there is actually a tax loss on the sale because the tax basis of the White River facilities is greater than the expected proceeds. This results in a taxes receivable. Public Counsel uses the taxes receivable to reverse the rate base addition proposed by PSE in the form of a taxes payable amount.¹⁹⁴

129 Staff adopts Public Counsel's approach. It is appropriate to recognize the potential tax loss on the White River sale. There is also no dispute about the mechanics of the adjustment because it uses a calculation that PSE itself performed.¹⁹⁵

130 PSE argues that tax costs or benefits associated with the sale cannot yet be determined because the proceeds from the possible sale of surplus property cannot be estimated.¹⁹⁶ This argument is striking given PSE's initial assumption that all gross proceeds from the sale would be taxed.

131 This argument is also flawed given PSE's admission that the tax impacts of the sale of surplus property cannot yet be determined.¹⁹⁷ Unlike the sale of White River assets, the

¹⁹² Exhibit No. JHS-14T at 47:4-7.

¹⁹³ Exhibit No. JRD-1CT at 14:25-15:8.

¹⁹⁴ Exhibit No. JRD-1CT at 15:9-20.

¹⁹⁵ Exhibit No. JRD-4 at 4.

¹⁹⁶ Exhibit No. MRM-4T at 3:16-20.

¹⁹⁷ Exhibit No. MRM-4T at 3:17-19.

sale of surplus property has not received Commission approval.¹⁹⁸ There is no reason to delay reflecting the tax impacts of the sale of White River assets.

132 Finally, proceeds from the sale of White River assets and all related costs have been deferred without amortization.¹⁹⁹ Application of the proceeds will be addressed in the next general rate case after the sale of all assets and surplus property is complete.²⁰⁰ Public Counsel's adjustment is consistent with this order.

iii. Colstrip Settlement Payment

133 PSE seeks to establish and amortize over 5 years a regulatory asset of \$8.4 million, including carrying costs, for the Colstrip Settlement payment.²⁰¹ Staff opposes the proposal.

134 As stated above, Commission approval of a regulatory asset is considered only in unusual or extraordinary circumstances.²⁰² Otherwise, a cost is expensed as occurred, in accordance with FERC's Uniform System of Accounts and GAAP.

135 Therefore, the significance of an expense should be evaluated to determine whether it should be capitalized with carrying charges for recovery in future periods. Here, the \$8.4 million settlement payment is relatively immaterial: 0.42 percent of total test year operating expense.²⁰³ Therefore, Staff expensed the entire amount. This approach recognizes that costs of this nature do occur from time to time and, therefore, should be considered as a cost of business relative to their contribution to total expense.

¹⁹⁸ PSE requested waiver of the requirement for Commission approval of the sale of Surplus Property, but its request was denied. *In the Matter of the Application of Puget Sound Energy, Inc.*, Docket UE-090399, Order 01 at ¶12 (May 14, 2009).

¹⁹⁹ *In the Matter of the Petition of Puget Sound Energy, Inc.*, Docket UE-032043, Order 06 at ¶¶251-253 (February 18, 2005).

²⁰⁰ *In the Matter of the Application of Puget Sound Energy, Inc.*, Docket UE-090399, Order 01 at ¶13 (May 14, 2009).

²⁰¹ Exhibit No. JHS-14T at 47:16.

²⁰² *Supra*, fn.153.

²⁰³ Colstrip Settlement of \$8,403,596 (Exhibit No. JHS-14T at 47:16) divided by total test year expense of \$1,992,758,652 (Exhibit No. JHS-16 at 1:32).

g. 10.33, Fredonia Power Plant

136 The adjustment involves the Company's purchase of Fredonia Units 3 and 4. Staff's original adjustment reflected PSE's lease payments because the sale had not been finalized and the costs used by PSE were estimates based on forecasts.²⁰⁴

137 The purchase was since completed on January 13, 2010, and was determined by Staff to be prudent.²⁰⁵ Staff has reviewed the final purchase documents and accepts PSE's adjustment as a reasonable representation of rate base and depreciation expense. Staff also includes an amount for property insurance in Adjustment 10.23.

138 However, PSE's adjustment includes a rate year forecast of property tax expense.²⁰⁶ That projection does not reflect PSE's tax liability for Fredonia since PSE is centrally assessed and levy rates have not been finalized.²⁰⁷ Therefore, Staff has rejected PSE's adjustment for property taxes and, instead, in Adjustment 10.15, reflected an appropriate amount of tax for all properties based on the Company's 2008 actual tax liability.²⁰⁸

h. 10.34, Mint Farm Deferred Cost

139 PSE requests approval under RCW 80.80.060(6) to defer the fixed and variable costs of Mint Farm, beginning on the acquisition date of December 5, 2008, and ending with the effective date of new rates in this proceeding. The request contains several elements:

- PSE proposes to suspend operation of the new resource recovery provisions of the PCA, as defined by Exhibit G.²⁰⁹
- PSE proposes to accrue interest on the deferred amounts at the authorized net of tax rate of return of 7 percent.²¹⁰

²⁰⁴ Exhibit No. KHB-1TC at 36:14-19.

