BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKETS UE-111048 and UG-111049 (*consolidated)*

BRIEF OF PUBLIC COUNSEL

MARCH 16, 2012

REDACTED VERSION

TABLE OF CONTENTS

I. INTRODUCTION 1

II. PRUDENCE OF LOWER SNAKE RIVER PHASE 1 2

A. Overview. 2

B. Applicable Law -- The Prudence Standard. 3

C. PSE Has Failed To Establish A Need For LSR 1. 6

1. PSE has no need for additional renewable resources in 2012 and no need until 2016 at the earliest. 6

2. PSE's "need" showing relies entirely on its economic analysis. 6

D. PSE Has Failed To Show By A Preponderance Of The Evidence That LSR 1 Is Cost Effective 7

1. The 2010 RFP process and analysis overview. 7

2. The forecasted LSR 1 benefits were *de minimis*. 9

3. 2010 RFP Analysis runs of the PSM model contained significant errors that made the results unreliable. 12

4. PSE's overall end effects methodology incorrectly assumes wind resources would not be replaced 13

5. Other factors bearing on the validity of the cost-effectiveness analysis. 15

a. Addendum to Appendix M. 15

b. The "Comments" Tab. 18

c. The PSM III model was untried and untested. 19

d. The estimated benefit of LSR 1 is inflated by use of an unreasonably high capital cost estimate for generic wind resources. 20

e. PSE did not adequately consider its REC alternatives 22

(1) PSE's failed to adequately model purchasing RECs as a long term strategy to comply with the RPS. 22

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(2) It was not prudent for PSE's analysis to ignore REC banking provisions or to disregard the possible availability of RECs from the Southern California Edison 2 contract....26

E. The Board Was Not Properly Informed and Involved....28

F. Other Considerations Bearing on PSE's Prudence....31

1. PSE's analysis and decision making were influenced by its early commitment to the Lower Snake River project....31

2. PSE's RFP process did not comply with Commission rules....32

3. Subsequent events should not be given weight to demonstrate prudence....35

4. The treatment of the Treasury Grant is not before the Commission....36

G. Summary of Public Counsel Prudence Analysis....37

III. LSR 1 IS NOT "USED AND USEFUL"....38

A. Applicable Law - Used & Useful Rule....38

B. LSR 1 Is Not Used and Useful Because It Does Not Provide Net Benefits To Customers Until 2016 At The Earliest....38

C. Public Counsel Disallowance Recommendation....42

IV. CONSERVATION SAVINGS ADJUSTMENT (CSA)....42

A. PSE's Proposed CSA Mechanism....42

A. The CSA Is Not Consistent With The Guidance In The Commission's Policy....43

B. The CSA Unfairly Shifts Risk to Customers....46

C. The CSA Does Not Advance Conservation Goals....46

D. The Savings Estimates Proposed For Use With The CSA Were Never Intended To Be Used To Directly Set Rates....47

E. Verification Of Savings Remains Unclear....48

F. There Are Several Additional Problems With The CSA....49

1. The CSA double counts some lost revenue....49

2. It is not clear whether PSE would treat the CSA as a "cost" of energy efficiency. 49

3. If adopted, the CSA should be a line item on customer bills. 50

4. The Home Energy Report (HER) program should be excluded from the CSA if adopted. 51

G. PSE's Power Supply Load Forecast Incorporates Excessive Conservation Savings. 51

V. FULL DECOUPLNG 52

A. Overview. 52

B. NWEC's Proposal Has Multiple Drawbacks. 54

VI. EXPEDITED RATE MAKING MECHANISM 56

VII. REVENUE REQUIREMENT ISSUES 58

A. Return Adjustment on Chelan Deferred Carrying Charges. 58

B. DFIT Repairs and Retirements. 59

C. Net Operating Loss. 60

VIII. SQI-9 DISCONNECTION RATIO 62

A. The SQI-9 Disconnection Ratio Should Be Reinstated Because It Creates Incentives For PSE To Work With Ratepayers To Avoid Disconnections. 62

IX. PUBLIC COMMENTS 66

A. Written Public Comments. 66

B. Public Hearings. 67

X. CONCLUSION 68

TABLE OF AUTHORITIES

Cases

In re Illinois Power Company,
101 PUR 4th 525 (Illinois Commerce Commission 1989) 40

Iowa-Illinois Gas & Elec. Co. v. Iowa State Commerce Comm'n,
347 N.W. 2d 423, 429 (1984) 40

Madison Gas & Electric Co. v. Public Service Commission of Wisconsin,
109 Wis. 2d 127, 135-136, 325 N.W. 2 d 339, 343-344 (1982) 40

POWER v. WUTC,
101 Wn.2d 425, 430, 649 P.2d 425 (1984) (citing Webster's Third New International Dictionary, 2524 (1976)) 38

US WEST Communications, Inc., v. Washington Utilities and Transportation Commission,
134 Wn.2d 74, 126-27, 949 P.2d 1337, 1363 39

Statutes

RCW 19.285 *et seq* 5

RCW 19.285.040(1) 46

RCW 19.285.040(2)(a) 22

RCW 19.285.040(2)(e) 26

RCW 19.285.050(2) 5

RCW 80.04.130(4) 4, 65

RCW 80.04.250 38

Other Authorities

In Re Pacific Gas and Electric Co.,
288 P.U.R. 4th 299, 2011 WL 1143091 (Cal. P.U.C. 2011) 25

Rules

WAC 480-107-015 32

WAC 480-107-015(2)(b) 34

WAC 480-107-135 32

WAC 480-107-135(1) 33

WAC 480-107-135(3) 33, 35

Treatises

Leonard S. Goodman,
The Process of Ratemaking, 857 ..... 4, 5

UTC CASES

In the Matter of Puget Sound Energy, Inc.'s, Proposed Request for Proposals,
Docket No. UE-091618, Order No. 1, December 23, 2009 34

In the Matter of the Application of Puget Sound Power & Light Co,
Docket Nos. UE-951270, UG-960195, 14th Suppl. Order Accepting Stipulation;
Approving Merger (February 5, 1997) 63

In the Matter of the Washington Utilities and Transportation Commission Inquiry on Regulatory Treatment for Renewable Energy Resources, Report and Policy Statement Concerning Acquisition of Renewable Resources by Investor Owned Utilities,
Docket No. UE-100849 (January 3, 2011) 5, 22

In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives, Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets, Docket U-100522, (November 4, 2010) 43, 45, 46

PSE 2007 Integrated Resource Plan,
Docket Nos. UE-071063, UG-071074, WUTC Acknowledgment Letter, p. 2
(November 13, 2007) 11

Washington Utilities and Transportation Commission v. Puget Sound Energy,
Docket UE-031275, Order 14, pp. 17-18 42

Washington Utilities and Transportation Commission v. Puget Sound Energy,
Docket Nos. UE-090704, UG-090705, Order 11 ¶ 197 59

WUTC v. PacifiCorp,
Docket No. UE-050684, Order No. 04, ¶ 50 (April 17, 2006) 38

WUTC v. PacifiCorp,
Docket No. UE-050684, Order No. 6 Denying PacifiCorp's Petition for
Reconsideration, ¶ 50 (July 14, 2006) 38

WUTC v. PacifiCorp,
Docket UE-100749 (*PacificCorp 2010 GRC*) Order 06, n.378 59

WUTC v. Puget Sound Energy Co.,
Docket Nos. UE-072300, UG-072301, Order 16 (Aug. 31, 2010) 63

WUTC v. Puget Sound Energy Co.,
Docket Nos. UE-072300, UG-072301, Order 14 (Nov. 13, 2009) 63

WUTC v. Puget Sound Energy,
Docket No. U-110808, Complaint (October 26, 2011) 64

WUTC v. Puget Sound Energy, Inc.,
Docket No. U-111465, Complaint (December 14, 2011) 64

WUTC v. Puget Sound Power & Light,
Docket Nos. UE-920433, UE-920499, UE-921262 (consolidated),
11th and 19th Supplemental Orders ..... passim

I. INTRODUCTION

1. Puget Sound Energy's (PSE) 2011 general rate case is the twelfth request for a rate increase since 2000, with requests totaling well in excess of $1 billion over that time. PSE's appetite for increases has not slackened through the depths of the worst economic downturn experienced in Washington state since the Great Depression. While 20 percent of its customer base is now classified as low income, PSE continues to state publicly that its pace of nearly annual rate case filings will continue.

2. The case currently before the Commission, however, could have been avoided. The requested rate increase is driven almost entirely by two discretionary items: the decision to pursue construction of an $830 million wind project not needed until 2016 or later, and the decision to seek higher returns for the investor-owners. Absent these two components, there would have been little reason for this case.

3. Public Counsel focuses significant attention in the brief addressing PSE's requested finding of prudence for the Lower Snake River Phase 1 (LSR 1) project, by far the largest component of the proposed increase. PSE has not shown that LSR 1 is necessary or cost-effective. PSE's Board of Directors was not adequately informed of critical information and not sufficiently involved in this important decision. PSE's decision to proceed with this large wind project was not prudent and the project is not used and useful.[1]

4. In addition to the general rate request, PSE seeks a Conservation Savings Adjustment surcharge which would further increase gas and electric customer rates. The Northwest Energy Coalition (NWEC) makes an alternative "full decoupling" proposal. Public Counsel recommends that both be rejected as not consistent with the Commission's policy guidance in this area, or with the interests of PSE's customers.[2]

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[1] Public Counsel and the Industrial Customers of Northwest Utilities jointly sponsored Scott Norwood's testimony regarding LSR 1. The LSR 1 portion of the brief is filed on behalf of both parties.

[2] Public Counsel and The Energy Project jointly sponsored the testimony of Andrea Crane on the CSA and NWEC decoupling proposals. The CSA and decoupling portion of the brief are filed on behalf of both parties.

5. This brief also addresses two important tax issues, and recommends that the Commission reinstate PSE's service disconnection ratio (SQI-9), rather than permanently eliminating the metric as proposed by the Company and Staff.

II. PRUDENCE OF LOWER SNAKE RIVER PHASE 1

A. Overview.

6. LSR 1 was an $830 million discretionary investment made by PSE during a period of major economic and regulatory uncertainty arising from the world-wide financial crisis in late 2008. PSE's 2010 decision, made nearly six years before LSR 1 was needed to meet I-937 renewable portfolio standard (RPS) requirements, was based on a seriously flawed economic analysis that was marred by errors and unreasonable assumptions. The primary model relied on by PSE had never been used before to analyze a major resource and was undergoing continual updating and corrections to address problems even after the LSR 1 recommendation was sent to the Board.

7. The forecasted net benefits of LSR 1 were insubstantial, and customers would see no financial benefit for the first 10 to 20 years of the project. Even without consideration of the flawed analysis, the total net benefit PSE calculated for LSR 1, including the tax benefits, was too small to represent a reliable projection, given the uncertainty of forecasting savings with accuracy over the decades-long time frame of PSE's analysis.

8. Several key items of information were never presented for Board consideration, although known to PSE staff and management. PSE never seriously or thoroughly considered the option of purchasing renewable energy credits (RECs) instead of building its own project, which could have been far more economical, and less risky, for customers. PSE's analysis for the Board did

not reflect the most current information on declining capital costs, which had the effect of exaggerating the benefits of "early wind."

9. For these reasons, Public Counsel recommends that the Commission find that the LSR 1 decision was not prudent and that the project is not used and useful for purposes of full inclusion in rates. Public Counsel recommends a conservative level of disallowance of $55 million based on an estimate of the additional cost expected to be incurred due to early wind additions, based on Company estimates during its LSR 1 analysis. This partial disallowance will allow PSE a reasonable level of cost recovery for the plant while also recognizing the excessive costs imposed on customers by the early pursuit of this self-build option.

B. Applicable Law -- The Prudence Standard.

10. The Commission detailed the factors to be considered in evaluating prudence in what has come to be known as the *Puget Prudence Case*.[3] Under the standard enunciated in that case, the elements required to establish prudence are:

> (1) The utility must first determine whether new resources are necessary;[4]
>
> (2) Once a need has been identified, the utility must determine how to fill that need in a cost effective manner. When a utility is considering purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself;[5]
>
> (3) The utility must analyze the resource alternatives using current information that adjusts for such factors as end effects, capital costs, impact on the utility's credit quality, dispatchability, transmission costs, and whatever other factors its planning and good practice will disclose need specific analysis at the time of an acquisition decision.[6]

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[3] *WUTC v. Puget Sound Power & Light,* Docket Nos. UE-920433, UE-920499, UE-921262 (consolidated), 11th and 19th Supplemental Orders (*Puget Prudence Case).*
[4] *Puget Prudence Case,* 19th Suppl. Order, p. 11.
[5] *Id.*
[6] *Id.* at 37, 48.

> (4) The utility should inform its board of directors about the purchase decision and its costs. The utility should also involve the board in the decision process;[7] and
>
> (5) The utility must keep adequate contemporaneous records of its decision process which will allow the Commission subsequently to evaluate its decisions.[8] The Commission should be able to follow the utility's decision-making process, knowing what elements the utility used, and the manner in which the utility valued these elements.[9]

The company bears the burden of proving its decisions with respect to these elements were prudent[10] by a preponderance of the evidence.[11]

11. An evaluation of prudence is done without the benefit of hindsight.[12] Accordingly, the test is "what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made the decision."[13] "This test applies both to the question of need and the appropriateness of the expenditure."[14]

> The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made.[15]

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[7] *Id.* at 37, 46.
[8] *Id.* at 37.
[9] *Id.* at 17.
[10] RCW 80.04.130(4).
[11] *Puget Prudence Case,* 19th Suppl. Order, p. 9.
[12] *Id.* at 65.
[13] *Id*; Leonard S. Goodman, *The Process of Ratemaking*, 857.
[14] *Puget Prudence Case,* 11th Suppl. Order, p. 20.
[15] *Puget Prudence Case,* 19th Suppl. Order, p. 10.

Elaborating on this test, Leonard S. Goodman explained that "[t]he overriding issue is not the reasonableness of the cost in the abstract but a reasonable and prudent business expense, which the consuming public may reasonably be required to bear."[16]

12. While this case involves acquisition of a renewable resource in the context of the Energy Independence Act (EIA),[17] the EIA did not repeal the "prudence" and "used and useful" standards. The Commission has issued a *Renewables Resource Policy Report* addressing "prudence" and "used and useful" standards for resource acquisitions under the EIA.[18] The EIA affirms the continuing applicability of the prudence standard,[19] and the Commission's discussion of these standards in the context of EIA acquisitions relies on existing Washington precedent. Those existing precedents were the guidance in place when PSE's management and Board of Directors made their decision to go forward with LSR 1 prior to the Commission's policy statement on renewable acquisition. While the Commission has found early acquisition of resources to be prudent in some circumstances, as discussed in the *Renewables Resource Policy Report,* it is not the rule in Washington that "any renewable resource, at any time, at any cost" is prudent or used and useful. A utility must still establish that the acquisition is cost-effective and a benefit to customers, as well as meeting the other elements of the prudence test, and demonstrating the overall reasonableness of the decision.

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[16] Leonard S. Goodman, *The Process of Ratemaking*, 857.
[17] RCW 19.285 *et seq.*
[18] *In the Matter of the Washington Utilities and Transportation Commission Inquiry on Regulatory Treatment for Renewable Energy Resources,* Report and Policy Statement Concerning Acquisition of Renewable Resources by Investor Owned Utilities, Docket No. UE-100849 (January 3, 2011)(*Renewable Resource Policy Statement).*
[19] RCW 19.285.050(2) ("utility is entitled to recover all prudently incurred costs associated with compliance").

C. PSE Has Failed To Establish A Need For LSR 1.

1. PSE has no need for additional renewable resources in 2012 and no need until 2016 at the earliest.

13. In order to show that its decision to initiate operation of LSR 1 at this time was prudent, PSE must establish that it has a need for the new resource, in other words that it is "necessary" for LSR 1 to go on line and to be included in rates in 2012 in order to meet a proven resource need.

