BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENRGY, INC., Respondent.	Docket Nos. UE-111048/UG-111049 *(Consolidated)*

POST-HEARING BRIEF

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

March 16, 2012

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I. INTRODUCTION

1 Pursuant to WAC § 480-07-390 and the July 22, 2011 Prehearing Conference Order, the Industrial Customers of Northwest Utilities ("ICNU") submits this post-hearing brief requesting that the Washington Utilities and Transportation Commission ("WUTC" or the "Commission") significantly reduce Puget Sound Energy, Inc.'s ("PSE" or the "Company") proposed rate increase. PSE originally requested a $161 million rate increase, however, as a result of reductions in net power costs and financing costs, PSE has lowered its request to $126 million.[1/] PSE's lowering of its rate increase request is not due to the Company accepting many contested revenue requirement proposals from other parties, but is instead because of factors outside its control that it cannot dispute.[2/] PSE has taken a hard line on its requested rate increase, and has been unwilling to agree to or make even minor adjustments in its costs.

2 The Commission should carefully scrutinize the Company's rate increase request and make significant reductions that should eliminate most or all of PSE's claimed revenue deficiency. The Commission should reject PSE's proposed capital structure and cost of equity, lower net power costs to reflect more accurate and reasonable amounts, and make a consolidated tax adjustment to reflect a small portion of the savings that ratepayers provide to PSE's parent company. In particular, ICNU is surprised that PSE has persisted with its cost of capital request in this proceeding and is

1/ Story, Exh. No. JHS-11T at 1:16—2:3; Story, Exh. No. JHS-18T at 2:6—3:1.
2/ Story, Exh. No. JHS-18T at 3.

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making numerous arguments similar to those the Commission just rejected in the recent PacifiCorp general rate case. The Commission should also order a final power cost update in the manner it has required PSE to perform in previous proceedings, because it may significantly lower power costs. ICNU also supports the rate spread, rate design and renewable energy credit tracker settlement and does not oppose the meter and billing performance standard settlement, but is not addressing these issues in this brief.

3 As detailed in the separate brief of Public Counsel, ICNU recommends that the Commission account for PSE's early and imprudent acquisition of the Lower Snake River ("LSR") wind project. The ICNU and Public Counsel $55 million LSR adjustment still allows PSE to recover the majority of its LSR costs, but makes a reasonable reduction to reflect that the Company could have delayed construction and acquired lower cost wind power to met its renewable portfolio standard needs. The LSR project is not only a major issue in this case, but will have significant precedential impacts as Washington utilities plan to acquire more wind resources in the near future. PSE can, and should, acquire renewable resources at lower costs than it is doing now, and the Company should be encouraged to meet its statutory obligations to purchase renewable power in a more cost effective manner. If the Commission approves the LSR project without any modification or disallowance, then it could be providing PSE with a green light to acquire more expensive and unnecessary resources in the future.

4 The table below identifies ICNU's proposed revenue requirement adjustments in this case:

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ICNU Proposed Adjustments to PacifiCorp's Rate Increase (millions)	
Cost of Capital	$49.3[3/]
Income Tax	$8.8
Net Power Costs	
Hedging Costs	$4.5[4/]
Production O&M Expense	$8.6
Wind Integration Costs	$2.6
Peaking Resource Costs	$1.1[5/]
CCCT Operating Constraints	$0.4[6/]
Interstate Pipeline Increases	$0.9
OATT Revenues	$2.5
FERC 557 Account/A&G	$1.8
Lower Snake River	$55.0
Total ICNU Adjustments	**$135.5**

II. ARGUMENT

A. PSE Has the Burden of Proof to Support Its Requested Rate Increase

5 PSE bears the burden of proof to demonstrate that its proposed tariffs are just and reasonable.[7/] This burden includes "the burden of going forward with evidence and the burden of persuasion."[8/] The Company retains this burden throughout the proceeding and must establish that any rate increase is just and reasonable.[9/]

3/ PSE has calculated the value of Staff's rate of return ("ROR") proposal as $44.3 million. Story, Exh. No. JHS-18T at 3. ICNU disagrees with this calculation, because the Company ignored the impact of interest synchronization. ICNU estimates that the actual value of Staff's ROR recommendation is $56.4 million.

4/ This adjustment is subject to the final power supply update, as PSE may have executed more hedges (both sales and purchases). Based on PSE's rebuttal filing, this value was $6.5 million, as they had procured even more hedges.

5/ Subject to final market price update.

6/ Subject to final market price update.

7/ RCW § 80.04.130(4); WAC § 480-07-540; WUTC v. Avista, Docket No. UE-100467 and UG-100468 Order No. 1 ¶ 12 (Apr. 5, 2010).

8/ WAC § 480-07-540.

9/ WUTC v. Pacific Power & Light Co., Cause No. U-84-65, Fourth Suppl. Order at 17 (Aug. 2, 1985).

6 When setting rates, a utility is allowed an opportunity to recover its operating expenses and to earn an ROR on its property that is used to provide service.[10/] The amount of a utility's operating expenses included in rates is typically "based on actual operating expenses in a recent past period referred to as the 'test period' or 'test year.'"[11/] A utility "cannot include every expense it wishes" in rates, because the Commission reviews the utility's costs "to disallow those which were not prudently incurred."[12/] The Commission also removes from rates all property not used and useful to serve Washington customers,[13/] all non-recurring or one-time expenses, and other costs that a utility is unlikely to experience during the term of the proposed rates.[14/] Costs which are abnormal, fluctuate, or are not accurately estimated in the test period are normalized to achieve an expected level of costs based on typical conditions.[15/] Finally, regardless of prudence, costs and expenses that do not benefit ratepayers or were incurred to benefit shareholders must be removed from rates.[16/]

B. Cost of Capital

7 The Commission should reject PSE's proposal to increase its costs of capital and overall ROR because it is inconsistent with the current state of the economy

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10/ People's Org. for Wash. Energy Resources v. WUTC, 104 Wn.2d 798, 808-11 (1985); WUTC v. PSE, Docket Nos. UE-090704 and UG-090705, Order No. 11 ¶ 19 (Apr. 2, 2010).

11/ People's Org. for Wash. Energy Resources, 104 Wn.2d at 810.

12/ Id.; see also WUTC v. PSE, Docket No. UE-031725, Order No. 14 ¶ 93 (May 13, 2004).

13/ RCW § 80.04.250; WUTC v. PacifiCorp, Docket Nos. UE-050684 and UE-050412, Order No. 4 ¶¶ 48-70 (April 17, 2006).

14/ WAC § 480-07-510(3)(e); WUTC v. PacifiCorp, Docket No. UE-100749, Order No. 06 ¶¶ 134-6, 141-42, 259-61 (March 25, 2011); WUTC v. Avista Corp., Docket Nos. UE-991606 and UG-991607, Third Suppl. Order ¶¶ 205-07 (Sept. 29, 2000).

15/ Docket Nos. UE-991606 and UG-991607, Third Suppl. Order ¶ 34.

16/ See U.S. West v. WUTC, 134 Wn.2d 74, 126-27 (1997); WUTC v. Avista Corp., Docket Nos. UE-080416 and UG-080417, Order No. 8 ¶ 29 (Dec. 29, 2008).

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and the capital markets. In addition, the proposed ROR will provide the Company with excessive revenues, and it departs from Commission precedent, especially the most recent decisions regarding overall cost of capital, estimated growth rates, and an appropriate equity ratio. Capital costs continue to decline as investor-owned utilities are seen as favorable investment opportunities, and the Commission should reflect this reality by reducing PSE's return on equity ("ROE") and maintaining its current equity ratio.

8 The Commission sets an appropriate ROR to permit the utility to continue to attract the capital required to provide electricity at just and reasonable rates.[17/] A utility's ROE should be set to provide an opportunity for the utility to earn a return on the value of the property providing service to customers that is commensurate with the returns in other businesses that have similar risks.[18/] Similarly, the Commission will adopt a capital structure that balances safety with the impact upon customers, while achieving an overall goal of financing the utility in a manner that provides ratepayers benefits commensurate with costs.[19/]

9 PSE ignores the Commission's established standards in proposing to increase its ROR to 8.26%, which is primarily driven by a requested 10.75% ROE and a 48% common equity ratio.[20/] This is a significant increase compared to PSE's last approved ROR of 8.10%, which was based on a 10.10% ROE and a 46% equity ratio.[21/]

[17/] People's Org. for Wash. Energy Resources v. WUTC, 104 Wn.2d at 810.

[18/] Docket No. UE-100749, Order No. 06 ¶ 44 (citing Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Virginia, 262 U.S. 679 (1923), and Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)).

[19/] Docket No. UE-100749, Order No. 07 ¶¶ 11-13.

[20/] Gaines, Exh. No. DEG-14T at 28:1-3.

[21/] Gorman, Exh. No. MPG-1T at 2:3-8.

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The Commission should reject this increased ROR, and instead set a lower cost of capital based on ICNU witness Michael Gorman's recommended 7.83% ROR, including a 9.7% ROE and a 46% equity ratio.[22] The Commission could further reduce PSE's ROE to 9.5%, because there is ample evidence that PSE's cost of equity is even lower.[23] Finally, the Commission should lower PSE's ROE to the lowest of any reasonable range if it adopts either PSE's limited decoupling Conservation Savings Adjustment ("CSA"), NWEC's decoupling proposal, or Staff's full decoupling explanation.[24]

1. The Company's Return on Equity Should Be Significantly Reduced

10 The Commission has noted that estimating a cost of equity that is commensurate with the returns of other similar business can be "the most challenging" aspect of a general rate case filing.[25] The Commission typically relies upon expert witness recommendations, but ultimately uses "a broader body of evidence to make [its] determinations, which are informed by, but not dictated by the experts' modeling results."[26] These other factors include how well the utility has been able to attract capital at its current rates, the state of capital markets and overall economy, the decisions of other utility commissions, and whether the utility's decisions are the most economical for customers.[27]

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[22] Id.
[23] Gorman, Exh. No. MPG-1T at 1:20-22, 2:14—4:20.
[24] See id.
[25] Docket No. UE-100749, Order No. 06 ¶¶ 44-45.
[26] PSE v. WUTC, Docket Nos. UE-060266 & UG-060267, Order No. 8 ¶ 84 (Jan. 5, 2007).
[27] Docket Nos. UE-060266 & UG-060267, Order No. 8 ¶¶ 85-86; Docket Nos. UE-050684 and UE-050412, Order No. 04 ¶ 231; Docket Nos. UE-090704 and UG-090705, Order No. 11 ¶¶ 292-93; WUTC v. PacifiCorp, Docket No. UE-100749, Order No. 07 ¶¶ 23-32 (May 12, 2011).

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11 The weight of the evidence in this proceeding strongly supports lowering the Company's authorized ROE at least to 9.7%. Despite the lagging economy, the electric industry credit outlook "has improved over the recent past and is now stable."[28/] Electric utilities are performing well, have favorable access to capital, and remain a popular safe haven for conservative investors.[29/] Similarly, PSE's individual credit rating outlook remains stable.[30/] PSE has been able to attract capital, which demonstrates that the Company's current ROE does not need to be increased.

12 The expert testimony in this proceeding also supports lowering, rather than increasing, PSE's authorized cost of equity. The Commission has traditionally used three generally accepted ROE models, including the Discounted Cash Flow ("DCF") method, the risk premium method, and the Capital Asset Pricing Model ("CAPM").[31/] Recently, the Commission has relied upon the DCF and risk premium to set actual ROEs, and used the CAPM as a useful check on the reasonableness of the other model results.[32/] Mr. Gorman followed this approach, recommending a 9.7% ROE based on the high end of his average cost of equity estimates of his DCF model results (9.83%) and risk premium model (9.5%), with their reasonableness verified by his CAPM model estimate

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28/ Gorman, Exh. No. MPG-1T at 5:6-7.
29/ Id. at 4:21—7:17.
30/ Id. at 9:1-8.
31/ E.g., Docket No. UE-100749, Order No. 06 ¶ 45.
32/ Docket No. UE-100749, Order No. 06 ¶¶ 88-91; Docket Nos. UE-090704 and UG-090705, Order No. 11 ¶¶ 292-300.

