

**BEFORE THE WASHINGTON  
UTILITIES AND TRANSPORTATION COMMISSION**

**In the Matter of the Petition of**

**PUGET SOUND ENERGY, INC.**

**For an Accounting Order Approving the  
Allocation of Proceeds of the Sale of  
Certain Assets to Public Utility District #1  
of Jefferson County.**

**DOCKET UE-132027**

**REPLY BRIEF ON BEHALF OF COMMISSION STAFF**

**June 17, 2014**

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## I. INTRODUCTION

1 Staff's Initial Brief<sup>1</sup> responds to most of the arguments offered by Puget Sound Energy, Inc. (Company or PSE) in its Post-Hearing Brief.<sup>2</sup> We address the exceptions in this Reply, but one item merits special attention now.

2 PSE's analysis is premised on the false assumption that "[t]here is no presumption, or a past practice, that customers bear losses for sales of property when the sale is below book value."<sup>3</sup> That assumption is thoroughly refuted by the many examples of past practices where customers have borne capital losses (including value reductions) due, for example, to plant obsolescence, plant abandonment and environmental damage, among others.<sup>4</sup>

3 This is yet another example that proves PSE's theory is out of touch with the reality of regulation in this state, in which PSE customers shoulder ownership risk; that is one reason why customers are entitled to the gain on sale in this case. The Commission should reject PSE's theory for this reason, and for the additional reasons set forth below.

## II. ARGUMENT

### A. PSE Fails to Justify a Different Regulatory Treatment for a Sale Under Threat of Condemnation, Compared to a Voluntary Sale

4 PSE insists this case is unique because it involves a sale under threat of condemnation, and because the sale is "deemed approved as a matter of law."<sup>5</sup> Neither argument holds water. While PSE supports its "deemed approved" argument with RCW 80.12.020(2) and the Commission's Declaratory Order in Docket UE-101217,<sup>6</sup> those sources simply "exempt" the

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<sup>1</sup> Initial Brief on Behalf of Commission Staff (June 10, 2014) (Staff Initial Brief)...

<sup>2</sup> Post-Hearing Brief of Petitioner Puget Sound Energy, Inc. (June 10, 2014) (PSE Post-Hearing Brief).

<sup>3</sup> PSE Post-Hearing Brief at 3, ¶ 5 and at 29, ¶ 44.

<sup>4</sup> Staff Initial Brief at 23-28, ¶¶ 75-89.

<sup>5</sup> PSE Post-Hearing Brief at 4-8, ¶¶ 8-12.

<sup>6</sup> PSE Post-Hearing Brief at 5, footnote 7. Notably, PSE cites to the Declaratory Order in general, rather than specific language from that order. In fact, the Commission did not use the term "deemed approved" in that order.

JPUD transaction from the Commission approval requirement. In fact, that is precisely what the Commission concluded in its Declaratory Order.<sup>7</sup>

5 As Staff has explained, the Commission has the authority to apply the same “public interest” test and “risk/reward” principle here as in a voluntary sale.<sup>8</sup> In addition, voluntary and involuntary sales share the same basic standard for assessing the value of the sale: fair market value is the guidepost in each context.<sup>9</sup> More importantly, the same balance of “risks and rewards” applies to each type of sale; a forced sale does not change the fact that PSE’s customers have and will continue to bear the risk of capital loss for utility property.

6 The problem is obvious: PSE is inappropriately conflating the issue of determining fair market value<sup>10</sup> with the issue of who is entitled to the gain on sale of regulated utility property. These are different issues; the first involves calculating fair market value using various factors, while the second is based on the public interest and the application of the risk/reward principle. PSE does not keep these issues separate, and a defective analysis is the result.

#### **B. The Commission Should Not Adopt the Policy of the California Commission**

7 PSE relies heavily on a policy decision of the California Public Utility Commission (CPUC) in *City of Redding II*<sup>11</sup> to give shareholders 100 percent of the gain on sales due to

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<sup>7</sup> *Petition of Puget Sound Energy, Inc., for a Declaratory Order Regarding the Transfer of Assets to Jefferson Cy. Pub. Util. Dist.*, Docket U-101217, Order 03, Final Order Approving and Adopting Settlement Agreement; Granting Petition of Declaratory Judgment (February 1, 2011) (Declaratory Order) at 17, ¶ 42, Conclusion of Law 5.

<sup>8</sup> Staff Initial Brief at 5, ¶ 13-16.

<sup>9</sup> Fair market value is the eminent domain standard. 26 Am. Jur. 2d, *Eminent Domain* § 298 at 709 (1996): “...the United States Supreme Court has ... employed the concept of fair market value to determine the condemnee’s loss.” As Mr. Bellemare testified, the price for the PSE distribution system in Jefferson County reflected the fair market value of that system. Bellemare Direct, Exh. No. RCB-1T at 11:8-13. Outside the condemnation context, the Commission has ruled that “the difference between net book value and fair market value should be considered the gain on the sale of the property ...” *Utilities & Transp. Comm’n v. Puget Sound Power & Light Co.*, Cause U-85-53, Second 2d Supplemental Order, 74 Pub. Util. Rep. (PUR) 4<sup>th</sup> 536, 563 (1986).

