

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**DOCKET UE-111048
DOCKET UG-111049
(Consolidated)**

INITIAL BRIEF ON BEHALF OF COMMISSION STAFF

March 16, 2012

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I. INTRODUCTION

1 Puget Sound Energy, Inc. (“PSE” or “the Company”) seeks to increase electric and natural gas rates by \$126 million (6.2 percent) and \$28.5 million (2.7 percent), respectively.¹ PSE also proposes a new annual surcharge related to conservation that will provide \$9.8 million in additional electric revenues and \$2 million in additional gas revenues in the rate year.²

2 Staff proposes an increase in electric revenues of \$40 million (2 percent) and an increase in gas revenues of \$1.5 million (.1 percent).³ Staff opposes the conservation surcharge.

3 The flaws in the Company’s proposals are addressed at length below. However, it should be noted at the outset that PSE requests an increase in profits for its entire rate base through a 10.75 percent return on equity compared to the 10.1 percent the Commission determined fair in the Company’s last general rate case. PSE also asks ratepayers to pay an additional surcharge for lost revenues from the same conservation measures they also already fund.

4 The Commission heard testimony from citizens who strongly condemned such proposals. This testimony provides a real world perspective while the Commission considers the many issues in this proceeding. Staff’s case offers a thorough evaluation of those issues, including PSE’s significant investment in new renewable generation. It is a fair portrayal of PSE’s costs that balances appropriately the Commission’s overall responsibility to set rates that are just, reasonable and sufficient.⁴

¹ Story, Exh. No. JHS-22 at 1:13 and Stranik, Exh. No. MJS-14 at 1:15.

² Piliaris, Exh. No. JAP-1T at 38-39, Tables 3 and 4.

³ Martin, Exh. No. RCM-2 at 1:2 (January 30, 2012 Version) and Mickelson, Exh. No. CTM-2 at 2:2. Staff’s electric and gas revenue requirements are now slightly higher than shown in these exhibits because Staff has withdrawn some of its adjustments based on the Company’s rebuttal presentation, as discussed below for each relevant adjustment. Staff will rerun its revenue requirement exhibits if requested by the Commission.

⁴ RCW 80.28.010(1) and RCW 80.28.020.

II. COST OF CAPITAL

5 The cost of capital for PSE is one of the most significant issues in this proceeding. There are two areas of dispute among Mr. Kenneth L. Elgin for Staff, Dr. Charles E. Olson and Mr. Donald E. Gaines for PSE, and Mr. Michael P. Gorman for the Industrial Customers of Northwest Utilities (“ICNU”):⁵

<u>Issue</u>	<u>PSE</u>	<u>Staff</u>	<u>ICNU</u>
Common Equity Ratio	48.0%	46.0%	46.0%
Cost of Common Equity	10.75%	9.50%	9.70%
Total Cost of Capital	8.26%	7.59%	7.83%

6 For the following reasons, the Commission should find that the total cost of capital for PSE is Mr. Elgin’s 7.59 percent.

A. Capital Structure

7 PSE requests a hypothetical capital structure containing 48.0 percent common equity based upon a calculation of the actual, average of monthly average balances during the 2010 test year.⁶ This request contains too much equity, which places excessive costs on ratepayers. In contrast, Mr. Elgin recommends a hypothetical capital structure with an equity ratio of 46.0 percent that appropriately balances the interests of safety and economy.

1. A Capital Structure Containing 46 Percent Equity is Consistent with Commission Policy to Balance Safety and Economy

8 The Commission’s policy for determining an appropriate capital structure is to balance the amount of equity (safety) with its cost to ratepayers (economy) in order to ensure a company’s financial integrity.⁷ This policy embodies a fundamental principle that a properly

⁵ All parties use a short term debt ratio of 4.0 percent, a short term debt cost of 2.68 percent, and a long term debt cost of 6.22 percent. The difference in long term debt ratio between PSE (48 percent) and Staff/ICNU (50 percent) is the result of the other capital structure recommendations.

⁶ Gaines, Exh. No. DEG-4 at 2:17, column (O).

⁷ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-040641 and UG-040640, Order 06 at ¶27 (February 18, 2007).

balanced capital structure should ensure a utility efficiently finances its long-lived assets to achieve the lowest possible cost for ratepayers.⁸ This policy was affirmed recently in a case where capital structure was contested.⁹

9 A critical factor in applying these principles here is the fact that PSE is privately held by owners who control the Company's capital structure in order to maximize their returns at the holding company level. Therefore, the Commission must ensure PSE's regulated operations are properly capitalized since the owners' incentive is to capitalize the utility with too much equity.¹⁰

10 This "double-leverage" concern is not theoretical. PSE increased its dividend to its parent, Puget Energy, by roughly 25 percent immediately following its 2009 acquisition.¹¹ An additional dividend increase was declared in 2011.¹² Thus, the evidence suggests that PSE's request to increase its equity ratio from 46 to 48 percent is designed to support the cash requirements of Puget Energy to fund holding company debt. This is inconsistent with PSE's commitment that the cost of capital would not increase as a result of the 2009 acquisition.¹³

11 Mr. Elgin's recommendation for a capital structure with 46 percent equity is based upon numerous factors that implement Commission policy to maintain PSE's financial integrity, while also protecting ratepayers from excessive costs of the holding company structure:

- A 46 percent equity ratio is consistent with PSE's actual 2010 year-end equity ratio of 46.5 percent.¹⁴

⁸ Elgin, Exh. No. KLE-1T at 13:18-22. See also, *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 302 (1988) (authority of commission to adjust ratemaking capital structure to limit burden on ratepayers of high equity costs).

⁹ *WUTC v. PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-100749, Order 07 at ¶10 (May 12, 2011).

¹⁰ Elgin, Exh. No. KLE-1T at 14:1-18. See also, *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 302 (1988).

¹¹ In 2008, PSE paid dividends to Puget Energy of \$145 million. That payment increased in 2010 to \$187 million. Gaines, Exh. No. DEG-22CX at 2 and Gaines, TR. 823:9-824:20.

¹² Elgin, Exh. No. B-13C.

¹³ *In the Matter of the Joint Application of Puget Holdings LLC and Puget Sound Energy, Inc.*, Docket U-072375, Order 08, Attachment A, Appendix A, Commitment 24 (December 30, 2008).

¹⁴ Elgin, Exh. No. KLE-1T at 15:18-16:2.

- A 46 percent equity ratio recognizes PSE's issuance of new debt in 2011.¹⁵ In fact, the actual equity ratio declined to 44.5 percent, based upon its September 30, 2011 balance sheet with the effect of new debt issued in November 2011.¹⁶
- A 46 percent equity ratio is consistent with the consolidated equity ratios of utilities engaged principally in regulated electricity and electricity and natural gas service, and the equity ratios of the proxy companies Mr. Elgin studied for his cost of equity recommendation.¹⁷
- A 46 percent equity ratio will support the Company's BBB corporate credit rating and A- secured bond rating, consistent with industry standards.¹⁸
- A 46 percent equity ratio is consistent with PSE's financial forecasts.¹⁹
- A 46 percent equity ratio is the same ratio the Commission found reasonable in PSE's 2009 general rate case. There, the Commission rejected a 48 percent equity ratio PSE advocated to account for the initial recapitalization by its new owners that brought PSE's equity ratio up to 52.9 percent.²⁰
- A 46 percent equity ratio, combined with Mr. Elgin's recommended 9.5 percent cost of equity, produces a reasonable pre-tax, unadjusted interest coverage.²¹

2. PSE's Proposal to Increase Its Equity Ratio to 48 Percent Violates Commission Policy to the Advantage of Its Owners At the Expense of Ratepayers

12 PSE claims that it is "established practice" for the Commission to accept a company's actual capital structure in place on average during the test year, unless there is a "clear and compelling" reason to do otherwise.²² Thus, it argues, Mr. Elgin deviates from established practice by referring to PSE's actual equity ratio at one point in time, December 31, 2010, as 46.5 percent, and then inexplicably recommending 46.0 percent.²³

¹⁵ Elgin, Exh. No. KLE-1T at 16:3-9.

¹⁶ Elgin, Exh. No. KLE-1T at 16:9-11.

¹⁷ Elgin, Exh. No. KLE-1T at 16:18-17:16.

¹⁸ Elgin, Exh. No. KLE-1T at 17:18-18:10. Mr. Gorman recommends a 46 percent equity ratio also because it supports PSE's current bond rating. Gorman, Exh. No. MPG-1T at 2:10-11.

¹⁹ Elgin, Exh. No. KLE-1T at 16:12-13.

²⁰ Elgin, Exh. No. KLE-1T at 19:4-12; Gaines, Exh. No. DEG-1T at 7:2-4; and Gaines, Exh. No. DEG-23CX at ¶270.

²¹ Elgin, Exh. No. KLE-8CX at 2.

²² Gaines, Exh. No. DEG-1T at 12:1-4 and Gaines, Exh. No. DEG-14T at 12:4-6.

²³ Gaines, Exh. No. DEG-14T at 12:1-13:11.

13 PSE's position has been rejected by the Commission's recent affirmation that its policy is to balance safety with economy, whether that occurs through a capital structure that is actual or hypothetical.²⁴ Mr. Elgin recommends a 46 percent equity ratio specifically because it provides that balance and not because capital structure should be based on a utility's actual equity ratio at any particular time or over any particular period.²⁵ His approach is also consistent with the Staff presentation in PSE's 2009 rate case, contrary to PSE's assertion.²⁶

14 PSE argues that a higher credit rating may result from an increase in equity ratio that creates savings greater than the cost to achieve those savings.²⁷ This argument should be rejected because it assumes that a credit rating increase is driven by one factor only: equity ratio. No evidence was provided supporting that assumption.

15 Moreover, the cost/benefit analysis presented by PSE compares estimated interest savings over the entire 30-year life of the outstanding securities with a single year of costs to achieve those savings. When the costs of increasing the equity ratio are compared to the estimated interest savings over the same period, the present value of the costs exceed the present value of the benefits by a ratio of at least 4 to 1.²⁸ Thus, a 48 percent equity ratio, even as a means to improve bond ratings, is too costly for ratepayers.

16 PSE criticizes Mr. Elgin because he did not adjust the capital structures of his peer group holding companies for non-utility operations, arguing that such an adjustment results in an average equity ratio of 48.05 percent for the utility subsidiaries.²⁹ However, the equity ratios

²⁴ *WUTC v. PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-100749, Order 07 at ¶¶8-10 (May 12, 2011).

²⁵ Elgin, Exh. No. KLE-8CX.

²⁶ Gaines, Exh. No. DEG-14T at 13:7-11. Nowhere in the 2009 rate case does the Commission describe Staff's approach as adopting the actual capital structure in place on average during the test year. In fact, the Commission cites Mr. Parcell's assertion that PSE's actual capital structure should not be used because it reflects decisions of the new owners and may not be balance safety and economy. Gaines, Exh. No. DEG-23CX at 3-4, ¶272.

²⁷ Gaines, Exh. No. DEG-1T at 9:16-18.

²⁸ Elgin, Exh. No. KLE-1T at 21:1-18 and Gaines, TR. 831:17-21.

²⁹ Gaines, Exh. No. DEG-14T at 5:12-19.

claimed by PSE do not represent the actual equity ratios of the utilities in Mr. Elgin's peer group holding companies. They are only the equity ratios authorized by regulatory commissions.³⁰ Even if the equity ratios were adjusted for non-utility operations, the equity ratio supporting utility operations would *decline* because non-utility operations are typically funded with shareholder equity.³¹ PSE's criticism is also misplaced because Mr. Elgin's proxy group screening criteria eliminated holding companies with significant non-utility operations.³²

17 Finally, PSE disputes Mr. Elgin's conclusion that a 46 percent equity ratio is consistent with PSE's financial forecasts.³³ In fact, the most recent forecast undermines the Company's own case. It shows PSE is not expected to have sufficient equity to support the Company's capital structure proposal until 2016.³⁴

18 In short, Mr. Elgin's 46 percent equity ratio is supported fully by the record and it meets the Commission's policy to balance safety (the preservation of investment quality credit ratings and access to capital) against economy (the lowest overall cost to attract and maintain capital). PSE's proposal for a 48 percent equity ratio falls woefully short on both counts.

B. Cost of Common Equity

19 In PSE's most recent rate case the Commission determined that a fair rate of return on equity was 10.1 percent.³⁵ PSE now seeks an increase to 10.75 percent based on Dr. Olson's cost of equity in the range of 11 percent to 13 percent. Mr. Elgin recommends an equity return of 9.5 percent, the high end of his range of 9 percent to 9.5 percent.

³⁰ Gaines, TR. 827:19-24 and Gaines, Exh. No. DEG-17. Even that information was bloated by double counting equity ratios for combination gas and electric utilities and by including old data. Gaines, TR. 828:19-830:14.

³¹ Elgin, Exh. No. KLE-10CX.

³² Elgin, Exh. No. KLE-10CX.

³³ Gaines, Exh. No. DEG-14T at 16:6-16.

³⁴ PSE projects long-term debt of \$3.773 million at the end of the rate year. Gaines, Exh. No. DEG-15 at 4. Thus, it needs the same amount of equity given its proposed capital structure of 48 percent for both equity and long-term debt. The Company's financial forecast does not show that amount of equity until 2016. Elgin, Exh. No. KLE-9CX at 103 and Elgin, TR. 874:12-875:13.

³⁵ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 11 at ¶301 (April 2, 2010).

20 Mr. Elgin's recommendation is supported by changes in the capital markets that have lowered the cost of capital.³⁶ A decrease in the authorized return of equity is also supported by the comprehensive analytical methods Mr. Elgin presented.

1. Changes in Capital Markets Support Staff's Recommendation to Reduce the Company's Cost of Equity

21 In the most recent case where cost of equity was contested, the Commission determined that 9.80 percent was a fair return on equity.³⁷ Since then, the market has assimilated the fact that the Federal Reserve will continue to keep short-term interest rates near zero.³⁸ The market also has discounted the prospect of inflation. PSE has sold long-term debt well below 5.0 percent. *Value Line* reports that the electric industry has outperformed broader market averages during recent market volatility.³⁹

22 All of this is strong evidence of continued downward pressure on the cost of equity capital. Thus, the Commission would be well within a "zone of reasonableness" to provide PSE an opportunity to earn in the low end of Mr. Elgin's range.⁴⁰ Anything above his 9.5 percent provides excessive compensation to PSE's owners, in violation of the requirement that ratepayer and investor interests must be balanced equally.⁴¹

2. Mr. Elgin's Analytical Methods Support a Reduction in PSE's Equity Return

23 It is evident that the 9.5 percent return on equity proposed by Mr. Elgin properly reflects the current cost of equity for PSE. First, Mr. Elgin places primary reliance on the Discounted

³⁶ Cost of capital witnesses must support a change in the authorized return on equity with evidence of changed circumstances in the capital markets. *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267, Order 08 at ¶84 (January 5, 2007).

³⁷ *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.*, Docket UE-100749, Order 6 at ¶94 (March 25, 2011).

³⁸ Elgin, Exh. No. KLE-1T at 49:3-10.

³⁹ Elgin, Exh. No. KLE-1T at 9:5-10.

⁴⁰ *Federal Power Commission v. Natural Gas Pipeline*, 315 U.S. 575, 585 (1942).

⁴¹ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1942).

Cash Flow (“DCF”) model, which reflects Commission historical preference.⁴²

24 Mr. Elgin’s DCF analysis employed the constant growth DCF model, which combines the current dividend yield for a group of proxy utilities with several indicators of expected dividend growth. His group of proxy companies began with the same utilities selected by Dr. Olson, but then removed companies with excessive financial risk (NV Energy), excessive revenues from unregulated operation (OGE), or is regulated on the basis of fair value (Pinnacle West).⁴³ Mr. Elgin added Avista Corporation because it is a combination utility similarly situated to PSE with respect to business risk and jurisdictional oversight, and Portland General Electric Company because it faces similar regional issues as PSE.⁴⁴

25 For the dividend yield component of his DCF, Mr. Elgin evaluated the actual dividend paid by each proxy firm and used a range of “expected” prices to calculate a dividend yield for that group. This process accounted for the diversity of investor expectations for future dividends over time. Finally, he compared his dividend yield for PSE and his proxy group to dividend yield projections by *Value Line* and *Morningstar*.⁴⁵ He concluded that a reasonable dividend yield is in the range of 4.25 percent to 4.5 percent.

26 For the dividend growth component of his DCF, Mr. Elgin provided a comprehensive analysis of four financial indices of investor expectations, as projected by *Value Line* for each proxy company: 1) book value; 2) internal growth; 3) dividends per share; and 4) earnings per share.⁴⁶ He concluded from this analysis that investors can reasonably expect a long-term dividend growth of 4.5 percent to 5.0 percent. Combined with his estimate of dividend yield, he

⁴² *WUTC v. Puget Sound Energy, Inc.*, Dockets UG-040641 and UG-040640, Order 06 at ¶73 (February 18, 2005).

⁴³ Elgin, Exh. No. KLE-1T at 24:19-25:8.

⁴⁴ Elgin, Exh. No. KLE-1T at 25:9-18.

⁴⁵ Elgin, Exh. No. KLE-1T at 28:8-30:2.

⁴⁶ Elgin, Exh. No. KLE-1T at 31:11-37:11 and Elgin, TR. 854:12-22.

concluded that a reasonable range for the cost of equity for PSE is 9.0 percent to 9.5 percent. He recommended a return on equity of 9.5 percent for ratemaking purposes.⁴⁷

27 Mr. Elgin's conclusion was corroborated by his Capital Asset Pricing Model study, which supported a return on equity in the low end of his DCF range, although he cautioned that the study should be interpreted only to mean that the cost of capital will remain low.⁴⁸ His equity risk premium of 375-450 basis points over PSE's long-term debt cost also shows that his DCF return on equity of 9.5 percent provides adequate compensation for PSE's owners.⁴⁹

28 It is clear that Mr. Elgin's DCF conclusions are more appropriate than Dr. Olson's DCF results of 11 percent to 13 percent. This is largely because Mr. Elgin considered multiple measures of dividend growth whereas Dr. Olson uses only one: analysts' earnings estimates.⁵⁰ As Mr. Elgin indicated, it is not proper to rely exclusively on analysts' earnings estimates since investors routinely consider other information, such as that provided by *Value Line*, regarding the alternative measures of growth that Mr. Elgin studied.⁵¹ Analysts' earnings estimates are also typically short-term and change over time for many different reasons, such as unusual weather or other extraordinary events.⁵² They also tend to overstate what investors can reasonably expect because they are provided by persons with an interest in selling securities.⁵³

⁴⁷ Elgin, Exh. No. KLE-1T at 38:4-12.