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of a 9.0% ROE.[33/] Similarly, Mr. Elgin's testimony supports a 9.5% ROE, and correcting PSE witness Charles Olson's model supports lowering the Company's ROE.[34/] Finally, Mr. Gorman's recommendation would be sufficient to support PSE's investment grade bond ratings and allow PSE to attract reasonably priced capital.[35/]

13 PSE criticizes Staff and ICNU's ROE estimates because they are lower than what investors could achieve from other companies, including those involved in software development.[36/] PSE witness Dr. Charles Olson raises the hyperbole questioning why "would any rational investor put money into PSE" at ICNU and Staff's proposed ROEs.[37/] PSE appears to have misunderstood the purpose of setting a utility's ROE, which is to allow PSE to earn returns commensurate with those in businesses having similar risks.[38/] PSE's authorized earnings should be much lower than private businesses in riskier and more innovative areas of the economy. PSE's ROE should reflect that utilities are conservative investments that have lower returns than successful software companies. In addition, it is noteworthy that PacifiCorp is not having any trouble attracting capital after the Commission just awarded that utility a 9.8% ROE and

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33/ Mr. Gorman frequently used the high end of his average or model results to error conservatively upon recommending higher ROEs. For example, Mr. Gorman's CAPM model produced an 8.83% ROE, which he rounded up to 9.0%, and the actual midpoint between his DCF and risk premium models is 9.665% and not his recommended 9.7%. Gorman, Exh. No. MPG-1T at 35:19-22, 36:5-7.

34/ Elgin, Exh. No. KLE-1T at 48:20-21; Gorman, Exh. No. MPG-1T at 41:1—46:8.

35/ Gorman, Exh. No. MPG-1T at 36:13—40:23.

36/ Olson, Exh. No. CEO-10T at 2:12—3:2.

37/ Id.

38/ Docket No. UE-100749, Order No. 06 ¶ 44 (citing Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Virginia, 262 U.S. 679 (1923), and Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)).

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the Idaho Public Utility Commission awarded PacifiCorp a 9.9% ROE, similar to ICNU's recommendation in this case.[39]

a. The Commission Should Rely Upon ICNU's DCF Analysis When Setting an ROE in this Case

14 The DCF model is a well recognized tool for estimating utility cost of equity and has been relied upon by this Commission in numerous proceedings. Mr. Gorman's analysis relied upon three DCF models (the constant growth DCF, the sustainable growth DCF, and the multi-stage growth DCF model), that estimated a 9.83% ROE for PSE.[40] The DCF model is based on the premise that the value of any asset is the present value of all future cash flows,[41] and uses a current stock price, expected dividends, and expected growth rates to estimate the cost of equity.[42] As Commissioner Jones noted at the hearing, the key issue of dispute regarding the DCF model is the appropriate growth rate.[43]

15 The Commission has relied upon Mr. Gorman's DCF analysis and forecasted growth rates in recent proceedings. For example, in PacifiCorp's 2006 general rate case, the Commission found "persuasive Mr. Gorman's argument, that if growth in GDP is used for this critical input to the DCF formula, it should be a forward-looking, not an historical average."[44] Similarly, in the 2010 PacifiCorp general rate case, the

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[39] Docket No. UE-100749, Order No. 06 ¶¶ 92-94.
[40] Gorman, Exh. No. MPG-1T at 14:18—26:3.
[41] Id. at 16:11-14.
[42] Id. at 17:7-10.
[43] TR. 400:4-12 (Jones/Gorman), 853:24—855:1 (Jones/Elgin); Gorman, Exh. No. MPG-1T at 18:1—19:20, 42:1—43:25; see also Docket Nos. UE-050684 & UE-050412, Order No. 04 ¶ 261.
[44] Docket Nos. UE-050684 & UE-050412, Order No. 04 ¶ 261.

Commission found that Mr. Gorman's DCF analysis was preferable because it more accurately estimated the current market and relied upon shorter-term growth rates.[45/] Mr. Gorman has continued to use the same models, which still reflect the Commission's preference that "[i]t is better to rely on short-term growth rates because we should be able to confirm their reliability in a comparatively brief time."[46/] The Commission's "greater confidence in short-term growth rates" should lead it to again "rely more heavily on ICNU's DCF recommendations regarding the various growth estimates."[47/]

16 Mr. Gorman's three DCF analysis produced an average 9.83% ROE, which was based on a 10.75% result from the analysts constant growth DCF model, 9.19% from the sustainable constant growth DCF model, and 9.54% from the multi-stage growth DCF model.[48/] Mr. Gorman was concerned that his analysts constant growth DCF model results are not reflective of current conditions because the model "cannot reflect a rational expectation that a period of high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth."[49/] The Commission previously agreed with Mr. Gorman that too much weight should not be placed on long-term growth rates such as nominal Gross Domestic Product ("GDP") rates, "because we are uncertain if the growth rates can be sustained over the long-term."[50/]

[45/] Docket No. UE-100749, Order No. 06 ¶¶ 81-82.
[46/] Id. at ¶ 82
[47/] Id.
[48/] Gorman, Exh. No. MPG-1T at 25:10-11.
[49/] Id. at 22:16-23.
[50/] Docket No. UE-100749, Order No. 06 ¶ 82; Gorman Exh. No. MPG-1T at 20:5—21:4.

17 PSE witness Charles Olson disagrees with the Commission and Mr. Gorman's analysis of growth rates, claiming high short-term growth rates can exceed GDP for a long period of time.[51/] Dr. Olson points to non-utility companies in the software technology sector that have exceed growth in the economy for a long time, and argues that the electric industry is changing, stating that "Mr. Gorman may not understand the dynamics that are changing the electric utility industry."[52/] Mr. Gorman has extensive experience and knowledge regarding cost of capital and electric utility issues that he understands very well, and he simply disagrees with Dr. Olson that growth rates in the electric industry should be compared with software companies or that the electric industry will indefinitely grow at a rate that exceeds the U.S. economy.[53/] Nothing has changed since the Commission rejected similar arguments less than a year ago.[54/]

18 Despite his concerns about unrealistic growth rates, Mr. Gorman did not reject the analysts constant growth DCF model. Instead, Mr. Gorman averaged the model results with two more realistic models, including the sustainable growth DCF model that estimated a 9.19% ROE.[55/] The sustainable growth model uses a growth rate "based on the percentage of the utility's earnings that is retained and reinvested in utility plant and

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51/ Olson, Exh. No. CEO-10T at 15:11—16:18.
52/ Id.
53/ Gorman, Exh. No. MPG-1T at 19:21—21:4; Exh. No. MPG-2 (Qualifications of Michael Gorman).
54/ Docket No. UE-100749, Order No. 06 ¶ 82; Gorman Exh. No. MPG-1T at 20:5—21:4.
55/ Gorman, Exh. No. MPG-1T at 21:5—22:14.

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equipment" and its results are a reasonably accurate estimate of PSE's cost of capital, because it relies upon more sustainable growth estimates.[56/]

19 Finally, Mr. Gorman relied upon the multi-stage DCF model, which estimated PSE's ROE at 9.54%. The multi-stage DCF model better reflects the possibility of changing growth expectations, a circumstance that is particularly appropriate in the current financial situation.[57/] The Commission has placed less weight upon this model in some past proceedings,[58/] but relied upon it in the most recent proceeding in which cost of capital issues were fully litigated.[59/] The multi-stage DCF model should be one of a number of models used in this proceeding, because it has more realistic growth expectations based on consensus economists' estimates of short, medium, and long periods.[60/]

b. Mr. Gorman's Risk Premium Model Results of 9.5% Should Be Used to Set PSE's ROE

20 The Commission should rely upon Mr. Gorman's risk premium model results when setting PSE's authorized ROE in this case. The risk premium model assumes that investors require a higher return to assume risk, and estimates the premium that investors require to invest in equity rather than bonds.[61/] Specifically, the model estimates this premium by calculating the difference between the ROE investments and

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[56/] Id.
[57/] Id. at 22:15-23.
[58/] Docket Nos. UE-050684 & UE-050412, Order No. 04 ¶ 261.
[59/] Docket No. UE-100749, Order No. 06 ¶¶ 81-85, 92-94; Gorman, Exh. No. MPG-1T at 20:5—21:4.
[60/] Gorman, Exh. No. MPG-1T at 22:15—25:8.
[61/] Id. at 26:6-9.

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U.S. Treasury bonds, and the difference between regulatory commission authorized ROEs and "A" rated bond yields.[62/] Mr. Gorman's risk premium model estimated an ROE between 9.4% and 9.5% for PSE, which he rounded up to 9.5%.[63/]

21 PSE criticized the usefulness of the risk premium model, but also produced an inflated risk premium model result that estimates the Company's ROE at 10.45% to 12.35%.[64/] Dr. Olson's risk premium model should not be relied upon because it attempts "to estimate an expected return on the market, not an expected return on utility stock investments."[65/] This is a common error in PSE's analysis that ignores that "utility stock investments are generally regarded as below market risk investments," which results in PSE's models calculating cost of equities that exceed a utility's fair compensation.[66/] Any model results that estimate utility ROEs in the 12% range in the current economy should be rejected out of hand.

22 PSE proposes the risk premium as a "check" on the reasonableness of the DCF model, but not to determine a range of reasonable returns.[67/] While the risk premium model is not as commonly used as the DCF model, the Commission has used its results for years when estimating a reasonable range of ROEs, and not merely as a useful "check."[68/] In fact, the Commission just used Mr. Gorman's risk premium model because

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62/ Id. at 26:13—27:9.

63/ Id. at 30:22-23.

64/ Id. at 44:1—45:5; Olson, Exh. No. CEO-10T at 17:16—19:2.

65/ Gorman, Exh. No. MPG-1T at 44:11-17.

66/ Id.

67/ Olson, Exh. No. CEO-10T at 17:16—18:8.

68/ Docket No. UE-100749, Order No. 06 ¶¶ 86-87, 92-94; Docket No. UE-050684 and UE-050412, Order 04 ¶ 261.

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it was a “reasonable approach.”[69] PSE has not presented any new information that would warrant departing from this recent precedent.

c. The CAPM Model Results Support Adopting an ROE at the Low End of the Range of Reasonable Model Results

23 Mr. Gorman used the CAPM model to estimate an equity return of 8.83%, which he rounded up to 9.0%.[70] The CAPM is based on the concept that the market required return for securities is equal to a risk free rate, plus a risk premium associated with the specific type of security.[71] Mr. Gorman’s CAPM utilizes the long-term Treasury rate to estimate the risk free rate, and uses forward looking and long-term historical information to estimate the risk premium.[72] Mr. Gorman relied upon market analysts reports, even though he believes they overestimate and inflate the risk premium.[73]

24 Dr. Olson also performed a CAPM analysis to estimate ROEs between 10.63% and 10.85%.[74] Dr. Olson’s CAPM analysis is significantly inflated because his projected Treasury bond yield exceeds observable yields and independent economists’ consensus projections.[75] Essentially, “Dr. Olson’s CAPM return estimate is substantially overstated because it does not reflect consensus market participant outlooks for future

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69/ Docket No. UE-100749, Order No. 06 ¶¶ 86-87, 92-94.
70/ Gorman, Exh. No. MPG-1T at 35:19-22.
71/ Id. at 31:2-5.
72/ Id. at 32:12—35:18.
73/ Id. at 34:7—35:2.
74/ Olson, Exh. No. CEO-1T at 28-29.
75/ Gorman, Exh. No. MPG-1T at 45:5-20.