²⁰⁵ Exhibit No. RG-53HCT at 48:4-5 and Exhibit No. DN-1HCT at 29-32.

²⁰⁶ Exhibit No. JHS-1T at 55:12-13.

²⁰⁷ Exhibit No. MRM-5.

²⁰⁸ Exhibit No. B-3 at Exhibit No. KHB-2, page 2.40.

²⁰⁹ Exhibit No. JHS-1T at 69-70.

²¹⁰ Exhibit No. JHS-1T at 73.

- PSE proposes to amortize the deferred costs plus interest over ten years.²¹¹
- PSE proposes credits to the deferred variable costs to reflect the estimated cost of market purchases that would be displaced with Mint Farm energy.²¹²
- PSE proposes that any PCA over-collections during the deferral period be used to offset the remaining deferred variable costs of Mint Farm.²¹³

140 Staff supports the Company's request to defer Mint Farm costs. Staff also supports the credit and offset proposals described in the final two bullets above.

141 However, Staff opposes suspension of Exhibit G and opposes carrying costs on the deferral balance.²¹⁴ Staff also recommends an amortization period of 15 years.²¹⁵

i. The Commission should not suspend PCA Exhibit G

142 PSE provided no reason why it could not have filed a Power Cost Only Rate Case to recover Mint Farm fixed and variable costs after it decided to acquire the facility. Instead, it seeks to suspend the operation of Exhibit G of the PCA to assure that it can recover all variable costs of Mint Farm.²¹⁶

143 PSE's request should be denied.²¹⁷ Section 7 of the PCA addresses a long-term resource like Mint Farm during the period between its acquisition and its inclusion in rates.

It provides that resource costs may be included in the PCA:

... at the lesser of the actual cost or the average embedded cost in the PCA (including transmission into PSE's Puget Sound system) as a bridge

²¹¹ Exhibit No. JHS-14T at 52:4-5.

²¹² Exhibit No. JHS-1T at 71.

²¹³ Exhibit No. JHS-1T at 72.

²¹⁴ Exhibit No. RCM-1T at 20:21-22:7 and 22:19-24:16.

²¹⁵ Exhibit No. RCM-1T at 22:8-17. Mint Farm deferred costs include fixed and variable costs, as defined by the PCA. Exhibit No. JHS-1T at 66: 13-14. However, in calculating its adjustment, PSE excluded variable costs on the assumption that all such costs will be offset by the credit for market power or the credit for over-recovery of power costs. This will be true-up in a subsequent rate cases based on actual deferrals. Exhibit No. JHS-1T at 56:12-16. Rather than assuming that all variable costs will be offset and waiting for the true-up, Staff's adjustment includes actual deferred variable costs as of November 2009 from Exhibit No. JHS-27C. Staff's adjustment is shown on Exhibit No. B-3 at Exhibit No. KHB-2, page 2.41.

²¹⁶ Exhibit No. JHS-1T at 70:3-10.

²¹⁷ Exhibit No. RCM-1T at 22:19-24:16.

mechanism, until the then future costs of these new resources can be reviewed in a Power Cost Only Rate review.²¹⁸

Exhibit G implements this provision by comparing the actual variable costs of a new resource with the baseline Power Cost Rate, and determining whether a price adjustment is warranted. Variable costs that exceed the baseline rate are excluded from that determination.²¹⁹

144 Thus, Exhibit G is a vital component of a complex mechanism designed specifically to address the recovery of long-term resource acquisitions. PSE's request to suspend Exhibit G for Mint Farm circumvents the operation of this mechanism.

145 The Company states that RCW 80.80.060(6) establishes a public policy that justifies its proposal to suspend Exhibit G for Mint Farm.²²⁰ However, nothing in that statute restricts the current operation of the PCA. In fact, the Commission has affirmed recently that the current operation of the PCA is a reasonable mechanism to recover the costs of new power resources.²²¹

ii. The Commission should not authorize carrying costs on Mint Farm deferrals

146 There are several reasons to deny carrying costs on Mint Farm deferred cost balances. Some of these reasons are found in RCW 80.80.060(6) itself.

147 First, PSE seeks carrying costs on the theory that recovery will be in the future and interest will make the Company whole.²²² However, RCW 80.80.060(6) deprives PSE of the protection it seeks from regulatory lag. The statute states expressly that

²¹⁸ *Id.*

²¹⁹ The excluded variable costs lower the allowable costs available for sharing. A negative balance of the ratepayer share reduces rates when the cumulative customer share of the credit reaches \$30 million or more. If the balance is positive, PSE can increase rates when the balance of the deferral account is approximately \$30 million. Exhibit No. RCM-1T at 23:17-23.