14. The record is clear in this case that PSE has no need for LSR 1, or other new renewable resources in 2012. PSE does not dispute this, freely acknowledging in the rebuttal testimony of Roger Garratt that "PSE understood that its RPS need would not exist until 2016 at the earliest."[20] Mr. Garratt's rebuttal further states that PSE decided to construct LSR 1 to meet the RPS requirement for 2016, not an earlier date, and it concedes that the 2012 in-service date is "ahead of the 2016 requirement."[21] PSE has not cited any regulatory decision from Washington or other jurisdictions which approved the placement of a resource into rates four years or more in advance of need, under any theory.

2. PSE's "need" showing relies entirely on its economic analysis.

15. Whether PSE's RPS need arises in 2016 or later, because PSE cannot show that it has an actual need for resources to meet RPS requirements in 2012, and not for several years to come, it must base its prudence case on a different theory – the proposition that it is cost-effective for PSE to acquire the wind resource early, ahead of actual need, and place it in rates. For PSE in

[20] Exh. No. RG-28CT, p. 19:18-19.
[21] *Id.*, p. 12:10-14. *See also* Exh. No. AS-3HC, p. 8-9.

this case, the "need" element of the prudence test is, therefore, fully dependent on its ability to show by a preponderance of the evidence that early development of LSR 1 is cost-effective.[22]

16. Cost-effectiveness is also a showing that must be made under the prudence standard, whether or not a resource is being acquired early. The next section of the brief addresses the cost-effectiveness issues.

D. PSE Has Failed To Show By A Preponderance Of The Evidence That LSR 1 Is Cost Effective.

17. PSE claims that its economic analyses demonstrate that its early investment in LSR 1 was cost-justified. In support of this assertion, in its initial case, PSE pointed to four primary studies it conducted: (1) the 2009 IRP; (2) the 2009 IRP "Re-run"; (3) the Discounted Cash Flow (DCF) analysis; and (4) the 2010 Request for Proposals (RFP) process.[23] In it rebuttal testimony, PSE now characterizes the 2010 RFP Analysis as the "definitive analysis" which ultimately was relied on by the PSE Board to approve LSR 1.[24] In light of PSE's de-emphasis of the earlier analyses,[25] Public Counsel's brief will focus on the 2010 RFP Analysis.[26]

1. The 2010 RFP process and analysis overview.

18. The cost-effectiveness analysis presented to the Board of Directors on May 5, 2010, was based on an accelerated RFP process conducted in the period between March 2 and April 22, 2010. The process differed from PSE's standard approach in that PSE ordinarily would have

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[22] Garratt, TR. 167:4-168:8. Exh. No. RG-28CT, p. 12:8-p.14:22 (discussing need and early acquisition).
[23] Seelig Direct, Exh. No. AS-1HCT, pp.19:1-26:5; Garratt Direct, Exh. No. RG-1HCT, pp.6:23-8:2, 12:1-13:10. *See also*, Exh. No. AS-9 CX.
[24] Exh. No. AS-4HCT, p. 2:1-3; Seelig, TR. 226:1-6;Garratt, TR. 168:17-21. Staff witness David Nightingale echoes the PSE argument minimizing the importance of the earlier analyses. Exhibit No. DN-2T, p. 8:17-21.
[25] Exhibit No. AS-4HCT, p. 10:5-6 ("PSE did not make a recommendation to the PSE Board of Directors to construct LSR Phase 1 based on these analyses.").
[26] Public Counsel focuses on the economic and quantitative analysis of LSR, rather than the qualitative discussion. If the resource is not cost-effective, then the qualitative components of the analysis are not relevant.

conducted a clearly delineated two-phase analysis requiring approximately six months to complete. In this case, however, PSE collapsed the two phases of the 2010 RFP Analysis into one process, conducted in a substantially shorter time period.[27]

19. Although the Phase II economic analysis was by design a more rigorous and in-depth process, including "optimization" and review of multiple scenarios[28] using the PSM III model, the only quantification of cost-effectiveness benefits from LSR 1 that was presented to the PSE Energy Management Committee (EMC) and Board was based on a single base-case scenario from the "Phase 1" PSM I model economic analysis of LSR 1.[29]

20. The 2010 RFP Analysis process produced two elements which were presented to the PSE Board, and are now presented to the Commission, to demonstrate cost-effectiveness in this case:

(1) the results of the PSM I screening model, which quantified the portfolio benefit[30] associated with the acquisition of LSR 1 under a single base-case scenario, and

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[27] Exh. No. AS-3HC, p. 23, Figure 14 (standard RFP) and p. 26, Figure 15 (accelerated RFP). Phase 1 was a preliminary and discrete screening phase, using PSM I, a simplified production cost screening model, designed to generate a short list of projects for further analysis. Under normal circumstances this screening analysis would have been conducted between March and May 2010. Phase 2 of the RFP, ordinarily consisting of an in-depth rigorous due diligence analysis of the short-listed proposals, interaction with bidders, review of various "uncertainty" scenarios (e.g. "2010 Trends" and "Low Growth"). In addition to this qualitative analysis, PSE would conduct a quantitative "optimization" analysis using the more sophisticated PSM III production cost simulation model. Phase 2 of the RFP would ordinarily have required from May until August to complete, at which time results would have been presented to the Energy Management Committee and to the Board sometime after that. Seelig, TR. 219-221 (regarding models).

[28] These scenarios incorporate a number of cost and risk variables, such as natural gas prices, load growth, carbon prices, and resource capital costs, associated with multiple potential futures, resource combinations and the timing of resource additions. Exh. No. AS-1HCT, p.17:4-18:15.

[29] Seelig, TR. 286:15-25 (only "savings" number was derived from the PSM I model, from a single scenario, 2010 Trends). The term "savings" refers to the portfolio benefit. The single scenario was "2010 Trends."

[30] Exh. No. AS-1HCT, p. 13:12-20. Portfolio Benefit is the difference between the net present value portfolio revenue requirement with a proposed project, and the net present value portfolio revenue requirement of the generic portfolio strategy. A positive portfolio benefit means that the proposed project yields lower cost to the portfolio than a comparable "generic" resource. A negative portfolio benefit indicates the proposed resource is more expensive than a generic resource. Portfolio benefit measures the difference between total system cost (including LSR 1 + other wind bids) vs total system cost with "all generic" wind resources.

(2) the results of the PSM III v. 13.6 optimization model, which only provided an indication of whether a resource was selected as part of an optimized portfolio.[31] This analysis did not provide the Board with an LSR-only benefit number to quantify cost-effectiveness.[32]

Both of these analyses had significant flaws. As discussed further below, at the time of the Board decision, PSE staff was aware of at least one error in both of the analyses, but there is no record that the errors were presented to, discussed, or considered by the Board in it decision on May 5, 2010.[33]

2. The forecasted LSR 1 benefits were *de minimis*.

21. PSE acknowledges that the only quantified cost-effectiveness analysis in the 2010 RFP Analysis and presented to the Board of Directors to support its decision on May 5, 2010, was the portfolio benefit calculation in the "Phase 1" PSM I analysis.[34] The figure presented to the Board was $68 million.[35] Due to the acknowledged errors in PSE's modeling discussed in detail below, this number is not reliable and, in fact, represents an inflated forecast of the potential benefits. However, even if the Company's quantification is accepted at face value, this level of

[31] Exh. No. RG-13HC, pp.20-21.
[32] Nightingale, TR. 365:11-366:2; Exh. No. AS-26 CX; Seelig, TR. 275:22-25, TR. 277:4-8 (not LSR 1 only), TR. 286:13-14 (optimization does not create "savings" number) .
[33] As discussed below, PSE did not update the PSM I results. Exh. No. AS-20 CX and AS-21 CX. The updated results of the PSM III optimization model (version 13.9) were only "available for discussion" but were not presented to the Board. *See,* Exh. No. AS-59 CX.
[34] Seelig, TR. 285:1-286:25. Exh. No. AS-59 CX.
[35] Exh. No. AS-1HCT, Table 9. Throughout the materials provided to the Board for the May 2010 meeting, the Company included the PSM I portfolio benefit calculation of $68 million in sections of the presentation discussing the PSM III optimization model results, without explanation of the source of the figure.[35]

net estimated benefits of LSR 1 represents less than 0.5 percent[36] of PSE's total forecasted system portfolio costs over a 50 year analysis period.[37]

22. The cost-effectiveness analysis conducted by PSE, including the PSM I benefit presented to the Board, takes into account the full value of the tax incentives relied on by PSE to justify the project.[38] Even with these tax benefits, the cost-effectiveness result is so minimal in comparison to the total portfolio cost that it is not meaningful. It is simply not possible to forecast savings or benefits with that degree of accuracy over a 50 year period, or even a 20 year period. Even with the best of models and input assumptions, there is an inherent level of uncertainty in the modeling process. PSE's own witnesses have conceded this point, as have the witnesses for Staff and other parties.[39] As Ms. Seelig conceded at the hearing: "It's difficult to look at – to know with accuracy what a resource or what a portfolio is going to cost from the stand point of how it's going to interact with the market for 20 or 50 years; however, that's why we conduct a scenario analysis. We do a wide range of scenarios."[40]

23. Indeed, the Commission itself commented on concerns regarding the unreliability of long-range forecasting in its letter acknowledging PSE's 2007 IRP. The Commission noted that the quantitative analysis in the IRP found that the cost differences between the individual

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[36] $68.8 million divided by the 2010 Trends portfolio cost in $13.992 billion (Exh. No. AS-1HCT, Table 13) is equal to approximately 0.49 percent.

[37] The 50-year analysis period includes the 20-year planning horizon, and an end effects evaluation period for years 21-50. *See,* Exh. No. SN-1CT, p. 41:20-42:12.

[38] Exh. No. AS-3HCT, p.43. The proposed price included in the screening was based on pricing based on capturing the grant.

[39] Exh. No. AS-31 CX, Exh. No. DN-8 CX, Exh. No. MWD-15 CX, Exh. No. EDH-15 CX.

[40] Seelig, TR. 224:5-15. As discussed above, however, the only quantified benefit was based on a single scenario.

portfolios was small:

> Indeed it appears that only 2 to 3 percent separates the total cost of the least cost portfolio and the median cost portfolio for each future scenario. *Given the uncertainties associated with any projection of the future cost of fuel and generating infrastructure, the Commission wonders whether the calculated cost differences are meaningful.*[41]

24. In addition, based on PSE's own modeling data , it is clear that the benefits, if any, do not materialize until near the end of the LSR's forecasted 25-year service life. PSE's analysis of the cost-effectiveness of early wind additions shows that early wind is significantly more costly than postponing wind additions until needed for RPS requirements for all scenarios evaluated over the next 10 years, and for half of all scenarios over the next 20 years.[42]

25. While the forecasted benefits of LSR 1 are very small and uncertain, if the project is approved what is certain is that PSE's customers will be paying an additional $120 million per year in higher rates than they would otherwise pay if LSR 1 were not constructed early. PSE argues this is justified in order to achieve a total benefit of $68 million, a benefit which is speculative at best, particularly given the known errors discussed below. While it may be argued that up-front costs are always higher for large capital investments, while benefits, by definition, come later, this view only makes sense if there is clear evidence that the project is cost-effective overall, over a wide range of scenarios, which is not the case for LSR 1.

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[41] *PSE 2007 Integrated Resource Plan,* Docket Nos. UE-071063, UG-071074, WUTC Acknowledgment Letter, p. 2 (November 13, 2007)(Emphasis added).
[42] Exh. No. SN-1CT, p. 4, Figure 1 (Early Wind Benefits/(Cost) vs. No Early Wind.

3. 2010 RFP Analysis runs of the PSM model contained significant errors that made the results unreliable.

26. It is undisputed that the PSM modeling results presented to the Board of Directors on May 5, 2010, contained errors.[43] Primary among these was the "end-effects trending" error. [44] PSE staff identified the error after approval of LSR 1 at the April 22 Energy Committee Meeting and the finalization of materials for the May 2010 Board meeting.[45] This error significantly impacted the forecasted market wind revenues in the model outputs.[46] PSE's "end-effects trending" error drove the wind revenues in the model runs significantly higher. For example, in 2036, the final year of LSR's 25-year life, the wind revenue value used for PSM I portfolio benefit calculation was approximately **[Begin Highly Confidential]** XXXX **[End Highly Confidential]** higher than the wind revenue amount included in the corrected optimization analysis conducted after April 22.[47]

7. Because the primary economic value of wind resources is the value of energy displaced by wind energy, this error has the effect of significantly increasing the value of the wind resource in the run being modeled, in this case LSR 1.[48] Although the error was discovered prior to May 5, 2010, PSE did not correct the PSM I model run used to develop the portfolio benefit figure

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[43] Exh. No AS-20 CX, Exh. No AS-22 CX, Exh. No AS-24 CX. *See also,* Exh. No. AS-77 HC CX.
[44] This problem emerged from a trend function used by PSE that exaggerated the relative difference between market prices and costs. Later, in the PSM III 13.9 model, this trend function was replaced with a method that tied the escalation to inflation. Exh. No. AS-5HC, p.4.
[45] Exh. No. AS-4HC, p. 11; Exh. No. AS-5HC; Exh. No. AS-75HC CX, p. 9 (entries for April 23, 2010, re "changed trending functions in the end effects.")
[46] The "wind revenue" in the model answers the question: "But for the wind resource, what would we have had to pay for energy?" A high "wind revenue" number indicates that the wind is more valuable.
[47] Exh. No. AS-77 HC CX, p. 2. The magnitude of this error is evidence by the fact that in later years the wind revenue values rise to over **[Begin Highly Confidential]** XXXXXXXXX **[End Highly Confidential].** At the hearing, Ms. Seelig confirmed that at a market price of this magnitude would cause her to take pause. Seelig, TR. 270:12-14.
[48] Exh. No. SN-1CT, p. 32:4-8.

that had been presented to the Board.[49] The error rendered the estimate of benefit both unreliable and overstated.[50]

28. The end-effects analysis contained a second error. This error was the result of PSE staff incorrectly entering carbon price information into the model.[51] This error was discovered by PSE in August 2011, when preparing a response to discovery.[52] As a result, the PSM I modeled savings results also incorporated this error, which has never been corrected.

4. PSE's overall end effects methodology incorrectly assumes wind resources would not be replaced.

29. The Commission has identified the "end effects" analysis as a required part of the resource analysis required to demonstrate the prudence of a resource acquisition.[53] End effects represent the estimated remaining value of generating resources beyond the period evaluated in resource planning studies. End effects are often considered when comparing resource plans that include plant additions that occur at different times during the planning period.[54] The end-effects analysis is particularly important in the case of LSR 1 because in many of the scenarios of the

[49] PSE did not re-run the PSM I model (which had been altered to include LSR as an "existing resource" after approval by the EMC on April 22). Exh. No. AS-20 CX. In Exh. No. AS-21 CX, the Company states that it "tested" the effect of correcting the trending error in the PSM III model prior to the Board meeting, and because the recommendation did not change under the PSM III model, they did not rerun the PSM I model. The problem with this approach is it assumes that the accuracy of the portfolio benefit that was produced by the PSM I model was not relevant to the analysis of whether to proceed with the development of LSR 1.

[50] The PSM III v. 13.6 model run which generated the optimization results included in the Board presentation, also included the errors described above. PSE's runs of PSM III version 13.9, which corrected for this problem after April 22, had dramatically lower wind benefits than the PSM I run, over **[Begin Highly Confidential]** XXXXX **[End Highly Confidential]** lower by the later years of the analysis. Exh. No. AS-77HC CX, p. 2. There is no evidence the Board was aware of any of the "corrected" runs after April 22.

[51] Exh. No. AS-77HC CX, p. 2 (Years 2024-2029); Seelig, TR. 268:21-269:3, AS-14HC-CX, AS-15 CX.

[52] Exh. No. AS-38 CX.

[53] *Puget Prudence Case*, 19th Supp. Order, pp. 37, 48.

[54] Exh. No. SN-1CT, p. 41:14-17.

earlier studies PSE conducted analyzing early wind, such as the 2009 IRP re-run, benefits did not begin to appear until after the first 20 years[55] and were small.