Treasury bond yields" and correcting this error with more reasonable estimates would result in a CAPM estimate of 8.9%.[76]

25 In contrast to its direct reliance upon the DCF and risk premium models, the Commission has recently used the CAPM model as a check or reference point against which the other models can be compared.[77] At this time, the CAPM model produces low estimates of utility ROEs because it relies upon interest rates, which are currently low and not likely to change in the near future.[78] Interest rates are relevant to estimating the cost of equity, and while ICNU believes it would reasonable to provide additional weight on the CAPM beyond a mere reference point, Mr. Gorman's analysis only used the CAPM "to check the reasonableness of the DCF and Risk Premium analysis, and supports the adoption of an ROE at the lower end of midpoint or other studies."[79] Therefore, the CAPM supports the reasonableness of the DCF and risk premium models' estimate of a 9.7% ROE.

d. The Commission Should Lower PSE's ROE if It Adopts Decoupling

26 If the Commission decides to approve either the CSA or a full decoupling mechanism modeled on NWEC's proposal or Staff's Response to Bench Request No. 3, the Commission should select an ROE at the low end of the reasonable range to reflect the reduction in risk that accompanies decoupling. The Commission has already

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[76] Id. at 45:5—46:6.

[77] Docket No. UE-100749, Order No. 06 ¶¶ 88-95; Docket Nos. 090704 and UG-090705, Order No. 11 ¶¶ 292-300.

[78] Docket No. UE-100749, Order No. 06 ¶¶ 88-91.

[79] Gorman, Exh. No. MPG-1T at 36:9-12.

concluded that, by shifting the risk of revenue stability to customers, decoupling supplies immediate benefits to a utility and an increased assurance that dividends can be paid to shareholders.[80/] Industry experts agree that it is improper to make customers wait years or decades for the bond market to reward them for the risks they have assumed.[81/] Relying in part on a faulty study that has been thoroughly debunked in this case, NWEC joins PSE claiming no adjustment to capital costs or capital structure should accompany decoupling.[82/] This position runs contrary to the great majority of jurisdictions that currently have a decoupled electric utility, where decoupling has been accompanied by a reduction – often 50 basis points or more – in the utility's ROE.[83/] The Commission should follow the approach suggested by Mr. Gorman and Staff and select an ROE at the low end of reasonable, if decoupling or the CSA is approved.[84/]

2. The Commission Should Adopt a 46% Common Equity Ratio for PSE

27 PSE's capital structure should be set with a reasonable 46% equity ratio that will maintain the Company's financial integrity at the lowest cost to ratepayers. A capital structure must balance investor and ratepayer interests, and should include the lowest amount of high cost equity that is necessary to safely and reliably operate the

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80/ WUTC Investigation into Energy Conservation Incentives, Docket No. U-100522, Report and Policy Statement at ¶¶ 26-27 (Nov. 4, 2010) ("Policy Statement").

81/ Cavanagh, Exh. No. RCC-7 at 36 (Revenue Regulation and Decoupling: A Guide to Theory and Application, June 2011).

82/ Cavanagh, Exh. No. RCC-1T at 20:5-11; but see Reynolds, Exh. No. DJR-3T at 8:11-15 (discussing the methodological shortcomings of the Brattle Study); Deen Exh. No. MCD-5T at 18:5-17 (discussing the inapplicability of the Brattle Study to electric decoupling).

83/ See Deen, Exh. No. MCD-6 (ROE Adjustments for Decoupled Utilities).

84/ Gorman, Exh. No. MPG-1T at 1:20-22; Deen Exh. No MCD-5T at 19:10-12. Staff has proposed an adjustment that could be as great as 50 basis points. See Reynolds, Exh. No. DJR-3T at 17:5-6.

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utility business at the lowest overall cost to customers.[85] Utilities like PSE are not publicly traded and ratepayers do not control the level of equity that shareholders may elect to infuse into the Company.[86] The Commission must protect against the expansion of equity in amanner that serves the interests of the parent company, if it is "inconsistent with the ratepayer interest in a capital structure that reflects economy."[87]

28 PSE has proposed increasing its equity ratio from 46% to 48% based upon the argument that the Company's actual equity ratio is slightly higher (48.5%) and is lower than the Commission recently awarded to PacifiCorp (49.1%).[88] In contrast, ICNU and Staff recommend that the Commission should maintain PSE's equity ratio at its current rate of 46%.[89] Mr. Gorman's recommendation is based on estimating PSE's actual equity that is used to support regulated operations, similar to his recommendation that was approved to set PacifiCorp's equity ratio.[90] Mr. Elgin's recommendation is based on estimating the Company's equity ratio for the test period in a manner consistent with PSE's financial projections and similar to actual equity ratios of other similar companies.[91] Both Messrs. Gorman's and Elgin's approaches are reasonable and will maintain PSE's current credit rating and financial condition.[92]

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[85] Docket No. UE-100749, Order No. 07 ¶¶ 11-18.
[86] Id. at ¶¶ 12-13.
[87] Docket No. UE-100749, Order No. 06 ¶¶ 40-41; Docket No. UE-100749, Order No. 07 ¶¶ 12-13; Elgin, Exh. No. KLE-1T at 14:1-19.
[88] Gaines, Exh. No. DEG-14T at 2:9—4:2.
[89] Gorman, Exh. No. MPG-1T at 9:9—12:6; Elgin, Exh. No. KLE-1T at 15:1—22:6.
[90] Gorman, Exh. No. MPG-1T at 9:9—12:6.
[91] Elgin, Exh. No. KLE-1T at 15:1—22:6.
[92] Gorman, Exh. No. MPG-1T at 36:13—40:23; Elgin, Exh. No. KLE-1T at 17:18—18:10, 19:19—22:6.

29 Mr. Gorman calculated PSE's actual equity used to support regulated operations as 46.7% by deconstructing the Company's inaccurate estimate of a 48.5% actual capital structure.[93/] Mr. Gorman noted that the Company: 1) removed only subsidiary retained earnings for Puget Western ("PWI") and Hydro Energy Development Corporation ("HEDC"), instead of removing all the common equity supporting these non-regulated subsidiary investments; and 2) made an inappropriate adjustment related to Other Comprehensive Income ("OCI") and derivative accounting that is inconsistent with accepted accounting principles.[94/]

30 PSE argues that Mr. Gorman's removal of non-regulated subsidiary equity is a double count.[95/] For example, Mr. Gaines argues that the only equity remaining from non-regulated subsidiaries on its balance sheet "is any retained earnings, positive or negative, from PWI's management of the property" and that it is only necessary "to remove PWI's retained earnings."[96/] PSE makes a similar argument related to the HEDC subsidiary.[97/] Mr. Gaines' theory that only retained earnings support investments in subsidiaries can be followed on PSE's FERC Form 1. For example, page 110 (line 21) shows total investment in subsidiary companies, and page 112 shows subsidiary retained earnings (line 12) and retained earnings from internal operations (line 11).[98/]

93/ Gorman, Exh. No. MPG-1T at 10:3-9.
94/ Id. at 10:11—11:23.
95/ Gaines, Exh. No. DEG-14T at 5:4-7, 6:1—7:9.
96/ Id. at 6:3-18.
97/ Id. at 6:19-21.
98/ Gaines, Exh. No. DEG-24CX at 3 (PSE FERC Form 1); see also Gaines, Exh. No. DEG-14T at 7:1-9.

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31 PSE is only telling half the story, and the rest of its FERC Form 1 demonstrates that PSE's consolidated common equity supports investments in these subsidiary investments. Pages 224-25 of the FERC Form 1 show investments in subsidiary companies.[99/] These pages include PSE's full investment in subsidiary companies at the beginning of the year ($52,614,832) and the end of the year ($49,380,155).[100/] PSE's investments in subsidiary companies include the subsidiary retained earnings as PSE notes, but they also include amounts for capital stock and paid in capital.[101/] Mr. Gaines' claim that PSE's only investment in its subsidiary investments is their retained earnings is simply false. As a result, Mr. Gaines did not remove all the common equity supporting these non-regulated subsidiary investments from PSE's regulated capital structure, and PSE has overstated the amount of common equity supporting utility operations and inflated the common equity ratio.

32 PSE also argues that PSE's common stock should be adjusted for OCI pension and derivative accounting, because it is the Commission's established practice.[102/] When asked to identify this Commission precedent, PSE could find no orders and only pointed to the last Commission order in PacifiCorp's case adopting Mr. Gorman's recommendation to remove equity not used for utility plant operations.[103/] PSE argues that pension expense is not included in rate base, so it should be removed

99/ Gaines, Exh. No. DEG-24CX at 6-7, lines 2-4, 8-10.
100/ Id. at 6, line 42, column d, and 7, line 42, column g.
101/ Id. at 6-7.
102/ Gaines, Exh. No. DEG-14T at 7:10—8:12.
103/ Gaines, Exh. No. DEG-25CX at 1 (PSE Response to ICNU DR 10.02).

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from the capital structure.[104] Obviously, parent company temporary cash investments removed in the PacifiCorp case are different from pension costs. Utility pension obligations are related to utility operations that should remain in the capital structure. PSE's position would also violate Generally Accepted Accounting Principles accounting for utility pension obligations. PSE's OCI pension adjustments to common equity overstates the amount of common equity available to support utility operations, and resulted in an inflated equity ratio.[105]

33 Finally, PSE argues that Mr. Gorman's 46% equity ratio should be rejected because his analysis demonstrates that the Company's actual equity ratio is 46.7%.[106] While Mr. Gorman's analysis shows that PSE's actual equity ratio is 46.7%, the Commission should nevertheless maintain a 46% equity ratio, because PSE has not demonstrated that any increase is warranted or that it needs any higher equity ratio to economically provide service to customers. Further, PSE's actual common equity ratio has been declining throughout the test year, and a 46% common equity ratio actually equals or exceeds PSE's actual common equity ratio for each of the last six months in 2010.[107] In addition, as explained on the stand by Staff witness Ken Elgin, PSE's estimates in this case regarding its actual equity ratio are inconsistent with its financial documents.[108] PSE's financial documents show that its equity ratio is not expected to be

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[104] Id. at 1-2.
[105] Id.
[106] Gaines, DEG-14T at 5:13-15
[107] Gorman, Exh. No. MPG-4 at 1:9 (Utility Capital Structure).
[108] TR. 874:2—875:18; DEG-15 at 1 (PSE Utility Capital Structure); Confidential Exh. No. KLE-9CCX at 110, 130 (PSE Financial Documents).

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significantly increased until 2016, which further supports maintaining its current 46% equity ratio.[109]

3. Mr. Gorman's Recommended Overall Rate of Return Will Maintain PSE's Financial Integrity

34 Mr. Gorman's recommended 9.7% or 9.5% ROE and 46% equity ratio will support a strong financial condition for PSE, including supporting the Company's current bond rating.[110] Mr. Gorman analyzed the key credit rating agency financial ratios for PSE and concluded that they would support the Company's investment grade bond rating under either of his recommendations.[111] There is no credible evidence in this proceeding that Mr. Gorman's recommendations would not allow PSE to continue to attract capital on favorable terms either as a publicly traded company or under its current ownership structure.

D. Power Supply Costs

35 PSE's power supply related costs are significantly inflated and should be reduced to account for ICNU's adjustments. Specifically, the Commission should:

- Normalize operations and maintenance ("O&M") expense, Bonneville Power Administration ("BPA") rate case expense, and other power cost related administrative and general ("A&G") expense;
- Remove the inflated costs of peaking market purchases, gas financial hedges, and wind integration;
- Make known and measurable adjustments for hourly thermal generation transmission revenues, and fixed gas transportation cost allocation rates; and

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[109] TR. 874:2—875:18.
[110] Gorman, Exh. No. MPG-1T at 36:13—40:23.
[111] Id. at 36:13—40:23.