²²⁰ Exhibit No. JHS-14T at 55:16-56:32.

²²¹ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-072300 and UG-072301, Order 13 (January 15, 2009).

²²² Exhibit No. JHS-1T at 73:13-15.

the creation of a deferral account “does not by itself determine actual costs of the [resource addition], whether recovery of costs is appropriate, or any other issues decided by the Commission in a general rate case.”

148 Second, RCW 80.80.060(6) limits the length of time deferrals can accumulate: the deferral begins when a power plant begins commercial operation and continues for no more than 24 months or until a Commission order in a rate case, if a rate case is filed during the 24-month period. Since PSE controls when it files a rate case, the statute effectively allows PSE to control how soon cost deferrals will be recovered. Allowing PSE to add carrying costs is an additional, unwarranted advantage.

149 Third, in the PCA, a portion of Mint Farm fixed costs is return on net rate base consisting of plant balance, accumulated depreciation, and deferred income tax. Therefore, if carrying costs are allowed, the total return on investment will exceed the 7 percent net of tax return authorized in the last rate case. This results in double recovery that violates the Commission’s prior determination of a fair rate of return.²²³

150 Finally, ratemaking includes in rate base an allowance for investor-supplied working capital. This allowance, upon which PSE earns a return, provides the Company with funds to pay its current obligations while awaiting payment from customers. Since a return on those funds is already embedded in rates, no further allowance for carrying costs is necessary.

iii. The Commission should authorize a 15-year amortization of Mint Farm deferred costs

151 Staff proposes a 15-year amortization period for Mint Farm deferred costs. This compares to the 10-year period proposed by PSE.

²²³ Exhibit No. RCM-1T at 21:1-7.

152 Staff's recommendation should be adopted. The magnitude of the Mint Farm deferred costs is approximately five times greater than Goldendale deferred costs, which were amortized over 3 years. Therefore, it is reasonable to amortize Mint Farm deferred costs over 15 years in order to mitigate the impact on rates.²²⁴

153 Mint Farm has a remaining life of 25-30 years.²²⁵ Therefore, it would be reasonable to amortize the deferred costs over that period in order to match the depreciation of plant costs. Staff's proposal to shorten that period to 15 years accelerates recovery in the Company's favor.

i. 10.38, Wild Horse Deferred Cost

154 This adjustment amortizes deferred costs associated with the expansion of the Wild Horse Generating Facility. On October 27, 2009, PSE filed with the Commission a notice of intent to defer, as permitted by RCW 80.80.060(6). Deferrals began on November 9, 2009, the same day the expansion became operational.²²⁶

155 Staff and PSE use a 24-month amortization period for the deferred costs. For the same reasons stated above for Mint Farm, Staff's adjustment excludes carrying costs and includes the deferred variable costs net of the market price offset.²²⁷ Similarly, Staff recommends that the operation of Exhibit G not be suspended and that over-collections of power costs under the PCA be applied as a credit to the deferred variable cost balance.²²⁸

156 PSE states that application of over-collected power costs as a credit to plant deferrals should not apply to Wild Horse because it was intended only as a "good faith offer" to

²²⁴ Exhibit No. RCM-1T at 22:8-17.

²²⁵ Exhibit No. DN-1HCT at 16:14-19.

²²⁶ Exhibit No. RCM-1T at 17:11-19.

²²⁷ Staff's adjustment uses the actual data through December 2009 and monthly estimates for the remainder of the deferral period, as provided in Exhibit No. JHS-34 at 3 and 5. The calculation of Staff's adjustment is shown on Exhibit No. B-3 at Exhibit No. KHB-2, page 2.45.

²²⁸ Exhibit No. RCM-1T at 18:7-8.

mitigate Mint Farm variable costs.²²⁹ The Company provided no substantive rationale to distinguish between the plants. Nor do the PCA and RCW 80.80 make such a distinction. There is simply no reason to deny ratepayers the benefit of mitigating deferred costs, whether those costs relate to Mint Farm or Wild Horse.

j. 10.37, Production Adjustment

157 The Commission has stated that the Production Adjustment preserves test year relationships by adjusting rate year costs to match test-year loads.²³⁰ The Commission has also stated that the adjustment is necessary only in “appropriate circumstances”.²³¹

158 Appropriate circumstances do not exist in this case. For the first time since the adjustment was applied, PSE forecasts a reduction of test-year loads during the rate year, rather than load growth as did persist at all other times.²³² PSE does not, however, present any plan to manage costs to mitigate the effects of reduced load. Instead, PSE simply compensates itself for the financial consequences of projected reduced loads and the effects of those reductions on revenues. This unfairly shifts risk from PSE to ratepayers.²³³

159 Moreover, the Production Adjustment was never intended to be an attrition offset for projected load reductions. It was designed to offset the pro forma rate base calculation where new plant was added outside the test year to serve increasing loads. If PSE believes that there is an attrition mismatch between test period expenses, revenues and rate base, it had the opportunity to present a proper attrition analysis, but failed to do so.