30. As just discussed, PSE's end-effects analysis for LSR 1 involved a serious "trending" error. In addition, however, PSE's end-effects analysis also had a basic methodology problem. PSE assumed in its analysis that wind resources that were retired after the 20 year evaluation period would not be replaced.[56] This assumption ignores the fact that PSE would need to maintain approximately 1100 MW of wind generation to meet its RPS requirements after 2029 in all scenarios. By failing to replace units that are required during the end-effects period, PSE's method creates a mismatch between the level of wind in the end-effects evaluation period as between the "early wind" and "no early wind" scenarios.[57]

31. This results in two effects: (1) the "no early wind" scenario has higher end-effects costs because it has to add resources later; and (2) at the same time, end effects for "early wind" scenarios are understated because their units are retired earlier during the end-effects period. The overall result of this mismatch is to overstate the benefit of early wind by approximately **[Begin Confidential]** XXXXX **[End Confidential]** on a present value basis,[58] favoring PSE's preferred strategy of early wind acquisition.

32. PSE in rebuttal acknowledges that the end-effects methodology recommended by Scott Norwood is a reasonable approach.[59] The Company defends its own approach with the argument that it has used the same approach used here since 2003.[60] Subsequent to 2003, however, there

[55] Exh. No. SN-1CT, Tables 1 and 2.
[56] Exh. No. AS-62 CX.
[57] Exh. No. SN-1CT, p. 41:18-42:8.
[58] Exh. No. SN-1CT, pp. 41-42; Exh. No. SN-11C.
[59] Exh. No. AS-4HCT, p.32:6-7.
[60] Exh. No. AS-61 CX.

has been a key change in the law, namely the passage of I-937. As a result of I-937, instead of replacing an expiring renewable resource with the next least cost resource of any type, it must now replace the resource with the another renewable resource that would allow the Company to continue to meet its RPS requirement. By not adopting this assumption, PSE's end-effects analysis creates a mismatch between existing legal requirements and the theoretical future practices of the Company.

5. Other factors bearing on the validity of the cost-effectiveness analysis.

33. The cost-effectiveness analyses PSE relied on in this case to make its decision contained additional serious problems, often known to PSE staff.[61] These cast further doubt on whether PSEs analysis was a reliable basis for the LSR 1 recommendation to the Board of Directors.

a. Addendum to Appendix M.

34. In rebuttal, for the first time in testimony, PSE affirmatively disclosed that it had continued to run the PSM III v. 13.6 optimization model after April 22 to address the effect of PTC extension and to address some questions about the model.[62] A memorandum detailing this activity, entitled "Addendum to LSWRP Appendix M – Development Plan" (hereafter "Addendum" or "memorandum") was attached to Ms. Seelig's rebuttal.[63]

35. The Addendum describes analysis "not completed in time either for the April EMC meeting or for the Board documents on Lower Snake River Wind Project that were posted and

[61] The majority of the errors in PSE analysis in this case were identified by Public Counsel in discovery and through the analysis of Public Counsel's expert power cost witness, Scott Norwood. PSE has acknowledged the thorough analysis performed by Mr. Norwood and its value to the case. Exh. No. RG-28CT, p. While seeking to minimize the significance of Mr. Norwood's conclusions, PSE has not challenged the accuracy of Mr. Norwood's key analyses. The Company did not conduct any cross-examination of Mr. Norwood, and did not object to the introduction of "summary" exhibits which he prepared to demonstrate key flaws in model results. (Exh. No. AS-74HC CX, Exh. No. AS-76HC CX, and Exh. No. AS-77HC CX.).
[62] Exh. No. AS-4HC, p. 11.
[63] Exh. No. AS-5HC.

sent to Board members on April 22."[64] The Addendum has two components. First it describes the effect of the federal tax incentives on the LSR 1 cost-effectiveness analysis. Second , it describes updates to the model made to "improve the robustness of the linear optimization model"[65] which led to the discovery of some errors.

36. Prior to April 22, the possibility of an extension of the Production Tax Credit (PTC) had not been modeled for inclusion in the EMC or Board materials (i.e. the expiration of the PTC was treated as 100 percent certain in the modeling).[66] When PSE staff decided to conduct a PTC extension analysis after April 22, PSE staff "discovered several data and logic issues" with the PSM III optimization model.[67] PSE made "corrections" to address these issues, as listed and described in the Addendum.[68]

37. In the notes for PSM III v. 13.9, [69] the Addendum reflects that during this process the PSE staff identified the "end effects trending" problem discussed in detail above. The memorandum notes that the error had the effect of tending to "exaggerate the relative difference between market prices and costs," in other words, exaggerating the benefits of early wind in the model run. This is consistent with the impact of the end-effects trending error shown in Exh. No. AS-77 CX and discussed above.

38. This additional review also identified a problem with the "optimization logic" of the PSM III model.[70] However, PSE staff overrode the optimization function and forced the model to

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[64] Exh. No. AS-5HC, p. 1.
[65] *Id.*
[66] Exh. No. AS-4HCT, p.11:11-12 This also represents a prudence issue, as discussed in Mr. Norwood's testimony. Exh. No. SN-1CT, p. 38:12-17.
[67] Exh. No. AS-5HC, p. 3.
[68] *Id.* The Addendum mentions, for example, that "hand testing found more optimal solutions"; "data errors" were discovered; and analysts "corrected wind acquisition end effects."
[69] Exh. No. AS-5HC, p. 4.
[70] Exh. No. AS-5HC, p. 4.

select LSR 1 under the Low Growth with Base Capital scenario.[71] A version of the Addendum contained in Ms. Seelig's workpapers contained the additional statement that "PSE analysts continue to explore reasons why the PSM III model does not always find the optimal solution."[72]

39. In summary, this evidence in the Addendum reflects that the PSM III optimization model was still being developed and that there were multiple problems and errors which affected the model outputs on which the Board presentations were based. PSE staff had to attempt to address these issues in a short window of time in advance of the May 5, Board Meeting. PSE argues that these errors did not change the outcome because the model selected the resource for the optimized portfolio. But PSE cannot reasonably rely on such an opaque analysis, particularly for a decision of this magnitude. The Board should have been provided quantified measures of cost-effectiveness from the PSM III optimization analysis. Instead, they were presented with conclusory binary results—cost-effective/not cost-effective—produced from a "black box" model.[73] The PSM III optimization model selected a resource as cost-effective whether the net benefit of the resource was one dollar or $1 million. The model results presented to the Board did not provide information about the margin or degree of cost-effectiveness. By itself, this did not and does not demonstrate cost-effectiveness for prudence purposes.

40. Given that LSR 1's margin of cost-effectiveness, as analyzed in PSM I, was already razor thin, PSE management's obligation, knowing of the end effects and the optimization logic problems, was to inform the Board of these issues, and to provide quantifications of the changed

[71] Seelig, TR.241:18-242:6; TR. 242:2-3 ("We put it in as a choice that it couldn't choose not to make.").
[72] Exh. No. AS-73HC, p. 6. This document was provided to all parties as part of Ms. Seelig's workpapers, however, it does not appear it came to any party's attention until a version was filed as Exh. No. AS-5.
[73] In Exh. No. AS-5, these binary results appear as an "X" in a box.

impact on benefits, so that the Board could decide the significance of these factors and make an informed decision with full knowledge of the important facts.

b. The "Comments" Tab.

41. Additional evidence of the still-evolving nature of the PSM III optimization model during the LSR 1 analysis is reflected in the model's "Comment Tab", found in the record as Exh. No. AS -75HC CX. This exhibit includes a record of the various changes made to the PSM III model dating from January 2010 to April 26, 2010, and the dollar impact of the changes.[74] While such a "comments tab" is frequently a standard feature of a model, allowing users to track changes and adjustments, Ms. Seelig testified that this comment log was "unique because PSM III had never been run for an RFP" and was still in development.[75] Many of the changes noted result from identification of "errors" and resulted in "corrections" to the model. The financial impact of the changes was substantial in many cases.

42. The "Comments Tab" exhibit reports 17 modifications to the PSM III optimization model between April 22 and April 26, including references for April 23 showing changes made to address the "end effects trending" error.[76] The changes on April 23 for the PSM III v.13.9 optimization model, for example, impacted the power supply portfolio cost by approximately **[Begin Highly Confidential]** XXXX **[End Highly Confidential]**.[77] Changes of this magnitude make the significance of the small benefit number presented to the Board seem highly unreliable. On their face, these modifications indicate that the model and its optimization logic

[74] The "Comments Tab" also tracks changes and corrections to prior versions of the PSM model going back to August 2009.
[75] Seelig, TR. 248:23-249:3.
[76] A comparison of the list of "data and logic" issues in the Addendum and the changes shown on the Comments tab exhibit that occurred during the post-April 22 period reveals that the list in the Addendum is essentially a summary of what is included in the comments tab. Seelig, TR. 254:19-20.
[77] Exh. No. AS-75HC, p. 9.

had problems and was a work in progress during the short time frame in which the 2010 RFP Analysis of renewable resources took place.

c. The PSM III model was untried and untested.

43. The PSM III model was new to PSE and has never been used by PSE in a prior rate case.[78] This case represents the first time PSE has used the PSM III model to perform an optimization analysis for a major resource acquisition in an RFP process.[79] The key aspects of the PSM III model used by PSE in this case were developed by and are proprietary to the Company.[80] Because it is proprietary to PSE, no other utilities use PSM III.[81] As a result, PSM III could not have been tested or verified by other parties prior to the Board decision.

44. Although benchmarking is a method of validating the accuracy of a model, PSE has not benchmarked the PSM III optimization model, in terms of its output functions, arguing that its situation is too unique to make benchmarking worthwhile.[82] The numerous revisions that were necessary to update and to correct errors and other problems reflected in the record is particularly concerning, given the untried and unverified nature of the model. The hurried analytic and decision-making schedule which PSE chose to pursue did not allow sufficient time to work out

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[78] Seelig, TR. 290:6-8. During cross-examination regarding the "Comments Tab" exhibit, Ms. Seelig stated that the model was not actually working until January 19, 2010, Seelig, TR. 253:19-20, and that at least as of November 2009, "nothing was tested and verified." TR. 250:2-3.

[79] Seelig, TR. 288:1-4, 290:9-10.

[80] Seelig, TR. 288 (financial calculations are proprietary). On redirect (Seelig TR 335:17-337:5) Ms. Seelig stated that the PSM III model is basically PSM I—the Company's own propriety model—with the addition of the Front Line Systems optimizer, which is a third-party-created, off-the-shelf tool. The fact that the optimizer was developed by a third party does not absolve the concerns with how it was functioning. Even with PSE's Microsoft Excel-based PSM I model, the veracity of its outputs depends upon the accuracy and reasonableness of the Company's data inputs, assumptions and constraints. Furthermore, PSE's own testimony indicates that the application of this third-party-developed tool to its required months of development and adjustments on the part of the Company. Seelig, TR. 252:14-19, 253:19-20.

[81] Seelig, TR. 289:5-6.

[82] Seelig, TR. 290:19-24, 291:7-10. Mr. Nightingale also argues that "benchmarking" is not necessary to validate the accuracy of the PSM III model. Exh. No. DN-8 CX.

the problems with the model prior to the Board decision. This provides more reason to question the reliability of the "cost-effectiveness" evidence provided to the Board, and relied on by PSE in this case.

d. The estimated benefit of LSR 1 is inflated by use of an unreasonably high capital cost estimate for generic wind resources.

45. PSE's portfolio benefit estimate for LSR 1 was calculated by comparing the cost of the project to the estimated cost of generic wind resources.[83] At the time PSE was preparing this forecast of LSR 1 benefits in April 2010, wind turbine costs were decreasing.[84] Notwithstanding the decreasing trend in wind turbine prices, in quantifying the estimated benefits of LSR 1, the Company used data from a prior period that did not adequately reflect the changes in the market.

46. The outdated nature of the assumptions for the "base" wind generic capital costs[85] is clear from information included in Ms. Seelig's workpapers, which shows that the generic wind costs were based in part on information from earlier vintage wind projects.[86] These costs were not updated to reflect lower capital costs for similar projects at the same site that were received in the 2010 RFP. In the case of one of the projects, the capital costs were as much as **[Begin Highly Confidential]** [redacted] **[End Highly Confidential]** lower.[87]

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[83] Seelig, TR. 286:20-25.
[84] Garrett, TR. 201:15-17. Mr. Garratt's Direct testimony confirms that the market has remained "soft" and that prices have continued to decline. Exh. No. RG-1HCT, p.71:3-5.
[85] As shown in Exh. No. AS-1HCT, Table 2 three of the five scenarios evaluated relied upon the base capital cost assumptions (2010 Trends, BAU, and Low Growth+Base Cap Ex) Only the Low Growth scenario relied upon the a "low" capital cost assumption.
[86] Exh. No. AS-12 CX provides a general reference to the Phase I generic resource capital assumptions in Ms. Seelig's workpapers. The source in the workpapers for the capital cost assumptions is the same for Phase I and Phase II, as described in Exh. No. AS-13 CX.
[87] The generic cost was based in part on information from a **[Begin Highly Confidential]** [redacted] **[End Highly Confidential]** (*See*, Exh. No. AS-12 and AS-13 for workpaper citation, Tab: WindCapEx) However, in response to the 2010 RFP, PSE received **[Begin Highly Confidential]** [redacted]. **[End Highly Confidential]** (*See*, Exh. No. AS-78HC, Disc 4 of 7, Folder: AS-WP (HC) Renewable Phase I, File: 14-

47. Given the downward trend in wind turbine prices, at a minimum, PSE should have updated "base" assumptions with up-to-date market data. By doing this, PSE's portfolio benefit analysis would have more reasonably reflected the trend in wind turbine prices and would have provided a more realistic comparative estimate of the benefit of LSR 1.[88] The fact that the Company's forecasted benefit of LSR 1 was only $68 million, even after assuming a significant capital cost advantage over generic wind resources, provides a further basis to question the economic benefit of LSR 1.

48. Additionally, the optimization results for the Low Growth scenario, which contained lower capital cost assumptions for generic wind,[89] indicated that LSR 1 was not an optimal resource.[90] This result raises questions as to what the result might have been if PSE's base generic capital costs had properly reflected declining costs, or if PSE had taken additional measures to ensure that its analysis adequately reflected the trends in the turbine market. The Commission's prudence standard requires a company to use "current information" in its resource analysis.[91] However, PSE did not model for presentation to the Board scenarios in which generic wind resource capital cost continued to decline, despite the trend at that time.[92] It is noteworthy, therefore, that on June 9, shortly after the Board decision, in preparation for the capacity phase of

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2_Results Summary_Renewable_v1.xls, Tabs: **[Begin Highly Confidential]** XXXXXXXXXXXXXXX XXXXX **[End Highly Confidential]**.

[88] The Portfolio Benefit analysis was derived from the 2010 Trends scenario, which used the "base" (rather than "low" or "high") capital cost assumptions. See, Exh. No. AS-1HCT, p. 17.

[89] The Low Growth scenario assumed capital costs roughly 15 percent below those of LSR. Exh. No. AS-1HCT, p.18:2

[90] Exh. No. AS-1HCT, p.27, Table 7.

[91] *Puget Puget Prudence*, 19th Suppl. Order, pp. 37, 48.

[92] Garratt, TR. 202:8-13.

the 2010 RFP evaluation, PSE updated its generic wind capital cost assumptions,[93] reducing them to the level assumed for LSR 1 in earlier analysis.[94]

e. PSE did not adequately consider its REC alternatives.

(1) PSE's failed to adequately model purchasing RECs as a long term strategy to comply with the RPS.