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- Adopt Staff's non-duplicative power cost proposals identified in the testimony of Alan Buckley.

These adjustments, exclusive of the gas price update, which has an unknown value at this time, should lower PSE's revenue requirement increase by approximately $22.4 million.[112/]

36 Two of ICNU's power cost proposals have been resolved. First, in rebuttal testimony, PSE provided updated information regarding its Mid-Columbia hydro projects. ICNU does not dispute this update and is dropping this adjustment.[113/] In contrast, PSE's rebuttal filing accepts ICNU witness Michael Deen's recommendation to increase the revenues associated with PSE's transmission capacity reassignment by about $1.2 million.[114/]

1. PSE's Production O&M Expenses Should Be Normalized

37 The Commission should normalize PSE's production gas generation O&M expense based on the actual average O&M expense for the most recent four-year period. PSE's historic test period shows substantial O&M expense at some Company-owned gas plants. Using an abnormally high test period level of expense is inappropriate and will not result in a reasonable forecast rate period O&M expense because these plants are only

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112/ The final revenue requirement impact of three ICNU adjustments may change in the final power cost update (quantity of hedges, peak capacity cost, and the gas generation operating characteristics).

113/ Mills, Exh. No. DEM-11CT at 45:1—47:4.

114/ Id. at 42:1—43:2; Deen, Exh. No. MCD-1CT at 5:1—6:16.

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overhauled every three or four years.[115/] ICNU's proposal will lower PSE's power cost related revenue requirement by about $8.6 million.[116/]

38 PSE is proposing huge increases in production O&M expense. For example, PSE is proposing $25.4 million in higher production O&M expenses, as compared to the levels in its 2009 general rate case.[117/] While about half of the production O&M expense increases are due to new wind resources, much of the higher costs are related to projected increases in thermal resource expense.[118/] PSE has estimated its test period production O&M expense for its gas generation resources using unadjusted test year values, but used projected rate year budgets for other resources such as Colstrip.[119/]

39 For some gas resources, unadjusted test year costs do not provide accurate estimates of the costs PSE will actually incur in the rate period because "maintenance costs of generating facilities can and do vary significantly year to year due to major maintenance overhaul schedules . . . ."[120/] ICNU witness Don Schoenbeck analyzed PSE's historic and budgeted gas-fired production O&M expense and determined that the expense has a highly cyclical nature with major overhauls occurring within a four-year

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115/ Schoenbeck, Exh. No. DWS-1CT at 3:17-21.

116/ Id. at 2. ICNU continues to support its original recommendation, but would not oppose adjusting the proposal to include additional gas plants and a longer operational history for Sumas that in total would reduce the value of the adjustment to $7.9 million.

117/ Id. at 10:14—11:2.

118/ Id.

119/ Id. at 11:3-11.

120/ Id. at 11:8-11.

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window.[121/] For example, the Frederickson, Fredonia, Mint Farm and Sumas plants have budgeted only $323,000 in total combined production O&M expense in the rate year, but PSE has proposed to recover $8.6 million in expense based on unadjusted 2010 test period numbers.[122/] Thus, PSE is proposing to recover about $8.3 million more than its actual forecasted expense for these four facilities.

40 The Commission should address the problem of highly cyclical gas fired facility production O&M expense by normalizing over a four-year average.[123/] The Commission could also estimate PSE's gas production O&M expense based on PSE's rate period budgets, which would result in a larger reduction in power supply costs, but ICNU recommends that a four-year average is better than budgeted amounts because historic costs are known, have been audited, and do not allow for budget gaming.[124/]

41 PSE opposes ICNU's normalization proposal and breaks down ICNU's adjustment into four categories: 1) core O&M expense adjustment ($1.7 million); 2) contract major maintenance expense adjustment ($0.3 million); 3) non-contract major maintenance expense adjustment ($5.1 million); and 4) other discretionary expense adjustment ($1.3 million). As a preliminary matter, ICNU disagrees with PSE's categorization of $1.7 million of the adjustment as related to "core O&M expense," because PSE inappropriately includes highly variable supplemental expense in its

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121/ Id. at 11:3-12:6; Exh. No. DWS-5 (PSE Responses to Public Counsel DR 026 and ICNU DRs 5.6—5.10).
122/ Schoenbeck, Exh. No. DWS-1CT at 12:3-6.
123/ Id. at 12:11-12, 13:2-3.
124/ Id. at 12:6-13:9.

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category of stable core expense. For example, the Frederickson plant's 2010 expenses include $6.9 million in historic expenses, which includes $1.3 million of core maintenance, $0.84 million in supplemental maintenance, and $4.76 million in non-contract major maintenance.[125] PSE, however, includes this supplemental maintenance with its estimate of ICNU's "core O&M expense" to argue that ICNU is proposing to disallow a larger amount of core O&M than ICNU is actually recommending.

42 PSE opposes normalizing "core" and "major maintenance" expense, because the Company claims that costs incurred in prior years will not be representative of future costs due to changes in operations.[126] PSE also opposes normalization of core maintenance, because the Company claims that core maintenance is less variable than major maintenance and that core maintenance costs have been increasing.[127] Finally, PSE opposes normalizing other maintenance expense because this category allegedly has not seen as large of swings in increasing or decreasing costs.[128]

43 PSE's arguments, however, do not address Mr. Schoenbeck's fundamental observation that there have been wild swings in overall gas generation production O&M expense. Using 2010 production O&M expense levels will be far less representative of future costs than a four-year average because 2010 represents an abnormally high level of expense compared to the Company's budgets for the rate effective period. PSE also fails

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[125] Exh. No. DWS-5 at 14.
[126] Gould, Exh. No. WRG-1T at 19:1-10.
[127] Id. at 9:3—10:12, 19:11-19; Exh. No. WRG-4 (Gas Combustion Turbine O&M).
[128] Gould, Exh. No. WRG-1T at 24:6-11.

to recognize that using a four-year average will capture trends toward higher or lower expense because higher years will be included in the average numbers.

44 PSE also argues that ICNU has made selective comparisons of actual to budget expense, and that overall rate year production O&M expense is $6.7 million greater, rather than $8.3 million less, than test-year amounts.[129/] PSE is incorrectly comparing total production O&M expense that ICNU is not disputing in this case, including the large increases in wind production O&M.[130/] It is not appropriate to compare stable production O&M expense with the extremely variable gas production O&M expense. Focusing only on gas resources, the production O&M expense in the 2010 test period is $5.1 million higher than the actual amount PSE is planning to spend.[131/]

45 Finally, PSE claims Mr. Schoenbeck's calculations include errors or omissions, because he did not include all PSE's gas generation resources, and that the Sumas plant should include two and half years of operation rather than only two years.[132/] Mr. Schoenbeck did not include PSE's Encogen, Goldendale and Whitehorn facilities, because the information provided by PSE in discovery did not show significant differences between rate and test period expense. In addition, ICNU did not include the first few months of operations for Sumas, because these initial months of operation may

129/ Id. at 11:10—12:2; Exh. No. WRG-6 (Excess of Rate Year O&M over Test Year O&M).
130/ Exh. No. WRG-9CX (ICNU Revision to PSE Exh. No. __(WRG-5)); Exh. No. DWS-1CT at 10:14—11:2.
131/ Exh. No. WRG-9CX.
132/ Gould, Exh. No. WRG-1T at 10:13—11:9.

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not be reflective of the ongoing forward normalized costs. While ICNU believes its calculation was properly calculated and is fully supported, ICNU would not be opposed to applying a four-year average to all of PSE's gas plants or including two-and-one-half rather than two years of Sumas operations.

2. PSE Is Obtaining Additional Transmission Revenues that Will Offset Any Revenue Deficiency

46 The Commission should adopt a pro forma adjustment related to PSE Open Access Transmission Tariff ("OATT") revenues that are known and measurable and are not expected to be offset by any other factors. The Federal Energy Regulatory Commission ("FERC") has approved on an interim basis a PSE OATT rate related to revenues from wind generation that is exported out of the Company's balancing authority.[133/] PSE is currently obtaining revenues from at least one third-party wind generator on its system, and these revenues should be included as a known and measurable adjustment in this case that reduces power costs and the Company's revenue deficiency by about $2.4 million.[134/]

47 PSE does not dispute that it is currently receiving these transmission revenues, but argues that this adjustment is not appropriate because the rates have not been approved on a final basis, are still in litigation and are potentially refundable.[135/] While it is possible that FERC may reject the tariff or order a portion of the amounts

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133/ PSE, Docket No. ER11-3735, Order Accepting and Suspending Proposed Tariff Revisions, Subject to Refund, and Establishing Hearing and Settlement at 24-25 (Oct. 20, 2011); Deen, Exh. No. MCD-1CT at 8:8—9:2.

134/ Deen, Exh. No. MCD-1CT at 8:8—9:2.

135/ Story, Exh. No. JHS-18T at 19:9—20:5.

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refunded, PSE fails to note that FERC routinely accepts tariffs as "subject to refund," and the vast majority of the tariffs are eventually approved. In addition, FERC has already rejected many of the challenges to PSE's tariff and concluded that the remaining protests do not warrant rejecting the tariff outright.[136/] As FERC declined to reject the tariff out of hand, it is far more likely that FERC will allow all or the majority of the tariff to remain in effect. Unless the Commission adopts ICNU's adjustment, PSE will be able to keep all of the revenues it is actually receiving without any benefit to ratepayers. The fact that PSE will receive the revenues is certain; the claim that they could be refunded is speculative.

3. PSE's Proposed Gas Transportation Cost Increases Should Be Rejected

48 The Commission should reject PSE's speculative and unsubstantiated proposed increases in its firm natural gas transportation costs. PSE is forecasting that its gas transportation costs will increase during the test period, but there is a significant amount of uncertainty regarding whether and (if so) how much they will increase.[137/] The Commission should adopt Mr. Deen's proposed recommendation on gas transportation costs that reduces the revenue requirement request by about $0.9 million.[138/]

136/ Docket No. ER11-3735, Order Accepting and Suspending Proposed Tariff Revisions, Subject to Refund, and Establishing Hearing and Settlement at 21, 24.

137/ Deen, Exh. No. MCD-1CT at 11:21-27.

138/ Riding, Exh. No. RCR-4HCT at 9:6-12 (PSE originally sought to recover $1.6 million in these costs, but reduced the amount to $0.9 million in rebuttal testimony. This significant change in the estimated amount of these costs underscores that they are speculative and not known and measurable).

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49 PSE states that it its gas transportation cost increase should be allowed, because it is based on the Company's "informed judgment."[139/] PSE has included estimated rate increases from Westcoast Energy, some of which will not be filed until January 1, 2013 or become final until March 1, 2013, and estimates of potential increases by Cascade that could occur in July 2012.[140/] In addition, PSE has estimated increases because Northwest Pipeline will file a FERC rate case on July 1, 2012, with rates effective January 1, 2013. Any new rates may be approved on an interim basis, subject to refund. Essentially, PSE believes its gas transportation costs will change, but does not know how much, if any, they will increase.

50 PSE's position on gas transportation cost increases is completely contradictory to its position on its OATT transmission rate increase. PSE has already been allowed to increase its own fully supported OATT transmission rates by a known and specific amount, which PSE argues should not be reflected in this case, because it is "subject to refund." In contrast, for its gas transportation contracts, PSE proposes that the Company be allowed to estimate potential rate increases associated with rates that have not yet been filed, the amount of the proposed rate increase (if any) is unknown, and some of the rates will be subject to refund. It is unclear whether PSE's gas transportation contract costs will increase at all, and the Company should not be allowed to provide guesstimates of not yet proposed changes. The Commission should adopt a

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139/ Riding, Exh. No. RCR-4HCT at 6:1-4.
140/ Id. at 6:5—7:20.