²²⁹ Exhibit No. JHS-14T at 58:10-19.

²³⁰ Avista Order at ¶50.

²³¹ *Id.*

²³² The Company forecasts a load reduction of 3.9 percent. Exhibit No. DEG-9CT at 9, Table 1.

²³³ Exhibit No. MPP-1T at 19:11-19.

160 PSE's only rejoinder is to describe the mechanics of the adjustment.²³⁴ No rebuttal is offered regarding the underlying rationale of Staff's position.

3. Natural Gas Contested Adjustment: 9.24, Jackson Prairie Plant

161 In May 2009, PSE received a refund of sales tax from DOR that was originally paid and capitalized to the Jackson Prairie expansion project.²³⁵ PSE accounted for the refund in the same manner as the original tax by decreasing Jackson Prairie rate base by \$246,875. Public Counsel proposes an adjustment to reduce the plant balance for Jackson Prairie by the amount of the sales tax refund.²³⁶ Staff has adopted Public Counsel's rate base adjustment. PSE does not expressly oppose the adjustment.²³⁷

IV. MINT FARM PRUDENCE

A. The Company Met Its Burden To Prove That The Acquisition Of The Mint Farm Energy Center Satisfies Commission Prudence Standards

162 The Mint Farm Energy Center ("Mint Farm") is 311 megawatt ("MW") natural gas-fired, generation facility located in Longview, Washington. It was purchased by PSE in December 2008 during a competitive environment for new resource acquisition.²³⁸ Nevertheless, PSE purchased the plant at a 30 percent discount from the cost to build a new facility.²³⁹ Mint Farm is currently part of the PSE's resource portfolio serving customers.²⁴⁰

²³⁴ Exhibit No. JHS-14T at 15:3-9.

²³⁵ Exhibit No. MRM-4T at 4:5-17.

²³⁶ Exhibit No. JRD-1CT at 17:5-15.

²³⁷ Exhibit No. MRM-4T at 5:3-9.

²³⁸ Exhibit No. RG-3HC at 8-10, Exhibit No. RG-53HCT at 4:7-6:16 and Exhibit No. DN-3HCT at 7:9-10.

²³⁹ Exhibit No. RG-53HCT at 27:21-22 and 44:15-16.

²⁴⁰ Exhibit No. DN-1T at 9:18-19.

163

PSE requests a Commission determination that it was prudent to acquire Mint Farm.²⁴¹ PSE also asks the Commission to determine that Mint Farm complies with the greenhouse gases emissions performance standard (“GHG Standard”) of RCW 80.80.

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Public Counsel is the only party that challenges the Company’s prudence request. Public Counsel’s arguments should be rejected by the Commission.

1. PSE performed the appropriate analyses, decision-making and documentation to satisfy the Commission’s test for prudence

The standard the Commission applies in prudence reviews is not disputed:

The test the Commission applies to measure prudence is what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made a decision. This test applies both to the question of need and the appropriateness of the expenditures. The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made.²⁴²

The Commission has implemented this standard by focusing on the three factors:²⁴³

- Whether the new generation resource is needed.²⁴⁴
- Whether the utility has evaluated alternative resources.²⁴⁵
- Whether the resource complies with applicable state laws.²⁴⁶

165

Staff witness David Nightingale conducted an independent review of the entire record addressing Mint Farm. He also reviewed data request responses, PSE’s 2007

²⁴¹ PSE also seeks a Commission ruling that it was prudent to acquire Fredonia Units 3 and 4, the expansion of the Wild Horse wind project, and power purchase agreements (“PPAs”) with Credit Suisse, Barclay’s Bank, Puget Sound Hydro, and Qualco Energy. Staff’s analysis supports that request. Exhibit No. DN-1T at 21-37. No other party challenges that request. Thus, they are not discussed further.

²⁴² *WUTC v. Puget Sound Energy, Inc.*, Docket UE-031725, Order 12 at ¶ 19 (April 7, 2004).

²⁴³ In addition, the Commission examines whether the utility involved the board of directors and whether its decision was adequately documented. *Id.* Public Counsel does not challenge PSE on these factors.

²⁴⁴ *WUTC v. Puget Sound Power & Light Co.*, Docket UE-921262, *et al.*, 19th Suppl. Order at 11 (September 27, 1994).