49. The Energy Independence Act (EIA) provides utilities with the alternative of purchasing RECs as a means of complying with the RPS requirements of the Act. The applicable language states:

> Each qualifying utility shall use eligible renewable resources *or acquire equivalent renewable energy credits, or a combination of both*, to meet the following annual targets;[95]

Consistent with the statute , the Commission's Policy Statement specifically states that "[a] utility may comply with the EIA by purchasing renewable energy credits (RECs)."[96] The Commission has recognized that a utility may "select REC purchase as its primary means of meeting its RPS" provided the company can demonstrate that this option results in "more economic benefits than acquiring a renewable resource."[97]

50. In his direct testimony, Mr. Norwood identifies PSE's failure to fully consider this option as a deficiency in the Company's analysis, [98] noting that PSE could have met its RPS requirements through 2020 without LSR 1 at a much lower cost, based on the Company's

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[93] Exh. No. AS-3HC, p. 174. In discovery, Public Counsel inquired as to what impact this changed assumption would have had on the cost-effectiveness of LSR 1, and PSE responded that since the update was made "a full month" after LSR was approved, PSE did not conduct this analysis. Exh. No. AS-33 CX.

[94] Exh. No. AS-23 CX. The information in this discovery response allows for a comparison between the PSM I v.14.2 model (used for the renewable phase of the evaluation) and the PSM I v.14.6 model (used for the capacity phase of the evaluation in July 2010). PSE used the same generic capital cost assumptions in both the PSM I and PSM III models. Exh. No. AS-12 CX.

[95] RCW 19.285.040(2)(a)(Emphasis added).

[96] *Renewable Resources Policy Report*, ¶ 48.

[97] *Id.*

[98] Direct Testimony of Scott Norwood, Exh. No. SN-1T, p. 43:4-15 (December 7, 2011).

forecast.[99] Failing to consider this option resulted in PSE's over estimate of the benefits of acquiring new wind energy projects early, such as LSR 1, by approximately **[Begin Confidential]** XXXXXXX **[End Confidential]**."[100]

51. In rebuttal, PSE responds that it did evaluate REC purchases as an alternative.[101] PSE argues that the 2010 RFP called for submission of proposals for unbundled RECs, that a limited number were received, which, after analysis, were found to be inadequate to meet PSE's needs.[102] PSE also argues with the REC price estimated in Public Counsel's testimony.

52. There are a number of problems with PSE's position. First, while PSE certainly evaluated the responses it received to its RFP, the RFP itself did not directly and clearly seek "just in time" REC proposals for 2016. While the RFP states that the Company has a renewable energy need as of 2016, this statement is immediately followed by a statement that PSE's recommended acquisition strategy was to add 300 MW of wind in 2012.[103] The specific request asked for "RECs that will be produced beginning in year 2011 or later."[104]

53. At the time of the RFP, bidders were clearly aware that PSE not only had excess RECs in advance of the 2016 RPS deadline, but was also selling its excess RECs into the market.[105] Prior to any actual need for the renewable credit, REC contracts would add all cost and no benefit to a

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[99] *Id.* at p. 43:7-8. Mr. Norwood calculated estimates using Company data including a cost of $8/REC.
[100] *Id.* at p. 43: 13-5 citing Exh. No. SN-12C.
[101] Exh. No. AS-4, p. 36.
[102] Exh. No. AS-4, pp.36-37.
[103] Exh. No. RG-5, p. 24.
[104] Exh. No. RG-5, pp. 29, 79.
[105] See, for example, Exh. No. RG-38, PSE's 2007 Petition for Accounting Order (Renewable Energy Credits and Emission Reduction Allowances). Additionally, it was public knowledge that PSE was in the development process for LSR, which could have also impacted the number of and size of renewable bids that the company received in response to the RFP. See, for example, Exh. No. RG-39, Excerpt of Prefiled Direct Testimony of Roger Garratt, Docket No. UE-090704 .

portfolio, and thus would be unlikely to be selected.[106] PSE asked for resources that, on their face, would impose only cost and no value for the early years of the proposals.

54. PSE received a limited number of bids for unbundled RECs in response to the RFP. Even so, a few bids offered attractive prices, including one that was competitive enough to make it to short list the Renewable Phase II evaluation [107] Since PSE was conducting an RFP to meet an actual need that was over five years away, it is not surprising that the Company did not receive a large enough number of REC-only bids to meet that need, especially in light of the parameters of the solicitation. In addition, as a practical matter, any bid from a project not ready to be operational by 2011-2012 faced a serious challenge in any qualitative comparison with LSR 1.

55. Second, PSE did not actually do a full economic modeling analysis of meeting the RPS requirement with REC purchases. PSE's modeling analysis of the limited universe of specific offers received in the RFP is not a substitute for a thorough modeling of the REC purchase option. PSE's rebuttal points to no evidence that PSE considered an "all REC purchase" approach at any earlier point in the process, prior to the 2010 RFP. In light of the REC market and PSE's own forecasts of the prices of RECs, the Company should have modeled a generic REC purchase option or other separate evaluation of the REC-only option, outside of the RFP responses, to determine whether REC-only purchases could cost-effectively meet some or all of the renewable need.[108]

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[106] See Exh. No. RG-13HC, p. 203. The REC proposal evaluated in the Phase II PSM III evaluation was only selected in one scenario, because the optimization model chose to add resources beyond the RPS need, Thus, "the REC contract only adds additional cost to the portfolio."

[107] Exh. No. AS-1HCT, p.34. See, Exh. No. AS-46HC CX for prices.

[108] This would have been particularly useful in combination with REC banking. In addition, its important to recall that until late 2009, PSE was prepared to go to the Board without an RFP, and hence without any consideration of

56. Lastly, PSE disputes the $8/REC price used by Mr. Norwood in his analysis, even though it was PSE's own figure. Ms. Seelig argues that it is a proxy modeling price for surplus RECs, not a price in a compliance market. PSE does not offer an alternative price except to point to the prices in the RFP proposals, which were submitted in response to a narrowly drawn RFP, as discussed above. While higher than $8/REC,[109] all of those prices are significantly below the cost of LSR 1[110] and therefore would have supplied PSE's REC requirements at a fraction of the cost it proposes to recover for LSR 1.

57. In addition to disregarding the potential cost savings from the REC purchase option, the self-build strategy pursued by PSE has the effect of shifting the risk of lower than estimated wind energy production from project owners and their shareholders to ratepayers. The California Public Utilities Commission (CPUC) recognized this in a decision denying a Certificate of Public Convenience and Necessity to PG&E for a major wind project. [111] The CPUC pointed out that the cost analysis "is potentially the most complex matter" at issue when determining whether to build a wind generating facility, "as it is not based on one formula or mutually agreed upon methodological approach."[112] Because the ratepayers would "pay a lump sum cost rather than a performance-based cost" any event or instance that causes lower than expected generation has

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unbundled RECs bid into an RFP. PSE does not claim that any other consideration of the REC purchase option occurred, other than the 2010 RFP. Exh. No. AS-4HCT, pp. 36-40.

[109] Exh. No. AS-46HC CX.

[110] This argument also ignores the fact that Mr. Norwood's analysis assumed that only a modest volume of REC purchases would be necessary to supply PSE's relatively small forecasted REC shortfalls that would be expected to occur in 2018, 2019 and 2020 in the event LSR 1 was not constructed. These shortfalls could easily be supplied by a single wind generation facility and therefore represent a conservative (i.e., low) estimate of the surplus RECs that are likely to be available for purchase by PSE in this timeframe.

[111] *In Re Pacific Gas and Electric Co.*, 288 P.U.R. 4th 299, 2011 WL 1143091 (Cal. P.U.C. 2011)(page citations in text to Westlaw internal pagination).

[112] *Id.* at 11.

the effect of increasing the project's levelized cost of energy.[113] CPUC concluded that the project posed an "unacceptable risk to ratepayers."[114]

(2) It was not prudent for PSE's analysis to ignore REC banking provisions or to disregard the possible availability of RECs from the Southern California Edison 2 contract.

58. The record in this case raises serious questions as to whether LSR 1 is even needed to meet RPS requirements in 2016. PSE admits that its economic analysis of LSR 1 did not take REC banking into account. [115] In fact, until PSE contracted, in **[Begin Highly Confidential]** XXXX **[End Highly Confidential]**, to sell **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** of RECs to California (the "Southern California Edison (SCE) 2" contract), the prudent use of the REC banking provisions[116] would have allowed PSE to delay the date new renewable resources were needed until 2018 or later.[117] PSE does not dispute this analysis as a factual matter.[118] Instead PSE argues simply that, because the SCE 2 contract had been signed prior to the May 5, 2010, Board of Directors approval of LSR, it "would have been inappropriate, *at that time*, for PSE to rely on the banking provisions of those RECs to meet its RPS obligations in 2016."[119]

59. It was imprudent for PSE's economic analysis to adopt the assumption with 100 percent certainty, throughout all the LSR 1 analysis, that the SCE 2 contract RECs would not be available. At the time the PSE Board made its LSR decision, the SCE 2 contract was not a

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[113] *Id.* at 7.
[114] *Id.* at 1.
[115] Exh. No. SN-7.
[116] RCW 19.285.040(2)(e).
[117] Exh. No. SN-1CT, p. 24, Figure 4. This contract was signed at the same time as PSE was concluding its 2009 IRP, which recommended the acquisition of early wind. There is no indication that PSE modeled REC banking in its 2009 IRP. Exh. No. RG-3.
[118] Exh. No. RG-28CT, p. 15:1-8.
[119] *Id.* (Emphasis added).

certainty. It was not operative, and was awaiting approval by the California Public Utility Commission (CPUC).[120] The SCE 2 contract contained a contingency provision permitting termination of the contract by June 2010, only a month after the Board meeting, if CPUC approval was not received. Furthermore, well before the Board's meeting to consider LSR 1 there was uncertainty regarding the SCE 2 contract due to regulatory changes in California that went into effect after the contract was signed.[121]

60. Notwithstanding this fact, PSE management did not provide the Board with any analysis or modeling of a scenario under which the SCE 2 contract would terminate, and the RECs assumed to be sold under the contract would be available to meet RPS requirements.[122] There is no evidence this contract uncertainty was discussed with or presented to the Board at the May 5, 2010 meeting. Mr. Garratt stated at the hearing that he was not sure to what extent the Board was aware of the terms of the contracts and that there was no place in his testimony or exhibits that could provide evidence that this information went to the board.[123] In discovery, the Company characterized the contract termination issue as too "granular" for the Board.[124] It was not prudent for PSE disregard the REC banking provisions and the SCE 2 contract uncertainty in its economic analysis of need and "cost-effectiveness," since these factors could have delayed the need for new wind resources until 2018 or later.[125]

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[120] Exh. No. RG-28CT, p. 16:10-17:2.
[121] *See*, for example, Exh. No. RG-1HCT, p. 58:10-14. Because of these changes it was possible the contract would not be approved because it would not provide an RPS-eligible resource to SCE.
[122] Exh. No. AS-71 CX.
[123] Garratt, TR. 196:22-24, 197:7-9.
[124] Exh. No. RG-37 CX.
[125] As explained in Mr. Garratt's testimony, the CPUC officially rejected the SCE 2 contract in December 2011. Exhibit No. RG-28CT, p. 17:1-2.

E. The Board Was Not Properly Informed and Involved.

61. In addition to establishing need and cost-effectiveness, PSE must also show that its Board of Directors was informed and involved in the decision to proceed with development of LSR 1.[126] The record in this case does not reflect that this requirement was met.

62. It is important first to view the Board's decision in context, in terms of the sequence of events around the Board decision. The key event, for purposes of examining Board involvement is the May 5, 2010, Board meeting. Indeed, the decision could not have occurred earlier because, according to PSE, the "definitive analysis", the 2010 RFP Analysis, upon which the Board decision was assertedly based had only recently been conducted, between March 2 and April 22.[127] PSE originally planned to seek Board approval for LSR at the January 2010 meeting, however, the decision was postponed to allow for LSR to be compared against the results of the 2010 RFP Analysis, which would be conducted in a modified and accelerated format.

63. The materials that were presented to the Board were finalized on April 22, the same day as the Energy Management Committee meeting. Thus, it was apparently assumed to be certain, or at least highly likely that the EMC would approve LSR 1, that no new questions would arise, no new analysis would be required, and consequently that the Board materials could be prepared without waiting for the result of the EMC. This suggests that either the EMC or the Board meeting or both were treated as relative formalities.

64. Against the backdrop of short timelines and modeling problems, the record shows that the

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[126] *Puget Prudence Case*, 19th Supp. Order, pp. 37, 46.

[127] PSE is now taking the position in rebuttal that the earlier analyses it conducted were not viewed as a sufficient basis to go forward with LSR 1.

information provided to the Board on May 5, 2010, did not include important information bearing directly on the cost-effectiveness and prudence of the LSR 1 project. PSE has failed to provide evidence that the PSE Board of Directors was informed of, or involved in any discussion of the following items that could have been, but were not provided:

- The existence of the "end effects trending error" discovered after April 22 and its impact on estimates of cost-effectiveness.
- A "re-run" of the PSM I model to generate a new "savings" (net benefit) number, correcting for the "end effects trending error," which would have shown a reduced savings number.
- The "optimization logic" problem, including the fact that (a) it caused the model to not select LSR 1 under some circumstances, and (b) that PSE staff were continuing to investigate why the model did not select optimal solutions.
- Analysis that updated the "generic wind" assumptions to reflect up-to-date information about declining capital costs (due to the declining cost of wind turbines) in all model scenarios.
- The possible termination of the SCE 2 contract within 30 days under its contingency clause, and any related modeling of a scenario in which the additional RECs would be available to meet RPS need.[128]
- Information to enable the Board to determine the margin of cost-effectiveness shown by the results of the PSM III "optimization" modeling, rather than the binary results of the "black box" model runs.

[128] Exh. No. RG-37 CX. This information was viewed as too "granular" to present to the Board, even though it had the potential to postpone PSE's RPS need by several years.

- A full economic modeling analysis of the option of meeting RPS requirements entirely with REC purchases.

65. The Board minutes do not provide any evidence that any discussion occurred at the Board meeting with respect to any of the above items, or with regard to the cost-effectiveness of the LSR 1 investment in any respect. The minutes reflect only that the board discussed the construction schedule, risks to that schedule and consequences of any delays, the payment schedule for the project's various components and the impact of such spending on the Company's capital budgets, and strategies for recovery of costs (particularly the interconnection costs) through the regulatory process.[129]

66. This conclusion is further borne out by a statement of Roger Garratt at the hearing. When asked whether the Board had been made aware of the post April 22 analysis described in the Addendum, Mr. Garratt responded that he wouldn't have expected such a discussion to occur, since the Board had already had many discussions about LSR 1 and "the discussion was not as long as – certainly not as long as what it might have been if this were the only time that they had a discussion on this topic."[130] This statement is surprising, given PSE's description of the process in its written testimony, which disclaims the significance of the earlier analyses in 2009 and is careful to specify that the decision was not made until after the "definitive" 2010 RFP Analysis.[131] Furthermore, the Board could not have discussions at prior meetings about the Addendum contents, which had only been generated since April 22.

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[129] Exh. No. RG-33HC CX, pp.4-5. There is also no evidence that the PTC extension scenario, which staff made a special effort to model after April 22, was discussed or inquired about.
[130] Garratt, TR. 347:23-348:15.
[131] Exh. No. AS-4HCT, p.2:1-3 and p. 10:5-6 (the May 2010 recommendation was not based on the earlier analyses).

67. All of the matters enumerated were known to PSE management and staff prior to and at the time of the Board meeting. With knowledge that the portfolio benefit calculation had a known error in it and that its new and untested model was producing errors that affected the magnitude and reliability of its cost-effectiveness results, PSE management nevertheless decided not to provide information about the problems to the Board, instead portraying the results of the model runs to the Board as highly reliable. By deciding to withhold this information and the other listed information from the Board, PSE staff and management substituted their own judgment for that of the Board, and effectively prevented the Board from being fully informed and involved in the LSR 1 decision.

F. Other Considerations Bearing on PSE's Prudence.

1. PSE's analysis and decision making were influenced by its early commitment to the Lower Snake River project.

68. PSE traces its commitment to an "early wind" strategy to 2006,[132] with approval provided by the Board of Directors in 2007.[133] PSE's initial direct investment in the Lower Snake Project dates back to December 2008 when it acquired a one half interest in the development rights.[134] By August 2009, PSE had increased its commitment to LSR 1 by acquiring 100 percent of the development rights.