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bright line rule that allows revenues or higher costs associated with charges FERC has already allowed to go into effect to be reflected in rates, but not allow revenues or higher costs that are contemplated but not yet filed.

4. PSE's "Outside the Model" Wind Integration Costs Should Be Removed

51 PSE has proposed an "outside the model" adjustment that increases its power costs by about $2.6 million to approximate the day-ahead costs for all wind generation in its balancing authority.[141/] Both ICNU and Staff have proposed to exclude these wind integration costs because PSE does not know whether it will actually incur the costs, there is no method to track its wind integration costs, these costs may be offset by other factors, and PSE can recover any actual integration costs through its power cost adjustment mechanism.[142/]

52 PSE's power cost model already indirectly charges customers for some wind integration costs. The AURORA model calculates the expected value of the variable costs of PSE's system.[143/] PSE designates its wind generation resources as "'must run' in the model and therefore PSE's other resources must operate around them at potentially less than optimal dispatch levels."[144/] Ratepayers also pay PSE for operating reserves that are intended to compensate PSE for all the costs of changes in loads and resources, including wind integration.[145/]

141/ Deen, Exh. No. MCD-1CT at 6:17—8:8.
142/ Id.; Buckley, Exh. No. APB-1CT at 19:10—20:17.
143/ Deen, Exh. No. MCD-1CT at 7:11-23.
144/ Id.
145/ Buckley, Exh. No. APB-1CT at 19:10—20:17.

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53 PSE asserts that this does not capture all of its costs, because the AURORA power cost model does not specifically include day-ahead wind integration costs, and PSE proposes to estimate these costs with an outside the model adjustment.[146/] PSE estimates its wind integration costs by calculating the day ahead wind production forecast error (the amount of energy allegedly needed), and the market price deferential between day-ahead and hour-ahead prices (the alleged per megawatt opportunity cost).[147/]

54 PSE has not demonstrated that it actually incurs any additional costs associated with day-ahead wind integration. PSE admitted that "it is difficult to isolate and track the effects of just one variable" and that it "does not have the systems and mechanisms in place to capture actual day-ahead wind integration cost."[148/] Similarly, PSE does not pay any other balancing authority for its alleged day-ahead wind integration costs.[149/] While PSE can establish that there is a difference between its wind forecasts and actual wind generation, PSE has not presented any evidence that the difference results in PSE actually incurring costs that are not already accounted for in AURORA or operating reserves already paid by customers.

55 PSE has also not refuted the arguments of Messrs. Deen and Buckley that, even if it is incurring additional wind integration costs, these costs are not offset by other factors. PSE's proposal to account for wind integration costs using assumptions regarding the opportunity costs to reserve capacity for wind fails to recognize that PSE's

146/ Mills, Exh. No. DEM-11CT at 13:5—21:3.
147/ Id. at 14:1—16:9.
148/ Id. at 17:3-5; Exh. No. MCD-4 at 6 (PSE response to ICNU DR 2.80).
149/ Deen, Exh. No. MCD-1CT at 7:14-16; Exh. No. MCD-4 at 7 (PSE Response to ICNU DR 2.83).

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power cost model will always differ from actual operations.[150] These "variations are similar to normal variations in load that occur every hour and are addressed using the Company's Mid-C hydro resource and other resources" with automated generation control.[151] For example, lower than forecast amounts of wind generation may not cause any increased costs if it is offset by other changes in load or other generation. PSE is already compensated for these costs with the operating reserves that customers pay, and it would be "arbitrary to isolate a hypothetical day-ahead opportunity cost to system optimization from wind integration outside the AURORA forecast while not, for example, identifying potential benefits to consumers of the Company's operations not captured in the model."[152]

5. The Commission Should Remove PSE's Peaking Market Purchase Costs

56 PSE has proposed to include costs associated with peaking market purchases that are based on an extreme test period weather event. The majority of these costs should be removed from rates, and PSE's peaking costs should be set based on expected normalized weather conditions. ICNU's adjustment would lower power supply costs and the associated revenue requirement request by about $1.1 million, dependent upon the market price update.[153]

150/ Deen, Exh. No. MCD-1CT at 7:24—8:7; Buckley, Exh. No. APB-1CT at 19:11-21.
151/ Buckley, Exh. No. APB-1CT at 19:15-17.
152/ Deen, Exh. No. MCD-1CT at 8:4-8.
153/ Schoenbeck, Exh. No. DWS-1CT at 2:10-11, 3:22-26.

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57 PSE estimates that it will incur a premium above the Mid-C price for delivered power during peak hours of the winter months of November through February.[154] ICNU does not dispute that PSE will need to incur a premium for some power during the peak winter months, but "the crux of the issue is really the number of hours this is likely to occur."[155] PSE estimates that it will need premium power in about 400 hours in each winter month based on estimates shortages "in each and every on-peak hour of the four month period based on the assumed monthly peak times a planning reserve margin of 15.7%.[156]

58 PSE's forecast need for premium power during peak periods is highly unrealistic. PSE's actual hourly load data for the winter months from 2007 to 2010 demonstrates that PSE has relatively sharp and short monthly peaks.[157] In addition, there is no need to inflate PSE's estimated need for premium power with a very high 15.7% reserve margin that is used for long-term resource planning.[158] For near term rate period forecasts, PSE's needs should be based on the expected forced outage rate of generating units instead of a long-term planning value.[159] Based on PSE's historic data and actual needs, Mr. Schoenbeck developed a more reasonable estimate of PSE's expected need for premium peaking power during the rate effective period.[160]

154/ Id. at 13:11—14:2.
155/ Id. at 14:3-5.
156/ Id. at 14:5-9.
157/ Id. at 14:9—16:1.
158/ See id. at 14:10-12.
159/ Id. at 14:11-14.
160/ Id. at 14:12—16:1.

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59 PSE opposes Mr. Schoenbeck's recommendation, arguing that PSE must purchase peaking "insurance" to cover all its unexpected winter peaking events, ICNU "presupposes the Company is able to predict the actual hour in which a peak event will occur," and there is no reliable standard hourly option.[161/] ICNU agrees that PSE should plan to cover its unexpected winter peaking, but PSE has not shown that "insurance" is not available on a shorter-term basis instead of only as block for all peak winter hours. In addition, PSE does not need a standard hourly option for meeting its peaking needs, and should instead buy premium power during the winter peak periods on an as needed basis rather than for every hour.

60 PSE mischaracterizes Mr. Schoenbeck's recommendation by claiming that ICNU assumes that PSE can predict the hours that peak events will occur.[162/] Mr. Schoenbeck is not asserting that PSE can forecast with perfect accuracy the hours that PSE will need peaking power, but that the Company should only buy peaking power for the number of hours the power is likely to be needed. If PSE actually needs more power, then any prudently incurred costs can be recovered through the power cost adjustment mechanism ("PCAM"). In contrast, ratepayers will pay too large of a premium if the Company unnecessarily buys power for all its on-peak winter hours.

161/ Mills, Exh. No. DEM-11CT at 36:9—37:15.
162/ Id. at 37:6-10.

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6. PSE's Out of the Model Hedging Costs Should Be Recovered Through the Power Cost Adjustment Mechanism Instead of Base Rates

61 The Commission should remove all of PSE's mark-to-market costs in excess of the amount needed in its power cost model for the rate year, which would reduce PSE's revenue requirement increase by about $4.5 million.[163/] ICNU is not opposed to PSE recovering any prudently incurred actual gas hedging costs in excess of what AURORA forecasts through PSE's PCAM.[164/]

62 PSE engages in hedging strategies to manage its power and gas cost volatility and risk. ICNU is not disputing the hedging costs that PSE's AURORA model projects for the rate period. PSE, however, includes additional hedging costs through a "Not-In-Models" calculation, which increases net power costs. PSE makes this calculation because there is a difference between PSE's estimated needs based on current market conditions and the AURORA forecast that uses Commission established regulatory standards.[165/] Commission Staff makes a similar proposal, but it is less accurate because it uses annual hedges instead of monthly hedges.[166/]

63 ICNU proposes that PSE's out of the model calculation of hedging costs should be removed from base rates, and that the actual hedging costs be recovered (if any are actually incurred) through the PCAM. PSE's "base power cost determination should be based on the gas need reflected for serving the projected load based on the regulatory

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163/ Schoenbeck, Exh. No. DWS-1CT at 2:10-11, 9:9-12. The final net power cost amount could change based on the actual hedge position and gas need estimate in the power cost update

164/ Id. at 9:13-21.

165/ Id. at 8:10—9:12.

166/ See Mills, Exh. No. DEM-11CT at 26:11—27:3 (comparison of ICNU and Staff recommendations).

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standards imposed by the Commission."[167/] If loads and gas needs change, then "these costs can and should flow through" the PCAM.[168/]

64 PSE argues that ICNU's recommendation should be rejected, because the Commission rejected a similar proposal in PSE's 2009 rate case, PSE does not use the AURORA model for hedging, and there are alleged errors in ICNU's calculation.[169/] ICNU recognizes that the Commission rejected a proposal to completely remove these out of the model hedges from rates, but ICNU has modified the proposal to allow for recovery of these costs in the PCAM.[170/] This is consistent with how the Commission sets power costs in a general rate case using an approved model to forecast costs, and allowing all prudently incurred costs "that deviate from normalized rate making standards (examples would be load deviations, resource forced outage rate deviations, hydro deviations, and forward market prices)" to be recovered in a PCAM.[171/]

65 PSE also incorrectly asserts that Mr. Schoenbeck's recommendation is not accurately calculated.[172/] First, PSE claims that ICNU is double counting by including both physical and financial gas hedges at Sumas to determine the quantity of the above model need.[173/] Mr. Schoenbeck did not double count, because both physical and financial transactions are hedges that lock in a known price for gas at Sumas. Thus, both physical and financial hedges should be included in the adjustment.

167/ Schoenbeck, Exh. No. DWS-1CT at 9:13-21.
168/ Id.
169/ Mills, Exh. No. DEM-11CT at 27:4—31:20.
170/ Schoenbeck, Exh. No. DWS-1CT at 10:1-12.
171/ Id. at 10:5-10.
172/ Mills, Exh. No. DEM-11CT at 28:15—29:10.
173/ Id. at 28:19-25.

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66 PSE also claims that "ICNU erroneously uses the average cost of all hedges for a month rather than the average cost of the hedges to be removed to determine the reduction to power costs."[174] There is no error, and PSE merely disagrees with the manner in which the adjustment is calculated. The average price of all transactions is preferable, because the amount of hedging varies based upon a variety of factors, and an average is more accurate than attempting to color code transactions.

7. The Commission Should Normalize FERC and BPA Power Supply Related Accounts

67 The Commission should use a five-year average to normalize PSE's expenses in FERC account 557 (other power costs) and BPA-related costs that PSE reclassified from power costs to administrative and general accounts. The patterns in these accounts show significant variation throughout the years, and it would be more appropriate to use a five-year average than test period amounts. Each of Mr. Deen's recommendations would reduce PSE's revenue requirement increase by about $0.9 million and in total would reduce rates $1.8 million.[175]

68 PSE opposes Mr. Deen's recommendation based on the argument that the total balance in FERC account 557 is growing, there are vague errors, and that ICNU has not provided any "proof that BPA or other regulatory legal actions will be less over the next few years, or even if it was higher in the test year versus other years."[176] FERC account 557 costs have trended upwards, but PSE did not demonstrate that this trend is

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174/ Id. at 29:1-10.
175/ Deen, Exh. No. MCD-1CT at 2:11-12, 12:1—13:2.
176/ Story, Exh. No. JHS-18T at 20:6—21:23.