⁴⁸ Elgin, Exh. No. KLE-1T at 45:7-16.

⁴⁹ Elgin, Exh. No. KLE-1T at 48:5-12.

⁵⁰ Olson, Exh. No. CEO-4.

⁵¹ Elgin, Exh. No. KLE-1T at 56:15-57:5.

⁵² Elgin, TR. 856:8-20.

⁵³ PSE cites an article for the notion that analysts' earnings estimates must be used exclusively to estimate long-term dividend growth. Olson, Exh. No. CEO-11T at 7:6-12. However, the article states only that future earnings estimates are superior to historical results. The article does not state that future earnings are superior to the future estimates of growth in book value, retained earnings or dividends that Mr. Elgin used. Olson, Exh. No. CEO-18CX.

29 Indeed, Dr. Olson's exclusive use of analysts' earnings estimates results in long-term dividend growth rates that are grossly overstated.⁵⁴ For example, his methodology results in an 11.75 percent estimate of dividend growth for NV Energy, meaning that the earned return on book would have to rise above 22 percent and be sustained over the long-term.⁵⁵ Likewise, his data show dividend growth rates for Alliant of 9.3 percent, Great Plains of 8.90 percent and Wisconsin of 8.5 percent.⁵⁶ These estimates clearly strain any notion of reasonableness.

30 In short, the issue for the Commission is to determine, in an environment of low capital costs, the degree to which the Company's owners should be compensated for providing equity capital to PSE. Staff submits that sufficient compensation will be paid to the owners using a 9.5 percent return on equity. The record clearly supports Staff's conclusion.

C. The Company Has Failed to Carry Its Burden to Prove Attrition

31 The Company proposes to increase both its return on common equity and the equity component of its capital structure as specific remedies for historical test-year ratemaking, which it argues causes "attrition" because of regulatory lag during periods of significant replacement of plant.⁵⁷ PSE provided no separate study to support its criticism of historical test-year ratemaking.⁵⁸ It draws its criticism only by implication from the frequency of rate cases.⁵⁹

32 Moreover, PSE's evidence of attrition is inadequate and its proposed remedies are unjustified under sound and well-established Commission policy.

⁵⁴ The same conclusion can be reached for Mr. Gorman who also relied exclusively on analysts' earnings estimates. However, he acknowledged the propriety of using internal growth as used by Mr. Elgin. Gorman, Exh. No. MPG-1T at 21:6-22:5. His DCF estimate of 9.83 percent would have declined had he used internal growth. Compare the average (6.43 percent) and median (5.79 percent) analysts' growth rates in Gorman, Exh. No. MPG-6 with the average (4.93 percent) and median (4.87 percent) sustainable growth rates using an internal growth methodology in Gorman, Exh. No. MPG-10 at 1.

⁵⁵ Elgin, Exh. No. KLE-1T at 58:1-10.

⁵⁶ Olson, Exh. No. CEO-4.

⁵⁷ Olson, Exh. No. CEO-1T at 7:19-8:17; Olson, Exh. No. CEO-16CX; and Elgin, Exh. No. KLE-1T at 63:14-19. PSE also proposes the Conservation Savings Adjustment as a remedy for its alleged attrition. Elgin, Exh. No. KLE-1T at 63:19. We address the shortcomings of the CSA in Section IV below.

⁵⁸ Olson, Exh. No. CEO-15CX.

⁵⁹ Olson, Exh. No. CEO-12CX.

1. PSE's Remedies for Attrition Violate Commission Policy and Practice

33 Since the early 1980's, the Commission has remedied claims of attrition by authorizing additional revenue when a utility makes a detailed showing that the test year relationship between revenues, expenses and rate base will erode in the rate year, and a calculation of the impact of that erosion on rate of return.⁶⁰ This "attrition adjustment" addressed the same problems PSE claims today: growing infrastructure, rising costs and regulatory lag. The intent was to ensure a utility could finance construction and maintain financial integrity, consistent with the Commission's statutory obligation to set rates that are fair, just, reasonable and sufficient.⁶¹

34 PSE does not avail itself of this remedy despite its express claim of attrition. Instead, it turns on Staff by characterizing Staff's description of Commission precedent as a "wondrous mosaic of confusion and bewilderment."⁶² This claim insults Commission practice and policy, especially in light of the Commission's recent affirmation that an attrition adjustment is a proper response to proven earnings erosion, including that caused by the impact of conservation:

The guidance provided in this policy statement does not imply that the Commission would not consider other mechanisms in the context of a general rate case, including an appropriate attrition adjustment designed to protect the company from lost margin due to any reason.⁶³

Thus, if PSE believes existing policies are insufficient, it must show circumstances warranting a new approach that meets the statutory requirements for setting rates. As discussed next, PSE's simple showing that historical per book earnings are lower than authorized returns is insufficient.

⁶⁰ Elgin, Exh. No. KLE-1T at 67.

⁶¹ RCW 80.28.020. Excerpts from relevant Commission orders are contained in Elgin, Exh. No. KLE-6.

⁶² Gaines, Exh. No. DEG-14T at 22:14-15.

⁶³ *In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives*, Docket U-100522, Report and Policy Statement, ¶34 (November 4, 2010) ("Decoupling Policy Statement").

2. Per Books Earnings Lower Than Authorized Levels Is Insufficient Evidence of Attrition

35 PSE did not present an attrition adjustment in this case.⁶⁴ Instead, Mr. Gaines and Dr. Olson present comparisons of actual (per books) returns on equity with authorized returns on equity. Mr. Gaines asserts PSE has under-earned the authorized return on equity since 2007.⁶⁵ Dr. Olson alleges that this earnings short-fall is attrition.⁶⁶

36 The Company's presentation belies other evidence suggesting there is no attrition. For the first 9 months of 2011, PSE financed all construction (\$784.6 million) with internally generated cash (\$795.2 million).⁶⁷ This could not occur if earnings were insufficient.

37 PSE's presentation should be rejected also because it assumes that regulation guarantees a specified *ex post* return. No such guarantee exists. In fact, valid rate making may produce a lower than authorized return:

Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base.⁶⁸

38 Moreover, actual returns on equity are impacted by too many factors to be an accurate gauge of financial performance.⁶⁹ This was confirmed by other Company testimony on the volatile nature of actual results.⁷⁰ It was also confirmed in 1988 when the Commission amended its financial reporting rules to require normalized results rather than actual results.⁷¹ Finally, the

⁶⁴ In its 2006 general rate case, the Company presented an attrition study it asserted was necessary to address regulatory lag and erosion of earnings due to increasing costs of new plant. Elgin, Exh. No. KLE-1T at 74:1-12. No reason was given in the current case why an attrition study could not be provided to address the very same problems.

⁶⁵ Gaines, Exh. No. DEG-1T at 23, Chart 1.

⁶⁶ Olson, Exh. No. CEO-1T at 8:10-12 and 15-17.

⁶⁷ Gaines, Exh. No. DEG-21CX at 11.

⁶⁸ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1942).

⁶⁹ Elgin, Exh. No. KLE-1T at 74:14-18. See also Elgin, Exh. No. KLE-1T at 76:9-21.

⁷⁰ Harris, Exh. No. KJH-1T at 3:15-22.

⁷¹ Elgin, Exh. No. KLE-1T at 75:21-76:77.

data presented by Mr. Gaines is for combined gas and electric operations.⁷² Thus, the Commission cannot determine the cause and extent of attrition, if any, and what remedy, if any, may be necessary and appropriate for each line of business.

39 In short, PSE failed to present a proper analysis of attrition or explain why established Commission practice to address attrition is no longer valid. Its claim of attrition is, therefore, unsubstantiated and should be rejected by the Commission.⁷³

D. Staff's Proposal for Expedited Rate Relief Will Address the Issue of Regulatory Lag

40 Despite PSE's deficient presentation on attrition, the Company did present testimony regarding ongoing costs for infrastructure additions, replacements and maintenance.⁷⁴ This testimony warranted a response, but one that is consistent with historical test-year ratemaking.

41 Staff proposed an expedited form of general rate relief using a simple and straight-forward process to update the test period relationships between rate base and net operating income. The process would utilize the type of financial information required by Commission basis reports.⁷⁵ It could be filed in early March to allow a decision by September that coincides with the winter heating season when PSE generates 70 percent of its annual net operating income.⁷⁶ The case would contain only restating adjustments, such as temperature normalization. PSE could not request a change in rate of return, except to update debt costs.⁷⁷

42 The advantages of the Staff proposal are numerable:

- Rates would be based upon known costs - not budgets;

⁷² Gaines, Exh. No. DEG-1T at 23, Chart 1.

⁷³ The Company drew attention to a Moody's statement expressing concern with PSE's under-earning relative to authorized returns. However, Moody's statement uses information provided by PSE and cannot be considered an entirely independent evaluation. Elgin, TR. 842:13-18.

⁷⁴ McLain, Exh. No. SML-1T.

⁷⁵ WAC 480-90-257 (gas) and WAC 480-100-257 (electric).

⁷⁶ Elgin, Exh. No. KLE-1T at 82:21-83:8.

⁷⁷ Elgin, Exh. No. KLE-1T at 81:5-22.

- Rates would capture changes to test year customer growth and load including any changes that result from conservation;
- Rates changes would be implemented to maximize the impact on financial results; and
- This process provides for more streamlined and less contentious rate proceedings.⁷⁸

43 PSE agrees that an expedited rate case process will assist in addressing attrition caused by regulatory lag.⁷⁹ Nevertheless, it suggested the Commission instead adopt a future test period approach based on budgets and forecasts rather than audited, historical results.⁸⁰

44 The Commission has rejected a future test year approach because budgets and forecasts are subject to error, revision and unreliability.⁸¹ Moreover, setting rates based on forecasted expenditures from a budget reduces a utility's incentive to efficiently manage and control expenditures.⁸² This is inconsistent with Commission policy that regulation should always motivate a utility to efficiently manage costs.⁸³ A future test year also introduces significant burden on the Commission and parties because it requires them to both evaluate a utility's estimates of future expenditures and audit past expenses for consistency with those forecasts.⁸⁴

45 PSE claims that Staff offers nothing more than already provided by rule for rate requests of less than 3 percent and, in fact, is more restrictive because Staff would exclude pro forma adjustments.⁸⁵ PSE misreads the rules. The rules do not require expedited relief. They only exclude from specific filing requirements requests that are not "general rate cases" because they

⁷⁸ Elgin, Exh. No. KLE-1T at 8:7-17. See Schooley, Exh. No. TES-1T at 8:12-10:5 for a description of the particular regulatory difficulties presented currently by PSE that could be alleviated by Staff's proposal.

⁷⁹ Olson, Exh. No. CEO-17CX.

⁸⁰ Olson, Exh. No. CEO-1T at 10:1-4.

⁸¹ *WUTC v. Washington Water Power Company*, Cause No. U-81-15/16, 2nd Suppl. Order at 7 (November 25, 1981).

⁸² Olson TR. 811:21812:22. See also Elgin, Exh. No. KLE-1T at 68:21-69:3.

⁸³ *In the Matter of the WUTC's Investigation into Energy Conservation Incentives*, Docket U-100522, Report and Policy Statement, ¶26 (November 4, 2010).

⁸⁴ Olson, TR. 811:11-20.

⁸⁵ Story, TR. 1065:16-25 and Story, TR.1066:20-25.

do not exceed 3 percent.⁸⁶ Thus, a request below 3 percent is still a request to revise rates that can take the full 10 month suspension period.⁸⁷ Staff offers a process for quicker resolution whether a request is more or less than 3 percent.

46 Finally, PSE claims that Staff's expedited rate case lacks too many details to support at this time.⁸⁸ However, Staff described the process with sufficient specificity as to timing, supporting data and allowed adjustments.⁸⁹ PSE controls the filing of its cases. It should take the initiative to implement Staff's proposal as soon as this case is completed.⁹⁰ Staff is willing to meet with PSE to confirm mutual expectations of this filing if that will facilitate the process.

III. RESOURCE ACQUISITION

A. Klamath Winter Power Purchase Agreement

47 The Klamath Winter Power Purchase Agreement provides up to 100 MW of winter peaking capacity.⁹¹ The resource coincides with the 2009 integrated resource plan ("IRP"), which described a need for 160 MW of peak capacity by 2012.⁹² It was selected for acquisition in PSE's 2010 Request for Proposal ("RFP") and provided the highest Portfolio Benefit Ratio of all capacity proposals.⁹³ Thus, PSE demonstrated both the need for this resource and that it was a cost effective resource to acquire to meet that need. No party challenges the prudence of this acquisition by the Company.

B. Lower Snake River Wind Project

1. Background

48 The Lower Snake River Wind Project ("LSR") adds 343 MW of name plate capacity to

⁸⁶ WAC 480-07-505(1) and WAC 480-07-510.

⁸⁷ RCW 80.04.130(1).

⁸⁸ DeBoer, TR. 531:5-19.

⁸⁹ Schooley, Exh. No. TES-1T at 7:11-8:3 and Elgin, Exh. No. KLE-1T at 82:21-83:8.

⁹⁰ Elgin, TR. 861:25-862:5.

⁹¹ Garratt, Exh. No. RG-26C.

⁹² Garratt, Exh. No. RG-3 at 10.

⁹³ Selig, Exh. No. AS-3HC at 54 and 55.

PSE's existing portfolio.⁹⁴ It is located in Garfield County and connects to PSE through the transmission system of the Bonneville Power Administration ("BPA"). LSR became operational on February 29, 2012.⁹⁵ Thus, LSR is now part of PSE's resource portfolio serving customers.

49 LSR results in PSE's portfolio exceeding the 9 percent renewables requirement before that level must be met by the 2016 deadline of the renewable portfolio standards ("RPS") in the Energy Independence Act ("EIA"), codified at RCW 19.285. However, acquisition of LSR will not allow PSE to meet the RPS of 15 percent from renewables by 2020.⁹⁶

2. Legal Standards

50 In order for any resource to be included in rate base for ratemaking purposes, the resource must be "used and useful for service in this state."⁹⁷ The phrase "used and useful for service in this state" means "to benefit the ratepayers of Washington, either directly (*e.g.*, flow of power from a resource to customers) and/or indirectly (*e.g.*, reduction of cost to Washington customers through exchange contracts or other tangible or intangible benefits)."⁹⁸ The benefits must be "tangible and quantifiable" before a resource will be included in rates."⁹⁹

51 The Commission has stated that the "used and useful" statute does not prevent early acquisition of a renewable resource that will meet the RPS at some point in the future.¹⁰⁰ Therefore, "a resource acquired to comply with the EIA can be acquired in advance of need but must still be prudently acquired."¹⁰¹

52 The general standard the Commission applies in a prudence review is the following:

⁹⁴ Garratt, Exh. No. RG-1HCT at 3.

⁹⁵ Garratt, Exh. No. RG-13HC at 22, Table 6.

⁹⁶ Selig, Exh. No. AS-3HC at 372.

⁹⁷ RCW 80.04.250.

⁹⁸ *WUTC v. PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-050684, Order 04 at ¶50 (April 17, 2006).

⁹⁹ *Id.* at ¶68.

¹⁰⁰ *In the Matter of the Washington Utilities and Transportation Commission's Inquiry on Regulatory Treatment for Renewable Energy Resources*, Docket UE-100849, Report and Policy Statement Concerning Acquisition of Renewable Resources by Investor-Owned Utilities at ¶55 (January 3, 2011) ("Renewable Policy Statement").

¹⁰¹ Renewable Policy Statement at ¶40.

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.¹⁰²

The Commission has implemented this prudence standard by focusing on the following factors:

- The new resource is needed.
- The new resource fills the need in a cost-effective manner, evaluating that resource with up to date information against other available purchases and against what it would cost the utility to build the resource itself.
- Management kept its board of directors informed and involved the board in the decision process.
- The company has adequate contemporaneous records that will allow the Commission to evaluate its actions with respect to the decision process.¹⁰³

53 When a utility acquires a renewable resource ahead of an RPS, the utility must show that the resource produces benefits offsetting the cost of early acquisition. Such benefits can include the sale of energy, sale of RECs, or other value attributable to the resource.¹⁰⁴ In this case, valuable attributes included significant federal and state tax incentives, and reduced turbine prices.

3. **The Company's Acquisition of LSR Satisfied All Applicable Legal Standards**

54 Staff witness Mr. David Nightingale conducted a full and independent review of all testimony and exhibits addressing LSR. He reviewed responses to hundreds of data requests.¹⁰⁵ He reviewed PSE's 2009 Integrated Resource Plan ("IRP") and IRP Update, its 2010 Request for

¹⁰² *WUTC v. Puget Sound Energy, Inc.*, Docket UE-031725, Order 12 at ¶19 (April 7, 2004).

¹⁰³ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 11 at ¶320 (April 2, 2010).

¹⁰⁴ Renewable Policy Statement at ¶¶52 and 56.

¹⁰⁵ Nightingale, TR. 370:9-15.

Proposal (“RFP”) and related modeling analyses, the transaction documents, Board of Director’s presentations and meeting minutes, and other related documents. Mr. Nightingale concluded that PSE performed and documented all appropriate analyses and decision-making to support a finding that the acquisition of LSR was prudent under all applicable legal standards.¹⁰⁶

55 First, in PSE’s 2009 IRP and IRP Update, various future scenarios were modeled to determine the likely timing of resource needs, including renewable resources, for the next 20 years.¹⁰⁷ The analysis showed that PSE did not have sufficient renewables or contracts for renewable energy credits (“RECS”) to satisfy the RPS through 2020. This included estimated needs for nameplate capacity of additional wind resources of 300 MW by 2012, 600 MW by 2016, and 1,000 MW by 2020.¹⁰⁸

56 To satisfy this need, the Company issued an “All Sources” RFP in January 2010.¹⁰⁹ 64 proposals from 55 respondents were submitted. 31 of these responses were for renewable resources and 21 of the 31 were for wind.¹¹⁰

57 PSE evaluated all proposals using a “fatal flaw” array of qualitative and quantitative analyses to screen out the least competitive offers. The remaining short-list of proposals was subjected to further due diligence using a dynamic simulation of the PSE system within the Western United States.¹¹¹ The model selected various combinations of available additional resources under several scenarios and simulated 20 years of operation to find the lowest revenue

¹⁰⁶ Nightingale, Exh. No. DN-1HCT at 5:6-13; Nightingale, Exh. No. DN-16CX; and Nightingale, Exh. No. DN-17CX. Mr. Nightingale also reviewed the acquisition by PSE of the Mint Farm Generation Facility. The Commission concurred with his opinion that the acquisition was prudent. *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 11 at ¶¶ 327 and 337 (April 2, 2010).