²⁴⁵ *Id.*

²⁴⁶ *WUTC v. PacifiCorp, d/b/a, Pacific Power & Light Co.*, Docket UE-090205, Order 09 at ¶67 (December 16, 2009).

Integrated Resource Plan (“2007 IRP”) and 2008 All-Source Request for Proposals (“2008 RFP”), and other due diligence documents.²⁴⁷ His review led Mr. Nightingale to conclude that PSE had performed all appropriate analyses and decision-making to support a prudence finding. He also concluded that Mint Farm complies with the GHG Standard.

a. PSE established a need for new resources

166 PSE has substantial mid- and long-term needs to acquire new electric resources to replace other expiring and retiring resources.²⁴⁸ The 2007 IRP projected a need for nearly 700 average Megawatts (“aMW”) by 2011 and more than 1600 aMW by 2015.²⁴⁹ The 2007 IRP indicated that most of this energy need that cannot be met through demand-side and renewable resources will be met from 2011 onward by new CCCT generating capacity.²⁵⁰

167 The 2007 IRP load forecast was updated for the 2008 RFP. PSE’s energy need for supply-side resources for the 2008 RFP was 143 aMW by 2011.²⁵¹ The supply-side energy need grew to 700 aMW by 2012 and 977 aMW by 2013.²⁵² There were also significant capacity needs of 208 MW by 2011, 760 MW by 2012, and 771 MW by 2013.²⁵³

b. PSE engaged in a comprehensive evaluation of resource alternatives

168 The 2008 RFP resulted in 31 proposals.²⁵⁴ PSE used a two-phase process to analyze the qualitative and quantitative advantages and disadvantages of each proposal. The

²⁴⁷ Public Counsel may question the independence of Mr. Nightingale’s evaluation. See Exhibit Nos. DN-4, DN-5, DN-6, DN-8, DN-9 and DN-10. However, the burden to prove that the acquisition of Mint Farm was prudent falls only upon the PSE. Exhibit No. DN-4. Mr. Nightingale confirmed that the Company met that burden through his comprehensive review of all evidence presented by PSE, which Public Counsel does not challenge for authenticity. Mr. Nightingale also reviewed the testimony of Public Counsel. He found significant flaws in Public Counsel’s presentation. Exhibit No. DN-3HCT.

²⁴⁸ Exhibit No. KJH-5 at 8. From 2010 through 2012, PSE expects a reduction of over 787 MW in generation capacity due to expiring contracts. Exhibit No. WJE-21HCT at 7:10-11.

²⁴⁹ *Id.* See also, Exhibit WJE-21HCT at 4:7-9.

²⁵⁰ Exhibit No. KJH-5 at 218-219 (2007 IRP, pages 8-2 and 8-3).

²⁵¹ Exhibit No. WJE-3.

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ Exhibit No. WJE-1HCT at 9:5-10.

qualitative evaluation addressed compatibility with PSE's resource needs, cost minimization, risk management, public benefits, and other strategic, technical and financial factors.²⁵⁵ The quantitative evaluation examined each proposal using three matrices: the Portfolio Benefit Ratio, 20-Year Levelized Cost, and Portfolio Benefit.²⁵⁶ Application of all matrices to each proposal allowed PSE to evaluate each one on equal footing.²⁵⁷

169

Mint Farm emerged from the evaluation process as a candidate for acquisition

because:

- Mint Farm provided a significant contribution to meeting PSE's energy and capacity needs over the mid- to long-term.²⁵⁸
- Mint Farm minimized PSE's cost of power relative to new CCCT construction.²⁵⁹
- Mint Farm had a low heat rate compared to other CCCTs.²⁶⁰
- Mint Farm had pre-existing electric transmission rights in Western Washington.²⁶¹
- Mint Farm had sufficient gas transmission and supply.²⁶²
- Mint Farm was a new plant that, with good maintenance, had an expected service life of 25-30 years.²⁶³
- Mint Farm posed no risk of construction or counterparty default since it was an existing, operational facility.

²⁵⁵ Exhibit No. RG-1HCT at 6:20-7:5 and Exhibit No. RG-3HC at 13.

²⁵⁶ Exhibit No. RG-3HC at 15.

²⁵⁷ Exhibit No. DN-3HCT at 4:1-6.

²⁵⁸ Exhibit No. RG-1HCT at 42:7-14.

²⁵⁹ Mint Farm's "all-in" cost is about 60 percent of the price for new CCCT construction. Compare Exhibit No. RG-1HCT at 42:15-19 with Exhibit No. RG-3HC at 179 and Exhibit No. WEJ-1HCT at 30:10.

²⁶⁰ Exhibit No. DN-1T at 5:13-19. A lower heat rate means that Mint Farm requires less fuel supply than a higher heat rate CCCT to produce the same amount of energy.