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expected to continue. ICNU's analysis also does not contain any errors because the values were directly taken from the Company's workpapers and data responses. Any errors or use of select workpapers is incorrect, or based on PSE's own errors.

69 Finally, the record contains sufficient evidence to demonstrate that PSE's BPA-related costs during 2010 are abnormally high and not expected to recur during the test period. Mr. Deen worked primarily upon BPA-related matters for the last four years, and is well positioned to note that "[t]he past several years have seen an extraordinarily high level of ratemaking and legal activity by BPA related to implementing its new Regional Dialogue contracts with customers, developing new wind integration and thermal balancing rates, and finalizing the new long-term Residential Exchange Program Settlement Agreements."[177/] These were major proceedings that required "an immense amount of resources" and "enormous effort" by the parties, and this level of costs is not expected to reoccur during the rate effective period.[178/]

8. Gas Generation Operating Characteristics

70 The Commission should require PSE to update the "minimum up time" operating assumptions for the Company's generation resources. Mr. Deen analyzed the Company's actual hourly operating data for its gas generation resources and discovered that the minimum up times for the Goldendale, Mint Farm and Sumas facilities were significantly too high.[179/] Mr. Deen proposed a conservative adjustment that reduces the

177/ Deen, Exh. No. MCD-1CT at 12:1—13:2; Exh. No. MCD-2 (Qualifications of Michael Deen).

178/ See Exh. No. JHS-33CX at 6 (Excerpt of 2010 BPA Annual Report); Exh. No. JHS-34CX at 3 (Excerpt of REP-12-A-02); TR. at 1049:14-18 (Story).

179/ Deen, Exh. No. MCD-1CT at 13:3-23; Exh. No. MCD-4 at 2 (PSE response to ICNU DR 2.57).

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minimum up times for these facilities down to 10 hours, which is closer to (but still higher than) the amount that these facilities are expected to be operated at during the rate effective period.[180/] This adjustment would lower net power costs by about $0.4 million because it reflects that the generation facilities will cycle more economically.[181/]

71 PSE opposes ICNU's recommendation on the grounds that these changes only reflect a portion of the potential changes to operational characteristics of the Company's generation facilities.[182/] Notably, PSE does not dispute that Mr. Deen's changes to the minimum up times will be more accurate than the times included in PSE's initial filing. Instead, PSE argues that these changes should not be made without incorporating a number of other alleged changes that would result in a $2.6 million increase to net power costs.[183/] It is inappropriate for PSE to propose wholesale changes in its operational characteristics of its generation units in the rebuttal phase of the proceeding, which effectively prevents ICNU from submitting responsive testimony regarding whether the changes are appropriate. These types of updates should have been provided with PSE's direct testimony, or at least its supplemental filing, to allow parties adequate time to review and respond. Therefore, the Commission should make Mr. Deen's limited and conservative adjustment, and reject PSE's attempt to significantly broaden the scope of appropriate rebuttal updates.

180/ Deen, Exh. No. MCD-1CT at 13:11-20; Mills, Exh. No. DEM-11CT at 40:1-6.
181/ Deen, Exh. No. MCD-1CT at 13:18-21.
182/ Mills, Exh. No. DEM-11CT at 40:7-11.
183/ Id. at 40:7—41:17.

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9. The Commission Should Require a Forward Gas Price Update Close to the Time of PSE's Compliance Filing

72 The Commission should require PSE to update its power costs to include current forward gas prices and short term sales and purchases because it will result in a substantial reduction in projected power costs. Gas prices have dropped considerably, and ICNU and PSE agree that "projected rate year power costs should be updated to reflect more recent gas prices, just prior to rates going into effect and in the manner with which they have been updated in the past and in this proceeding."[184/] Therefore, the Commission should require PSE to make a power cost update because it will result in more accurate power costs and could significantly lower costs.

E. The Commission Should Adopt ICNU's Consolidated Tax Savings Adjustment

73 PSE's revenue requirement should be reduced by $8.8 million to account for ratepayers' fair share of the value of PSE's taxable income that is used to lower PSE's parent company's (currently Puget Holdings) overall federal income taxes.[185/] ICNU has carefully constructed its proposal to comply with the normalization provisions of the Internal Revenue Code ("IRC") and established ratemaking principles, including the guidance provided by this Commission in previous proceedings. ICNU's consolidated tax adjustment is designed to recognize the economic benefits provided by ratepayers that occur when a parent company files a consolidated tax return, but still allow the parent to

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184/ Mills, Exh. No. DEM-11CT at 61:17—62:3; Staff, ICNU, and PSE Responses to Commission Bench Request No. 21.

185/ Blumenthal, Exh. No. EB-1CT at 2:1-5 (the value of ICNU's adjustment is based on PSE's original filing and will change if the Commission adopts a different rate of return).

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retain the actual tax savings. ICNU's proposal does not transfer any of the tax savings to ratepayers but is limited to reflect only the fair share of the time value of the "loan" that PSE's ratepayers provide to lower the parent company's ultimate tax liability. The parent company's lower tax liability could not occur but for money collected from ratepayers, and customers should not be required to pay the full payment of taxes calculated on a stand-alone basis without being provided some of the benefits associated with PSE's participation in a consolidated tax return.

1. ICNU's Consolidated Tax Adjustment

74 ICNU has proposed a limited and conservative consolidated tax adjustment that does not provide ratepayers with the full value of the tax savings that they have created for PSE's parent company, but only the time value of money that results from the parent using PSE's taxable income to lower its overall taxes. Consolidated tax savings are simply those tax savings which result from the ability of a parent company to combine the taxable incomes with the tax losses of members of the tax group.[186/] Over the long-term, PSE's taxable income results in significant tax savings that they could not otherwise achieve without this ratepayer funded income.

75 ICNU proposes a relatively small consolidated tax adjustment. ICNU starts with the actual taxable incomes and losses reported by each member of the consolidated group. ICNU uses "the sum of each company's reported taxable income

[186/] Id. at 2:13—4:2.

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and/or loss for the most recent ten years."[187/] The continuing taxable incomes and continuing tax losses are segregated so that each company has the opportunity to offset its own losses before it requires a loan from its affiliates.

76 ICNU's consolidated tax adjustment recognizes that the companies with continuing taxable incomes have made loans to those companies with tax losses and the result is a lower consolidated tax liability. The total tax savings realized by the parent company is equal to the total losses times the federal income tax rate.[188/] PSE's fair share of these savings is its proportional share of the taxable income that has been loaned to the companies with tax losses.[189/] ICNU does not use the total amount that PSE ratepayers pay in taxable income for the consolidated tax adjustment, but only that portion of PSE's taxable income that has been loaned to the "loss" affiliates.

77 ICNU witness Ellen Blumenthal's testimony includes a simple example of how each affiliate's fair share of the tax savings would be calculated using three companies (one utility and two non-utility affiliates).[190/] If the utility company had $100,000 in taxable income, and the total taxable income from all the companies was $120,000, then the utility's fair share of any tax savings "would be approximately 83% ($100,000 divided by $120,000) of the total tax savings."[191/] In the hypothetical

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187/ Blumenthal, Exh. No. EB-1CT at 8:1-2.
188/ Id. at 3:3—5:8, 6:20—8:22, 9:11—10:13; Exh. No. EB-3 (Consolidated Tax Savings Adjustment Calculation Example); Exh. No. EB-4C (PSE Consolidated Tax Savings Adjustment Calculation).
189/ Blumenthal, Exh. No. EB-1CT at 3:15—4:2; Exh. No. EB-3.
190/ Blumenthal, Exh. No. EB-1CT at 3:3—4:13.
191/ Id. at 4:1-2.

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example, there was a total of $17,500 in tax savings, so the utility's fair share of the savings would be 83%, or about $14,500.

78 After determining the amount of tax savings attributable to ratepayers, ICNU's adjustment returns less than 10% of the savings to ratepayers. The value of the adjustment is based on the time value of the money that is used to lower the consolidated group's tax liability.[192/] The time value of PSE loaning its taxable income is computed with PSE's weighted average cost of capital.[193/]

79 Continuing the above hypothetical example, if the fair value of the tax savings properly attributed to ratepayers was $14,500, then ICNU's tax adjustment would be based on calculating the value of a $14,500 loan to Puget Holdings. The time value of this loan is determined by multiplying $14,500 by PSE's weighted cost of capital, which is around 8%.[194/] The amount of the consolidated tax adjustment would further be reduced to account for tax rates.[195/] In the end, ICNU's consolidated tax adjustment is only a small portion (or less than 10%) of the amount that PSE's ratepayers would contribute to consolidated tax savings, and is designed only to reflect the time value of money associated with PSE loaning its taxable income to the parent company.

192/ Id. at 6:20—7:1.
193/ Id. at 7:1-2.
194/ See Blumenthal, Exh. No. EB-1CT at 6:20—7:24; Exh. No. EB-3.
195/ See Blumenthal, Exh. No. EB-1CT at 7:9-24; Exh. No. EB-3.

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2. ICNU's Consolidated Tax Adjustment Is Consistent with Commission Precedent

80 The Commission has previously rejected consolidated tax adjustments because of concerns regarding improperly comingling regulated and non-regulated operations, as well as concerns whether a tax adjustment is consistent with the principles of benefits should follow burdens, cost causation, and prevention of cross-subsidization.[196/] The Commission has also expressed a desire that, if it were to allow a consolidated tax adjustment, then it must be shown to be balanced, free from computational errors, and does not result in a violation of the IRC.[197/] In a 2006 PacifiCorp case, the Commission rejected a consolidated tax adjustment proposal, because it had been mooted by a change in ownership, but also stated that there were important issues related to the benefit/burdens test that should be fully evaluated.[198/] The Commission also rejected a consolidated tax adjustment in the Avista case that was unbalanced and included computational errors, and the Commission again clearly stated that it expected fuller analysis of issues related to the benefits/burdens test, cross subsidization, separation of regulated and non-regulated operations, and consistency with the requirements of the IRC.[199/]

81 The Commission has established comprehensive "ring-fencing" provisions for utilities that are designed to isolate ratepayers from the impacts of a utility's non-

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[196/] Docket Nos. UE-050684/050412, Order Nos. 04 and 03 ¶¶ 159-60; Docket Nos. UE-080416/UG-080417, Order No. 08 ¶¶ 28-33.

[197/] Docket Nos. UE-080416/UG-080417, Order No. 08 ¶¶ 28-33.

[198/] Docket Nos. UE-050684/050412, Order Nos. 04 and 03 ¶¶ 159-60.

[199/] Docket Nos. UE-080416/UG-080417, Order No. 08 ¶¶ 28-33.

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regulated operations so that ratepayers are not exposed to the risks or required to subsidize non-regulated operations.[200] The Commission has stated that it would allow a comingling of regulated and non-regulated operations if a "compelling reason" is shown, and the costs and benefits flow evenly and are balanced.[201]

82 ICNU's proposal has been designed not to comingle non-regulated and regulated operations. Unlike prior consolidated tax adjustments, ICNU is not capturing the full value that ratepayers contribute to the parent company's tax savings or calculating a new effective tax rate.[202] Although PSE strongly opposes the consolidated tax adjustment, even the Company agrees that it is differently constructed in an attempt to comply with Commission precedent.[203]

83 Similar consolidated tax adjustments have been adopted in other states without exposing ratepayers or utilities to problems or concerns associated with comingling "regulated and non-regulated operations, and have not violated any ring fencing provisions."[204] There is no evidence from any states that have adopted consolidated tax adjustments, nor any specific examples provided by PSE, which show how ICNU's proposal will violate ring fencing provisions, because ICNU's proposal will not comingle assets, or expose ratepayers to liabilities of unregulated operations.[205] ICNU only proposes to reflect "the value of the 'loan,' so there is no transfer of the tax

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200/ Id. at ¶¶ 28-31; Blumenthal, Exh. No. EB-1CT at 13:3—13:17.
201/ Docket Nos. UE-080416/UG-080417, Order No. 08 ¶ 29.
202/ Blumenthal, Exh. No. EB-1CT at 6:20—7:24.
203/ Marcelia, Exh. No. MRM-14T at 12:17—13:20.
204/ Blumenthal, Exh. No. EB-1CT at 13:11-14.
205/ Id. at 13:6-16.