69. Rate case testimony filed in PSE's s 2009 GRC reported that PSE planned to go forward with the project in 2011.[135] By fall 2009, PSE had determined it was prepared to take the LSR 1 project to the Board for final construction approval in January 2010, prior to the 2010 All-Source

[132] PSE has not updated this strategy since its inception, despite changes in the economy and wind market. Exh. No. RG-42 CX.
[133] The strategy was approved by the Board of Directors in August 2007, when projections showed that the Company would first need renewable energy to meet I-937 in 2016. Exh. No. RG-7HC.
[134] Exh. No. RG-1HCT, p. 29:13-15.
[135] Exh. No. RG-39 CX, p. 22.

RFP evaluation.[136] While PSE postponed this recommendation to the Board, and ultimately decided to analyze LSR alongside bids received in response to its RFP,[137] PSE's standard RFP two-phase analysis process was collapsed into a truncated seven-week span. Pursuant to its early wind development strategy, PSE had invested over **[Begin Confidential]** XXXXXXXX **[End Confidential]** in the LSR 1 project,[138] and at least **[Begin Confidential]** XXXXXXXX **[End Confidential]** on the Lower Snake River project as a whole.[139]

70. This chronology of events reflects that PSE had made substantial legal, financial, and operational commitments toward proceeding with the LSR 1 project well in advance of the cost-effectiveness analysis relied on in this case, and well in advance of the May 2010 Board meeting. It would not be unreasonable to conclude that the decision making of the Board of Directors and senior PSE management was influenced by this sequence of events, with momentum favoring continued investment, with less flexibility for an impartial analysis of changing circumstances.

2. PSE's RFP process did not comply with Commission rules.

71. Pursuant to WAC 480-107-015, a utility may participate in its own RFP bidding process as a power supplier, on conditions described in WAC 480-107-135. If it does participate, the utility must declare its participation to other bidders and must demonstrate how it will satisfy the requirements of WAC 480-107-135. Under the latter rule, if a utility obtains unfair advantage in the RFP process, the Commission may disallow all or part of the costs associated with the

[136] Exh. No. RG-1HCT, p. 48:5.
[137] Exh. No. RG-1HCT, p. 48:6-9.
[138] Exh. No. RG-13HC, p. 16. This was the amount represents the amount allocated to LSR 1 from monies spent through 2009.
[139] As of February 28, 2010. See, Exh. No. RG-15HC pp. 46 and 51.

utility's project. WAC 480-107-135(3). Utility participation warrants "additional scrutiny by the Commission."[140]

72. According to its own description of the 2010 RFP process, PSE's decision to move forward on the development of LSR 1 was based on its evaluation of the project as part of the 2010 RFP process.[141] However, PSE did not formally participate in the RFP in accordance with the Commission's rules. Mr. Garratt's stated in testimony that PSE postponed the recommendation to the Board of Directors in order "to be able to compare LSR Phase 1 against a more thorough and robust set of potentially viable market alternatives by waiting for the 2010 RFP process."[142] In the "RFP Process Document" the Company explains that "the timing of the 2010 RFP cycle made it possible to compare LSR Phase 1 to more than 40 other renewable resource proposals"[143] and that PSE "screened" several other self-build opportunities during the 2010 RFP process.[144]

73. In response to a question asking whether PSE submitted a bid in the RFP process, Ms. Seelig stated that the Company "evaluated LSR 1 alongside the RFP process."[145] However, when Ms. Seelig, who was the project manager for the 2010 RFP Analysis[146] was asked directly if LSR 1 was treated as a formal bid, she answered:

> I'm not sure what you mean by "a formal bid." We evaluated it like we evaluated all the other projects. Its the same way we approach unsolicited bids when we receive an unsolicited bid into the RFP. We evaluated them in the same manner.[147]

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[140] WAC 480-107-135(1).
[141] *See,* for example, Exh. No. RG-1HCT, p. 55:12-14.
[142] Exh. No. RG-1HCT, p. 48, ll. 6-9.
[143] Exh. No. AS-3HC, p. 10.
[144] Exh. No. AS-3HC, p. 10.
[145] Seelig, TR. 332:14-16. (Emphasis added)
[146] Seelig, TR. 217:14-18.
[147] Seelig, TR. 332:17-23.

She went on to state that the quantitative and qualitative criteria were applied as if the bid had been from an outside third party and that she did not believe there was any difference between LSR 1 evaluation that was done and the process if PSE had been a formal bidder.[148]

74. The Commission's rules require that a utility must submit to the Commission a proposed RFP and its accompanying documentation for approval prior to its issuance.[149] There is no indication, however, that PSE informed the Commission of its intent to evaluate LSR as a part of the draft RFP it filed on October 12, 2009. The Company confirmed in discovery that PSE management decided to postpone the Board decision and compare LSR against the RFP bids on December 17, 2009.[150] A review of the Commission's Order in that docket does not give any indication that PSE provided any revision or update to the draft RFP to advise the Commission of this decision. One week later, the Commission issued an order approving the draft RFP.[151] Subsequent to the Company's change in approach , on January 12, 2010, PSE submitted the final version of the All-Source RFP to the Commission, which again did not mention the Company's revised plans to review LSR 1 in the RFP process.[152] The RFP, however, did state that no PSE affiliate or subsidiary would be participating in the RFP process.

75. Under the Commission's RFP rules, PSE should have submitted LSR 1 as a formal bid in the 2010 RFP process. By not identifying LSR 1 as a formal bid to the Commission or bidders, while at the same time evaluating the project as if it were, with the participation of staff who had extensive knowledge of the project, PSE's self-build option benefitted from an "unfair

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[148] Seelig, TR. 332:24-333:7.
[149] WAC 480-107-015(2)(b).
[150] Exh. No. RG-43 CX.
[151] *In the Matter of Puget Sound Energy, Inc.'s, Proposed Request for Proposals,* Docket No. UE-091618, Order No. 1, December 23, 2009.
[152] Exh. No. RG-5, pp. 5-12.

advantage" under the rules. This provides the Commission an additional basis for disallowing all or part of the costs for LSR 1.[153]

3. Subsequent events should not be given weight to demonstrate prudence.

76. It is a basic tenet of prudence analysis that hind-sight may not be considered.[154] The task of the reviewer is to place him or herself in the position of the decision maker at the time of the decision. Notwithstanding this, PSE witnesses have provided evidence to the Commission of recent developments affecting LSR 1, subsequent the Board's decision, which appear designed to show the project in a positive light in order to influence the prudence determination.[155] Mr. Garratt provides evidence of the current status of the project budget, for example. None of this information was known to the Board and, therefore, could not have been considered in making its LSR 1 decision. These are not legitimate considerations for prudence review and should be given no weight by the Commission.

77. If the Commission determines that these factors can be considered, Public Counsel respectfully requests that other significant developments directly affecting the advisability of LSR 1 be considered as well. For example, PSE has additional RECs available to it as a result of the termination of the SCE 2 contract. According to the record of this case, these RECs are sufficient to allow PSE to meet its I-937 requirements with banked excess RECs until at least 2018 and perhaps beyond. Instead, PSE customers will, starting in 2012, be paying $120 million per year for wind that might not otherwise be needed for at least another 6 years. At the same time, natural gas prices have plunged dramatically, and with them market energy prices.

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[153] WAC 480-107-135(3).
[154] *Puget Prudence Case,* 19th Suppl. Order, p. 65.
[155] Exh. No. RG-28CT, pp. 21-30; Exh. No. AS-4HCT, pp. 48-51.

PSE could purchase inexpensive RECs and replace LSR 1 with cheaper market power. Changed regulation in California has dramatically dropped the price of RECs. These new changes make it highly unlikely that an analysis would show constructing LSR 1 in 2012 to be prudent or cost-effective today. These considerations do not provide a basis for finding LSR 1 imprudent, but given the substantial impact of committing ratepayers to this premature investment, they can be viewed as reasons for careful and heightened scrutiny of the decision-making leading up to May 2010.

4. The treatment of the Treasury Grant is not before the Commission.

78. The Company places significant emphasis on the recent Congressional decision to eliminate the "normalization" requirement for the Treasury grant.[156] PSE's provides new calculations to show that this change would accelerate the passing of tax benefits back to PSE customers, and thus offset the costs and rate impact of the project. This is likewise an improper consideration for prudence analysis. The PSE Board did not know, and could not have known in May 2010, that the normalization requirement would be changed. The fact that they may have hoped it would change, or were informed of efforts to change it, is irrelevant. Given the vagaries of the legislative process, there can have been no reasonable assumption that the law would change in any particular manner. For purposes of determining prudence, this can be given no weight. As already noted, even when the benefits of the Treasury Grant are taken into account, even under the Company's own numbers, the cost benefit to customers is *de minimis* and marginally reliable. PSE's arguments about the Treasury Grant are premature. Treatment of the

[156] Exhibit No. AS-4HCT, p. 48:7-18; Exhibit No. RG-28CT, p. 9:6-18.

grant proceeds is not before the Commission in this case.[157] The prudence of LSR 1 does not turn on the manner in which grant proceeds are passed on to PSE customers.

G. Summary of Public Counsel Prudence Analysis.

79. PSE has not established the prudence of its decision to proceed with early construction of LSR 1. The Company concedes it has no need for renewable resources in the 2012 rate year, and not until at least 2016. It rests its case instead on an assertion that the early self-build of LSR 1 is cost-effective. However, the only quantified cost-effectiveness benefit calculated by PSE, $68 million dollars, represents less than one half of one percent of its total power portfolio over a 50 year period. It is not possible to predict such a narrow margin with any degree of certainty. The record shows that LSR 1 will not produce benefits for customers for at least 10 years, and potentially not for 20 years under many scenarios. Even the small portfolio benefit estimate is based on flawed calculations. PSE acknowledges errors existed, that the key benefit calculation from the PSM I single scenario was not recalculated after the Company learned of the error, and that the Board had before it the uncorrected number. PSE's proprietary PSM III optimization model, used to examine uncertainty scenarios, had never been used on a major resource analysis before the 2010 RFP upon which PSE relies, and had received no outside testing or validation. The "optimization logic" of the model was not functioning properly during the key analytic period. PSE's Board of Directors was not fully or adequately informed of key factors that had a bearing on the cost-effectiveness analysis. PSE has not established by a preponderance of the evidence that this substantial discretionary investment was a reasonable and prudent business expense which the consuming public may reasonably be required to bear.

[157] Exhibit No. ACC-1T, p. 35:1-12.

III. LSR 1 IS NOT "USED AND USEFUL"

A. Applicable Law - Used & Useful Rule .

80. In Washington, the Commission "must find a resource to be used and useful in this State before its costs may be recovered in rates."[158] The Washington State Supreme Court recognized the applicability of the dictionary definitions of the words, stating "'used' is defined as 'employed in accomplishing something'; 'useful' is defined as 'capable of being put to use: having utility: advantageous: producing or having the power to produce good: serviceable for a beneficial end or object.'"[159] The Commission has since interpreted the phrase "used and useful for service in this state" to mean that the resource must provide benefits to ratepayers in Washington either: 1) directly, by flow of power from a resource to customers; or 2) indirectly, by reducing the cost to Washington customers through exchange contracts or other tangible or intangible benefits.[160] The Company bears the burden of "demonstrating a quantifiable benefit to Washington ratepayers."[161]

B. LSR 1 Is Not Used and Useful Because It Does Not Provide Net Benefits To Customers Until 2016 At The Earliest.

81. Even if the Commission concludes that the decision to construct LSR 1 at this time was prudent, that does not determine whether the project is "used and useful" for purposes of inclusion in rates. The Washington Supreme Court has been clear on this point, rejecting the

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[158] RCW 80.04.250.; *WUTC v. PacifiCorp*, Docket No. UE-050684, Order No. 04, ¶ 50 (April 17, 2006).
[159] *POWER v. WUTC*, 101 Wn.2d 425, 430, 649 P.2d 425 (1984) (citing Webster's Third New International Dictionary, 2524 (1976)).
[160] *See WUTC v. PacifiCorp*, Docket No. UE-050684, Order No. 04, ¶ 50 (April 17, 2006) (the examples of direct and indirect benefits here are illustrative and not comprehensive).
[161] *Id.* at ¶ 51; *WUTC v. PacifiCorp*, Docket No. UE-050684, Order No. 6 Denying PacifiCorp's Petition for Reconsideration, ¶ 50 (July 14, 2006) (stating "it would be fundamentally unfair to Washington ratepayers to pay for resources that the Company has not proved benefit them, as required by RCW 80.04.250").

argument that utility-related expenses that are prudent are necessarily recoverable in rates. As the Court stated:

> This position is not supported by Washington law. An expense may be prudent, but not recoverable from ratepayers *if it provides no benefit.*[162]

The record in this case establishes that PSE customers will see no benefit from LSR 1 for at least the first 10 years, and in some scenarios not for 20 years.[163] This means that it is undisputed that customers will see no quantifiable benefit in the period from 2012 to 2016, the period when it is acknowledged there is no need for the wind project.[164]

82. The fact that PSE is asking ratepayers to pay approximately $120 million per year for four years for a wind project that is not needed during the period is akin to cases where courts and commissions have addressed the problem of excess capacity in the ratemaking context. As Figure 5 in Mr. Norwood's direct testimony shows, acquisition of LSR 1 will place PSE in a very significant excess position with regard to RPS requirements in future years.

83. Commissions have addressed this type of situation by reducing the utility company's return. The Iowa Supreme Court upheld a decision by the Iowa State Commerce Commission to reduce a utility company's return on excess generating capacity. The utility argued that because the investment in the generating facilities was prudent and used and useful, its return should not be affected by excess capacity. The court rejected that argument, holding:

> Nothing in the constitutional requirement that a utility receive a fair return on its investment prohibits a lower return from the ratepaying public upon a part of the investment that turns out to be unnecessary, even when the utility's decision to make the investment was prudent[.] Utility investors are not insulated from the

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[162] *US WEST Communications, Inc., v. Washington Utilities and Transportation Commission,* 134 Wn.2d 74, 126-27, 949 P.2d 1337, 1363.
[163] Exh. No. SN-1CT, p. 4, Figure 1. PSE has not disputed the accuracy of these tables.
[164] As argued above, it is Public Counsel's position that the net cost-effectiveness number offered by PSE for the entire project is not a reliable quantifiable benefit.

> consequences of diseconomies resulting from a management decision that was prudent when made but which later events prove to have been mistaken. [165]

Based on this reasoning, the court upheld the Commission's use of a formula to reduce the return on excess capacity on a graduated scale, under which disallowed return increased at an accelerating rate commensurate with increases in excess capacity.[166]

84. The Wisconsin Supreme Court has likewise upheld the authority of its Public Service Commission to shift some of the cost of excess generating capacity to utility shareholders if the excess capacity was not used and useful.[167]

85. The Illinois Commerce Commission order in *In Re Illinois Power Company*[168] has a number of parallels to the LSR 1 case. The Illinois Commerce Commission determined that the excess capacity created by a newly delivered nuclear plant was not "used and useful in providing utility service." Accordingly, the Commission disallowed a common equity return on 72.8 percent of the prudently incurred investment, holding only 27.2 percent of the plant as used and useful. [169]

86. After determining that the investment in the nuclear plant was prudent, the Commission first applied an "economic benefits test" to determine if the resource was used and useful.[170] Economic analysis by several of the parties indicated that the plant was not expected to provide an overall economic benefit for approximately 15 years, and only after 25 years would the plant produce a cumulative net present value benefit for ratepayers. Other criticisms included the fact

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[165] *Iowa-Illinois Gas & Elec. Co. v. Iowa State Commerce Comm'n,* 347 N.W. 2d 423, 429 (1984).
[166] *Id.*, 347 N.W. 2d at 425.
[167] *Madison Gas & Electric Co. v. Public Service Commission of Wisconsin,* 109 Wis. 2d 127, 135-136, 325 N.W. 2 d 339, 343-344 (1982).
[168] *In re Illinois Power Company*, 101 PUR 4th 525 (Illinois Commerce Commission 1989).
[169] 101 P.U.R. 4th at 525 (additional page references to internal Westlaw pagination).

that unanticipated events could negate future plant benefits and that all of the plant capacity would not be needed for system reliability for over 20 years.