²⁶¹ Exhibit No. RG-1HCT at 30:10-17. PSE acquired Mint Farm with a minor deficiency of firm transmission capacity: 3 MW of Mint Farm's baseload capacity of 296 MW. However, PSE identified methods to manage this small deficit. Exhibit No. RG-53HCT at 42:11-43:12.

²⁶² Exhibit No. RCR-1CT at 2-7. PSE had a strategy to ensure firm capacity sufficient to deliver the full requirements to Mint Farm. Exhibit No. RCR-6T at 2-7. That strategy appears to have worked. Sufficient gas has been delivered whenever plant operations were warranted, including during December 2009 when record demands were recorded due to cold weather. Exhibit No. RCR-6T at 7:3-6.

²⁶³ Exhibit No. DN-1T at 16:14-19.

- As the last available CCCT in Washington with firm transmission rights, Mint Farm was a unique opportunity not likely to remain available during the Company's next RFP.²⁶⁴
- Mint Farm provided flexibility to meet variable loads including integrating wind resources.²⁶⁵

c. PSE demonstrated that Mint Farm complies with the GHG Standard

170

RCW 80.80.060(1) states:

No electrical company may enter into a long-term financial commitment unless the baseload electric generation supplied under such a long-term financial commitment complies with the greenhouse gases emissions performance standard.

The GHG Standard is 1100 pounds of greenhouse gases per megawatt-hour.²⁶⁶ The issue is whether Mint Farm is “baseload electric generation” that must meet this standard.

171

“Baseload electric generation” means energy from a facility that is “designed and intended to provide electricity at an annualized plant capacity factor of at least 60 percent.”²⁶⁷ In determining whether a facility meets that standard, the Commission focuses primarily on plant design and necessary operating permits.²⁶⁸

172

Mint Farm was designed to operate routinely over a 90 percent capacity factor.²⁶⁹ PSE has made no alterations that would affect the plant's capability.²⁷⁰

²⁶⁴ Exhibit No. DN-1T at 17:1-5. The Grays Harbor CCCT is the only other CCCT not under long-term contract, but it does not have available firm transmission capacity until 2015. Exhibit No. RG-1HCT at 43:1-8 and Exhibit No. RG-53HCT at 7:17-20.

²⁶⁵ Exhibit No. DN-1T at 15:10.

²⁶⁶ RCW 80.80.040(1)(a).

²⁶⁷ RCW 80.80.010(4).

²⁶⁸ *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.*, Docket UE-090205, Order 09 at ¶69 (December 16, 2009).

²⁶⁹ Exhibit No. RG-1HCT at 30:2-3 and 39:4-5 and Exhibit No. DN-1HCT at 42:10-43:9.

²⁷⁰ Exhibit No. DN-1HCT at 43:13-15.

173 There are no air quality permit restrictions on Mint Farm's ability to operate at or above a 60 percent annual capacity factor.²⁷¹ PSE also has sufficient firm gas supply and transportation to operate Mint Farm at or above a 60 percent annual capacity factor.²⁷²

174 Thus, Mint Farm is baseload electric generation. Mint Farm emits less than 1100 pounds of greenhouse gases per megawatt-hour.²⁷³ Therefore, it meets the GHG Standard. This satisfies the statutory compliance part of the prudence review and warrants a Commission determination that Mint Farm complies with RCW 80.80.060(1).²⁷⁴

2. Public Counsel's criticisms of the Mint Farm acquisition should be rejected

175 Public Counsel admits that "in the long-run ownership of Mint Farm should benefit customers."²⁷⁵ Nevertheless, he challenges the prudence of the acquisition. His arguments have no merit and should be rejected by the Commission.

a. Mint Farm is prudent even though it creates short-term surplus capacity according to the 2007 IRP

176 The 2007 IRP showed that Mint Farm creates surplus capacity through 2011. Thus, Public Counsel asserts that PSE failed to demonstrate a need to acquire Mint Farm.²⁷⁶

177 Public Counsel's criticism is striking given his position in another case. He agreed that the Chehalis Generating Plant was a prudent acquisition by PacifiCorp, even though the facility was acquired to fill a resource deficit that would not occur until 2012 according to an

²⁷¹ Exhibit No. JMH-3 and Exhibit No. DN-1HCT at 43:21-44:7.

²⁷² Public Counsel argues that Mint Farm is not baseload electric generation because forecasts show Mint Farm operating below a 60 percent annual capacity factor. Exhibit No. SN-1HCT at 28:5-24. This argument ignores plant design and other technical characteristics that are the focus. In any event, PSE's analysis projected an annual capacity factor for Mint Farm of over 60 percent in nearly half (45.7 percent) of all 1,800 test year runs. Exhibit No. WJE-1HCT at 29.

²⁷³ Exhibit No. JMH-5 (letter from the Department of Ecology).