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benefit, and is instead providing ratepayers their fair share" of the savings that result from PSE's inclusion in a consolidated tax return that could not occur but for money collected from ratepayers.[206/]

84 PSE argues that ICNU's proposal violates ring fencing requirements because the Company's regulated operations are not the cause of consolidated tax savings.[207/] Instead of identifying any ring fencing violations, PSE argues that ICNU's proposal should be rejected on cost causation grounds. PSE characterizes PSE's regulated operations as merely "a bystander," and asserts that "PSE is not responsible for the tax benefit" because PSE does not bear any "economic or theoretical burden in creating its contribution to the tax savings."[208/]

85 PSE's cost causation arguments ignore the fact that the only way consolidated tax savings can occur is if the consolidated group can monetize tax losses with taxable income. PSE's ratepayers fully contribute and pay all of the Company's prudently incurred costs related to federal income taxes that are not paid to the taxing authorities, but are instead used to offset other affiliate losses to lower the final consolidated tax amount. Ratepayers should not be burdened with the full federal tax payment without receiving at least some of "the benefits associated with the fact that there are tax savings resulting from participation in the filing of a consolidated tax return."[209/] ICNU's consolidated tax adjustment is fully "consistent with the principles of

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206/ Id. at 6:20—7:24.
207/ Marcelia, Exh. No. MRM-14T at 19:11—23:12.
208/ Id. at 17:14—18:5.
209/ Blumenthal, Exh. No. EB-1CT at 14:5-21.

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cost causation because the tax savings could not occur but for the inclusion of funds collected from ratepayers."[210/] Without ICNU's proposal, ratepayers will cross subsidize non-regulated operations, many of which could not monetize their losses, without a contribution of taxable income from regulated operations.

3. ICNU's Tax Adjustment Does Not Violate Tax Laws

86 The Commission has appropriately concluded that it will not adopt a consolidated tax adjustment that is shown to violate any provisions of the IRC.[211/] In rejecting the consolidated tax adjustment in the Avista case, the Commission identified a number of aspects of the IRC that a proponent should address to ensure that the IRC is not violated.[212/] ICNU structured its consolidated tax adjustment to only reflect the time value of PSE's taxable income loaned to the parent company, and not to recalculate a tax rate. This effectively circumvents many of these potential problems. Ms. Blumenthal's calculation does not: 1) inconsistently treat expenses, deferred taxes, or rate base; 2) flow through to ratepayers any benefits of accelerated tax depreciation; or 3) impact the calculation of the current provision for deferred taxes or the balance of accumulated deferred taxes.[213/] Similar consolidated tax adjustments have been adopted by other states, and they have been consistently found to be consistent with the IRC and not toviolate the IRC normalization requirements.[214/]

210/ Id. at 14:18-20.
211/ Docket Nos. UE-080416/UG-080417, Order No. 08 ¶ 33.
212/ Id.
213/ Blumenthal, Exh. No. EB-1CT at 10:20—11:6.
214/ Id. at 5:9—6:19; 10:14—11:6.

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87 PSE does not dispute that ICNU's proposal does not violate the IRC normalization requirements, but instead argues that the manner in which ICNU has calculated its adjustment is inconsistent with the IRC carry back/forward limitations, ignores changes in consolidated ownership, and ignores certain actual tax credits.[215/] ICNU used 10 years of data to provide a balanced adjustment that allows "loss" companies the opportunity to offset their own losses with taxable income, and to prevent cherry picking any subsidiaries or tax years to bias the adjustment in favor of either ratepayers or shareholders.[216/] ICNU prefers that 20 years of data be used, but recognized that such data may not be available and recommends that ten years of data be used to reflect "the ability of a company to go from a loss company to a gain company."[217/]

88 PSE argues that use of ten years of data is inconsistent with the tax laws, because the IRC does not allow for ten year carry backs.[218/] PSE misconstrues ICNU's adjustment, which is not designed to capture all tax savings or directly emulate the tax laws.[219/] Ms. Blumenthal is well aware of the two year IRC carry back provisions, and ICNU is not proposing any carry back or forwards, but rather that ten years of tax data be used to more fairly and accurately calculated the economic benefit that PSE ratepayers provide over time.[220/] The real reason that PSE opposes using ten or twenty years of data is that PSE produced losses in 2009 and 2010, and suggests that ICNU's tax adjustment

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215/ Marcelia, Exh. No. MRM-14T at 32:8—35:16, 40:1—41:8.

216/ Blumenthal, Exh. No. EB-1CT at 6:11—7:1, 8:1—9:10; see Docket Nos. UE-080416/UG-080417, Order No. 08 ¶ 31.

217/ Blumenthal, Exh. No. EB-1CT at 8:12—9:4.

218/ Marcelia, Exh. No. MRM-14T at 33:3—20.

219/ Blumenthal, Exh. No. 1CT at 8:23—9:4.

220/ Id. at 8:12—9:4.

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could result in PSE's customers paying shareholders.[221/] If for some reason ratepayers do not contribute to tax savings over the long-term, then ratepayers should not pay money to shareholders.

89 The Commission should adopt a tax adjustment based on ten or twenty years of data, because it allows loss companies to offset their losses with income in other years. PSE's proposal to use only one year of data would produce skewed and inaccurate results that would not reflect actual gains and losses experienced by companies. A ten or twenty year calculation period will also normalize and smooth out the adjustment by recognizing that companies can move from taxable loss to taxable gain from year to year.[222/]

90 Finally, PSE argues that ICNU's proposal does not reflect actual taxes because it does not include the alternative minimum tax ("AMT") or production tax credits.[223/] ICNU's proposal does not replicate actual taxes paid, but is instead based on taxable income reported to the government, which is before credits or adjustments.[224/] There is no double counting because, for example, the AMT is computed in a different manner and is essentially a prepayment.

221/ Marcelia, Exh. No. MRM-14T at 37:11—39:16.
222/ See Blumenthal, Exh. No. 1CT at 8:1—9:4.
223/ Marcelia, Exh. No. MRM-14T at 40:1—41:8.
224/ Blumenthal, Exh. No. 1CT at 8:23—9:4.

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4. Tax Sharing Agreements Are Irrelevant to a Consolidated Tax Savings Adjustment

91 PSE argues that the Commission should reject ICNU's consolidated tax adjustment because it "ignores the importance of tax sharing agreements."[225/] PSE is not objecting to ICNU's proposal specifically, but to any consolidated tax adjustment, which the Company states are "in direct contradiction of the tax sharing agreement adopted by the utility and its consolidated affiliates."[226/]

92 Tax sharing agreements address an entirely different issue, and should not govern whether a consolidated tax adjustment should be made.[227/] These are agreements among the consolidated group regarding how actual taxes will be paid, and provide protection if the parent company fails to pay its taxes.[228/] Tax agreements may not be reasonable from a regulatory standpoint and should not prevent a state regulatory commission from adopting a consolidated tax adjustment. In addition, a tax sharing agreement is not relevant, because Ms. Blumenthal's recommendation does not recompute taxes paid or attempt to capture actual tax savings.[229/] The fact that the Company does not specifically site to any provision of its tax agreement that would actually be violated demonstrates the weakness of PSE's position.[230/]

225/ Marcelia, Exh. No. MRM-14T at 24:13-14.
226/ Id. at 24:13—25:19.
227/ Blumenthal, Exh. No. EB-1CT at 4:14—5:1.
228/ Id.
229/ Id. at 5:15—6:19, 9:5-10.
230/ See Marcelia, Exh. No. MRM-14T at 24:13—25:19.

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F. The Commission Should Reject All the Decoupling Proposals

93 The Commission has been presented with three different decoupling proposals. These include the Company's limited decoupling CSA, NWEC's full decoupling proposal, and Staff's description of full decoupling presented in a response to Bench Request No. 3. All three proposals should be rejected, because none are fully supported or consistent with the Commission's decoupling standards.

1. The CSA is an Improper Limited Decoupling Mechanism that Violates the Matching Principle

94 The CSA rider will have the effect of increasing customer rates by approximately $2.4 million in the first year, beyond the $126 million overall rate increase PSE has requested.[231/] The CSA is another attempt to effect automatic rate increases through a creatively named limited decoupling mechanism. PSE disingenuously claims that "Parties Agree that PSE's CSA Proposal is Not Limited Decoupling."[232/] In fact, Staff quite simply states "the CSA is limited decoupling applied to electric operations;"[233/] Public Counsel notes that it is "most similar to a limited decoupling proposal" but fails to meet all of the Commission's requirements for such a mechanism;[234/] and ICNU describes it as similar to the mechanism rejected in 2009,[235/] which functioned as a limited decoupling mechanism.[236/] PSE is mischaracterizing the

231/ See Schoenbeck, Exh. No. DWS-1CT at 17:1-3.
232/ Piliaris, Exh. No. JAP-24CT at 3:11-12, 3:21, 10:3-4.
233/ Reynolds, Exh. No. DJR-1T at 3:12.
234/ Crane, Exh. No. ACC-1T at 8:13-17.
235/ Schoenbeck, Exh. No. DWS-1CT at 18:8-9.
236/ See WUTC v. PSE, Inc., Docket Nos. UE-090704/UG-090705, Order No. 11 ¶¶ 36-42 (April 2, 2010) (The Commission noted that the apparent reason that PSE refused to call the Conservation Phase-in Adjustment "decoupling" was that it was filed in violation of commitment not to propose decoupling for a two year period).

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positions of the other parties in an apparent attempt to circumvent the Commission's policy that limited decoupling is only appropriate for gas utilities. The CSA creates precisely the effect that the Commission wished to avoid, and can only be distinguished from limited decoupling by playing semantic games.[237/]

95 PSE states that the CSA is not a limited decoupling proposal; rather, it is lost revenue (or margin) adjustment mechanism ("LRAM"). It states that the "key distinction between an LRAM and the Commission's limited decoupling mechanism is that the LRAM is directly tied to utility-sponsored energy efficiency, whereas the Policy Statement's limited decoupling mechanism is tied to reductions in use-per-customer."[238/] Further, the Company claims that the Policy Statement does not address LRAMs, except in that it is receptive to "other mechanisms."[239/]

96 PSE's claims fly in the face of the plain language of the Policy Statement that defines a limited decoupling mechanism as a type of "lost margin recovery mechanism," stating "[i]t is precisely this type of mechanism – designed to protect a company from loss of earnings that are a 'direct result' of the companies' conservation programs . . . we endorse here for all gas utilities."[240/] The only distinction that can be drawn between the Commission's limited decoupling and PSE's description of its CSA is that the Commission used the word "recovery" rather than the word "adjustment" it its title. A limited decoupling mechanism, whether it goes by the acronym LRAM or

237/ See Policy Statement.
238/ Piliaris, Exh. No. JAP-24CT at 10:6-10.
239/ Id. at 10:13-16.
240/ Policy Statement at ¶ 17.

LRRM, serves the purpose of recovering revenue lost to utility-sponsored energy efficiency. For good reasons, the Commission confined this type of mechanism to gas utilities.