87. The Illinois Commission determined that the evidence on economic benefit was "contradictory." Because the burden of proving economic benefits to ratepayers was on the Company, the Commission held that the Company failed to meet its burden, finding that: "The Commission cannot assume that [the nuclear plant] will result in net economic benefits to ratepayers."[171] The Commission held that: "[t]herefore, the used and useful determination for [the nuclear plant] must rest on the need test." [172]

88. The utility argued that the resource was used and useful simply "because it was in commercial operation as an electric generating facility, operating on an economic dispatch basis, and was providing energy to serve [its] customers."[173] The Commission, took a different view, and determined the Company's need by considering the projected load and capacity figures set forth by the Company over a three year near term period[174] and calculated a disallowance of nearly 75 percent of costs, based on establishing an appropriate reserve margin.

89. This case is relevant because it demonstrates that excess capacity may not be used and useful, despite the fact that the generating facility is operational and providing energy to customers. At the same time the case recognizes the lumpy nature of resource acquisitions and strikes a balance by developing a diminishing reserve margin. Similarly, in this case, the

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[170] Illinois statute required that "a generation or production facility is used and useful only if, and only to the extent that, it is necessary to meet customer demand or economically beneficial in meeting such demand." 220 ILCS 9-212.
[171] *Id.*, at 102 (Emphasis added).
[172] *Id.*
[173] *Id.* at 97.
[174] The Commission found: "[c]onsideration of only one-year period does not give proper recognition to the lumpiness of capacity additions." *Id.* at 101-02.

Commission's should take into account the excess which LSR 1 creates over current and future RPS requirements, and adopt a proportionate or partial disallowance. [175] Public Counsel's proposal to that end is described in the next section.

C. Public Counsel Disallowance Recommendation.

90. For the reasons set forth above, Public Counsel recommends that the Commission disallow $55 million of the Company's request. This figure is based on PSE's own calculation of the average amount of increased cost over the next four years due to bringing LSR 1 on line early. The details behind the calculation are shown in Mr. Norwood's testimony,[176] which he also explained at the hearing in response to questions from the Bench.[177]

91. This is a conservative and reasonable recommendation, which still allows PSE to recover O&M costs, depreciation, property tax, insurance and other costs. Public Counsel is not taking the position that LSR should never be developed, but rather that the discretionary decision to proceed at this time, based on flawed analysis and assumptions, should preclude full recovery.

IV. CONSERVATION SAVINGS ADJUSTMENT (CSA)

A. PSE's Proposed CSA Mechanism.

92. PSE has proposed a new "lost margin" recovery mechanism in this case called a Conservation Savings Adjustment (CSA).[178] The CSA would result in a surcharge to customers

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[175] In the PSE Tenaska prudence disallowance order, the Commission observed there was "some merit" to the argument that if an asset is not providing benefits during a given rate period consistent with those originally projected, the costs should be disallowed going forward because the asset is not useful. *Washington Utilities and Transportation Commission v. Puget Sound Energy*, Docket UE-031275, Order 14, pp. 17-18. The relief granted was structured to disallow a portion of return on Tenaska going forward, even if PSE was acting prudently, if the gas purchasing plan was not creating a benefit, based on a set benchmark. *Id.*, pp. 20-21.

[176] Exh. No. SN-1CT, p. 51.

[177] Norwood, TR. 391:20-394:4. Mr. Norwood stated that the recommendation is conservative in part because level of projected benefits fell between the IRP re-run and the 2010 RFP. A disallowance based on the 2010 RFP would have been larger.

[178] Exh. No. JAP-1T, p. 32:14-17 (Piliaris).

based on the amount of estimated load reduction that results from Company-sponsored conservation programs each year. The Company is proposing that each month, the estimated conservation-related load reduction would be multiplied by the per-unit margin in order to determine the Company's estimated monthly lost revenues that it could collect through the CSA.[179] In order to estimate conservation-related load reduction for the CSA, the Company uses the savings estimates from PSE's energy efficiency programs. The CSA adjustment would be made annually, so twelve months of such losses would constitute the recoverable amount for that year.

93. The CSA mechanism would apply to both natural gas and electric service customers. The Company is proposing to recover $9.8 million from its electric customers and $2.0 million from its gas customers.[180] These CSA revenues would be in addition to any rate increase approved by the Commission in this general rate case.

94. For the reasons stated below, Public Counsel recommends that the Commission reject the CSA proposal.[181]

A. The CSA Is Not Consistent With The Guidance In The Commission's Policy Statement.

95. In November 2010, the Commission issued its *Decoupling Policy Statement* [182] in which it addressed three types of regulatory mechanisms: limited decoupling, full decoupling, and the

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[179] Exh. No. JAP-1T, p. 33:7-8 (Piliaris).
[180] Exh. No. JAP-1T, Tables 4 and 5 (Piliaris). 75 percent of these revenues would be collected in the first year of new rates and the additional 25 percent would be collected in year 2.
[181] No party to this case, other than PSE, supports the CSA proposal.
[182] *In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives,* Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets, Docket U-100522, (November 4, 2010)(*Decoupling Policy Statement).*

use of specific incentives to encourage conservation. Companies were invited to file proposals consistent with this policy guidance.

96. The CSA proposal does not follow the guidance provided by the Commission's Decoupling Policy Statement. While the program proposed by PSE is most similar to a limited decoupling proposal, in that it is ostensibly designed to respond solely to reductions in usage caused by conservation measures, the Company's program is inconsistent with the limited decoupling mechanism outlined in the Commission's Decoupling Policy Statement.

97. Indeed, the Company does not represent that it is following the policy statement, except in so far as it is presenting an "other" type of proposal.[183] The Company testimony expressly rejects the decoupling and incentive mechanisms envisioned in the Decoupling Policy Statement because they do not "meet PSE's needs."[184]

98. Contrary to the Decoupling Policy Statement, PSE's CSA mechanism is based solely on conservation lost margins, without taking into account any other usage factors (e.g. found margins). PSE's purpose in proposing the mechanism appears to be to address alleged regulatory lag issues. Thus, the proposal is structured to compensate shareholders for increases in cost in between rate cases, regardless of whether loads are increasing or decreasing, rather than to address conservation incentives. As designed, so long as PSE does not exceed its authorized rate of return, the CSA will always result in a rate increase. Moreover, by not considering found margins, the CSA reduces the incentive for PSE to control costs in between rate cases.[185]

99. The mechanisms outlined in the Decoupling Policy Statement were not intended to

[183] Piliaris, TR. 637:5-14.
[184] Exh. No. TAD-1T, p. 10:13-19 (DeBoer).
[185] Exh. No. ACC-1T, pp. 15-16 (Crane).

compensate the Company for increased operating costs. That is the function of a general rate case. PSE has more than a decade of history of filing frequent, almost annual, general rate cases and it has stated that it expects to continue to file frequent rate cases in the future. Thus, the Company's limited decoupling proposal is a one-sided attempt to increase shareholder earnings between general rate cases in the guise of implementing good public policy, i.e., conservation programs.

100. Under the Decoupling Policy Statement, a decoupling proposal must also address the impact of the proposal on low-income customers, demonstrating that impacts are not disproportionate to those experienced by other customers.[186] According to the Company, the percentage increase resulting from the CSA would be the same for low-income and non-low-income customers.[187] However, since the Company does not track participation in its residential conservation programs by income level, except for the Residential Low Income Weatherization Program, it is unable to demonstrate whether low-income customers are receiving comparable benefits from PSE's conservation programs as compared with other customers.[188] Given the fact that in order to take advantage of conservation incentives, customers are often required to make an initial investment, one cannot assume that low-income customers are able to take advantage of these programs to the same extent as other utility customers.[189] It is possible that low-income customers will be disproportionately harmed by the CSA, and PSE's filing does not adequately address this issue.

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[186] *Decoupling Policy Statement,* ¶ 28. If a Company's programs do not already achieve comparability, the Company must provide low-income customers targeted programs with the goal of achieving comparability, so long as the Company meets cost-effectiveness standards. *Id.*
[187] Exh. No. ACC-1T, p. 21:9-10 (Crane).
[188] Exh. No. JAP-53 CX, p. 1.
[189] Cavanagh, TR. 466:8-19.

101. Ms. Andrea Crane's testimony regarding the CSA was jointly sponsored by the Energy Project. The Energy Project brief will address the low-income aspects of the CSA in depth and Public Counsel supports and adopts the Energy Project briefing on this aspect of the CSA proposal.

B. The CSA Unfairly Shifts Risk to Customers.

102. A further objection to the Company's CSA proposal is that it does not provide any compensation to ratepayers for the undisputed shift of revenue risk from shareholders to ratepayers. If such a proposal is adopted, there should be a commensurate reduction in the cost of equity. Public Counsel has not filed its own cost of capital testimony in this case with a specific ROE adjustment, however, Public Counsel believes the recommendation of ICNU witness Michael Gorman is reasonable on this issue.[190]

C. The CSA Does Not Advance Conservation Goals.

103. PSE has not provided any evidence to suggest that its conservation efforts will increase, or that its conservation programs will become more effective, if its proposed mechanism is adopted. The Decoupling Policy Statement requires a utility requesting a limited decoupling mechanism to provide "evidence describing the incremental conservation the company may achieve in conjunction with the proposed mechanism."[191] PSE has not provided any such evidence. PSE is already required to "pursue all available conservation that is cost-effective, reliable, and feasible."[192] There is no need for a mechanism to provide special compensation to

[190] Exh. No. MPG-1T, pp. 1-4 (Gorman).
[191] *Decoupling Policy Statement*, ¶ 18.
[192] RCW 19.285.040(1).

PSE for complying with a legal mandate. PSE has described their electric and natural gas conservation targets for 2012-2013 as "aggressive."[193] Mr. Stolarski affirmed this at hearing.[194]

D. The Savings Estimates Proposed For Use With The CSA Were Never Intended To Be Used To Directly Set Rates.

104. As Staff witness Ms. Reynolds testified at hearing, the savings estimates that form the basis of the CSA were never intended to be used to set rates. Rather, as Ms. Reynolds testified, "these energy savings estimates are really intended to be used for forecasting and as a guide for making a decision about which plant to purchase, where plant A is conservation and plant B is a gas plant[.]"[195] Public Counsel agrees with Staff that these savings estimates are not rigorous enough for ratemaking.[196] They are primarily used for "program planning and for calculations of the cost-effectiveness of particular [energy efficiency] measures. However, the estimates do not represent what actually happened after the installation itself."[197]

05. Another design flaw with the CSA was identified during the hearing. During questioning from Chairman Goltz, Ms. Reynolds testified that the CSA "would create a perverse incentive for Puget to – for any company with this kind of program really to inflate their savings estimates numbers because those increases would directly translate into more money under this program[.]"[198] This in turn would create an administrative burden and require a level of scrutiny

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[193] Exh. No. RWS-18 CX, p. 2.
[194] Stolarski, TR. 694:12-15.
[195] Reynolds, TR. 772: 7-11.
[196] These savings estimates change over time, sometimes dramatically. Indeed, the Regional Technical Forum savings estimate that PSE uses for CFLs decreased by 33 percent, from 24 kwh to 16 kwh per-bulb, per-year, from 2011 to 2012. Exh. No. RWS-18 CX, p. 3. In 2009, the comparable RTF estimate was 33 kwh. Exh. No. RWS-19 CX, p. 3. Thus, in a three year period this savings estimate was reduced by half. Lighting is a substantial portion of PSE's residential conservation portfolio, representing 66% of the residential sector savings in 2011. Exh. No. RWS-18 CX, p. 3. This highlights the variability and lack of precision associated with these estimates, and why they are not appropriate for ratemaking.
[197] Exh. No. DJR-1T, p. 31:14-17 (Reynolds).
[198] Reynolds, TR. 767:2-6.

of the savings estimates that "no one could keep up with [.]"[199] Similarly, NWEC witness Mr. Cavanagh points out that "[t]he CSA would also create a powerful and perverse new incentive for the company to promote programs that look good on paper but deliver little or no savings in practice (because then the company would get a double recovery)." [200]

E. Verification Of Savings Remains Unclear.

106. While PSE states that it supports third-party verification, as explained in Ms. Crane's testimony for Public Counsel, PSE has provided confusing information about which verification plans would apply on both the electric and gas sides.[201] PSE argues that its evaluation, measurement, and verification processes result in savings estimates that are rigorous enough for ratemaking.[202] A fatal flaw with this reasoning, however, is that the impact evaluations used to develop the savings estimates focus on a particular aspect of customer energy use (e.g. a lighting impact evaluation would look at lighting use), as Mr. Stolarski confirmed at hearing.[203] However, a customer's overall energy use is likely to change due to a variety of factors, including weather, price elasticity, economic conditions, and conservation, as Mr. Stolarski describes in his rebuttal testimony.[204] A customer may install more efficient lighting, but their overall energy use could nevertheless increase due to the factors identified above. Because the CSA does not consider actual changes to load after installation, it fails to meet the known and measureable standard for ratemaking.[205]

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[199] Reynolds, TR. 767:13-14.
[200] Exh. No. RCC-1T, p. 23:20 – p. 24: 2 (Cavanagh).
[201] Exh. No. ACC-1T, p. 23:6 - p. 24: 6 (Crane).
[202] Exh. No. RWS-1T, pp. 3-24 (Stolarski).
[203] Stolarski, TR. 698:15-18.
[204] Exh. No. RWS-1T, p. 18:4-8 (Stolarski).
[205] Reynolds, TR. 770:23 – 771:16.

F. There Are Several Additional Problems With The CSA.

1. The CSA double counts some lost revenue.

107. In the first year of the CSA, the Company is seeking recovery of lost revenues based on conservation efforts since January 2010. Since 2010 is the test year in this case, at least some of these losses are already reflected in the weather-normalized historic test year sales used to develop pro forma revenue at present rates, as PSE conceded at the hearing.[206]

2. It is not clear whether PSE would treat the CSA as a "cost" of energy efficiency.

108. PSE is inconsistent on the issue of whether the CSA reflects part of the cost of energy efficiency. On the one hand, PSE asserts in a data request response (with Mr. DeBoer identified as the PSE witness) that if the CSA is approved, resulting in an additional rate surcharge for customers, "these rates will now reflect the full cost of energy efficiency."[207] While from this response, it appears that the Company considers the CSA part of the cost of energy efficiency, other Company witnesses muddy the waters.

109. Mr. Stolarski testified at the hearing that in his view the CSA revenues should not be added as a cost to the cost-benefit analysis of the conservation programs, known as the Total Resource Cost test (TRC), stating "I don't see these costs as being a cost of energy conservation."[208] Mr. Piliaris, on the other hand, testifying on whether the CSA would appear as a line item on customer bills, suggested that the CSA surcharge revenues could be included in the Schedule 120 energy efficiency tariff rider filing, "essentially as another conservation-related cost[.]"[209] The answer to this question could be important. For some programs, inclusion of CSA

[206] Piliaris, TR. 638:14 – 639:6.
[207] Exh. No. TAD-15 CX, p. 1 (DeBoer).
[208] Stolarski, TR 692:3-17.
[209] Piliaris, TR 653:14-15.

costs in the TRC could mean that the conservation program no longer qualifies as cost-effective. If that in turn causes some programs to be eliminated, it would mean that customers are essentially paying more for less conservation, in which case the CSA appears to curtail rather than enhance PSE's conservation efforts.