²⁷⁴ PSE also requests a Commission determination that the Sumas CCCT complies with the GHG Standard. The record shows that Sumas meets the standard. Exhibit No. DN-2. PSE's request should be granted.

²⁷⁵ Exhibit No. SN-1HCT at 21:15-16 and Tr. 209:24-210:7 (Harris).

²⁷⁶ Exhibit No. SN-1HCT at 9:4-6.

IRP.²⁷⁷ The Commission accepted Public Counsel's position.²⁷⁸ The Commission also saw the benefit of acquiring a plant that, like Mint Farm, otherwise was a "lost opportunity."²⁷⁹

178 Public Counsel also ignores the reality of resource acquisition. CCCTs become available in large blocks of capacity in a timeframe not often matched perfectly to demand.²⁸⁰ The result of acquiring such "lumpy" resources is that the power portfolio may at times be long. PSE's 2007 IRP showed a need for a CCCT by 2011.²⁸¹ The fact that Mint Farm created surplus capacity through 2011 is no reason to find the purchase imprudent.

179 Finally, the Company showed significant mid- and long-term supply-side energy and capacity needs for new resources. These projections are not disputed by Public Counsel.

b. Public Counsel inadequately considers all quantitative and qualitative measures employed by PSE to assess the Mint Farm acquisition

180 Public Counsel asserts that an "Alternative" PPA was a superior choice than Mint Farm from an economic benefit perspective.²⁸² This assertion is fraught with errors.

181 First, Public Counsel focuses on the Portfolio Benefit and Benefit Ratio criteria, and ignores the 20-Year Levelized Cost calculation also used by PSE to evaluate each resource proposal.²⁸³ In doing so, Public Counsel fails to consider PSE's comprehensive approach to assess all resources individually and collectively with the same criteria in order to provide a transparent platform for reasoned decision-making.²⁸⁴

182 The complete quantitative evaluation that Public Counsel ignores shows that Mint Farm had a positive Portfolio Benefit and Benefit Ratio, although not as high as the

²⁷⁷ *WUTC v. PacifiCorp, d/b/a, Pacific Power & Light Co.*, Docket UE-090205, Order 09 at ¶50 (December 16, 2009).

²⁷⁸ *Id.* at ¶¶66 and 77.

²⁷⁹ *Id.* at ¶66.

²⁸⁰ Exhibit No. DN-1HCT at 15:19-20.

²⁸¹ Exhibit No. KJH-5 at 79.

²⁸² Exhibit No. SN-1HCT at 12:1-3. The identity of the PPA is highly confidential.

²⁸³ Exhibit No. SN-1HCT at 11:15-12:3.

²⁸⁴ Tr. 195-96 (Harris), Tr. 219 (Garratt), and Tr. 289 (Elsea).

Alternative PPA.²⁸⁵ Mint Farm's 20-Year Levelized Cost was 30 percent less than the Alternative PPA, even with the financial burden of Mint Farm acquisition costs and surplus capacity through 2011.²⁸⁶ Thus, the added costs of Mint Farm before 2012 were outweighed by the increased benefits of its lower longer-term operating costs.²⁸⁷

183 The complete qualitative evaluation that Public Counsel also ignores shows that Mint Farm will run many more years and many more hours in any year due to its longer service life and lower heat rate. Thus, Mint Farm provides a cheaper variable source of energy. Had PSE acquired the Alternative PPA, PSE would have been exposed more often to variable market pricing because it would have produced less energy to meet load.²⁸⁸

184 Finally, the Alternative PPA was not a suitable fit to meet PSE's resource needs in 2011 due to pre-existing contractual requirements.²⁸⁹ It was placed on the "Continuing Investigation List" for future monitoring.²⁹⁰ Thus, future opportunities to extend the Alternative PPA have not been foreclosed.

3. PSE should be required to assess the dike system around Mint Farm and develop a flood contingency plan

185 While Staff concludes that the acquisition of Mint Farm was prudent, Staff does recommend that the Commission order PSE to perform a detailed potential hazard

²⁸⁵ Exhibit No. RG-3HC at 119 and Exhibit No. WEJ-11HC at 28.

²⁸⁶ *Id.*

²⁸⁷ Public Counsel attempted to show that the 20-Year Levelized Cost need not be evaluated independently because it uses the same cost inputs as the Portfolio Benefit and Benefit Ratio. Tr. 223:13-224:4 (Garratt) and Tr. 290:12-292:21 (Elsea). Public Counsel misses the point. The 20-Year Levelized Cost is the only criteria that measures the expected costs to deliver power for a specific resource over 20 years. Tr. 290:12-22 (Elsea). Thus, even if it shares cost inputs with the Portfolio Benefit and Benefit Ratio, it provides unique analytical results that were evaluated separately and collectively with all other quantitative and qualitative factors. Tr. 225:10-24 (Garratt) and Tr. 289:6-25 (Elsea).