¹⁰⁷ Nightingale, Exh. No. DN-1HCT at 11:7- 16; Garratt, Exh. No. RG-1HCT at 7-13; and Selig, Exh. No. AS-3HC at 5-6.

¹⁰⁸ Garratt, Exh. No. RG-3 at 10, Figures 1-4 and Garratt, Exh. No. RG-16HC at 5.

¹⁰⁹ Garratt, Exh. No. RG-5.

¹¹⁰ Selig, Exh. No. AS-3HC at 17.

¹¹¹ Selig, Exh. No. AS-1HCT at 3: 9-17 and Selig, Exh. No. AS-3HC at 157-160.

requirement that satisfies the RPS and capacity needs of PSE.¹¹² In particular, the modeling examined the impact of Section 1603 Treasury grant and state sales tax incentives, and falling prices for wind turbines (15 percent below 2008 prices).¹¹³ These exercises determined there were significant cost benefits to acquiring wind in advance of the RPS, including energy production and REC sales revenues.¹¹⁴ They also found that LSR was among the lowest cost alternatives and presented the lowest overall risk of construction and ability to secure the federal and state tax incentives.¹¹⁵ Accordingly, it was prudent for the Board of Directors to decide to acquire LSR upon the recommendation of senior management. That decision and all supporting evaluation processes and analyses were fully documented.

4. Public Counsel's and ICNU's Criticisms of the Acquisition of LSR are Unsupported and Should Be Rejected by the Commission

58 Public Counsel and ICNU, through the testimony of Mr. Scott Norwood, challenge the acquisition of LSR for two general reasons. First, Mr. Norwood states that LSR is not needed to satisfy an RPS deadline until 2018 or later.¹¹⁶ However, this assertion by itself is moot given the Commission's holding that a renewable resource can be acquired in advance of an RPS deadline without violating the "used and useful" statute.¹¹⁷

59 Mr. Norwood next argues that the price paid for LSR is too high because it exceeds the expected rate year price for market energy purchases.¹¹⁸ He supports this conclusion by alleging

¹¹² Seelig, Exh. No. AS-3HC at 42.

¹¹³ The cumulative discount from the federal and state incentives is 35.4 percent: 30 percent from Treasury grants and 5.4 percent from sales tax exemption. Nightingale, Exh. No. DN-1HCT at 17:15-16.

¹¹⁴ Seelig, TR. 344:2-13.

¹¹⁵ Nightingale, Exh. No. DN-1THC, pages 21-22. Other renewable proposals suffered from one or more significant qualitative risks: 1) Incomplete planning and permitting; 2) Lack of available transmission; 3) Lack of wind study to substantiate resource claims; 4) Lack of long-term agreements with dependent operations or fuel supply; 5) Improper wind turbine placement that would require project redesign; and 6) Lack of wind turbine site suitability and construction and start dates that made it unlikely the project would meet Treasury grant deadlines. Seelig, Exh. No. AS-3HC at 42.

¹¹⁶ Norwood, Exh. No. SN-1T at 3:8-11.

¹¹⁷ Renewable Policy Statement at ¶¶40 and 55 (Emphasis added).

¹¹⁸ Norwood, Exh. No. SN-1CT at 3:6-16.

flaws in PSE's analysis that caused PSE to overstate the benefits of acquiring early wind.¹¹⁹

60 However, Mr. Norwood selectively picks narrow sets of calculations based on outdated information, ignoring the more comprehensive and contemporaneous analysis the Company used to evaluate resource options. In doing so, he fails to demonstrate that there was no other more cost-effective and less risky option than LSR. Each of his claims, therefore, is without merit and should be rejected.

a. PSE Properly Evaluated LSR Against Other Available Renewable Resources

61 Mr. Norwood accuses PSE of using incorrect market energy price forecast inputs.

However, with regard to renewable resources, the Commission has stated:

When evaluating alternatives, the question for the utility, and for the Commission, is not whether the utility made the appropriate decision by comparing the cost of renewables with the cost of conventional resources. Rather, the question for the utility, and for the Commission, is whether the utility made a prudent decision *in choosing among available renewable options*. Therefore, we will not expect a utility to present evidence comparing a renewable generator with a non-renewable alternative.¹²⁰

Within that specific context of "choosing among available renewable options," the Commission "would support the acquisition of renewable resources in advance of RPS deadlines if the early acquisition can be cost-justified."¹²¹

62 Thus, Mr. Norwood's comparison of LSR to forecasted energy market prices should be given no weight because forecasted energy market prices are based on a combination of hydroelectric and combustion fueled generators in the region.¹²² Mr. Norwood presents no comparison between the price of LSR and other available renewable options.

¹¹⁹ Norwood, Exh. No. SN-1CT at 5-6.

¹²⁰ *Id.* (footnote omitted).

¹²¹ Renewable Policy Statement at ¶52.

¹²² Nightingale, Exh. No. DN-2T at 5:19-20.

b. The Company Properly Evaluated the Impact of REC Banking

63 Mr. Norwood alleges PSE failed to consider the REC banking provisions of the EIA in its analysis of early wind additions.¹²³ However, at the time the decision was made to acquire LSR, most excess RECs available through 2016 were already committed to other utilities and, thus, were not available for banking.¹²⁴

64 It is true that this commitment was later invalidated by California regulators, but that was not known at the time of the 2010 RFP and decision-making processes leading to LSR.¹²⁵ Moreover, California regulators had approved contracts for the sale of RECs on three prior occasions. Therefore, it was reasonable for the Company to assume that the sale of RECs would not be disapproved at the time the decision was made to construct LSR.¹²⁶

c. The Company Properly Calculated the End-Effects of Early Wind

65 Mr. Norwood claims that PSE's end-effects analysis unfairly gave preference to scenarios that assumed PSE would acquire wind in advance of an RPS. He suggests, instead, applying the average of all end-effects from all scenarios to all results, which would eliminate any end-effect differences between IRP-derived build-out scenario assumptions.¹²⁷

66 His analysis is based on data from the 2009 IRP, not modeling contemporaneous with the decision to build LSR from the 2010 RFP.¹²⁸ Furthermore, the requirement to analyze resource options using end-effects is needed to fairly judge resources with useful lives beyond the 20-year planning timeframe. Thus, Mr. Norwood's use of the average of all end effects applied to all

¹²³ Norwood, Exh. No. SN-1T at 34-35.

¹²⁴ Nightingale, Exh. No. DN-2T at 13:11-14.

¹²⁵ Nightingale, Exh. No. DN-2T at 13, n.24 and Nightingale, Exh. No. DN-13CX.

¹²⁶ Garratt TR. 196:2-10.

¹²⁷ Norwood, Exh. No. SN-1CT at 42 and Norwood, Exh. No. SN-11C.

¹²⁸ Nightingale, Exh. No. DN-2T at 7:19-8:8 and 10:16-18. An IRP is limited to general power planning and identifying the likelihood of future resource needs and what kind of resources might best fill that need. It does not provide specific analysis relative to any particular resources bid into a future RFP nor does it identify what specific resource should be used to fill identified needs. Nightingale, Exh. No. DN-2T at 8:10-10:4.

scenarios is inappropriate for determining end-effects for differently timed resources.¹²⁹ Finally, Mr. Nightingale examined PSE's end-effects analyses and found them reasonable.¹³⁰

d. The Company Was Prudent to Assume that Federal Tax Incentives Would Not Be Extended

67 Mr. Norwood argues that PSE assumed unreasonably that the time limit to use federal tax incentives to acquire a wind resource would not be extended by Congress.¹³¹ However, it is speculative to base significant capital investment decisions on what may be anticipated for future tax treatment. If anything, PSE was correct to act on existing law at the time the decision was made to acquire LSR, given the history of federal production tax credits that had expired previously on three occasions (1999, 2001 and 2003).¹³²

e. The Company Properly Modeled Carbon Price Forecasts

68 Mr. Norwood alleges that PSE used outdated and high carbon price forecasts.¹³³ He bases this assertion on high future carbon prices contained in the 2009 IRP Update.

69 However, those high carbon prices were not used during the 2010 RFP process when it was widely assumed that a federal carbon bill would be enacted.¹³⁴ Rather, low carbon prices were modeled in various scenarios from essentially \$0 per ton in the Business As Usual and Low Growth scenarios to higher prices per ton in other scenarios.¹³⁵ These price variations did not affect the outcome. LSR was still selected in most scenario runs.¹³⁶

¹²⁹ Nightingale, Exh. No. DN-2T at 11:3-6. A more detailed critique of the flaws in Mr. Norwood's end-effects analysis is found at Nightingale, Exh. No. DN-2T at 11:11-12:10.

¹³⁰ Nightingale, Exh. No. DN-8CX and Nightingale, Exh. No. DN-11CX.

¹³¹ Norwood, Exh. No. SN-1T at 36-38.

¹³² Garratt, Exh. No. RG-7HC at 5.

¹³³ Norwood, Exh. No. Exhibit SN-1T at 38-41.

¹³⁴ Nightingale, Exh. No. DN-14CX at 1.

¹³⁵ Seelig, Exh. No. AS-3HC at 31, 163 and 165, and Nightingale, Exh. No. DN-14CX.

¹³⁶ Garratt, Exh. No. RG-13HC at 203; Nightingale, Exh. No. DN-14CX at 1; and Nightingale, Exh. No. DN-15CX.

f. The Company Properly Evaluated Purchasing RECs as an Alternative to Building a New Wind Facility

70 Mr. Norwood argues that PSE did not evaluate the purchase of RECs as an alternative to building a new renewable resource.¹³⁷ This allegation is incorrect. In fact, there were bidders in the 2010 RFP who proposed REC products to PSE. The Company evaluated these proposals to see if they were the low cost options that Mr. Norwood assumed would exist.¹³⁸ These offers were relatively small compared to PSE's needs and the pricing was not favorable enough to be selected by the optimization model when compared to other renewable proposals.¹³⁹

g. Any Modeling Errors Performed By PSE Were Inconsequential

71 Mr. Norwood discovered an error in the IRP 2009 Business as Usual scenario modeled by PSE. However, when the model was corrected, the generic resources chosen did not change substantially. The ranking of the "No Early Wind" option went from eighth place out of eight to only seventh place out of eight. The development of "Early Wind" was still the lowest cost option.¹⁴⁰

72 Cross-examination by Public Counsel implied that he believes the Company's modeling exercises were flawed because analysts required the model to select LSR. However, the analysts forced LSR in only one of five scenarios.¹⁴¹ Moreover, the optimization model is designed specifically to find the lowest possible revenue requirement while meeting load and the RPS. To ensure the model operates as it is designed, analysts check the model in various ways, including the one scenario where LSR was a required choice.¹⁴² If this procedure had not been performed,

¹³⁷ Norwood, Exh. No. SN-1T at 43-44.

¹³⁸ Seelig, TR. 344:2-13.

¹³⁹ Seelig, Exh. No. AS-3HC at 117 and 125.

¹⁴⁰ Nightingale, Exh. No. DN-2T at 12:12-19.

¹⁴¹ Seelig, Exh. No. AS-5HC at 5; Seelig, Exh. No. AS-73CX at 6; and Nightingale, TR. 371:16-372:6.

¹⁴² Seelig, TR. 338:9-340:15.

it would have brought into question whether PSE was performing sufficient due diligence.¹⁴³

73 Finally, Mr. Norwood argued that the amount of savings projected for LSR was insignificant over a 20-year time horizon.¹⁴⁴ He references Figures 1 and 2 of his testimony as support. However, those tables utilize the 2009 IRP analysis, which was not contemporaneous with the decision on LSR.¹⁴⁵ He also selects only two scenarios, the 2009 Business as Usual and 2009 Trends. Even in the 2009 Trends scenario he did select, only one of eight cases remained negative at the 20-year mark. All others become positive between 10 and 20 years.¹⁴⁶ Finally, all of his calculations are based on a set of generic hypothetical resources. They are not actual cost differentials of proposed available alternatives. Consequently, they are irrelevant to a later decision by PSE months later to acquire a resource during the 2010 RFP process.

5. Normalization of LSR Treasury Grants is No Longer Required

74 A recent amendment to the American Recovery and Reinvestment Act (“ARRA”) of 2009 eliminated the requirement to normalize Section 1603 Treasury grants.¹⁴⁷ The amendment is not relevant directly to LSR because it occurred after the decision to build. However, it now allows ratepayers to benefit not only from the amortization of the grant as a credit to operating expense, but also from the return on the unamortized balance of the grant liability.

75 Therefore, Staff recommends that the Commission consider alternatives to normalization for returning the benefits of the LSR Treasury grant, and asks the Commission to order PSE to defer the grant, when received, with interest as a regulatory liability.¹⁴⁸ This will allow parties to propose alternative treatments when PSE files to update the Schedule 95A credit for the Treasury

¹⁴³ Nightingale, TR.358:3-361:4 and Nightingale, TR. 372:11-24.

¹⁴⁴ Norwood, TR. 377:18.

¹⁴⁵ Norwood, Exh. No. SN-1CT at 4.

¹⁴⁶ Norwood, Exh. No. SN-1CT at 4.

¹⁴⁷ The amendment occurred through Section 1096 of the National Defense Authorization Act for Fiscal Year 2012, H.R. 1540, 112th Congress, 1st Session.

¹⁴⁸ Schooley, Exh. No. TES-3T at 4:13-18.

grants.¹⁴⁹ Schedule 95A requires that filing within 60 days after PSE receives the grant.

IV. RATEMAKING ADJUSTMENTS

A. Uncontested Ratemaking Adjustments

76 The following Company adjustments were accepted by Staff in its response case and should be adopted by the Commission.¹⁵⁰

Electricity Adjustments

13.06, ASC 815 (Prev. SAS 133)
14.01, Temperature Normalization
14.03, Pass-Through Revenue & Expenses
14.08, Injuries & Damages
14.09, Bad Debt
14.12, Excise Tax & Filing Fee
14.14, Interest on Customer Deposits
14.16, Deferred Gains/Losses on Prop Sales
14.17, Property & Liability Insurance
14.18, Pension Plan

Natural Gas Adjustments

5.03, Contract Changes
6.01, Temperature Normalization
6.03, Pass-Through Revenue & Expenses
6.08, Injuries & Damages
6.09, Bad Debt
6.12, Excise Tax & Filing Fee
6.14, Interest on Customer Deposits
6.16, Deferred Gains/Losses on Prop Sales
6.17, Property & Liability Insurance
6.18, Pension Plan

77 On rebuttal, PSE conceded Staff Adjustments 14.19 and 6.19, Wage Increase, and Adjustments 14.20 and 6.20, Investment Plan.¹⁵¹ These adjustments recover contract wage increases for union employees and PSE's portion of investment plan expenses to reflect those

¹⁴⁹ The elimination of normalization requires revisiting the Treasury grant for the Wild Horse Expansion that was received by PSE during the test year on February 23, 2010 and amortized in rates starting January 1, 2011. *In the Matter of Puget Sound Energy, Inc. for an Accounting Order Regarding the Treatment of U.S. Treasury Grant*, Docket UE-091570, Order 01 (December 10, 2009). PSE states that eliminating normalization for the grant changes the allocation of \$375,811 total investor supplied working capital between electric, gas and non-operating, but that the change occurred too late to reflect in this docket. The rate of return on the grant liability is included in a separate Schedule 95A filing submitted on February 29, 2012 in Docket UE-120277. Story, Ex. No. B-23, B.

The amendment to ARRA states that the elimination of normalization is effective "as if included in section 1603 of the [ARRA] of 2009". Thus, an issue in Docket UE-120277 is whether PSE should compute the rate of return benefit during the period February 23, 2010 (the date the grant was received) through December 31, 2011 (the date the amendment to ARRA was enacted). Staff reserves the right to address this issue in Docket UE-120277.

¹⁵⁰ Adjustment numbers are consistent with Exhibit RCM-2 (Martin) for electricity and Exhibit CTM-2 (Mickelson) for natural gas. Corresponding PSE adjustments commence with "20" for electricity and "13" for natural gas.

¹⁵¹ Hunt, Exh. No. TMH-11T at 13:2-8.

increases. Staff included wages increases through May 15, 2012, the start of the rate year.¹⁵²

78 With respect to Employee Insurance Adjustments 14.21 and 6.21, on rebuttal, PSE used an average participant count of 2,817, which excluded laid off employees, and an average cost per union employee of \$988.¹⁵³ Staff accepts PSE's proposals, making the adjustments uncontested.

79 Finally, on rebuttal, PSE updated Revenue and Expenses Adjustments 14.02 and 6.02 to incorporate the impact on revenues of the settlement agreement on electric cost of service and rate design, and to reflect the exit of a major industrial gas customer in the spring of 2012.¹⁵⁴ Staff agrees with these updates, which makes these adjustments uncontested.

B. Contested Ratemaking Adjustments-Rate of Return Impact Only

80 The following adjustments are contested as between PSE and Staff, but only to reflect differences in rate of return:

Electricity Adjustments

13.05, Wild Horse Solar
13.08, Remove Tenaska
13.09, Chelan Payments
14.07, General Plant Depreciation

Natural Gas Adjustments

5.01, Water Heater Depreciation
5.02, Reclass Bare to Wrapped Steel
6.07, General Plant Depreciation

81 In addition, Adjustment 13.03, LSR PPD Transmission Deposit, involves prepaid transmission deposits made to BPA for LSR. Other than the impact of rate of return, PSE accepted the Staff adjustment.¹⁵⁵ Moreover, Commission resolution of the adjustment will dispose of the accounting petition in Docket UE-100882, where the Company requested deferred accounting treatment of the prepaid deposits.¹⁵⁶

¹⁵² Erdahl, Exh. No. BAE-1T 11:8-18.

¹⁵³ Hunt, Exh. No. TMH-12.

¹⁵⁴ Story, Exh. No. JHS-18T at 46:16-20 and Stranik, Exh. No. MJS-10T at 7:13-20.