3. If adopted, the CSA should be a line item on customer bills.

110. PSE has not provided a clear opinion as to whether the CSA should be a separate line item on the bill. At hearing, Mr. Piliaris initially testified that the surcharge would appear as a separate line item on the bill, described as a "Conservation Savings Adjustment."[210] However, when asked by Chairman Goltz how PSE customer service representatives or UTC consumer affairs staff should respond to customer inquiries regarding increases to the CSA charge, Mr. Piliaris backed away from his earlier response, suggesting that the CSA surcharge revenues could be included in the Schedule 120 energy efficiency tariff rider filing, treating them as a conservation cost.[211]

111. PSE's reluctance to separately identify the CSA on the bill underlines the problematic nature of the proposal. Certainly, combining the charge into Schedule 120 lets the Company avoid having to explain the convoluted nature of the Company's proposed CSA. While customers may be unhappy if they understand they are paying a surcharge on their bill that increases when they and others conserve more, that is no reason to conceal the information. Customer bills should accurately and transparently provide the information necessary for customers to understand the basis of their charges. While Public Counsel certainly does not recommend approval of the CSA or similar proposal, if it is adopted, Public Counsel strongly

[210] Piliaris, TR. 650:9-16, 652:16-21.
[211] Piliaris, TR. 653:14-15.

recommends a CSA surcharge be shown as a separate line item. Customers deserve and benefit from transparency.

4. The Home Energy Report (HER) program should be excluded from the CSA if adopted.

112. At hearing, PSE witness Mr. Stolarski testified that the Company believed it reasonable to exclude the Home Energy Reports (HER) program, administered by Opower, from the CSA.[212] This was not discussed in the direct or rebuttal testimony of Mr. Piliaris, PSE's primary witness on the CSA. It is Public Counsel's position that HER-related savings should not be included in the CSA, if adopted.[213] Mr. Stolarski characterized the savings from this program as being more highly variable, since they are based on changes in customer behavior, and not as stable as the estimated savings from "hardware-based measures."[214] At hearing, Ms. Reynolds also testified regarding the importance of making sure no double-counting occurs with the HER program savings and other measures.[215] For these reasons, they are not appropriately used as a basis for setting rates.

G. PSE's Power Supply Load Forecast Incorporates Excessive Conservation Savings.

113. In reviewing the CSA mechanism and the impact of conservation on PSE, Public Counsel identified an issue regarding PSE's conservation assumptions in the Company's power supply load forecast. While not directly related to the mechanics of the proposed CSA, since power supply costs are excluded from the CSA, it shows that PSE's retail rates may be $6.7 million higher due to an excessive conservation assumption in the power supply load forecast. PSE

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[212] Stolarski, TR. 727:8-13.
[213] For 2012, PSE is projecting electric savings of 5,500 MWh (about 4% of the residential electric portfolio) and natural gas savings of 346,700 therms (19% of the residential natural gas portfolio) for the HER program. Exh. No. RWS-16 CX, p. 3.
[214] Exh. No. RWS-1T, p. 19:15-16 (Stolarski).
[215] Reynolds, TR. 775:3-22.

acknowledges, appropriately, that the Company's power supply costs are based on forward-looking projections of load that take into account "a projection of the load-reducing effects of energy efficiency."[216] A review of those conservation projections for the rate year, however, reveals that they forecast a level of conservation that far exceeds what PSE has recently estimated in the Company's Biennial Conservation Target filing with the Commission. Specifically, PSE's F2011 Load Forecast assumes conservation savings of 616,198 MWh for the rate year (May 2012 to April 2013). [217] This *one-year* estimate is very nearly as much as PSE's recently proposed *two-year* conservation target for 2012-2013 of 666,000 MWh filed in October, 2011 in Docket UE-111881.[218] When asked about the rate impact if actual conservation were half of what is assumed in the power supply load forecast,[219] the Company responded that "PSE's revenue deficiency is estimated to be reduced by $6.77 million."[220] Thus, PSE's power supply load forecast assumption of a level of conservation that far exceeds the Company's recent conservation targets results in higher retail rates.[221]

V. FULL DECOUPLNG

A. Overview.

114. The only party making a "full decoupling" proposal in this case is NWEC. Although the Commission issued a Bench Request for such proposals, PSE declined the invitation and the

[216] Exh. No. JAP-1T, p. 30:1-5 (Piliaris).
[217] Exh. No. JAP-58CX, p. 1. The conservation savings included in the complete F2011 Load Forecast are provided in Attachment A to Exh. No. DEG-26 CX, pp. 4-8.
[218] Exh. No. RWS-16 CX, p. 2.
[219] Half of the amount of conservation assumed for the rate year would be 308,099 which is fairly close to PSE's conservation target for 2012 of 336,600 MWh. Exh. No. RWS-16 CX, p. 3.
[220] Exh. No. JAP-58 CX, p. 1.
[221] If PSE is required to revise its power supply costs at the conclusion of this proceeding, the Commission might consider incorporating more recent conservation estimates for the rate year, consistent with PSE's Biennial Conservation Target filing with the Commission.

Company opposes the NWEC proposal.[222] Commission Staff did respond to the Bench Request, but made clear in its response that its filing was made to comply with the directive in the Bench Request and was not an endorsement of a full decoupling proposal. Staff concluded that "[b]ased on the material in this response, the Commission likely cannot make a final decision on a decoupling proposal in this case."[223] In response to discovery, Staff clarified that it "did not 'propose' full decoupling in its response to the Commission's Bench Request[.]"[224] No other party to this case supports the NWEC proposal.

115. The NWEC proposal is described in Mr. Cavanagh's testimony.[225] It provides for an annual true-up of revenue-per-customer, based on the average per-customer revenues established in this rate case. Mr. Cavanagh proposes limiting annual increases resulting from his decoupling proposal to three percent, but recommends that adjustments over that amount be carried over to subsequent years indefinitely until such time as the adjustment can be made within the three percent cap. In calculating per-customer revenues to utilize in quantifying the decoupling adjustment, revenues related to power cost recovery would be excluded. Mr. Cavanagh proposes that the Commission "adopt two per-customer fixed-cost revenue requirements, one covering the residential class and the other representing a weighted average for all other classes included in the mechanism."[226] Mr. Cavanagh's proposal is limited to electric decoupling. According to Mr. Cavanagh, "[t]he Commission's Policy Statement is less clear regarding a preference for full

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[222] PSE filed an objection to the Commission's Bench Request No. 3 regarding decoupling, stating in part that it may result in the imposition of a regulatory mechanism that PSE did not request in this case. PSE's Objection to Bench Request, October 10, 2011, p. 1.
[223] Exh. No. JAP-40CX, p. 3.
[224] Exh. No. ACC-5T, p. 2:15-19 (Crane).
[225] Exh. No. RCC-1T, p. 9: 6 – p.10: 8 (Cavanagh).
[226] Exh. No. RCC-1T, p. 9:16-19 (Cavanagh).

decoupling on the gas side."[227] Mr. Cavanagh recommends that his proposed mechanism be reviewed after five years.[228]

116. Public Counsel recommends that the Commission reject the NWEC proposal. While the Commission stated that it will consider a full decoupling mechanism in an effort to encourage conservation efforts, the mechanism as proposed by Mr. Cavanagh on behalf NWEC would go far beyond this objective. Mr. Cavanagh's proposed mechanism would make the Company whole, from a revenue perspective, for fluctuations in revenues for any reason, including weather variations. Moreover, Mr. Cavanagh's proposal would ignore offsetting changes in expenses, rate base, or cost of capital that could serve to reduce the Company's revenue requirement.

B. NWEC's Proposal Has Multiple Drawbacks.

117. Mr. Cavanagh incorrectly concludes that a decoupling mechanism should not result in a return on equity adjustment. Mr. Cavanagh's proposed decoupling mechanism will eliminate the Company's revenue risk, including risks from weather variations, economic fundamentals, or conservation. Instead of being given an opportunity to earn a level of authorized revenues, PSE would have a guaranteed revenue stream. This reduction in risk should be reflected as an appropriate return on equity adjustment. This aspect of the NWEC position reflects the lack of balance in the proposal, with shareholder benefits appearing to be the paramount goal. As with the CSA, Public Counsel supports the recommendation of Mr. Gorman in this case with respect to a specific downward ROE adjustment, in the event a full decoupling proposal is adopted.[229]

118. An additional major problem with the NWEC proposal is that it is not tied to

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[227] *Id.*, p. 5:15-16.
[228] *Id.*, p. 21:1-4.
[229] Exh. No. MPG-1T, p. 4:5-7 (Gorman).

conservation efforts. Instead, Mr. Cavanagh's proposal would ensure that PSE receives a fixed amount of revenue regardless of the Company's conservation efforts. Thus, while his proposal may remove an alleged disincentive that the Company has to conserve, it does not provide any incentive to promote conservation or to increase its conservation efforts.[230]

119. Mr. Cavanagh recommends that increases in program budgets for low-income energy efficiency programs are "at least roughly proportional to increases in funding for energy efficiency programs for other residential customers[.]"[231] It does not follow, however, that conservation programs provide benefits to low income customers that are comparable to the benefits being provided to other ratepayers. Mr. Cavanagh's proposal does not attempt to evaluate the relative benefits of conservation programs to low-income customers, as required by the Commission's Decoupling Policy Statement. Mr. Cavanagh simply assumes that comparable spending equals comparable benefits, which is not necessarily the case. Low-income customers may respond differently to conservation programs than other residential customers. Indeed, at hearing, in response to a question from Commissioner Oshie that low-income customers may have more difficulty participating in conservation programs, and therefore, may shoulder an ever increasing share of the costs needed to support the residential class, Mr. Cavanagh stated that he shared this concern.[232]

120. An added problem with the NWEC proposal is its lack of an earnings cap. Mr. Cavanagh states that "it is not obvious why removing the linkage between retail sales and fixed-cost recovery should hinge on the Company's earnings."[233] The link is obvious to any observer

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[230] As discussed above regarding the CSA, PSE has described their conservation targets as "aggressive." *See* Exh. No. RWS-18 CX, p. 2, and Stolarski, TR. 694:12-15.
[231] Exh. No. RCC-1T, p 18: 2-4 (Cavanagh).
[232] Cavanagh, TR. 466:8-19.
[233] Exh. No. RCC-1T, p. 15:12-14 (Cavanagh).

looking at *both* ratepayer and shareholder impacts and interests. Mr. Cavanagh's statement, repeated at the hearing, simply reflects the one-sided advocacy of shareholder interests inherent in the NWEC proposal.[234] A decoupling mechanism should not result in over-earnings for shareholders. By design, a decoupling mechanism shifts risk from shareholders to ratepayers by guaranteeing shareholders a pre-determined level of revenue. From a regulatory perspective, however, even where approved, the purpose of such mechanisms is to make a utility whole for fluctuations in revenues, not to provide a mechanism to increase earnings over those previously approved by the regulator. Thus, an earnings test is critical for any decoupling mechanism. The existence of an earnings test does not correct all the problems inherent in a decoupling mechanism, but it does provide one key protection for ratepayers that is absent from Mr. Cavanagh's proposal.

121. For the foregoing reasons, Public Counsel recommends rejection of the NWEC full decoupling proposal. The proposal would compensate PSE for revenue fluctuations regardless of the underlying cause, would transfer risk from shareholders to ratepayers without adequate compensation, and would provide no incentive to increase conservation efforts.

VI. EXPEDITED RATE MAKING MECHANISM

122. In testimony in this case, Staff witness Ken Elgin proposes a regulatory response to the regulatory lag issues raised by PSE. At this time, he concludes that an attrition adjustment would not be appropriate, since PSE has not requested or supported one. To address the issue, however, he proposes an "expedited rate case" mechanism.[235]

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[234] Cavanagh, TR. 434:12-24.
[235] Exh. No. KLE-1T, pp. 80-84 (Elgin).

123. While Mr. Elgin raises an interesting proposal worth consideration, as an initial reaction, Public Counsel expresses certain reservations about the justification for exploring this type of option at this time. While PSE has certainly made claims of regulatory lag a central and repeated mantra of its advocacy in recent years, the claims ring hollow in the face of the relentless rounds of general rate case filings pursued since 2001 with virtually no break between rate effective dates and the next filing.[236] The claims also expect the Commission and other parties to ignore the fact that regulatory lag has well-understood and well accepted salutary effects as an incentive for regulated companies to control their costs. The existence of regulatory lag is an inherent part of ratemaking that has always been present and can have positive effects. It is not a newly discovered "problem" that must be eradicated. PSE's position on this issue is extreme, as reflected by the statement at the hearing to the effect that Commission-approved rates are by definition non-compensatory on the first day they go into effect.[237]

124. Public Counsel is also concerned that the discussion of this proposal may be prompted as much by rate case fatigue as by the merits of the proposal itself. Staff's testimony in this case rightly notes the tremendous pressures placed on the Commission's resources' by frequent rate case filings in the last decade. Public Counsel counts at least 36 energy rate cases filed with the Commission since 2000. Public Counsel and intervenors face these pressures as well. It is not clear, however, that the appropriate response to this pressure is to expedite the process for such requests, making rate increases potentially even more frequent and easier to obtain. As proposed, the new approach does not appear to offer any definitive trade-off that would result in

[236] The "attrition adjustment" was a mechanism that evolved in the era when utilities valued rate stability and rate cases were filed years apart, so that attrition was at least a potential issue. Attrition adjustments make little sense in today's environment, except in conjunction with extended stay out commitments.
[237] Piliaris, TR. 682:21 – 683:17. If PSE believes Commission ratemaking decisions are inherently confiscatory or non-compensatory, it has the ability to appeal the decisions to state court.

a reduced frequency of rate filings in return for streamlining. There must be benefits for both customers and companies in any new approach.

125. Notwithstanding these concerns, if the Commission decides that some mechanism to address rate case frequency or regulatory lag should be adopted, then Staff's proposal would certainly be preferable to the CSA proposed by PSE. Staff's proposal attempts to maintain the integrity of the ratemaking process by retaining the link between revenues, expenses, and rate base. However, there are several aspects of Staff's proposal that require further development. These include the type of adjustments that would be permitted pursuant to the expedited process, the plausibility of maintaining a narrow scope of issues that could be addressed in an expedited proceeding, and whether such an expedited rate proceeding is appropriate for other utilities at this time. Each of these concerns is addressed in Ms. Crane's cross-answering testimony.[238] Public Counsel believes that it would be premature to adopt a "streamlined ratemaking" framework on this record, but that it would be an appropriate topic for a collaborative process, if the Commission wishes to review a more well-developed proposal.

VII. REVENUE REQUIREMENT ISSUES

A. Return Adjustment on Chelan Deferred Carrying Charges.

126. Based upon review of PSE's rebuttal testimony on this issue, and confirmation provided by John Story at the hearing, Public Counsel withdraws this adjustment. Ms. Crane's concerns regarding the "net of tax" issue are addressed in the Company's deferred income tax reserve associated with the Chelan payments.[239]

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[238] Exh. No. ACC-5T, pp. 9-16 (Crane).
[239] Story, TR. 1036:20-1038:23; Exh. No. JHS-38 CX.

B. DFIT Repairs and Retirements.

127. As discussed in Mr. Marcelia's testimony, PSE has changed the accounting method used for repairs and retirements.[240] In both cases, the Company has changed the units of property (UOP) used for tax purposes relative to the UOP used for book purposes. As a result, this change results in a larger immediate tax deduction for repairs and retirements, which in turn results in an increase to deferred income taxes. Since deferred income taxes are deducted from rate base, this change would increase the Company's deferred tax reserve and reduce its rate base.

128. However, PSE made an adjustment to its per books accounts to reverse the impact of this accounting change. As a result, the Company's starting rate base balances have already been adjusted to eliminate the impact of this accounting change.

129. Public Counsel does not believe it is appropriate for the Company to ignore its accounting change for ratemaking purposes. PSE has now used the new method for repairs for three tax filings (2008-2010), and used a similar method for retirements in its most recently filed return. Moreover, in a recent case involving PacifiCorp, the Commission found that a similar accounting change that had been adopted by PacifiCorp should be reflected in rates. In the PacifiCorp case, the Commission referred to the PSE proceeding, stating that "[i]n the PSE case, we rejected the proposed adjustment because '[t]he final disposition with the IRS is not known and the tax impact is in any event subsequent to the test year.'"[241] In this case, the accounting change has been used for several years with regard to repairs, and was filed for retirements

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[240] Exh. No. MRM-1T, p. 18:10 (Marcelia).