97 Notwithstanding PSE's artificial distinctions, both the CSA and PSE's 2009 mechanism do not conform to the matching principle, because they acknowledge only lost margin directly caused by conservation efforts.[241/] Rejecting the similar 2009 mechanism, the Commission explained that there are "two aspects to the consideration of offsetting factors."[242/] The first is whether an increase in expense (or in this case, an increase in conservation) produces any direct offsets, and the second is whether "offsetting factors – contemporaneous changes in revenues or expenses that are not directly related . . . offset its financial impacts."[243/] Thus, the matching principle demands that both direct offsets and indirect offsets in revenue must be considered in order to meet the goal of keeping revenues and expenses in relative balance.

98 This principle runs throughout the Commission's Policy Statement, which explains that limited decoupling or a lost margin recovery mechanism is inappropriate for electric utilities because lost and found margins are in better balance.[244/] Rather, the Commission prefers full decoupling proposals, because these proposals account for lost

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241/ Schoenbeck, Exh. No. DWS-1CT at 18:8-12.
242/ Docket Nos. UE-090704/UG-090705, Order No. 11 ¶ 27.
243/ Id. at ¶ 28(emphasis added).
244/ Policy Statement at ¶ 22.

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and found margin when revenues rise or fall relative to the test year, and may either produce a surcharge or refund to customers.[245]

99 PSE repeatedly ignores this explanation. First, PSE disputes the Commission's statement that the matching principle considers both direct and indirect offsets, saying that only revenue increases directly caused by conservation can properly be considered offsets or "found margin."[246] PSE disagrees with the Commission's use of the terms "lost margin" and "found margin" and ignores the purpose of the revenue matching principle: to assure that lost and found revenues are reasonably balanced to give the Company a fair opportunity to earn its authorized return.[247]

100 On the other extreme, Company witness Piliaris claims that the CSA does in fact consider found margin through application of its earnings test. He presents a novel argument that the earnings test implicitly considers found margin, because it would prevent recovery of lost margin through the CSA once PSE has reached its ROR.[248] This claim ignores the fact that the Commission limits lost and found margin to potential revenue fluctuations caused by sales levels. Mr. Piliaris essentially says that anything affecting the Company's achievement of its rate of return should be balanced against found margin. Thus, anytime the Company failed to earn at its ROR for whatever reason, even if the failure has no imaginable relationship to sales levels or conservation, customers would automatically be charged with a rate increase under the CSA. This

245/ Id. at ¶ 28.
246/ DeBoer, Exh. No. TAD-1T at 19:8-9.
247/ DeBoer, Exh. No. TAD-4T at 18:20-19:2.
248/ Piliaris, Exh. No. JAP-24CT at 12:10-19.

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absurd result is far from a reasoned balancing of lost and found revenues. As Mr. Schoenbeck states, the CSA is "yet another attempt by the Company to impose automatic rate increases on its customers with no corresponding tangible benefit."[249]

101 Regardless of PSE's misrepresentations and contradictory assertions, the parties agree that the CSA actually functions as a limited decoupling mechanism. Limited decoupling is only appropriate when both customers and use per customers are declining. The CSA is inappropriate for PSE, because it ignores the matching principle and the likely presence of found margin in an environment where customers are increasing and, despite conservation measures, revenue per customer is flat.

2. A Full Decoupling Mechanism Should Be Considered in a GRC When PSE Has Properly Requested It in Direct Evidence

102 Staff and NWEC presented full decoupling proposals in this docket that conform to some of the Commission's standards; nonetheless, ICNU agrees with Staff that these proposals are insufficient as a basis for instituting decoupling at this time.[250] The Commission should delay action on any potential decoupling for PSE, because there is no evidence that throughput incentive is restraining PSE's conservation efforts, and a full decoupling mechanism should be rigorously supported in a utility's initial rate case filing.[251]

103 Typically, the purpose of full decoupling is described as removing the "throughput incentive" that a company may have to push more, rather than less, energy

[249] Schoenbeck, Exh. No. DWS-1CT at 17:12-13.
[250] Staff Response to Bench Request No. 3 at 3; Deen, Exh. No. MCD-5T at 2:20-3:2.
[251] Policy Statement ¶ 28.

through its wires in order to increase revenues.[252/] In theory, decoupling could remove this throughput incentive, making it more likely a utility would pursue conservation. The Commission has stated that the purpose of considering decoupling is to "remove barriers to utilities acquiring all cost-effective conservation or to encourage utilities to acquire all cost-effective conservation."[253/] The decoupling mechanisms presented here would accomplish neither of these goals.

104 Washington law mandates conservation. The Energy Independence Act ("EIA") requires PSE to acquire all cost-effective conservation available to it. PSE has not demonstrated that any barriers are preventing it from acquiring all cost-effective conservation; in fact, PSE claims that no throughput incentive is constraining it in this case.[254/] The EIA requires PSE's conservation target to include <u>all</u> cost-effective conservation available, and given the penalties for failing to reach this target, PSE does not need further incentive. In the words of the Commission, "the EIA already provides ample incentive."[255/]

105 This means that neither NWEC's decoupling proposal nor Staff's mechanism would have any actual effect on PSE's conservation efforts because they would neither remove existing barriers nor supply a needed incentive. The only change decoupling would likely bring is greater certainty of revenue to the Company regardless

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252/ Cavanagh, Exh. No. RCC-7 at iv.
253/ Policy Statement ¶ 12.
254/ DeBoer, Exh. No. TAD-4T at 9:11-14, 10:10-11.
255/ Policy Statement ¶ 24.

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of quality of service, economic conditions, or changes in customer use. The cost of this certainty would be borne by ratepayers.

106 ICNU also agrees with Staff that the Commission "does not have sufficient time or record in this docket" to approve full decoupling.[256/] PSE did not present a full decoupling proposal in direct testimony; therefore, neither the parties nor the Commission have been able to appropriately consider any proposal that provides "sufficient detail" to adopt decoupling.[257/] While Staff felt that its own proposal was insufficiently detailed for decoupling to be adopted, it was a far more comprehensive description of a mechanism than NWEC's proposal.

107 Further, the NWEC proposal failed to use a revenue-per-class true up, as called for by the Commission in the Policy Statement.[258/] This serious flaw is shared by the NWEC and Staff proposals, and would result in PSE's revenue requirement being raised when new customers are hooked up, rather than recognizing that marginal profit from growing sales should first be considered found margin that offsets margin lost to conservation.[259/] NWEC's proposal also departs from the Commission's Policy Statement in that it does not tie recovery under decoupling to a conservation test, nor does it reflect the risk shifting characteristics of decoupling in the Company's ROE or capital structure.[260/]

256/ Reynolds, Exh. No. DJR-3T at 16:11.
257/ Staff Response to Bench Request No. 3 at 3.
258 Cavanagh, Exh. No. RCC-1T at 9:7-10
259 Deen, Exh. No. MCD-5T at 9:1-15.
260/ Reynolds, Exh. No. DJR-3T at 4:2-3.

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108 Given that so few examples of full decoupling exist, the Commission has stressed the importance of carefully crafting a decoupling mechanism and has required that a utility provide evidence of a mechanism's effect on ROE, proper accounting for off-system sales, and discussion of what customer classes ought to be included, among other factors.[261/] Because the burden fell to Staff to consider full decoupling for PSE, the evidence on the record for these and other questions is sparse, at best. Both NWEC and Staff present options that are inconsistent with the Policy Statement on several key issues, and there is insufficient information in the record to build a well-designed decoupling mechanism. As Staff further points out, a full decoupling should only be considered in conjunction with revisions to the Company's PCA.[262/]

3. Any Potential Decoupling Should Not Include Industrial Customers

109 The Commission should reject the CSA and decline to decide on the question of full decoupling until it is requested and defended in direct testimony. Yet, if decoupling is approved for PSE, industrial customers should be excluded, and the Commission should reduce PSE's cost of capital.[263/]

110 The Commission has noted that a decoupling proposal would generally cover all customer classes, but there might be reasons that it would be in the public interest for some classes to be excluded.[264] Because industrial customers create only 4.5% of PSE's fixed costs, but account for 14% of its sales, industrial customers would

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261/ Policy Statement ¶¶ 16, 18-19.
262/ Reynolds, Exh. No. DJR-3T at 16:12-13.
263/ ICNU's decoupling cost of capital proposal is addressed in Section C.
264 Policy Statement ¶ 18.

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end up subsidizing other classes in a decoupling mechanism.[265/] Industrial customers are far more affected by economic changes than by utility conservation. This means that under a full decoupling scheme, during periods of economic slowdown, they will be punished for reducing their loads in response to lowered demand, not conservation. Given their unique load shapes and service requirements, and the small size of the class, industrial customers are at far greater risk of punitive prices during a slow economy.

111 PSE itself indicates that industrial rate classes have a minimal impact on fixed cost recovery – potentially less than 1%.[266/] Because of the importance of industrial employers to the economy of Washington, it is not in the public interest to put industrial customers at risk through decoupling, particularly because little or no conservation benefits would be realized by including them.

112 Finally, the decoupling proposals in this case also fail to address the unique characteristics of PSE's industrial customers that purchase power on the market. PSE has no throughput incentive to sell more electricity to retail wheeling customers, because it does not sell electricity to them. Retail wheeling customers pay for conservation in separate tariffs, and participate in a unique and highly successful self-direction program. Decoupling could harm the self-direction program by increasing these customers' rates when they conserve electricity, which may cause customers to decide not to invest in conservation.

265/ Deen, Exh. No. MCD-5T at 4:17-19.
266/ Id. at 5:1-5.

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G. Staff's Expedited Rate Case Proposal Should Be Rejected

113 The Commission should reject Staff's proposal to allow PSE to file an expedited rate case immediately following this case to address the so called problem of regulatory lag or attrition.[267/] Staff's proposal is designed to address problems that have not been shown to exist. First, given that PSE has a power cost adjustment mechanism, files numerous deferred accounts, has an automatic storm damage deferral, recovers its conservation costs in separate tariff riders, and has been filing near annual general rate cases, there is no evidence that the Company is experiencing any regulatory lag. Second, as Staff notes, PSE has not filed an attrition study or provide evidence "demonstrating that attrition exists, and, second, quantifying its impact on the rate of return."[268/] Finally, Staff's proposal is not fully developed, as is demonstrated by the fact that PSE opposes its adoption at this time.[269/] There are a large number of unknown issues regarding Staff's short proposal, including what (if any) issues would be appropriate to review on an expedited basis, whether it would apply to other utilities, how to conduct discovery, and what the cost baselines should be.[270/] Staff's proposal is not yet ready for prime time, and should be more thoroughly vetted and reviewed before the Commission seriously considers any new form of expedited rate case.

267/ Elgin, KLE-1T at 80:15—84:6.
268/ Id. at 80:5-13.
269/ TR. 544:2—545:12 (DeBoer/Commissioner Jones).
270/ Crane, ACC-5T at 11:20—16:6.

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IV. CONCLUSION

114 PSE has proposed a greatly inflated rate increase that warrants significant revisions by the Commission. PSE has approached this large $126 million rate increase with a business as usual approach, and is apparently unaware of the significant harm its filing will have upon its customers that are struggling in the current difficult economic times. For example, PSE has ignored recent Commission precedent on cost of capital issues, and is proposing a huge increase in its equity ratio and return on equity. PSE is also refusing to make all but the most obvious and required changes in its power costs, apparently in a effort not to compromise or leave any unnecessary dollars on the table. The Commission should significantly reduce PSE's rates to send a strong message that this type of large rate increase that departs Commission practices and policies is inappropriate.

Dated this 16th day of March, 2012.

Respectfully submitted,

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