¹⁵⁵ Story, Exh. No. JHS-18T at 25:4-14.

¹⁵⁶ Story, Exh. No. JHS-1T at 21:9-12.

C. Contested Ratemaking Adjustments

1. Contested Electricity-Only Adjustments

a. Adjustment 13.01, Power Costs

82 Initially, Staff recommended adjustments reducing normalized power costs by \$23.9 million.¹⁵⁷ Later information presented by PSE in rebuttal allows Staff to reconsider several adjustments. Staff's adjustments now reduce rate year power costs by \$24.9 million, subject to a final power cost update. A re-conciliation between Staff's initial and revised power cost adjustments is shown in Attachment A.

i. Non Contract Major Maintenance Using Average of Five Year Actual Costs

83 This adjustment normalizes production O&M costs for major maintenance on PSE's self-managed thermal generation resources.¹⁵⁸ PSE uses test year expense levels for each resource, ignoring the fact that the units have shown significant variability and no discernible trend in expense.¹⁵⁹ For example, Fredonia Units 1-4 show annual non-contract, major maintenance O&M ranging from zero to \$1.8 million over the last six years. Nevertheless, PSE uses the 2010 test year expense of \$1.8 million. Frederickson Units 1 and 2 expenses range from zero to \$4.8 million over the same time frame, but PSE uses the 2010 test period level of \$4.8 million.

84 Clearly, the simple use of test year amounts is excessive and, therefore, a wider range of actual historical experience should be used to normalize power costs. Staff's adjustment uses a 5-year average of annual non-contract, major maintenance from 2006 through 2010. This derives a rate year expense of \$4.66 million compared to PSE's \$8.2 million.¹⁶⁰

¹⁵⁷ Buckley, Exh. No. APB-2.

¹⁵⁸ The cost of major maintenance of natural gas turbines under a long term service agreement or a contract service agreement is addressed below in the discussion of Adjustment 13.10, Regulatory Assets & Liabilities.

¹⁵⁹ Buckley, Exh. No. APB-3.

¹⁶⁰ Buckley, Exh. No. APB-1CT at 8:1-10 and Buckley, Exh. No. APB-2, line 1.

85 The Company argues that Staff understates non-contract major maintenance because it does not capture more recent operating regimens or cost escalations experienced by those resources.¹⁶¹ However, PSE does not address the un-rebutted historical variability of the expenses. Nor has PSE demonstrated that cost escalations will hold for the rate year.

86 PSE did identify an error in Staff's adjustment because the Sumas, Goldendale, and Mint Farm plants were not owned during the entire period used by Staff.¹⁶² Staff accepts this correction, which reduces its adjustment from \$3.5 million to \$2.97 million.¹⁶³

ii. BPA Transmission Service Credit for Lower Snake River

87 PSE included fixed and variable expenses associated with transmission service from BPA to LSR for the rate year. This adjustment recognizes additional revenue credits due to an earlier startup date of LSR than was first expected.

88 PSE points out that the data used by Staff has been updated and that Staff's adjustment is duplicative of Adjustment 13.03 for LSR prepaid transmission deposits, which is uncontested.¹⁶⁴ Staff concurs, thus, its adjustment for BPA Transmission Service Credit is withdrawn.¹⁶⁵

iii. Gas for Power Hedges Cost Recovery Limitation

89 PSE includes "mark-to-market" ("MTM") costs related to the difference between the projected market price of gas and the actual price of forward gas contracts entered for the rate year. For the following reasons, Staff removed MTM costs associated with hedged gas that are greater than the volumes actually calculated by PSE to determine normalized power costs:

¹⁶¹ Gould, Exh. No. WRG-1T at 19:1-13.

¹⁶² Gould, Exh. No. WRG-1T at 20:4-15.

¹⁶³ Gould, Exh. No. WRG-1T at 20:12-15 and Buckley, Exh. No. APB-10CX.

¹⁶⁴ Story, Exh. No. JHS-18T at 18:15-19:3.

¹⁶⁵ Buckley, Exh. No. APB-10CX.

- MTM costs do not meet the “known and measurable” standard for a pro forma adjustment because the effect of a contract on overall MTM costs varies with each gas price update.¹⁶⁶
- It is inappropriate to include costs associated with hedging more gas volumes than are actually used.¹⁶⁷
- Staff did not eliminate full cost recovery of gas for power hedges because it affected only power expenses to set base rates. Any additional costs or benefits from hedged gas above normalized power costs would be run through the Power Cost Adjustment (“PCA”) and matched against revenues from secondary sales.¹⁶⁸

90 However, Staff’s adjustment has vanished as gas prices have fallen. Therefore, Staff’s adjustment is no longer necessary and is withdrawn. Staff reserves the right to assert the adjustment in future cases, as may be warranted by the circumstances.

iv. Extension of 23 MW Transmission Contract

91 The Company includes the costs of renewing a 23MW firm capacity contract with BPA for transmission from a City of Spokane Municipal Steam Waste project. However, PSE made no showing of sufficient margins from sales or reduced costs related to the acquisition. The Company states only that it “has increased its ability to purchase short-term resources at the Mid-C trading hub and reduced its transmission capacity need by 23 MW starting in 2012.”¹⁶⁹ Thus, Staff removes all costs associated with this renewed contract.¹⁷⁰

92 PSE disputes the Staff adjustment, but only cites a claim in its 2009 IRP that “short-term resources” may be used to meet load and that capacity needs will be reduced by 23MW starting

¹⁶⁶ WAC 480-07-510(3)(e)(iii).

¹⁶⁷ Buckley, Exh. No. APB-1CT at 13:4-14.

¹⁶⁸ Buckley, Exh. No. APB-1CT at 14:19-15:8. Presumably, PSE entered gas hedge volumes greater than shown by its normalized production cost model runs to support energy transactions above what is included in base rates.

¹⁶⁹ Mills, Exh. No. DEM-1CT at 15:11 -13.

¹⁷⁰ Buckley, Exh. No. APB-1CT at 22:11-19 and Buckley, Exh. No. APB-2, line 5.

in 2012 through 2015.¹⁷¹ PSE also states that its 2010 RFP concluded that short-term year round energy purchases would be an effective mechanism for meeting near-term capacity need.¹⁷²

93 PSE still provides no meaningful cost/benefit analysis justifying inclusion of the renewed contract. No connection was made between the broad statements in the 2009 IRP and 2010 RFP and what is correct for rate making. Thus, the Commission should adopt Staff's adjustment.

v. Day-Ahead Wind Integration Costs and Within-Hour Wind Integration Costs

94 The Company proposes to recover in base rates two categories of wind integration costs – those that are paid to BPA for resources within the BPA Balancing Authority (Hopkins Ridge, Klondike III, and LSR) and those identified as internal wind integration costs for resources within PSE's Balancing Authority (Wild Horse and the Wild Horse Expansion). However, through much of the year, PSE's Mid-C hydro resources are used to balance variations between scheduled and actual wind generation.¹⁷³

95 Moreover, PSE does not have the means to determine its actual day-ahead wind integration costs.¹⁷⁴ Instead, wind integration costs projected for the rate year are estimates using assumptions for the opportunity costs of reserving capacity to meet wind schedule deviation. Adding another level of uncertainty is the fact that the costs of providing day-ahead wind integration of LSR are developed using characteristics of another wind project.

96 Thus, Staff removes from base rates costs associated with day-ahead wind integration for all PSE-owned wind projects and within-hour wind integration for Wild Horse and the Wild Horse Expansion.¹⁷⁵ Any actual power supply costs or benefits necessary to balance wind and

¹⁷¹ Mills, Exh. No. DEM-11CT at 43:14-44:2.

¹⁷² Mills, Exh. No. DEM-11CT at 44:3-11.

¹⁷³ Mills, Exh. No. DEM-1T at 25:3-6.

¹⁷⁴ Buckley, Exh. No. APB-6.

¹⁷⁵ Buckley, Exh. No. APB-1CT at 18:12-19:2.

load will be included in the PCA. This treats unknown and variable wind integration costs or benefits in the same manner as actual variations in fuel costs, market prices, and load.¹⁷⁶

97 PSE argues that it has the ability to model day-ahead wind integration costs for the rate year.¹⁷⁷ However, it provided no analysis of the relationship between modeled and actual costs. It also admits that its model cannot isolate the effects of one variable (*i.e.*, wind forecast error) given its dynamic power portfolio of load and generating assets.¹⁷⁸ Thus, its modeling efforts actually highlight the uncertainty of the wind integration costs PSE seeks to include in base rates.

98 PSE notes other Northwest utilities that include day-ahead wind integration costs.¹⁷⁹ This has no bearing on this proceeding since no effort was made to describe the nature of their inclusion – whether by settlement or litigation, or by utilities that have or do not have a PCA.

99 Finally, the Company ignores the fact that Staff is not proposing to disallow the costs of wind integration. Rather, Staff proposes to capture those costs through the PCA such that, over time, PSE will be compensated properly for the variability in wind generation.

vi. Cedar Hills Contract Cost Limitation

100 This adjustment concerns a transaction to acquire emission credits associated with gas produced by the Cedar Hills Regional landfill. The Company intends to monetize the renewable attributes of the gas, but has not yet signed agreements for sale of the RECs. PSE also proposes that ratepayers absorb the MTM costs of with the transaction.¹⁸⁰

101 The issue is whether Cedar Hills' gas was acquired to meet generation needs or solely to monetize the renewable attributes of the gas and then ask ratepayers both to bear the speculative risk of purchasing and selling the gas commodity and to pay in base rates the MTM costs of the

¹⁷⁶ Buckley, Exh. No. APB-1CT at 5:7-16.

¹⁷⁷ Mills, Exh. No. DEM-11T at 14:1-16:20.

¹⁷⁸ Mills, Exh. No. DEM-11T at 17:3-5.

¹⁷⁹ Mills, Exh. No. DEM-11T at 19:1-14.

¹⁸⁰ Buckley, Exh. No. APB-1CT at 23:6-17.

transaction. PSE claims the transaction is to meet generation needs, but that it is more advantageous at this time to sell the RECs associated with the gas.¹⁸¹ PSE also agrees to defer revenues associated with the sale of the renewable attributes for future customer credit.¹⁸²

102 To assure these commitments, the Commission should order PSE to file a petition for an accounting order as part of its compliance filing. Such a process would allow Staff's adjustment to be withdrawn. Absent such a filing, however, the Commission should adopt Staff's adjustment reducing rate year power costs by \$1.6 million.¹⁸³

vii. Other Production O&M Using 2012 Budget

103 "Other" production O&M expense represents expenses attributable to all or part of the generation fleet that cannot be identified to any specific facility. Staff's adjustment used 2012 budgeted amounts because the test year amount was both significantly higher than the rate case budgeted expense and was a significant increase over expenses included in prior rate cases.¹⁸⁴ Staff also excluded a test year expense PSE called "discretionary benefits", noting that similar amounts were not included in the 2012 and 2013 budgets.¹⁸⁵ Staff's adjustment decreased rate year power costs by \$912,700.¹⁸⁶

104 In rebuttal, PSE revised the data Staff used for its adjustment. The revision reflected increases in the final 2012 and 2013 budgets for other production O&M expense.¹⁸⁷ The Company also provided an adequate explanation of discretionary benefits.¹⁸⁸ Moreover, PSE reduced rate year power costs by \$303,825 consistent with Staff's adjustment to update rate year

¹⁸¹ Mills, Exh. No. DEM-11CT at 32:11-15.

¹⁸² Mills, Exh. No. DEM-11CT at 32:15-17.

¹⁸³ Buckley, Exh. No. APB-1CT at 24:1-13 and Buckley, Exh. No. APB-2, line 6. Staff's adjustment removed the MTM costs assigned to Cedar Hills in order to exclude the cost of hedging associated gas not acquired for resale.

¹⁸⁴ Buckley, Exh. No. APB-1CT at 26:1-18.

¹⁸⁵ Buckley, Exh. No. APB-1CT at 26:19-27:2.

¹⁸⁶ Buckley, Exh. No. APB-2, line 7.

¹⁸⁷ Gould, Exh. No. WRG-8.

¹⁸⁸ Gould, Exh. No. WRG-1T at 23:1-19.

rental fees for the Jackson Prairie Storage Capacity Agreement.¹⁸⁹ Staff, therefore, accepts the Company's proposed expense levels for other production O&M and, accordingly, withdraws this component of its Power Cost Adjustment 13.01.

viii. Update for Current Gas Price Forecast

105 The Commission allows electric utilities to update power costs during a general rate case for forecasted gas and electric market prices, new firm contracts, or budget updates from third party owners of resources such as Mid-C projects.¹⁹⁰ Consistent with this practice, in rebuttal, PSE reduced rate year power costs by \$21 million.¹⁹¹ Its update of gas/energy prices to a December 8, 2011 3-month rolling average alone reduced net power costs by \$11.977 million.¹⁹²

106 Staff agrees that rate year power costs should be reduced by the net amount of these categories of adjustments. Staff also agrees that an additional update to gas forward rate year prices should occur as part of the compliance filing ordered by the Commission.¹⁹³

ix. Variable PCA Treatment for Jackson Prairie Storage Rent

107 PSE entered agreements to reserve excess storage of natural gas at Jackson Prairie for power generation. Staff recommends the test year rent expense (\$1,130,625) should be adjusted to the current annual rent expense (\$826,800).¹⁹⁴ PSE accepted Staff's adjustment.¹⁹⁵

108 However, the rental costs were recorded in Federal Energy Regulatory Commission ("FERC") Account 505 for power production O&M expense, which is a fixed cost in the PCA. PSE proposes to reclassify the expense to fuel for power, which is a variable cost in the PCA.¹⁹⁶

¹⁸⁹ Martin, Exh. No. RCM-1T at 12:20-13:5 and Mills, Exh. No. DEM-11CT at 53:3-15.

¹⁹⁰ Buckley, Exh. No. APB-1CT at 29:9-17.

¹⁹¹ Mills, Exh. No. DEM-11CT at 61, Table 10.

¹⁹² Mills, Exh. No. DEM-11CT at 61, Table 10.

¹⁹³ Buckley, Exh. No. B-21 (Staff Response to Bench Request 21B).

¹⁹⁴ Martin, Exh. No. RCM-1T at 12:6-13:5.

¹⁹⁵ Mills, Exh. No. DEM-11CT at 53:3-15.

¹⁹⁶ This is significant because, under the PCA, the fixed power expense included in base rates does not vary until it is reset in the next general rate case. In contrast, variable expenses are used at their actual levels in determining

PSE's reason is to align its electric operations with the gas operations treatment of the rental revenue, which is a variable cost in the Purchased Gas Adjustment mechanism ("PGA").¹⁹⁷

109 The Company's proposal should be rejected. The PGA is a straight pass through only of gas costs, while the PCA includes capital costs, dead bands and sharing bands.¹⁹⁸ Thus, aligning the electric and gas treatments of the storage rental transaction does not justify the change because the PCA and PGA are dissimilar mechanisms.¹⁹⁹

110 Moreover, rental expense to reserve Jackson Prairie storage for power generation has all the hallmarks of a fixed cost. While the purpose of the storage service varies hourly, daily or monthly, PSE's rent remains constant until revised by the rental agreement.²⁰⁰ The rental expense is also paid whether or not a gas-fired electric generation facility is operating.²⁰¹

b. Adjustment 13.02, Lower Snake River

111 This adjustment includes the pro forma levels of rate base and O&M expense for the addition of LSR. PSE's initial filing projected a rate base increase of \$687,710,765 and a net operating income ("NOI") decrease of \$39,435,507, based on an April 15, 2012 in-service date.²⁰² The Company's rebuttal case revised the rate base increase to \$664,324,546 and the NOI decrease to \$37,275,750, based on a mid-February in-service date.²⁰³ At hearing, PSE again revised its request to increase rate base by \$669,984,171 and decrease NOI by \$37,445,852 because of a delay in the in-service date to February 29, 2012.²⁰⁴

amounts subject to the sharing bands of the PCA. Thus, reclassifying the rental expense from fixed to variable enables PSE to true-up to actual the estimated amount in the power cost rate. Martin, Exh. No. RCM-1T at 11:7-14.

¹⁹⁷ Story, Exh. No. JHS-1T at 15:7-8.

¹⁹⁸ Story, TR. 1035:20-1036:10.

¹⁹⁹ Martin, Exh. No. RCM-1T at 11:19-21.

²⁰⁰ Martin, Exh. No. RCM-1T at 11:16-12:4 and Riding, TR. 930:22-931:1.

²⁰¹ Martin, Exh. No. RCM-1T at 11:22-12:4.

²⁰² Story, Exh. No. JHS-1T at 18:13 and 19:18-20:11.

²⁰³ Story, Exh. No. JHS-18T at 24:19-22.

²⁰⁴ Story, TR. 1025:10-1026:11 and Story, Exh. No. JHS-20 at 3.

112 Staff's adjustment substitutes changing PSE's rate base projections with the October 31, 2011 construction work in progress ("CWIP") balance of \$644,066,095.²⁰⁵ The CWIP balance reflects all of PSE's capital expenditures at that time and future expenditures that were provided by contract.²⁰⁶

113 Staff also removed \$2,967,101 in property tax expense for LSR resulting in a reduction to NOI of \$35,151,089.²⁰⁷ This is consistent with the Commission's treatment of property taxes for the Wild Horse expansion and Staff's property tax adjustments in this case.²⁰⁸ PSE's proposal to include a pro forma amount for LSR property taxes should be rejected also because:

- The pro forma expense represents an accrual and not an amount actually incurred by PSE during the rate year.²⁰⁹
- The average payment time for property taxes based on a substantial CWIP balance as of the January 1, 2012 lien date is 16 months after that date, which is after the rate year.²¹⁰
- The first property tax payment based on a completed LSR will occur in 2014, which is also outside of the rate year.²¹¹

114 PSE asks the Commission to reconsider the treatment it applied previously for the Wild Horse expansion.²¹² The request should be denied. As the Commission found for the Wild Horse expansion, the PSE's LSR 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 the "known and measurable" test for a pro forma adjustment.²¹³ In contrast, Staff's adjustment is based on actual data in conformance with that test.

²⁰⁵ Applegate, Exh. No. RTA-1T at 6:20.

²⁰⁶ Applegate, Exh. No. RTA-1T at 6:6-9.

²⁰⁷ Applegate, Exh. No. RTA-1T at 5:19-21 and 6:19.

²⁰⁸ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 12 at ¶232 (April 2, 2010).