²⁸⁸ Tr. 216 (Garratt); Exhibit No. DN-3HCT at 5:16-6:16.

²⁸⁹ Exhibit No. RG-53-HCT at 7:12-16.

²⁹⁰ Exhibit No. RG-3HC at 26 and Exhibit No. RG-53-HCT at 23:6-15; Tr. 211:8-9 (Harris) and Tr. 281:7-14 (Garratt).

assessment of the dike system protecting Mint Farm. PSE should also develop a flood contingency plan and determine necessary actions to protect the site from flooding.²⁹¹

186 PSE challenges these requirements solely with a 2007 inspection report of the U.S. Army Corps of Engineers.²⁹² However, this 4-page document merely concludes, without analysis, that “[t]he levee and pumping plants appear to be in good condition.” No evidence was presented that the levee has been evaluated for long-term stability. Nor is there evidence of actual system performance during floods.

187 Flood protection facilities should be assessed routinely for structural integrity. This is especially important for a plant that will run another 25-30 years and is located near the Columbia River on flat land.

188 The Commission should adopt Staff’s recommendation for a hazard assessment and contingency plan. Staff is ready to work with PSE on the detail of these measures to ensure they are developed in a timely way without undue burden.

V. RATE SPREAD AND RATE DESIGN

189 On January 15, 2010, all relevant parties in this proceeding filed separate multi-party settlement agreements on electricity and natural gas rate spread and rate design.²⁹³ Each settlement agreement was accompanied by supporting testimony.²⁹⁴

190 For the reasons set forth in the supporting testimony, the settlement agreements are in the public interest, and will produce rates that are just, fair, reasonable and sufficient. Staff recommends that the Commission adopt the settlement agreements in their entirety.

²⁹¹ Exhibit No. DN-1HCT at 20:21-21:3.

²⁹² Exhibit No. RG-53HCT at 22:8-17.

²⁹³ Exhibit Nos. JT-1 and JT-3.

²⁹⁴ Exhibit Nos. JT-2 and JT-4.

**VI. THE COMMISSION HAS LEGAL AUTHORITY
TO ORDER AN INCREASE IN NATURAL GAS REVENUES
ABOVE THE AMOUNT PRODUCED BY THE FILED TARIFFS**

191 PSE seeks to increase natural gas revenues by \$28.3 million. However, the tariffs under suspension produce a lesser amount of \$27.2 million.²⁹⁵ Therefore, Public Counsel may argue that the Commission does not have legal authority to grant the full increase sought by PSE, despite the likely theoretical nature of the issue in this case.

192 Public Counsel's argument is refuted by RCW 80.28.020:

Whenever the commission shall find, after a hearing had upon its own motion, or upon complaint, that the rates or charges demanded, exacted, charged or collected by any gas company, electrical company or water company, for gas, electricity or water, or in connection therewith, or that the rules, regulations, practices or contracts affecting such rates or charges are unjust, unreasonable, unjustly discriminatory or unduly preferential, or in any wise in violation of the provisions of the law, or that such rates or charges are insufficient to yield a reasonable compensation for the service rendered, the commission shall determine the just, reasonable, or sufficient rates, charges, regulations, practices or contracts to be thereafter observed and in force, and shall fix the same by order. (Emphasis added.)

RCW 80.28.020 does not restrict the Commission to the proposed tariffs. The statute allows the Commission to set whatever rates the evidence produced at hearing demonstrates are just, reasonable and sufficient, whether such rates are above or below the proposed tariffs.

193 RCW 80.28.060 does state that companies cannot change their rates except upon 30-days notice. However, that statute also states that the Commission may allow changes:

. . . without requiring the thirty days' notice by duly filing, in such manner as it may direct, an order specifying the changes so to be made and the time when it shall take effect.

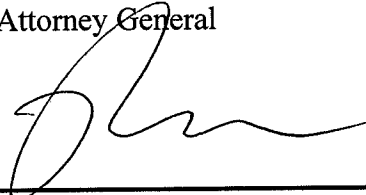
Thus, if evidence shows a need for revenue above the proposed tariffs, the Commission may allow PSE to file for the higher amount on less than 30-days notice. RCW 80.28.060 would allow that to occur through the compliance filing.

²⁹⁵ *WUTC v. Puget Sound Energy, Inc.*, Docket UG-090705, Order 01 (May 28, 2009).

In sum, tariff revisions are suspended and set for hearing, the Commission has authority to set just, reasonable and sufficient rates above or below the proposed tariffs, even if that generates an increase above the proposed revenue requirement.²⁹⁶ Public Counsel's arguments to the contrary should be rejected.

DATED this 19th day of February 2010.

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²⁹⁶ Commission rules reflect this conclusion. WAC 480-90-197 and WAC 480-90-194(4)(h).