[241] *Washington Utilities and Transportation Commission v. Puget Sound Energy*, Docket Nos. UE-090704, UG-090705, Order 11 ¶ 197, cited in *WUTC v. PacifiCorp*, Docket UE-100749 (*PacifiCorp 2010 GRC*) Order 06, n.378.

during the test year. Moreover, the accounting change has been authorized by the IRS, although the IRS has not yet completed its audit of the years in question.

130. Consistent with the recent order in the PacifiCorp case, Public Counsel recommends that the Commission reflect the impact of the accounting change for repairs and retirements in the Company's rate base calculation. Public Counsel's adjustment decreases the Company's electric revenue requirement by $4,055,959 and the Company's gas revenue requirement by $3,143,712.[242]

C. Net Operating Loss.

131. In its initial filing, PSE included a rate base addition of $23.2 million in its electric filing and $18.5 in its gas filing relating to the tax effect of net operating loss carry-forwards.[243] PSE claims that these adjustments are necessary because the Company has not been able to take advantage of all of the tax benefits that have been passed through to ratepayers in the deferred tax reserve.

132. The deferred tax reserve reflects the accumulated deferred taxes that have been recorded by the Company to reflect the timing difference between when the benefit of a tax deduction is recorded for tax purposes and when it is recorded for ratemaking purposes. In her direct testimony, Ms. Crane provides an example of how this can work such that the NOL rate base addition would completely offset the deferred tax rate base deduction, resulting in no rate base reduction being passed through to ratepayers.[244]

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[242] Exh. No. ACC-3, p. 3; Exhibit No. ACC-4, p.3.
[243] Exh. No. MRM-1T, pp.27-32 (Marcelia).
[244] Exh. No. ACC-1T, p. 26:7-p. 27:6 (Crane).

133. Public Counsel does not agree that rate base should be increased to reflect the tax effect of the NOLs available to PSE. Ms. Crane's adjustment would reduce PSE's revenue electric revenue requirement by $1.49 million and its gas revenue requirement by $1.19 million.[245]

134. While the Company's argument has some intuitive appeal, the Commission should bear in mind that the Company has calculated its federal income tax claim on a stand-alone basis at the statutory income tax rate. PSE has included income tax expense of $144.2 million in its electric revenue requirement claim and of $47.5 million in its gas claim.[246] These are actual dollars that will be collected from ratepayers to fund an income tax expense that the Company will not actually incur. If the Company wants to include the impact of its NOL in regulated rates, then the Commission should make a corresponding adjustment to the income tax *expense* that the Company is seeking to recover.

135. Ms. Crane states in her direct testimony that the Commission's current tax methodology used for ratemaking purposes does not consider when taxes are actually paid by the Company.[247] Mr. Marcelia for PSE asserts that Public Counsel is incorrect on this point.[248] He acknowledged on cross-examination, however, that revenues and expense reflected in the revenue requirement for ratemaking can differ from those reflected in the utility's tax return. This is in part due to the fact that there are timing differences between ratemaking and tax methodologies. Mr. Marcelia further agreed that the Commission establishes pro-forma tax expense, and does not use the Company's actual tax return to determine income tax expense for ratemaking purposes.[249]

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[245] Exh. No. ACC-1T, p. 28:15-20.
[246] Exh. No. JHS-4, p. 1 and Exh. No. MJS-4, p. 1.
[247] Exh. No. ACC-1T, p. 27.
[248] Exh. No. 14-T, p. 57:19 (Marcelia).
[249] Marcelia, TR. 997:4-25.

136. Mr. Marcelia also argues that if PSE were to account for the net operating losses in a different manner it would run afoul of the normalization provisions of the tax code. Public Counsel asked PSE to provide support for this contention in discovery. PSE provided three private letter rulings.[250] The first two are from 1988, and are too dated to apply to the current tax situation. The third, from 1993, addresses excess tax reserves, and relates to differences that arose due to changes in statutory tax rates. The NOLs at issue in this case relate to bonus depreciation rules adopted since 2009, not to changes in the statutory tax rates.[251]

137. If the Commission decides to accept the Company's adjustment to increase rate base by the tax impact of its NOL, then the Commission should extend this policy to a review of other tax issues, such as whether PSE should be subject to a consolidated income tax adjustment, or other adjustments that could reduce the income tax burden on ratepayers. It is unreasonable for the Company to argue that its deferred tax reserve should be adjusted to consider actual taxes paid, when other components of the revenue requirement calculation are not based on actual tax payments to the IRS. Public Counsel, therefore, recommends that the Commission reject the Company's proposed adjustment.

VIII. SQI-9 DISCONNECTION RATIO

A. The SQI-9 Disconnection Ratio Should Be Reinstated Because It Creates Incentives For PSE To Work With Ratepayers To Avoid Disconnections.

138. PSE proposed in this case that the Service Quality Index 9 (SQI-9) disconnection ratio be permanently eliminated from the Company's Service Quality Index. The Service Quality Index, first established in 1997, and reaffirmed subsequently by the Company, the Commission and

[250] Exh. No. MRM-36 CX.
[251] Marcelia, TR. 1001:1-1002:7.

multiple stakeholders, is a multi-part service quality incentive program which encourages PSE to meet specified metrics or face financial penalties. The SQI-9 disconnection ratio of .038 was first implemented in 1997.[252] The metric was reaffirmed in 2002, with a decrease in the ratio to .030. SQI-9 was subsequently increased to its original ratio of .038 in 2009.[253] SQI-9 was suspended on an interim basis in 2010, with the condition that permanent elimination would be considered in the next rate case.[254]

139. PSE's argument for elimination of the disconnection ratio is the assertion that "SQI-9 hinders PSE's ability to carry out Commission credit and disconnection rules set forth in the WAC."[255] The metric does not bar PSE from disconnection, however, or establish a fixed quota. Instead, it was intended [256] to create an incentive for PSE to "make sure [it] didn't use disconnects as a primary tool for credit and collections."[257] PSE may still pursue disconnection if other measures fail.

140. The claim that SQI-9 interferes with the operation of other rules is unpersuasive. Notably, Ms. McLain's very short testimony for PSE on this issue is replete with hypothetical and speculative comments. For example, she speculates that reinstatement of SQI-9 "*could* interfere with proper application" of the Commission's credit and disconnection rules.[258] Despite the fact that SQI-9 has been in place for well over a decade, PSE provides no actual

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[252] *In the Matter of the Application of Puget Sound Power & Light Co*, Docket Nos. UE-951270, UG-960195, 14th Suppl. Order Accepting Stipulation; Approving Merger (February 5, 1997).
[253] *WUTC v. Puget Sound Energy Co.*, Docket Nos. UE-072300, UG-072301, Order 14 (Nov. 13, 2009).
[254] *WUTC v. Puget Sound Energy Co.*, Docket Nos. UE-072300, UG-072301, Order 16 (Aug. 31, 2010).
[255] Exh. SML-1T, p. 50:4-5 (McLain).
[256] *In the Matter of the Application of Puget Sound Power & Light Co*, Docket Nos. UE-951270, UG-960195, 14th Suppl. Order Accepting Stipulation; Approving Merger (February 5, 1997).
[257] Kouchi, TR. 1082:6-10 (summarizing the testimony of Public Counsel's witness Barbara Alexander, who testified with regard to the SQI in Dockets UE-951270 and UE-960195).
[258] Exh. No. SML-1T, p. 50:20 (McLain).

quantitative analysis but merely speculates that there are "*potential* unintended financial and customer effects of any disconnection benchmark."[259] As a general matter, the Commission's credit and collection rules have been in place throughout the life of the metric. The Commission, the Company and other parties were aware when the SQI was originally adopted, and later when reaffirmed, that it would co-exist with other rules. Moreover, with the filing by the Commission of two complaint actions[260] against PSE for violations of customer protection rules regarding credit and collection, it is not the time for removal of incentives in this area.

141. Staff admits that PSE's customers benefit from the reduction in disconnections that occur with SQI-9 in place.[261] While SQI-9 was temporarily suspended, disconnections for nonpayment increased by 32 percent, from 53,500 disconnections in 2009 to 70,500 in 2010.[262] As a result of the challenging economic climate, approximately 20 percent of PSE's customers are classified as low-income.[263] Additionally, PSE admits that "there is a segment of the population that is not eligible" for federal assistance programs "that are facing severe challenges paying for energy bills."[264] Despite the benefits to its customers, and the severe economic climate facing ratepayers, PSE now seeks to permanently eliminate the protections of SQI-9.

142. Staff witness Mr. Kouchi asserts that a potentially adverse effect of fewer disconnections is that there is a potential for "uncollectibles to increase."[265] Again, this is speculative. Moreover, Ms. McLain states that PSE's O&M costs have increased due to increased

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[259] *Id.*, p. 50:11-12.
[260] *WUTC v. Puget Sound Energy, Inc.*, Docket No. U-111465, Complaint (December 14, 2011) (improper charges for disconnection visits); *WUTC v. Puget Sound Energy,* Docket No. U-110808, Complaint (October 26, 2011)(prior obligation rule, failure to complete corrective actions per Commission order).
[261] *See* Kouchi, TR. 1094:11-12 ("[i]t is beneficial to the consumers to not be disconnected").
[262] Exh. No. RK-1T, p. 8:13-15 (Kouchi).
[263] McLain, TR. 791:1-6 (low-income is determined "using the metric of 150 percent of [the] federal poverty level").
[264] McLain, TR. 791:7-12.
[265] Kouchi, TR. 1094:14-15.

disconnection and subsequent reconnections.[266] At hearing, Ms. McLain conceded that PSE has not quantified these additional costs.[267] Consequently, there is no analysis or evidence in the record regarding the net revenue impact of either terminating or reinstating the disconnection ratio.

143. PSE asserts that SQI-9's application results in "inequitable treatment because some customers eligible to be disconnected for nonpayment are, in fact, disconnected each month while others are not – simply because the quota of allowed disconnects has been met."[268] As noted, however, SQI-9 does not place a quota on disconnections.[269] PSE has the ability to administer disconnections equitably, for example by focusing on size or duration of arrearage. Furthermore, this supposedly inequitable consequence is instrinsic to the ratio, and was understood by the Commission, Company, and parties when SQI-9 was originally adopted.[270]

144. PSE has not met its burden of proof.[271] The record lacks any compelling argument for permanently eliminating SQI-9. The issues raised by PSE and Staff are either speculative or a product of the Company's self-imposed hard cap on disconnections that exceed the SQI-9 ratio, and are exacerbated by its frequent and substantial requests for rate increases in this unprecedentedly challenging economic climate. Accordingly, the SQI-9 ratio should be reinstated.

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[266] Exh. No. SML-1T, p. 48:11-16 (McLain).
[267] McLain, TR. 787:10-21.
[268] Exh. No. SML-1T, p. 50:7-10 (McLain).
[269] McLain, TR. 788:16-20.
[270] McLain, TR. 788:7-12.
[271] RCW 80.04.130(4). PSE's testimony was a mere 3 pages and included no exhibits. It offered no empirical data regarding the revenue impact of SQI-9.

IX. PUBLIC COMMENTS

A. Written Public Comments.

145. The Public Comment exhibit in this case consists of letters, e-mails, and other written materials submitted by the public to provide comment on this case. The exhibit includes a total of 790 comments, of these 747 oppose and the requested rate increase and three support the increase; the remaining 40 neither oppose nor support the request. Many of the comments eloquently express the challenges experienced by customers facing yet another rate increase from PSE.

146. John and Adelaide Haferbacker of Kent, wrote, opposing the increase, "At no time in our lives have we been in such a weakened financial condition, personally, with reductions in income occurring regularly and utilities costs rising. Utilities need to reduce their expenditures just like everyone else is, particularly government at all levels."[272] Mr. Jeff Ehlen of Seattle also expressed concern about possible economic hardships for himself, and all ratepayers, writing, "in the past couple of years, in the midst of a major recession, when costs should remain stable or go down, the costs for all my essential services: water, sewer, healthcare, etc. have gone up."[273] Ms. Anita Plaschka of Graham wrote: "In 2005 we reduced our use of electricity by about 40% and we were overjoyed that our monthly payment was reduced. Seven years later we are now paying more than before we cut our usage nearly in half."[274] Brian Backus of Trailside Cyclery in Orting wrote:

> I wonder, has PSE taken a cut in pay like most of the rest of us or are they just raising the price to make more profit? I personally have taken a 70% cut in pay because of the business climate we are in here in Orting Washington…(I run a

[272] Exh. No. B-6, Attachment "PC Letters and Emails," p. 11.
[273] *Id.*, p. 17.
[274] Exh. No. B-6, Attachment "UTC—Comments from Database Electric 111048," p. 48.

bicycle store). My wife is a school teacher; and she as you may know has taken a State Payroll cut of 3%. Police and Fire workers have taken pay cuts. All across the board people are having to make due with less. I do not believe it should be any different for PSE Workers, Administrators, or Stock Holders....My business is on the brink... I'm not saying that this PSE increase will make the difference BUT, I am saying that if this increase is about stock holder profit margins, wage increases, and union benefits, etc...then those people involved need to wake up and smell the coffee as this is not at all realistic in this current business climate.[275]

B. Public Hearings.

147. The Commission held two public comment hearings in February 2012, in Bellevue and Olympia. Jan Welker of Tumwater testified:

> [F]ortunately, I've been able to absorb the increases that we get every year, but I know my time is coming when I'm going to be between a rock and a hard place, if I live long enough. But anyway, what I want to tell you is what's been bothering me for a number of years, and I've never said anything about it, but I think now is the time. I used to work at St. Peter Hospital in the social service area, and I heard patients there saying how comfortable they were in the hospital, because they— it's the first time they could be warm and have enough to eat, both. And this was a number of years ago, and it's gotten worse and worse and worse.[276]

Dee Shaw of Lacey testified:

> I'm a single occupant. I purchased a heat pump in 2002, but was told it was not the month PSE was offering a rebate. I got no credit for the large purchase I did a refinance on my home for. I programmed my thermostat for 60 degrees at night when—and when I'm not at home, and 68 degrees when I am home. I also purchased a new energy efficient hot water heater and set it at a low energy setting. I'm down to showering about every three to four days. I'm only doing laundry every two weeks. I'm using the dishwasher once every two and a half to three weeks. I unplug my microwave, DVD player and computer when not in use. I use CFL bulbs on lights I absolutely need to have on, but have Christmas lights in each room, which are the primary sources of light. I don't turn my porch light on. I'm not sure how I can cut back even further. I live like a miser because I cannot afford for my PSE bill to go up. I've just been informed my power bills will be $216 more this year than last year, and I'm using less energy than last year.[277]

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[275] *Id.* p. 149.
[276] TR. 575:4-18.
[277] TR.582:11-583:9.

James Blake of Rainier testified:

> Please take a hard look at the effect the magnitude that this increase will have on actual homeowners....The single largest source of my income that I have is my State of Washington retirement, which has not increased since I retired over ten years ago.[278]

148. These are just a few of the approximately 800 written and oral comments which PSE customers have provided in this case, the vast majority opposing the rate increase. Customers sounded consistent themes: economic hardship,[279] frequency of increases,[280] concern about executive bonuses, [281] PSE's overly generous rate of return,[282] excessive power outages,[283] and the futility of efforts to reduce bills by curtailment of usage and conservation measures.[284] The Commission should keep these concerns clearly in mind in deciding this request.

X. CONCLUSION

149. For the reasons set forth in this brief, Public Counsel respectfully requests that the Commission adopt the recommendations of Public Counsel on behalf of PSE's customers, and reject the excessive and unsupported rate request of Puget Sound Energy in this proceeding.

150. DATED this 16th day of March, 2012.

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[278] TR.596:-19-597:3.
[279] Cumberland, TR. 606:11-18.
[280] Welker, TR. 575:4-6; Ferrier, TR. 608:1-2.
[281] Welker, TR. 576:1-8.
[282] Jacobs, TR. 576:17-577:3; Jorgenson, TR. 580:3-13.
[283] Stearns, TR. 590:2-5; Downey, TR. 589:1-10.
[284] Blake, TR. 595:17-596:13.