²⁰⁹ Story, TR. 1029:14-16.

²¹⁰ Marcelia, TR. 957:8-11.

²¹¹ Marcelia, TR. 958:9-11.

²¹² Story, Exh. No. JHS-18T at 3:14-17 and 7:23-8:8.

²¹³ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 12 at ¶231 (April 2, 2010).

c. Adjustment 13.04, MT Electric Energy Tax

115 This adjustment is contested only because of differing assumptions regarding Colstrip generation. There is no dispute in the methodology to calculate the adjustment.²¹⁴

d. Adjustment 13.07, Storm Damage

116 PSE's current storm damage recovery has three components. The first component includes a six-year average of costs of all storms below an \$8 million annual threshold. The second component allows PSE to defer and amortize over four years the costs from qualifying "IEEE" storm events that exceed the \$8 million annual threshold. These deferrals can earn a return through the working capital allowance. The third component represents the 10-year amortization of deferred storm expenses from the truly catastrophic Hanukkah Eve Storm of 2006. This balance also earns a return through the working capital.²¹⁵

117 This adjustment restates test year storm damage amounts to a mix of past cost averaging and amortization of deferrals. PSE seeks to amortize deferred storm damages from 2008 and 2010. Staff proposes to discontinue amortizing deferrals over a four year period and to include costs from 2008 and 2010 in the six-year normalization.²¹⁶ Existing deferred storm costs of 2006-2008 will continue amortizing until the remaining balances are depleted.²¹⁷ Staff's proposal increases NOI by \$2,107,628. PSE's adjustment increases NOI by \$1,349,515.²¹⁸

118 Staff's approach departs from the current standard of amortizing deferrals over four years. Such departure is justified because the current standard produces several undesirable results. First, because PSE delays the start of amortization until the deferrals are included in

²¹⁴ Story, Exh. No. JHS-18T at 25:16-20.

²¹⁵ Applegate, Exh. No. RTA-1T at 7:5-13. See also Story, Exh. No. JHS-18T at 30:1.

²¹⁶ Applegate, Exh. No. RTA-1T at 7:16-22.

²¹⁷ There are two storm items shown for 2008 in Exhibit JHS-20 at 8:24 and 25. Staff's revision affects only the 2008 item on line 25 (\$86,185) and the 2010 item on line 26 (\$13,909,769).

²¹⁸ Applegate, Exh. No. RTA-1T at 12:2 and Story, Exh. No. JHS-18T at 33:15.

rates, deferral balances accumulate, requiring future ratepayers to pay the cost of serving past or present ratepayers.²¹⁹ Second, four year amortization introduces greater rate volatility than a six year-normalized expense.²²⁰ Finally, the large accumulated deferral balances grant PSE a return on the regulatory asset through the working capital calculation.²²¹

119 PSE does not dispute Staff's contentions. Instead, it claims Staff's proposal will cause increased earnings risk and a write-off of approximately \$14 million, an alleged disallowance.²²²

120 PSE's contention of increased risk is debatable.²²³ Staff's proposal to average storm costs over six years will smooth expenses to PSE, but annual costs vary around that norm. While there may be slight earnings variation, given the present frequency of rate cases, Staff's approach will allow the recovery of a representative level of all storm costs over time.²²⁴ Moreover, while Staff's adjustment will result in a write-off of approximately \$14 million, it will not disallow any costs for ratemaking because it incorporates into the average all reported storm costs.²²⁵

121 In the event the Commission agrees with Staff's concerns, but finds a write-off of \$14 million unacceptable, it could adopt PSE's ratemaking adjustment in this case, but direct PSE to discontinue the use of four-year deferrals for future expenditures. This partial compromise would not address PSE's issue regarding earnings risk. However, it would resolve all of Staff's concerns with respect to future rate periods.

²¹⁹ Applegate, Exh. No. RTA-1T at 8:19-9:13.

²²⁰ Applegate, Exh. No. RTA-1T at 10:9-12.

²²¹ Applegate, Exh. No. RTA-1T at 8:18-9:2.

²²² Story, Exh. No. JHS-18T at 31:11-13 and 32:6-13.

²²³ PSE claims Staff's conclusion is "disingenuous" given the allegation that Staff argued in Docket UG-110723 that return on equity should be reduced for a lesser amount than is at issue for storm damage. Story, Exh. No. JHS-18T at 31:11-20. PSE's characterization is not based on any specific Staff presentation in Docket UG-110723. It relies solely on its own interpretation. Story, TR. 1033:2-10. Moreover, the Company based its claim, in part, on informal discussions with Staff that it then characterized at hearing as confidential settlement discussions. Story, Exh. No. JHS-32CX at 2, last paragraph and TR. 1034:4-13.

²²⁴ Applegate, Exh. No. RTA-1T at 11:2-7.

²²⁵ Applegate, Exh. No. RTA-1T at 11:19-20.

e. Adjustment 13.10, Regulatory Assets & Liabilities

122 A number of regulatory assets and liabilities are included in this adjustment. Several are uncontested because they were addressed by the Commission in prior proceedings.²²⁶ In addition, Staff's adjustment for RECs is withdrawn under the Multiparty Settlement.²²⁷ The contested elements of this adjustment are addressed below.²²⁸

i. Colstrip 1&2 Dedication Fee Amortization

123 The issue concerns the amortization period of a \$5 million dedication fee paid to the coal supplier at the time a 2007 coal purchase and sale agreement was entered by PSE, PPL Montana LLC and Western Energy Company. PSE amortizes the payment over nine years beginning January 1, 2011, arguing that the dedication fee relates to coal sales on and after that date.²²⁹

124 However, the contract became effective on January 1, 2010. Coal deliveries started then and continue through December 31, 2019, the earliest contract termination date. Thus, Staff applies a ten-year amortization schedule because ten years is the life of the contract. In doing so, Staff matches exactly the period of commitment by the parties to the agreement and the period over which ratepayers receive benefits.²³⁰

125 Staff's proposal is also consistent with other approved amortizations.²³¹ For example, West Coast Pipeline Capacity regulatory deferrals in Dockets UE-082013 and UE-100503 were amortized over the lives of the contracts. In the current case, PSE uses the contract life to amortize the Chelan PUD capacity reservation payment in Adjustment 13.09. There is no reason not to use a similar methodology for the Colstrip dedication fee.

²²⁶ The uncontested elements are listed at Martin, Exh. No. RCM-1t at 13:1-10. Additional uncontested adjustments were inadvertently excluded from this list, including White River Relicensing & CWIP, Westcoast Pipeline Capacity-UE-100503 (BNP Paribas), and FERC Part 12 Study Non-Construction Costs UE-070074.

²²⁷ Settling Parties, Exh. No. SPE-1T at 11:20-12:6.

²²⁸ All elements of the Staff Adjustment 13.10 are listed in Martin, Exh. No. RCM-2 at 15.

²²⁹ Story, Exh. No. JHS-18T at 37:20-38:2.

²³⁰ Martin, Exh. No. RCM-1T at 15:17-22.

²³¹ Martin, Exh. No. RCM-1T at 16:1-8.

ii. Contract Major Maintenance Amortization

126 The Company includes amortization and deferrals of major maintenance associated with Long Term Service Agreements (“LTSA”) and Contract Service Agreements (“CSA”) at their test year amounts, with their inclusion in the PCA baseline rate as a variable cost.²³² On a prospective basis, the costs of new major maintenance, as regulatory assets, will be added in the period that they occurred and will be amortized until the next major maintenance.

127 PSE’s proposal departs from the agreed treatment in the PCA, under which the amortization expenses and balances of regulatory assets and liabilities are adjusted to rate year amounts consistent with other power cost expenses and rate base.²³³ Therefore, Staff recommends that the costs of major maintenance under an LTSA or CSA should be treated similarly: rate year expenses and balances should be used for ratemaking purposes.

128 PSE claims Staff’s proposal makes it unlikely the Company will recover its costs that are being amortized over two years.²³⁴ The Company supports this contention only with a theoretical discussion about the length of adjudicative proceedings. No analysis was provided showing that the PCA does not operate appropriately with respect to all production-related regulatory assets and liabilities. Modifying the PCA, as the Company proposes, will introduce uncertain costs and create inconsistency with the existing regulatory assets and liabilities.

129 PSE agrees that the majority of the test year amounts will be fully amortized by the rate year, but downplays this fact by assuming there will be other maintenance events with costs that

²³² The major maintenance contracts at issue are the Sumas November 2010 HGP Inspection, Freddy 1 July 2009 HGP Inspection, Goldendale May 2009 Combustion Inspection, Sumas November 2008 Combustion Inspection, and Mint Farm June 2010 Combustion Inspection. Martin, Exh. No. RCM-1T at 14:12-20.

²³³ *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-011570 and UG-011571, 12th Suppl. Order, Appendix Exhibit A to Settlement Stipulation at 4 (Settlement Terms For PCA) (June 20, 2002).

²³⁴ Story, Exh. No. JHS-18T at 41:10-42:3. The two-year interval is contradicted by other testimony stating that the interval is every two to five years. Gould, Exh. No. WRG-1T at 17:5.

mirror test year costs.²³⁵ However, no proof was offered either that test year costs will replicate the costs of subsequent maintenance or that intervals between maintenance are certain. In fact, inspection, repair or replacement of key components of combustion turbines varies in interval because the time between inspections depends on the number of starts and operating hours.²³⁶

130 Finally, the Commission should reject PSE's proposal that new major maintenance should be added as regulatory assets once completed. This proposal implies that PSE has blanket authority to designate as a regulatory asset the in-between-rate case deferred costs of major maintenance. To the contrary, like any other regulatory asset and liability, deferred costs of major maintenance should first receive Commission approval for designation as a regulatory asset in a general rate case or similar proceeding. Outside of a rate case, the deferral methodology pursuant to Generally Accepted Accounting Principles ("GAAP") applies.²³⁷

iii. LSR Deferred Costs

131 This Staff adjustment amortizes over four years the estimated rate year expense and net rate base amount for deferred costs of LSR. The costs of the project from the in-service date (February 29, 2012) to the date the Commission's order becomes effective are being deferred by authority of RCW 80.80.060(6). Staff's adjustment avoids further build-up of a regulatory asset than if the deferral occurs over the twenty-four month period otherwise allowed by that provision.²³⁸ Staff's adjustment uses estimates provided by PSE, excluding estimated property taxes consistent with Adjustment 13.02, LSR and Adjustment 14.11, Property Tax.

²³⁵ Story, Exh. No. JHS-18T at 39:11-19.

²³⁶ Gould, Exh. No. WRG-1T at 13:17-21.

²³⁷ Martin, Exh. No. RCM-1T at 19:13-20:3.

²³⁸ Martin, Exh. No. RCM-1T at 20:5-21:3.

132 In rebuttal, PSE accepted the Staff adjustment (other than the exclusion of property taxes), using the same estimates and four-year amortization.²³⁹ Not content to stop there, however, PSE also alleges a “major inconsistency” between Staff Adjustment 13.02 for the LSR plant addition and this adjustment for LSR Deferral.²⁴⁰ The Company also devotes substantial testimony to the “contradictory and conflicting” application of the “known and measurable” ratemaking concept in Commission prior decisions.²⁴¹

133 PSE ignores the fact that estimates must be used for this adjustment because LSR costs subject to deferral were incurred after all evidence was admitted in this case. As a result, strict application of the “known and measurable” standard could not occur before the record closed.

134 This circumstance, however, is remedied by RCW 80.80.080(6), which PSE agrees²⁴² provides certainty that only actual costs incurred between the commercial start-up of LSR and the effective date of the Commission’s final order can be deferred:

An electrical company may account for and defer for later consideration by the commission *costs incurred* in connection with a long-term financial commitment, including operating and maintenance costs, depreciation, taxes, and cost of invested capital. *The deferral begins with the date on which the power plant begins commercial operation* or the effective date of the power purchase agreement and continues for a period not to exceed twenty-four months; provided that if during such period the company files a general rate case or other proceeding for the recovery of such costs, *deferral ends on the effective date of the final decision by the commission* in such proceeding. (Emphasis added.)

Thus, the Commission should order PSE in its compliance filing to recalculate this adjustment with only actual and allowable costs incurred between the date LSR began commercial operation

²³⁹ PSE addressed this issue through a new separate Adjustment 20.12. Story, Exh. No. JHS-20 at 14. Staff included this issue in Adjustment 13.10, Regulatory Assets and Liabilities. Martin, Exh. No. RCM-2 at 15.

²⁴⁰ Story, Exh. No. JHS-18T at 44:15-45:1.

²⁴¹ Story, Exh. No. JHS-18T at 4-13.

²⁴² Story, TR. 1029:17-1031:24.

and the effective date of the final order.²⁴³ If PSE cannot comply due to time constraints, the Commission may condition compliance on PSE's asymmetrical true-up proposal.²⁴⁴

f. Adjustment 13.11, Production Adjustment

135 This adjustment is required when major production plant outside the test year is added to rate base and the results of operations.²⁴⁵ The methodology is undisputed, but the adjustment should be updated based on the Commission's decision on other power cost adjustments.²⁴⁶

2. Contested Electricity and Natural Gas Adjustments

a. Adjustments 13.02 and 6.04, Federal Income Tax-Tax Accounting Method Change for Repairs and Retirements

136 PSE proposes to change the federal income tax treatment from flow-through to normalization for capitalized property taxes, injuries and damages, and bad debts. Staff witness Mr. Ralph Smith examined this proposal and concurred.²⁴⁷ Mr. Smith also agreed with PSE's treatment of bonus tax depreciation impacts on accumulated deferred income taxes ("ADIT").²⁴⁸

137 However, before the test year, PSE applied for and the Internal Revenue Service ("IRS") granted a significant change in tax accounting for repairs deductions. This change increased significantly ADIT by a known and measurable amount before and during the test year. A closely related change in tax accounting PSE made for retirements also had a known and measurable impact in the test year. Therefore, as Mr. Smith recommends, PSE's rate base

²⁴³ The "effective date" of a final order is the date the commissioners sign the order and not the date thereafter when rates take effect in compliance with that order. If the Commission decides to allow PSE to defer costs incurred between the *order* effective date and the *rate* effective date, it should state explicitly that its order regarding LSR deferrals is effective on the date new rates take effect. Otherwise, PSE cannot defer costs during that short interim period.

²⁴⁴ Story, Exh. No. JHS-18T at 13:9-14.

²⁴⁵ Martin, Exh. No. RCM-1T at 23:3-11.

²⁴⁶ Story, Exh. No. JHS-18T at 43:1-6.

²⁴⁷ Smith, Exh. No. RCS-1T at 33-40.

²⁴⁸ Smith, Exh. No. RCS-1T at 31:8-19.

should be reduced by the net impact of these tax accounting changes, as follows:²⁴⁹

	<u>Electric</u>	<u>Gas</u>	Total
Account 282 Repairs	\$41,842,225	\$24,996,849	\$66,839,074
Account 282 Retirements	(\$427,903)	(\$432,511)	(\$860,454)
Total	\$41,414,322	\$24,564,298	\$65,978,620

i. Background

138 On December 30, 2008, PSE requested permission from the IRS to change its tax accounting method for the treatment of repairs deductions.²⁵⁰ The IRS approved the request on August 20, 2009, and on September 15, 2009, PSE signed a consent letter making the new method effective for 2008 and subsequent years.²⁵¹ On its 2008, 2009 and 2010 income tax returns, PSE took deductions using the new tax accounting that produced larger repairs deductions than the prior method.²⁵² PSE's 2008 income tax return also reflected the cumulative impact of the tax accounting method change.²⁵³ The larger repairs deductions had an equal and offsetting impact on current and deferred income tax expense, and increased ADIT, which is a reduction to rate base.²⁵⁴ All of these events occurred before or during the test year.

139 The increase in ADIT from the change in tax accounting for only the repairs deductions is \$41,842,225 for electric operations and \$24,996,849 for gas operations through December 31, 2010, the end of the test year.²⁵⁵ PSE's 2010 rate base, therefore, should be decreased by these amounts, after they are netted against the related impacts from the change in tax accounting for

²⁴⁹ Smith, Exh. No. RCS-3. The \$41.414 million reduction in electric rate base is reflected in Adjustment 14.04, Federal Income Tax. Martin, Exh. No. RCM-2 at 20:22. The \$24.564 million reduction in gas rate base is reflected in Adjustment 6.04, Federal Income Tax. Mickelson, Exh. No. CTM-2 at 13:26.

²⁵⁰ Smith, Exh. No. RCS-1T at 4:1-2.

²⁵¹ Marcelia, TR. 959:18-25.

²⁵² Marcelia, TR. 958:24-959:4.

²⁵³ Marcelia, TR. 960:3-7.

²⁵⁴ Marcelia, TR. 960:12-23.

²⁵⁵ Smith, Exh. No. RCS-3.

retirements.²⁵⁶ However, the Company has not reflected the benefit of any rate base reduction in this case.²⁵⁷ PSE's justification for denying ratepayers these significant benefits is baseless.

ii. The Company's Position Ignores the Plain Reading of Prior Commission Decisions that Require the Impact of the Repairs Deduction Change in Tax Accounting to Reduce Rate Base

140 PSE proposes to not reflect any of the increase in ADIT on the basis that the IRS has not yet completed an audit of PSE's deductions for repairs under the new tax accounting method. PSE's position relies entirely upon Commission Order 11 in its 2009 general rate case.²⁵⁸ The Company grossly mischaracterizes that order and, therefore, its position should be rejected.

141 In PSE's 2009 general rate case, the Federal Executive Agencies ("FEA") argued that rate base should be reduced to reflect the impact on ADIT of the change in tax accounting for repairs deductions approved by the IRS. PSE opposed the adjustment because the IRS had not yet audited the Company's implementation of the new method and because IRS approval of the new method had not occurred until "long after the end of the test period" in that case. The Commission rejected FEA's adjustment, stating:

We accordingly reject FEA's adjustment in this case as an inappropriate pro forma adjustment. The final disposition with the IRS is not known and the tax impact is in any event subsequent to the test-year.²⁵⁹

Therefore, a critical factor in the Commission's decision was the fact that the tax impact of the new tax accounting method for repairs deductions occurred "long after" the test year. No such circumstance is presented in the current case where the tax impact of PSE's repairs deductions is irrefutably an event that occurred before and during the test year.

²⁵⁶ Smith, Exh. No. RCS-1T at 5:7-11.

²⁵⁷ Smith, Exh. No. RCS-1T at 8:10-21.

²⁵⁸ Marcelia, Exh. No. MRM-1T at 18-19 and Marcelia, Exh. No. MRM-14T at 45.

²⁵⁹ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 11 at ¶197 (April 2, 2010).

Moreover, following PSE's 2009 rate case, the Commission clearly addressed and expressly rejected the argument that a completed IRS audit is required before rate base can be reduced to reflect the impact on ADIT of the change in tax accounting for repairs deductions. The Commission stated that the "sole issue" is not the timing of a completed IRS audit, but, rather, the timing of the impact and the magnitude of the impact on rate base:

The parties do not dispute that PacifiCorp is expensing certain repair costs that it previously capitalized for tax purposes. Because the Company creates a book-tax difference by continuing to capitalize these costs, the parties also agree that the amount should be normalized. *Therefore, the sole issue is the timing of recognition and magnitude of the impact on rate base. . . .*

PacifiCorp argues that the Commission denied an adjustment in the 2009 Puget Sound Energy (PSE) rate case that is identical to the adjustment Staff proposed here. The Company's reliance on that case is misplaced. In the PSE case, we rejected the argument that no adjustment could be made to rate base until after an IRS audit because the amount was not known and measurable. Here, according to the Company, the accumulated deferred income tax liability balance as of December 31, 2009, is \$28,927,370. Thus, the amount is both known and measurable. In addition, the IRS allowed the tax treatment in the PSE case long after the end of the test year. Here, in sharp contrast, the IRS allowed the tax treatment during the test year.

We conclude that Staff is correct and we should accept its adjustment to reduce rate base by \$28,927,370, which reflects the impact of the full year of the change. *The repairs deduction is an ongoing difference in accounting that will be in effect for the same period as the rates set in this proceeding. The change is known and measurable.* Accordingly, it is reasonable to normalize and reflect the impact as if it were in effect for the entire period. The impact of this adjustment reduces the revenue requirement by \$1,822,309 in addition to the \$1.7 million the Company has already recognized.²⁶⁰

Accordingly, absence of a completed IRS audit is not adequate justification for PSE to ignore the known and measurable impacts on ADIT that occurred during the 2010 test year as a result of the new tax accounting method for repairs deductions.

Indeed, PSE's rate case is based upon income tax expense information for the 2010 test year and all of its other ADIT balances are based on 2010 information. However, Mr. Marcellia admitted that none of PSE's income tax calculations for 2008, 2009 or 2010 have been subject to

²⁶⁰ *WUTC v. PacifiCorp, d/b/a Pacific Power & Light Co.*, Docket UE-100749, Order 06 at ¶¶259-260 (March 25, 2011) (Emphasis added; Footnotes omitted).

a completed IRS audit.²⁶¹ Thus, if the requirement for an IRS audit were to be applied as the criteria for ratemaking recognition, none of PSE's claimed income tax expenses would qualify. This would essentially result in no allowance for federal income tax expense in this rate case. Clearly, requiring a completed IRS audit as PSE suggests is not a good standard for evaluating utility income tax issues in any rate case.²⁶²

144 PSE is also not the only utility to have made a change in its tax accounting for repairs. Other utilities have made similar changes, including, as noted above, PacifiCorp.²⁶³ Mr. Marcellia admitted that the full impact of the tax accounting change for PacifiCorp was recognized for ratemaking purposes as a known and measurable increase in ADIT which reduced PacifiCorp's rate base.²⁶⁴ Moreover, PacifiCorp's publicly available financial statements proved that PacifiCorp was under IRS audit for a number of years and that the IRS audits relating to PacifiCorp's repairs deductions had not been completed at the time the Commission issued its final order in the PacifiCorp rate case.²⁶⁵ Clearly, the lack of completed IRS audits for PacifiCorp was not a factor for the Commission in making the known and measurable adjustment to ADIT for the impact of the repairs deductions.

145 PSE's audited financial statements are also revealing on this issue. PSE issued financial statements for 2008, 2009 and 2010 in compliance with GAAP.²⁶⁶ The requirement to comply with GAAP is to ensure that PSE's financial statements were presented fairly and the reporting

²⁶¹ Marcellia, TR. 962:3-12 (PSE's tax returns for 2008 and 2009 are under audit; the 2010 tax return is not presently under audit.)

²⁶² Smith, Exh. No. RCS-1T at 12:1-15.

²⁶³ Marcellia, TR. at 962:13-25.

²⁶⁴ Marcellia, TR. at 963:7-17.

²⁶⁵ Marcellia, Exh. Nos. MRM-31CX at 12 and MRM-32CX at 14; Marcellia, TR. 966:24-967:24 (IRS audits of PacifiCorp complete only through 2003). PacifiCorp's financial statements also recognize that a company is subject to continuous examination by the IRS given the complex laws and regulations regarding income taxes, and that IRS audits generally take years to complete. Marcellia, Exh. Nos. 31CX at 5 and 32CX at 6. This disproves Mr. Marcellia's opinion that the repairs tax accounting method change is somehow unique and complex, thereby, requiring an IRS completed audit before it can be recognized for ratemaking purposes. See Marcellia, Exh. No. MRM-20CX at 2(1).

²⁶⁶ Marcellia, TR. 960:25-961:2.

quantified sufficiently in all material respects.²⁶⁷ GAAP also requires the identification and disclosure of “uncertain” tax positions.²⁶⁸

146 PSE conducted an extensive and detailed evaluation of its tax positions and concluded that there were no uncertain tax positions reportable under GAAP for any period covering the first quarter of 2009 through the fourth quarter of 2011.²⁶⁹ PSE’s independent auditors audited the financial statements and concurred with PSE’s analysis.²⁷⁰ Therefore, there is a glaring inconsistency between PSE’s financial reporting, which reflects that none of the repairs deductions is an “uncertain” tax position, and its ratemaking position, which assumes that all of the repairs deductions are “uncertain” and cannot be “known and measureable” for ratemaking purposes unless and until the IRS completes an audit of the 2010 tax year and approves the Company’s calculations.

147 Mr. Marcelia also agreed that the Commission has adopted FERC accounting by rule.²⁷¹ Under normal FERC accounting, the entire effect of income tax deductions on ADIT is deducted from rate base.²⁷² FERC also has no requirement that an IRS audit be completed for the ADIT balances to be deducted from rate base.²⁷³

148 Mr. Marcelia attempted to characterize the Commission’s order in PSE’s 2009 rate case as an intentional deviation from normal FERC accounting.²⁷⁴ However, he agreed that there is

²⁶⁷ Marcelia, TR. 961:3-15.

²⁶⁸ Accounting Standards Codification (“ASC”) 740 including the former Financial Accounting Standard Board (“FASB”) Interpretation No. 48 (“FIN 48”) requires the Company to evaluate and disclose its uncertain tax positions. Marcelia, TR. 969:17-20.

²⁶⁹ Marcelia, TR. 969:17-970:1; Marcelia, TR. 970:25-971:3; and Marcelia, Exh. No. MRM-23CX.

²⁷⁰ Marcelia, TR. 972:13-976:6.

²⁷¹ Marcelia, TR. 976:15-20. See WAC 480-100-203 (electric) and WAC 480-90-203 (gas).

²⁷² Marcelia, TR. 976:21-23.

²⁷³ Marcelia, TR. 976:25-977:4.

²⁷⁴ Marcelia, TR. 976:25-977:5.

no specific statement in the Commission's order from that case that stated that the Commission was deviating from normal FERC accounting.²⁷⁵

149 Mr. Marcellia also admitted that, if the Commission applied to PSE in the current case the same treatment that it applied in PacifiCorp's last general rate case, then all recorded ADIT related to repairs deductions would be deducted from PSE's rate base as a known and measurable adjustment. As he stated: "If you made a finding that is known and measurable for PSE, your result will look somewhat similar to PacifiCorp."²⁷⁶

150 Based on the overwhelming evidence in the current case, and consistent with the Commission's prior decisions, the impact of PSE's repairs deductions on ADIT through the 2010 test year *is* known and measurable and, therefore, must be reflected as a rate base deduction net of the related tax accounting change for retirements. It would be improper and unfair to ratepayers to ignore this significant source of non-investor supplied capital in establishing PSE's revenue requirement in the current case.

b. Adjustments 14.05 and 6.05, Tax Benefit of Pro Forma Interest

151 These adjustments assure that customers receive the tax benefit associated with the interest on debt used to support rate base. Staff and PSE adjustments differ only because of differences in rate base resulting from other adjustments and differences in the weighted cost of debt recommended by their respective cost of capital expert.

c. Adjustments 14.06 and 6.06, Miscellaneous Operating Expense

152 The only element at issue in this adjustment involves Board of Directors fees and meeting expenses. PSE includes 90 percent of the costs based on the portion of meeting agenda that

²⁷⁵ Marcellia, TR. 977:13-20.

²⁷⁶ Marcellia, TR. 978:16-18.

relates to utility operations. Staff allows 50 percent of the expenses because the Board provides services that benefit equally ratepayers and shareholders.²⁷⁷

153 The Company argues that Board of Directors fees and meeting expenses are a necessary cost of business for utility operations. PSE also notes that Staff does not claim that Board expenses are excessive, nor did Staff challenge lower amounts of such expenses in prior cases.²⁷⁸

154 However, PSE does not challenge Staff's underlying premise that ratepayers and shareholders are equal beneficiaries from Board activities. Indeed, the Commission's most recent treatment adopts that premise to split Board of Director expenses equally between ratepayers and shareholders.²⁷⁹ The Commission reached that decision *after* noting that the utility must first restate the test year to exclude extravagant expenses that provide no benefit to ratepayers.²⁸⁰ PSE has not shown why this same approach should not apply here.

d. Adjustments 14.10 and 6.10, Incentive Pay

155 The Company's incentive pay plan is based on employees meeting certain goals relating to service quality and financial performance. Staff includes incentive pay only when it is tied to service quality because that is what benefits ratepayers. Staff excludes incentive pay based on financial performance which only benefits shareholders. Staff removed 50 percent of test year incentive pay as a proxy for the amount related to financial metrics.²⁸¹

²⁷⁷ Erdahl, Exh. No. BAE-1T at 4:19-20 and 5:2-5. Staff also reduced the allocation to utility operations of Kimberly Harris' wages to the test year level of her predecessor. PSE agrees. Stranik, Exh. No. MJS-10T at 10:5-10.

²⁷⁸ Stranik, Exh. No. MJS-10T) at 12:2-6.

²⁷⁹ *WUTC v. Avista Corporation*, Dockets UE-090134, UG-090135 and UG-060518, Order 10 at ¶141-142 (December 22, 2009).

²⁸⁰ *Id.* at ¶142, n.171.

²⁸¹ Staff and the Company adjustments both exclude incentive compensation paid to executives. Hunt, Exh. No. TMH-1T at 7:17-19 and Erdahl, Exh. No. BAE-1T at 6:6-7.

156 The Commission should adopt Staff's adjustments for several reasons.²⁸² First, Staff's adjustments are consistent with prior Commission decisions.²⁸³

157 Second, a recent Commission decision requires companies to prove why rates should recover incentive pay related to earnings because ratepayers already bear the full burden of O&M.²⁸⁴ PSE is silent on that issue and only cites older precedent from its 2004 rate case when the Commission allowed recovery of incentive pay based on achieving financial measures.²⁸⁵

158 Finally, if incentive pay related to earnings is incorporated into rates and PSE does not pay those incentives in the rate year, then ratepayers are held responsible for a cost that is not incurred. Likewise, any cost savings resulting from employee cost control efforts made to achieve a financial metric do not accrue to ratepayers until the next general rate case. Only shareholders receive those benefits in the short term.

159 PSE argues that the Commission has held that the relevant inquiry is only whether compensation exceeds the market average, is unreasonable, and offers benefits to ratepayers.²⁸⁶ However, the incentive plan there at issue did not evaluate employees on the basis of financial performance.²⁸⁷ A separate plan for executives that awarded incentive pay based on financial performance was paid for exclusively by shareholders.²⁸⁸ Staff's adjustments for PSE are, therefore, entirely consistent with recent Commission precedent.

²⁸² Erdahl, Exh. No. BAE-1T at 7:5-8:4.

²⁸³ *WUTC v. Avista Corporation*, Dockets UE-991606 and UG-991607, Third Supp. Order, ¶271 (September 29, 2000); *WUTC v. Puget Sound Power & Light Co.*, Docket UE-020433, 11th Suppl. Order, page 61 (September 21, 1993); *WUTC v. US West*, Docket UT-950200, 15th Supp. Order, page 47 (April 11, 1996).

²⁸⁴ *WUTC v. Avista Corporation*, Dockets UE-090134, UG-090135 and UG-060518, Order 10, ¶128-129 (December 22, 2009).

²⁸⁵ Hunt, Exh. No. TMH-11T at 10:5-8.

²⁸⁶ Hunt, Exh. No. TMH-11T at 10:8-10 and 11:13-20, *citing*, *WUTC v. PacifiCorp d/b/a Pacific Power & Light*, Docket UE-100749, Order 6 (March 25, 2011).

²⁸⁷ *Id.* at ¶242.

²⁸⁸ *Id.*

160 In fact, PSE's incentive plan is heavily skewed toward financial performance over service quality performance. For example, if PSE achieves 8 out of 10 SQIs and 90 percent of the financial metric, the incentive payout is 40 percent. If the same SQIs are met and financial achievement goes up only 5 percent to 95 percent, the incentive payout rises 20 percent to 60 percent. However, if PSE achieves 9 out of 10 SQIs with 90 percent of financial performance met, the payout goes up only 5 percent.²⁸⁹ Even if only 5 of 10 SQIs are met, there is incentive pay if less than 90 percent of the financial metric is satisfied.

161 Thus, Staff's approach to disallow 50 percent of the cost of the incentive plan is not arbitrary, as PSE alleges.²⁹⁰ It is a reasonable approach that is fair to ratepayers and shareholders, in the absence of evidence from the Company delineating cost tied to financial performance versus service quality performance.

e. Adjustments 14.11 and 6.11, Property Tax

162 These adjustments determine the appropriate amount of property tax to recover in rates. PSE's adjustments estimate the property taxes it expects to pay for property owned *at the end* of the test year. Staff's adjustments allow the Company to recover the actual amount of property tax payable for property owned by PSE *at the start* of the test year.

163 The Commission addressed the issue of property taxes during the Company's 2009 general rate case:

We find Staff's property tax adjustment, using test year actual tax rates and DOR centrally assessed values, is appropriate. We reject PSE's proposal to use estimated levy rates that will not be known until sometime later this year and may vary significantly from the Company's estimates.²⁹¹

²⁸⁹ Hunt, Exh. No. TMH-10 at 4.

²⁹⁰ Hunt, Exh. No. TMH-11T at 9:14-17.

²⁹¹ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 12 at ¶59 (April 2, 2010).

Staff's adjustments follow this decision. They represent PSE's actual tax liability for all property owned by PSE as of the January 1, 2010 lien date, based on the actual, centrally-assessed valuations of the Department of Revenue and the actual levy rates announced by taxing districts.²⁹² In doing so, Staff's adjustments fairly compensate the Company for property taxes payable on property owned during the test year.²⁹³

164 In contrast, PSE's adjustments are based on a January 1, 2011 lien date²⁹⁴ and, thus, use forecasts of property taxes that rely on estimates of property value, system ratio,²⁹⁵ and levy rates.²⁹⁶ PSE's approach violates the Commission's test that new tax rates can be pro formed only when they are fixed by the taxing authorities and, thereby, become known and measurable. In fact, PSE has consistently overestimated its gas and electric property tax obligations.²⁹⁷

165 PSE alleges that the Commission's established method for property taxes violates the matching principle because it fails to match the costs in the test year with assets owned in the test year.²⁹⁸ In support of this argument, PSE asserts that it is inappropriate to ignore acquisitions or retirements of property that occur during the 2010 test year.²⁹⁹ Staff disagrees. Acquisitions and retirements of property during the test year do not affect the amount PSE must pay in property taxes during the following year.³⁰⁰ Therefore, it is appropriate to regard these changes as outside of the test year for rate making purposes, as Staff adjustments have done.³⁰¹

²⁹² Applegate, Exh. No. RTA-1T at 13:15-21 and Applegate, Exh. No. RTA-6 referencing Marcelia, Exh. No. MRM-13.

²⁹³ Applegate, Exh. No. RTA-1T at 14:8-14.

²⁹⁴ Marcelia, TR. 1010:18-19.

²⁹⁵ Applegate, Exh. No. RTA-1T at 15:1-6.

²⁹⁶ Marcelia, TR. 1003:16-1004:7. PSE also used forecasted Washington electric and gas levy rates to calculate its response to Bench Request 17. Marcelia, Exh. No. B-17 at Attachment A:17.

²⁹⁷ Marcelia, Exh. No. B-19 at Attachment A.

²⁹⁸ Marcelia, Exh. No. MRM-1T at 44:17-19.

²⁹⁹ Marcelia, TR. 1010:5-7.

³⁰⁰ Marcelia, TR. 1009:12-15.

³⁰¹ Applegate, Exh. No. RTA-1T at 14:6-14.

f. Adjustments 14.13 and 6.13, Directors & Officers Insurance

166 The Company's adjustments restate the portion of "D&O" insurance that should be allocated to subsidiaries. Staff recognizes that restating adjustment, but makes an additional adjustment to remove 25 percent of the cost of premiums, representing half of the premium expense related to members of the Board of Directors.

167 The Commission has previously allocated D&O insurance 90 percent to ratepayers and 10 percent to shareholders.³⁰² However, the Board of Directors provides services that benefit shareholders to the same degree as ratepayers. Therefore, it is fair that shareholders equally share this cost that serves their financial interest in PSE.³⁰³ This is consistent with Staff Adjustments 14.06 and 6.06G for Board fees and expenses, and with Commission precedent that also required equal sharing of Board of Directors fees and expenses.³⁰⁴

168 PSE argues that D&O insurance is a necessary cost of business that has declined since the 2009 merger.³⁰⁵ However, Staff does not question the level of insurance premiums or the need for insurance. Staff questions only the allocation of the expense relating to the Board of Directors.

169 PSE argues Staff's allocation is arbitrary.³⁰⁶ However, Staff's approach is consistent with Company workpapers showing an equal allocation of cost between directors and officers.³⁰⁷

170 Finally, PSE claims that Staff's approach was rejected by the Commission in its 2009 general rate case.³⁰⁸ However, Staff's approach there was to disallow 50 percent of the

³⁰² *WUTC v. Avista Corporation*, Dockets UE-090134, UG-090135 and UG-060518, Order 10 at ¶141-142 (December 22, 2009).

³⁰³ Erdahl, Exh. No. BAE-1T at 9:9-13.

³⁰⁴ *WUTC v. Avista Corporation*, Dockets UE-090134, UG-090135 and UG-060518, Order 10 at ¶141-142 (December 22, 2009).

³⁰⁵ Stranik, Exh. No. MJS-10T at 15:16-19.

³⁰⁶ Stranik, Exh. No. MJS-10T at 16:12-15 and 17:12-13.

³⁰⁷ Stranik, Exh. No. MJS-22CX at 2:3-4.

³⁰⁸ Stranik, Exh. No. MJS-10T at 16:17-21.

premiums related to both directors and officers.³⁰⁹ Here, Staff advocates a disallowance of only half the amount associated only with directors.

g. Adjustments 14.15 and 6.15, Rate Case Expense

171 These adjustments restate test year rate case expenses to normalized levels. PSE's adjustments consider the costs of the Company's two most recent general rate cases and two most recent power cost only rate cases ("PCORCs"). To calculate the normalized natural gas rate case expense, PSE averages the cost of the general rate cases, allocates 50 percent of this cost to natural gas operations, and then adjusts the number by the frequency of filings. PSE follows the same process for calculating normalized electric rate case expense, except that it adds the average PCORC cost adjusted for the frequency of those filings.

172 PSE's approach suffers from several deficiencies. It violates the matching principle because general rate cases contain costs from multiple years.³¹⁰ It results in an unfair cross subsidy from gas ratepayers to electric ratepayers because electric costs are a disproportionately larger share of PSE's overall costs.³¹¹ Finally, it includes PCORC costs that have already been recovered in base rates even though no PCORCs have been filed since 2007.³¹²

173 Thus, Staff recommends that the Commission reject PSE's proposed rate case expense adjustments in their entirety and allow the Company to recover its 2010 test year rate case expenses. The recovery of test year expenses provides reasonable and fair compensation to PSE because test year values include substantial costs associated with the 2009 and 2011 general rate

³⁰⁹ *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-090705, Order 11, ¶60 (April 2, 2010).

³¹⁰ Applegate, Exh. No. RTA-1T at 17:3-9. For example, PSE's last general rate case saw combined electric and natural gas charges of \$109,000 in 2008, \$1,330,000 in 2009, and \$583,486,000 in 2010. In order to match a year's revenue with a year's expense, this adjustment would have to be normalized by the number of years reflecting expense, not the frequency of filings as PSE has done.

³¹¹ Applegate, Exh. No. RTA-1T at 17:10-14.

³¹² Applegate, Exh. No. RTA-1T at 17:15-22.

cases.³¹³ Test year costs also contain the costs of Docket UG-101644, a stand-alone natural gas rate case that increased PSE's rates on margin by 4.76 percent.³¹⁴

174 PSE argues that Staff's approach would significantly increase the costs to customers when the test period is perfectly aligned with statutory processing period.³¹⁵ Staff does not dispute this conclusion, but observes that the timing of a prior rate case should have little to do with the timing of the test period for the following rate case.

h. Adjustments 14.22 and 6.22, Working Capital-Debit Balance in Account 236, Accrued Federal Income Taxes Payable

175 These adjustments include two items, one of which is uncontested. Both Staff and PSE agree that a misclassification of two special deposit accounts should be corrected.³¹⁶

176 The contested portion involves a Company proposal to include in the working capital component of rate base a 2010 monthly average debit balance in Account 236 of \$47.3 million for accrued federal income taxes payable. Staff recommends that the \$47.3 million debit balance should be removed from rate base for the following reasons.

177 First, Account 236 is a current liability account that typically will have a credit balance, reflecting that there is a liability to make a payment for current income taxes. Thus, it is highly abnormal to have a debit balance in this account as large as the balance PSE recorded in 2010.³¹⁷

178 Second, PSE reduced Account 236 by \$49.66 million on January 14, 2011, shortly after the test period.³¹⁸ Therefore, the large debit balance in Account 236 was a temporary situation that occurred in the 2010 test year.³¹⁹

³¹³ Applegate, Exh. No. RTA-1T at 16:13-18. General rate case expenses in the test year totaled \$912,000.

³¹⁴ Applegate, Exh. No. RTA-1T at 16:19-21.

³¹⁵ Stranik, Exh. No. MJS-10T at 19:2-4 and Stranik, Exhibit MJS-21.

³¹⁶ Stranik, Exh. No. MJS-10T at 24:9-16.

³¹⁷ Smith, Exh. No. RCS-1T at 33:3-5.

³¹⁸ Marcelia, Exh. No. MRM-30CX at 4.

³¹⁹ Smith, Exh. No. RCS-1T at 33:5-15.

179 Third, on a going forward basis, the balance in Account 236 would normally be a credit showing taxes payable, but PSE is in a net operating loss (“NOL”) carry-forward situation and is not paying federal income taxes. Therefore, a representative going forward balance for Account 236 for ratemaking purposes should be zero.³²⁰

180 On rebuttal, PSE noted that, while it credited Account 236 for \$49.66 million, it debited the same amount in Account 131, Cash. Therefore, according to the Company, since cash is a working capital account, the removal from Account 236 does not affect cash working capital.³²¹ However, PSE ignores that it would not be prudent management to leave \$49.66 million sitting in a cash account for an extended period.³²² Rather, if not spent on operations, that amount should be invested temporarily to earn interest.³²³

181 Moreover, PSE shows total net cash of \$6.355 million on average per month for the test year, all but \$165,000 of which is for utility operations.³²⁴ Clearly, it is not realistic to add \$49.66 million to cash in Account 131 and assume such a high level would remain for the rate year. However, it is unreasonable to expect any company to maintain \$47.3 million in cash for an extended period. Rather, an amount that size would be transferred into temporary cash investments until it is used. Temporary cash investments are excluded from working cash because it earns its own return.³²⁵

³²⁰ PSE’s balance in Account 236 has ranged from large credit balances to unusually high and abnormal debit balances in late 2009 and in 2010 when PSE realized that it had vastly over-projected its income tax liability and should instead be expecting substantial tax refunds. Marcelia, Exh. Nos. MRM-14T at 59:11-13 and MRM-27 at 3-4. However, as noted, PSE’s Account 236 debit balance decreased by \$49.66 million in January 2011. While PSE continues to have a debit balance in 2011 ranging from \$7.5 million to \$11.1 million, those balances should easily revert to zero during the rate year given PSE’s large NOL carry-forwards.

³²¹ Marcelia, Exh. No. MRM-14T at 60:1-7.

³²² Marcelia, Exh. No. MRM-17.

³²³ Marcelia, Exh. No. MRM-30CX at 6-7.

³²⁴ Marcelia, Exh. No. MRM-30CX at 9.

³²⁵ Marcelia, Exh. No. MRM-17.

182 In sum, under no circumstance should the temporary and abnormally high debit balance recorded in 2010 in Account 236 be included in rate base as working capital. Consistent with PSE's test year and future expectations of not having any federal income tax liability, the accrued federal income taxes payable in Account 236 should be set at zero for ratemaking purposes.³²⁶

IV. CONSERVATION DECOUPLING PROPOSALS

183 The Decoupling Policy Statement addressed three specific mechanisms to encourage conservation: limited decoupling for gas utilities only, full decoupling for gas or electric utilities, and direct conservation incentives. For each mechanism, the Commission listed a combination of required elements and criteria for approval.³²⁷

184 While the Decoupling Statement is advisory only, it does lay out the Commission's current opinion, approach and likely course of action.³²⁸ Thus, whether a proposal falls under only one of the three mechanisms, or shares aspects of some, these elements and criteria should be addressed by any party advocate. PSE's Conservation Savings Adjustment ("CSA") and the NW Energy Coalition's ("NWECC") full decoupling proposal do not take on that responsibility.³²⁹ Therefore, they should each be rejected by the Commission. Both proposals should be rejected also because they are unnecessarily complex responses to load reduction caused by conservation.

185 Moreover, the Company agrees that the CSA is a form of limited decoupling.³³⁰ Therefore, at the outset, the CSA for the Company's electric operations should be rejected because it violates the Decoupling Policy Statement's restriction of limited decoupling to gas

³²⁶ As shown in Martin, Exh. No. RCM-6 at 1:23 and Mickelson, Exh. No. CTM-2 at 31a:35, the \$47.3 million Account 236 debit balance increased operating investments and decreased total investor supplied working capital by equal amounts, effectively preventing the Account 236 debit balance from inclusion in rate base as working capital.

³²⁷ Decoupling Policy Statement at ¶¶18, 28, and 33.

³²⁸ RCW 34.05.230(1).

³²⁹ Reynolds, Exh. Nos. DJR-1T at 17:4-18:7 and DJR-3T at 3:1-11.

³³⁰ Piliaris, TR. 659:20-660:8.

utilities only. PSE did not explain why such restriction should be lifted.³³¹ The CSA should be rejected also because there are significant deficiencies in mechanism itself.

A. Description of the Company and NWECC Proposals

186 The Company proposes the CSA to recover revenues “lost” from customers conserving electricity or gas under Company-sponsored conservation programs. It is a form of “limited decoupling” that establishes an annual tariff rider for both electric and gas service.³³² The annual adjustment is calculated by multiplying a fixed-cost-recovery rate from the most recent general rate case test period by the energy savings estimates from PSE’s conservation programs.³³³

187 The NWECC proposes a full decoupling mechanism in which PSE’s electric revenues would be based upon a separate revenue-per-customer (“RPC”) value for residential customers and a combined group of certain commercial customers (Schedules 24, 25, 26, 29, 31, 35, 43, 57).³³⁴ PSE would be guaranteed recovery of the RPC through a deferred accounting and true-up process. True-ups of actual revenue to the RPC would occur annually, subject to a three percent rate increase cap. Any amount above the cap would be deferred and recovered it in later annual rate changes. The mechanism would run for at least five years, subject to a future evaluation.

B. The Company’s CSA and NWECC’s Full Decoupling Mechanism Do Not Comply with the Decoupling Policy Statement

1. Neither the Company nor NWECC Analyze the Impact of Their Proposals on Rate of Return

188 The Commission contemplates that full or limited decoupling will reduce a utility’s cost of capital by reducing the risk of volatility of revenue based on customer usage. The advocate of

³³¹ Reynolds, Exh. No. DJR-1T at 20:13-21.

³³² Piliaris, Exh. No. JAP-1T at 32:12-35:2. “Limited decoupling” permits the utility to “recover lost margin due only to the conservation efforts of the utility.” Decoupling Policy Statement at ¶ 12. The CSA does not rely on “lost margin” to identify reduction in use, but does use savings estimates from PSE’s conservation programs for that purpose. It also shares with limited decoupling required elements of a true-up mechanism and an earnings test. Thus, it is reasonable to classify the CSA as a form of limited decoupling. Reynolds, Exh. No. DJR-1T at 17:8-21.

³³³ Piliaris, Exh. No. JAP-1T at 35:4-43:10.

³³⁴ Reynolds, Exh. No. DJR-3T at 3:1-11.

full or limited decoupling must, therefore, present evidence evaluating the impact on risk to investors and ratepayers, and the effect on a company's return on equity.³³⁵

189 Neither PSE nor NWECC complied with this requirement. Mr. Cavanagh opined that the impact of NWECC's mechanism on the cash flows of PSE is not large enough to materially affect the enterprise from an investor perspective.³³⁶ However, he also admitted that "...in the record of this proceeding, there is no actual evidence on the effect on cost of capital for any decoupled utility in the country."³³⁷

190 PSE stated that the CSA will reduce its risk of revenue loss from conservation.³³⁸ Mr. DeBoer admitted, however, that PSE has done no analysis of the impact on the Company's cost of capital if the CSA is approved for gas, electric, or both.³³⁹

191 Mr. Gorman also supported the principle that decoupling lowers the cost of capital. However, his specific proposal to reduce return on equity by 20 basis points if decoupling is approved was based only on a "gut feeling" rather than any specific analysis.³⁴⁰

192 In short, the Commission expects advocates of full or limited decoupling to present evidence of cost of capital impacts of their decoupling proposals. Insufficient evidence was presented on that issue for the Commission to approve either the Company or NWECC proposal.

³³⁵ Decoupling Policy Statement at ¶¶18 and 27-28. See also, Elgin, Exh. No. KLE-1T at 78:20-79:3.

³³⁶ Cavanagh, TR. 476:13-17.

³³⁷ Cavanagh, TR. 436:13-19. Mr. Cavanagh opined that full decoupling could *increase* the cost of capital, but if reduced, ratepayers should get that benefit if and only if, and only after, the utility actually decreases its equity ratio. Cavanagh, Exh. No. RCC-1T at 20:8-17. The former opinion, however, was based on a Battle Group study that did not isolate the impact of decoupling on cost of equity. Reynolds, Exh. No. DJR-3T at 8:11-15. The latter opinion is actually contradicted by the Ratepayer Assistance Project report Mr. Cavanagh himself cites. Reynolds, Exh. No. DJR-3T at 9:5-17.

³³⁸ DeBoer, Exh. No. TAD-1T at 5:1-3.

³³⁹ DeBoer, TR. 515:25.

³⁴⁰ Gorman, TR. 424:3-6.

2. Neither the Company nor NWECA Account for Offsets or Found Margin

193 The Commission requires the advocate of limited decoupling to provide evidence of any source of offset or found margin that could make the adoption of a mechanism unfair to ratepayers.³⁴¹ For full decoupling, the Commission goes farther, requiring off-system sales and avoided costs attributable to conservation to be netted against the true-up in the mechanism.³⁴²

194 Mr. Cavanagh suggests the Commission ignore this policy based on his belief that the Company's PCA "already addresses this concern" regarding enhanced wholesale sales.³⁴³ He is misinformed on the impact of the PCA. The PCA does not account for offsetting revenues because it contains dead bands and sharing bands that allow PSE to retain all of the benefit of avoided power costs or increased off-system sales revenues when power is freed up from lower customer use that results from conservation.³⁴⁴

195 PSE also ignores that the PCA does not account for offsetting revenues. Therefore, with the addition of the CSA, the Company will be able to retain both the foregone revenue from conservation and the avoided power cost or greater off-system sales.³⁴⁵ In fact, PSE claims that it has a greater opportunity to recover its costs through retail sales than through sales in the market.³⁴⁶ It will not discourage electricity consumption because it intends to take full advantage of found margins.³⁴⁷

3. Neither the Company nor NWECA Account for Incremental Conservation

196 The Commission requires the advocate of full or limited decoupling to provide evidence describing any incremental conservation the company intends to pursue in conjunction with the

³⁴¹ Decoupling Policy Statement at ¶18.

³⁴² Decoupling Policy Statement at ¶28.

³⁴³ Cavanagh, Exh. No. RCC-1T at 16:9.

³⁴⁴ Reynolds, Exh. No. DJR-1T at 26:12-17.

³⁴⁵ Reynolds, Exh. Nos. DJR-1T at 27:19-28:3 and DJR-3T at 15:12-17.

³⁴⁶ DeBoer, Exh. No. TAD-1T at 20:17-19.

³⁴⁷ DeBoer, TR. 546:1-7.

mechanism.³⁴⁸ In addition, incentive mechanisms should only encourage investment in conservation above a company's conservation target.³⁴⁹

197 PSE and NWECC fail this requirement as well. The only specific levels of conservation Mr. Cavanagh references are the conservation targets already in place for PSE today, absent decoupling.³⁵⁰ Likewise, the CSA would reward PSE for meeting its conservation target, rather than rewarding it for only incremental conservation above the target.³⁵¹ The Company admitted that the record is devoid of evidence of incremental conservation for gas or electric operations.³⁵²

C. The Company's CSA Contains Significant Flaws that Warrant Its Rejection

1. The CSA Uses Energy Savings Estimates that are Not Known and Measureable

198 The CSA does not rely on "lost margin", defined by the Commission as "a reduction in revenue during a rate-effective period due to a reduction in use, from the level of use determined using a modified historic test year in a general rate case." Instead, to identify the reduction in use, PSE uses conservation savings estimates based on the Regional Technical Forum ("RTF") or other engineering sources.³⁵³ Those savings estimates have been used for program planning and conservation target setting under RCW 19.285.040(1)(e). They have been acceptable for those purposes because cost-effectiveness calculations have shown them to be conservative enough to conclude that particular measures, on average, contribute savings to the program.³⁵⁴

³⁴⁸ Decoupling Policy Statement at ¶¶18 and 28.

³⁴⁹ Decoupling Policy Statement at ¶33.

³⁵⁰ Cavanagh, Exh. No. RCC-1T at 6-8. Staff has opined that it is enough to measure conservation acquired during the measurement period as long as the decoupling proposal describes how it will do so, including appropriate third party evaluation. Reynolds, Exh. No. DJR-3T at 17, n.40. The Commission has not ruled on this issue.

³⁵¹ Reynolds, Exh. No. DJR-1T at 29:20-22.

³⁵² Piliaris, TR. 672:5-9.

³⁵³ Reynolds, Exh. No. DJR-1T at 31:11-16.

³⁵⁴ Reynolds, Exh. No. DJR-1T at 30:4-16 and 31:8-17.

199 However, the Company agreed that many factors beyond conservation, such as weather or the economy, influence test-period load.³⁵⁵ Therefore, the savings estimates upon which the CSA relies are not “known and measurable” because they do not represent what actually happens after an efficiency measure is installed.³⁵⁶ As Ms. Reynolds stated, “the Company’s CSA is calculated with a precision that is not justified by the underlying data.”³⁵⁷

200 The Company agreed that the veracity of the savings estimates is critical to getting the CSA rate correct.³⁵⁸ Nevertheless, PSE acknowledged that the CSA does not take into account actual customer behavior with conservation measures.³⁵⁹ Nor does the Company reevaluate savings estimates from prior periods reflected in the CSA calculation.³⁶⁰

201 The Company also failed to provide any evidence concerning the reliability of its conservation savings in its direct case. Only on rebuttal does PSE argue that the savings estimates are subject to extensive “Evaluation, Measurement and Verification” (“EM&V”) that, “on average”, ensures that the estimates are “precise”.³⁶¹ However, the Company glosses over the fact that an independent third party review of PSE’s savings estimates and EM&V practices made several recommendations for improvements that were already apparent to PSE, especially with respect to tracking and reporting practices and measure installation verification.³⁶²

202 More important, the Company misses the point. The engineering estimates used in the conservation programs are appropriate for their intended purpose: a guide for decision making

³⁵⁵ Piliaris, TR. 629:4-16.

³⁵⁶ Reynolds, Exh. No. DJR-1T at 30:5-7. PSE questioned the applicability of the “known and measurable” standard because that concept applies to a pro forma adjustment and the CSA is not a pro forma adjustment. PSE’s criticism is misplaced. Ratemaking, in general, must rely on quantifiable and verified data. To suggest that those data can be less than known and measurable for the CSA defies that principle. Reynolds, TR. 771:4-16.

³⁵⁷ Reynolds, Exh. No. DJR-1T at 30:15-16.

³⁵⁸ Stolarski, TR. 696:19-22.

³⁵⁹ Stolarski, TR. 733:10-17.

³⁶⁰ Stolarski, TR. 737:10-738:11.

³⁶¹ Stolarski, Exh. No. RWS-1T at 4:19-24 and Stolarski, TR. 734:2-6.

³⁶² Stolarski, Exh. No. RWS-12 at 13-18.

about which resource to purchase.³⁶³ They were never intended to be used to identify actual impacts on load. They were intended only to identify what the energy savings would be if conditions were normal.³⁶⁴ Thus, they are inadequate for measuring changes in use between a general rate case period and a rate-effective period, as is proposed under the CSA.

203 PSE was critical of Staff's position because Staff members attend PSE's Conservation Resource Advisory Group, which has opportunities for "substantial input" into the framework of protocols for establishing conservation savings estimates.³⁶⁵ However, Staff's review of actual tariff filings focuses only on program delivery and whether PSE met its budget for program participation. Staff does not attempt to calculate energy savings actually achieved by a program.³⁶⁶ Likewise, the savings estimates used to set conservation targets under RCW 19.285.040(1)(e) are not intended for ratemaking purposes.³⁶⁷ Finally, any analogy between the CSA and Avista's limited decoupling mechanism would fail because the Avista mechanism uses actual load to increase or decrease the deferral amount. The CSA, on the other hand, uses estimates to only increase revenue requirement and never to decrease revenue requirement.³⁶⁸

2. The CSA Inappropriately Uses Savings Estimates Like Billing Determinants

204 Generally speaking, a utility's revenue requirement can be represented by multiplying billing determinants times a rate.³⁶⁹ The billing determinants used in this process represent the

³⁶³ Reynolds, TR. 772:8-9.

³⁶⁴ Reynolds, TR. 758:11-4. As Ms. Reynolds described, the energy savings estimates are like EPA estimates for vehicle gas mileage. Those estimates reflect driver behavior under normal conditions, but they do not take into account other factors that impact actual mileage such as terrain (hilly v. flat) or driver behavior (aggressive v. conservative). Reynolds, TR. 772-773.

³⁶⁵ Stolarski, Exh. No. RWS-1T at 5:12.

³⁶⁶ Reynolds, Exh. No. DJR-1T at 31:1-6. The savings estimates used for Schedule 120 are also trued up to actual. The CSA does not include a true-up. Reynolds, TR. 749:12-750:20.

³⁶⁷ Reynolds, Exh. No. DJR-4CX and Reynolds, TR. 748:4-12.

³⁶⁸ Reynolds, Exh. No. DJR-1T at 19:10-14.

³⁶⁹ DeBoer, TR. 550:17-551:4.

entire population of applicable customers. They do not represent only a sample of the population.³⁷⁰

205 In contrast, the revenue requirement the Company develops under the CSA is based upon engineering estimates representing only a sample of the population of installations.³⁷¹ For example, the RTF estimate of savings from commercial power strips used a sample of only 250 installations.³⁷² As a result, the estimates are not significant statistically and cannot be extrapolated beyond the study population to the entire population of customers who installed that measure.³⁷³ Thus, they cannot be used to develop a revenue requirement as PSE proposes.

3. The CSA Will Result in Automatic Rate Increases

206 The CSA effectively accepts as lost revenue for PSE the impacts of prospective conservation under ideal engineering standards. Thus, if the Commission accepts the tariff for calculating the annual program surcharge, it sets in stone the deferred amount of revenue for both electric and natural gas operations that PSE will be allowed to recognize as earnings.

207 As a result, the CSA will result in annual, automatic rate increases for both electric and gas service.³⁷⁴ Staff recommends that the Commission reject a process that institutionalizes rate increases for customers without ongoing oversight by the Commission.

D. NWECE's Decoupling Proposal Contains Significant Flaws that Warrant Rejection

1. NWECE's Decoupling Proposal May Cause Unlawful Rate Discrimination

208 NWECE exempts from its full decoupling mechanism customers from the six rate large industrial Schedules: Schedule 40 – Large Demand General Service Greater Than 3 aMW;

³⁷⁰ Reynolds, TR. 774:24-775:2.

³⁷¹ Stolarski, TR. 700:13-14.

³⁷² Reynolds, TR. 776:13-23.

³⁷³ Reynolds, TR. 774:6-775:2. See also Reynolds, Exh. No. DJR-5CX at 26 (Reynolds), a report by Lawrence Berkeley National Laboratory on energy savings analysis for PSE's Home Energy Report program. It describes an analysis based on large, well defined participant and control groups, which achieved 10%-15% accuracy with 95% confidence. The report also concludes that savings should be re-analyzed every year as conditions change.

³⁷⁴ Piliaris, Exh. No. JAP-1T at 32:12-35:2.

Schedule 46 – High Voltage Interruptible Service; Schedule 49 – High Voltage General Service; Schedule 448 – Power Supplier Choice; Schedule 449 – Retail Wheeling Service; and Schedule 459 – Back-up Distribution Service. In doing so, NVEC violates the Decoupling Policy Statement which requires full decoupling to include all customer classes.³⁷⁵

209 The Commission did state that it will consider a full decoupling proposal that applies to fewer classes if shown to be consistent with the public interest and if unlawful rate discrimination or undue preference does not result.³⁷⁶ However, Mr. Cavanagh’s proposal exempts these schedules only because they have few members (140) and account for a relatively small fraction of PSE’s projected revenues from energy charges (4 percent).³⁷⁷ He provides no connection of those facts to the Commission’s test. In fact, high voltage customers under Schedules 46 and 49 that would be excluded from the NVEC mechanism all participate in the Company’s conservation programs, making them “similarly situated” with the customer classes NVEC includes in its proposed mechanism.³⁷⁸ Even on rebuttal, NVEC admits that the mechanism in Staff’s Response to the Commission’s Bench Request on Full Decoupling is “more comprehensive in coverage”.³⁷⁹

210 Mr. Cavanagh raises a concern about PSE encouraging customers to change rate schedules in order to increase profits.³⁸⁰ But, again, he does not explain how his concern is resolved by excluding high-voltage customers from full decoupling. Nor does he explain why his concern makes his proposal non-discriminatory. This lack of justification for excluding some customer classes is another reason to reject NVEC’s full decoupling proposal.

³⁷⁵ Decoupling Policy Statement at ¶ 28.

³⁷⁶ Decoupling Policy Statement at ¶ 28. The prohibitions against unlawful rate discrimination and undue preference are contained in RCW 80.28.090 and RCW 80.28.100.

³⁷⁷ Cavanagh, Exh. No. RCC-1T at 13:12-15.

³⁷⁸ Reynolds, Exh. No. DJR-3T at 5:23-6:1.

³⁷⁹ Cavanagh, Exh. No. RCC-6T at 3:13-14.

³⁸⁰ Cavanagh, Exh. No. RCC-1T at 11:14.

2. NWEC's Decoupling Proposal Fails to Condition Recovery on Conservation Achievement

211 The Decoupling Policy Statement declares that "Revenue recovery by the company under the [decoupling] mechanism will be conditioned upon a utility's level of achievement with respect to its conservation target."³⁸¹ The full decoupling proposal of NWEC does comply with this requirement, providing yet another reason to reject that proposal.

212 Moreover, NWEC states that "Staff's approach to conservation achievement [in its Response to the Commission's Bench Request on Full Decoupling] seems generally reasonable."³⁸² That Staff response does include a mechanism that conditions recovery on conservation achievement.³⁸³ Mr. Cavanagh provided no explanation as to why NWEC's full decoupling mechanism did not also include such a condition.

E. The Proposals of the Company and NWEC Are Unnecessary and Complex Responses to the Impact of Conservation

213 During the evidentiary hearings, the commissioners questioned the Company at length about the calculation of the CSA rate adjustment. This discussion highlighted both the extreme complexity of the mechanism and the difficulty of explaining the mechanism to ratepayers paying the surcharge.³⁸⁴ Similar concerns would apply to NWEC's full decoupling proposal.

214 In contrast, annualizing ratemaking adjustments are already in place capturing significant changes in customer use from conservations.³⁸⁵ Those changes impacted electric revenue requirement only .21 percent (\$4.5 million) and gas revenue requirement only .09 percent (\$900,000). This questions the necessity of the CSA and NWEC proposals.

³⁸¹ Decoupling Policy Statement at ¶ 28.

³⁸² Cavanagh, Exh. No. RCC-6T at 3:13-14.

³⁸³ Piliaris, Exh. No. JAP-40 at 16.

³⁸⁴ Piliaris, TR. 647-650 and 657-66.

³⁸⁵ Reynolds, Exh. No. DJR-1T at 32:18-21.

215 Moreover, an attrition study is a direct and simpler tool to address load changes caused by all factors, including conservation, and the impact of those changes on the Company's ability to earn a fair rate of return.³⁸⁶ There is no need to establish a complex separate mechanism, such as those proposed by PSE and NWECA, to address conservation impacts on customer load.³⁸⁷

V. SQI 9: DISCONNECTION RATIO

A. Background

216 SQI-9: Disconnection Ratio ("SQI-9") sets a cap on the number of customers per 1,000 that PSE may disconnect for nonpayment.³⁸⁸ On June 15, 2010, PSE proposed to eliminate SQI-9, which Staff supported. The Commission granted PSE's application on an interim basis. Permanent elimination of the benchmark will be addressed in this general rate proceeding.³⁸⁹

B. SQI-9 Interferes With the Proper Application of Existing Customer Protections and Results in Inequitable Treatment of Customers

217 There are several reasons why SQI-9 should be eliminated.³⁹⁰ First, eliminating SQI-9 will not harm customers because other rules already offer significant and meaningful protections:

- Customers have the right to receive a bill stating the amount owed and the date payment is due.³⁹¹
- Customers have the right to have billing and service disputes investigated by PSE and Staff, and may not be disconnected while these investigations are pending.³⁹²
- Customers have the right to advance, written notice of PSE's intent to disconnect service for non-payment of bills.³⁹³

³⁸⁶ Elgin, Exh. No. KLE-1T at 79:16-80:3.

³⁸⁷ In fact, the Commission recognized the potential for decoupling to create unreasonable administrative burden. Decoupling Policy Statement at ¶ 29.

³⁸⁸ In 2009, the benchmark was increased from .030 to .038, allowing 38 disconnections per 1,000 customers.

³⁸⁹ *WUTC v Puget Sound Energy, Inc.*, Dockets UE-072300 and UG-072301, Order 14 (November 13, 2009).

³⁸⁹ *WUTC v Puget Sound Energy, Inc.*, Dockets UE-072300 and UG-072301, Order 16 (August 10, 2010).

³⁹⁰ Kouchi, Exh. No. RK-1T at 6:12-8:2.

³⁹¹ WAC 480-90-178 / WAC 480-100-178.

³⁹² WAC 480-90-173 / WAC 480-100-173.

³⁹³ WAC 480-90-128 / WAC 480-100-128.

- Customers have the right to re-establish service by paying a reconnection charge and one-half of a deposit. PSE may not require customers to pay their outstanding “prior obligation” as a condition for reconnecting service.³⁹⁴

218 Second, existing rules presume that PSE should promptly disconnect any customer who does not pay for service in order to protect all ratepayers from the burden of higher uncollectible revenues. The rules also recognize the essential nature of energy service by allowing disconnected customers to resume service without first having to pay their prior obligation. Maintaining SQI-9 interferes with the proper application of these policies.

219 Third, because SQI-9 limits the number of customers that can be disconnected, the Company must select those customers to disconnect from a larger pool of eligible customers. This results in inequitable and unfair treatment of customers at the sole discretion of PSE.

220 Public Counsel and the Energy Project did not file testimony on PSE’s proposal to eliminate SQI-9. However, their cross-examination shows they oppose the request because they view SQI-9 as a means to protect low-income customers during difficult economic times.

221 Their opposition assumes that SQI-9 is intended to limit the number of disconnections. They are wrong. The purpose of SQI-9 was to preclude over-reliance on disconnection as a credit and collection tool when other more preferable payment arrangements are available to customers such as equal payment plans and preferred payment dates.³⁹⁵ Thus, SQI-9 may actually impede PSE’s incentive to offer such arrangements to customers.

222 Public Counsel and the Energy Project noted that disconnections for nonpayment grew 32 percent from 53,500 customers in 2009 to 70,500 customers in 2010.³⁹⁶ However, they ignore the fact that disconnection complaints increased only 4.8 percent from 2009 to 2010, suggesting

³⁹⁴ WAC 480-90-123 / WAC 480-100-123.

³⁹⁵ Kouchi, TR. 1082:1-11. See WAC 480-100-138/WAC 480-90-138 and WAC 480-100-143/WAC 480-90-143.

³⁹⁶ Kouchi, TR. 1087:11-22 and Kouchi, Exh. No. RK-2 at 3.

that the interim suspension of SQI-9 did not have a significant impact on customer concerns.³⁹⁷

Moreover, PSE is precluded by workforce limitations from disconnecting more than about 80,000 customers, suggesting that elimination of SQI-9 may not, as a practical matter, significantly increase the number of disconnections.³⁹⁸

223 Public Counsel and the Energy Project noted that neither PSE nor Staff quantified the burden of higher uncollectible revenues.³⁹⁹ Their argument, however, is inconsistent with the attention they drew to the increase in disconnections that occurred once SQI-9 was suspended in 2010. If that increase is significant, as they suggest, then the level of uncollectible revenues associated with that increase must also be significant.

224 Public Counsel and the Energy Project noted that SQI-9 does not cap the number of customer disconnections, but only triggers a penalty if PSE exceeds the disconnection ratio.⁴⁰⁰ Of course, the same argument can be made for any SQI metric: the Company can ignore any metric as long as it is willing to pay the fine, regardless of the impact on customers. Surely, Public Counsel and the Energy Project would oppose such behavior.

225 Moreover, penalties for violating SQI-9 are significant, ranging from \$337,000 to \$1.5 million.⁴⁰¹ It would be inappropriate for Public Counsel and the Energy Project to argue that PSE could simply exceed the SQI-9 ratio and pay the fines.

VII. LOW INCOME ASSISTANCE

226 The Energy Project proposes that PSE increase its funding for low-income residential bill assistance from .51 percent to .665 percent of total annual operating revenues.⁴⁰² This is a

³⁹⁷ Kouchi, Exh. No. Exhibit RK-3.

³⁹⁸ Kouchi, TR. 1088:2-1089:8.

³⁹⁹ McLain, TR. 787:6-9 and Kouchi, TR. 1096:3-9.

⁴⁰⁰ McLain, TR. 783:5-10 and 788:15-20, and Kouchi, TR. 1080:10-16.

⁴⁰¹ *WUTC v Puget Sound Energy, Inc.*, Dockets UE-011570 and UG-011571, Updated Appendix I to Exhibit J, in Compliance with Order 17, Dockets UE-072300 and UG-072301 (November 29, 2010).

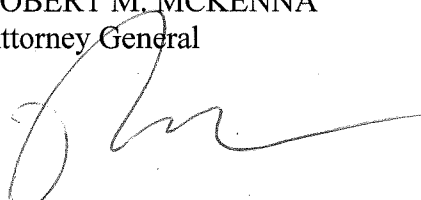
relatively minor increase with little impact on the remaining customers that fund the program through a surcharge. Therefore, Staff recommends the Commission approve the proposal.⁴⁰³

227 However, the Energy Project's proposal is based solely on a comparison of PSE's low-income funding to similar programs by Avista, Seattle City Light, Snohomish PUD, three utilities in California, and three utilities in New England.⁴⁰⁴ This does not account explicitly for factors impacting the need for low income assistance, such customer demographics and economic conditions.⁴⁰⁵ Therefore, the Commission should warn any party proposing further increases in later PSE rate cases that they should support that proposal with more detailed analysis of these and other relevant factors.⁴⁰⁶

DATED this 16th day of March 2012.

Respectfully submitted,

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⁴⁰² Howatt, Exh. No. JGH-1T at 20. Based on 2010 operating revenues, this would increase low-income bill assistance from \$15.5 million to \$20.2 million.

⁴⁰³ Reynolds, Exhibit No. DJR-3T at 18:5-9.

⁴⁰⁴ Howatt, Exh. No. JGH-1T at 11:10-19.

⁴⁰⁵ Howatt, Exh. No. JGH-5.

⁴⁰⁶ Reynolds, Exh. No. DJR-3T at 19:10-16 (Reynolds). The importance of a comparative analysis was discussed at hearing. Howatt, TR. 502:25-504:20.

**ATTACHMENT A
TO
COMMISSION STAFF'S INITIAL BRIEF**

STAFF POWER COSTS ADJUSTMENTS
(000,000)

		Initial	Revised
A	Other Power	Non contract Major Maintenance Using Average of Five Year Actual Costs	
		\$ 3.54	\$ 2.97
B	565	0.844	0
C	547	1.265	0
D	555	5.386	5.386
E	565	0.414	0.414
F	547	1.617	0
G	Other Power	0.913	0
H	547	9.960	11.977
I	Other Power		-0.36
J	547		1.56
K	Other Power		2.63
L	Other Power		0.304
Total Adjustments		<u>\$ 23.94</u>	<u>\$ 24.88</u>

G	Other Power	Other Production O&M: Note 1: Included in \$912,700 is \$223,076 for Jackson Prairie Rent Adjustment. In a separate adjustment is \$80,749. The sum of these 2 is \$303,825 shown in line L.
L	Other Power	Variable PCA Treatment for Jackson Prairie Storage Rent Note 2: The dollar amount of this adjustment is not at issue, only the treatment of such costs in the PCA mechanism.