<sup>10</sup> PSE Post-Hearing Brief at 24-26, ¶¶ 38-40, citing *City of Omaha v. Omaha Water Co.*, 218, U.S. 180 (1910) and *Kimball Laundry Co. v. United States*, 338 U.S. 1 (1949).

<sup>11</sup> *Ratemaking Treatment of Capital Gains from the Sale of a Pub. Util. Distribution Sys. Serving an Area Annexed by a Municipality or Pub. Entity*, 104 Pub. Util. Rep. (PUR) 4<sup>th</sup> 157 (Cal. PUC 1989) (*City of Redding II*).

municipalization.<sup>12</sup> The CPUC’s decision was based on the premise that investors bear “general financial risk” of making the investment in utility property, and thus, “they should be assigned the rewards.”<sup>13</sup>

8           The Company fails to recognize the substantial shortcomings in the CPUC’s reasoning. For example, in *City of Redding II*, the CPUC failed to explain why that financing risk is not borne by customers through the cost of capital, *i.e.*, customers pay the utility’s cost of capital for all utility assets through the weighted cost of capital applied to the rate base. An elemental principle of regulation is that rates should be sufficient to enable the utility to finance its regulated operations on reasonable terms.<sup>14</sup> Therefore, through the rate-setting process, customers effectively bear the risk of financing.

9           Notably, the CPUC itself recognized that very fact in a later case, contradicting the premise of *City of Redding II*, *i.e.*, that investors bear the financial risk. The later case was a rulemaking on the general subject of treatment of gains on sales of utility property. In its order, the CPUC justified its policy decision to give customers 100 percent of the gain on sales of depreciable utility property on the basis that “[customers] bear the burden of the financial risk of the investment.”<sup>15</sup> The CPUC never explained this obvious contradiction with the premise underlying its earlier decision in *City of Redding II*.<sup>16</sup>

10           Also, in *City of Redding II*, the CPUC was concerned that if it gave customers the gain on the sale due to municipalization, that “would be a deterrent to the reinvestment of retained

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<sup>12</sup> PSE Post-Hearing Brief at 6-8.

<sup>13</sup> *City of Redding II*, 104 Pub. Util. Rep. (PUR) 4<sup>th</sup> at 157.

<sup>14</sup> See Staff Initial Brief at 12, ¶36, quoting the *Hope* decision of the United States Supreme Court.

<sup>15</sup> *Allocation of Gains from Sales of Energy, Telecomm., and Water Util. Assets*, Rulemaking 04-9-3, 249 Pub. Util. Rep. (PUR) 4<sup>th</sup> 478, 493 (Cal. PUC 2006) (emphasis supplied). In that order, the CPUC did not change its treatment of gains from sales of utility property due to municipalization, saying only that it had “not been presented with an adequate record” to change that treatment. 249 Pub. Util. Rep. (PUR) 4<sup>th</sup> at 493.

<sup>16</sup> The CPUC further explained with regard to depreciable property, that “[t]he regulatory compact requires that if ratepayers bear such costs, they must be compensated for such burdens once the utility sells the property.” *Id.* 249 Pub. Util. Rep. (PUR) 4<sup>th</sup> at 493.

earnings and to the attraction of new capital.”<sup>17</sup> That concern does not apply here, because PSE will reinvest the proceeds from the JPUD sale in new facilities,<sup>18</sup> and there is nothing to suggest that after the sale, PSE will be any less able to attract new capital than before. In short, PSE has not lost the opportunity to make the cash raised from the JPUD sale work to the Company’s economic benefit.<sup>19</sup> The CPUC’s analysis in *City of Redding II* does not apply for the further reason that PSE’s customers bear the risk of loss related to PSE’s utility property in this state.<sup>20</sup>

11 For each of these reasons, the Commission should reject the rationale California apparently adopted regarding sales of a distribution system to a municipality.

### C. Partial Versus Total Liquidation

12 PSE argues that the Commission should evaluate the sale of a part of the Company’s system in the same manner as if its entire system were sold. PSE applies the CPUC policy in *City of Redding II*, which treats a partial liquidation the same as a total liquidation, and argues that all the gain should go to shareholders, because remaining customers allegedly are unaffected.<sup>21</sup> This PSE argument exposes two more flaws in the Company’s case.

13 First, as Staff has shown, there is indeed harm to remaining customers. Staff provided evidence of the near term harm for power supply costs of \$39.303 million.<sup>22</sup> PSE does not dispute this fact. Instead, PSE claims there is no harm, if only the Commission will focus on benefits that might arise over a 20-year time frame. Despite the uncertainties of long-term projections, and using actual load and revenue data provided by PSE, Staff calculated nominal

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<sup>17</sup> *City of Redding II, supra*, 104 Pub. Util. Rep. (PUR) 4<sup>th</sup> at 164.

<sup>18</sup> PSE Petition at 20, ¶42 (PSE will reinvest the proceeds in similar utility property); Marcellia, TR. 115:19-21 (cash proceeds have “been used” by PSE).

<sup>19</sup> Staff Initial Brief at 17-18, ¶¶ 53-58.

<sup>20</sup> Staff Initial Brief at 19-29, ¶¶ 61-93.

<sup>21</sup> PSE Post-Hearing Brief at 8, ¶ 12.

<sup>22</sup> Keating, Exh. No. EJK-4.



harm to remaining customers of \$195.922 million over 20 years.<sup>23</sup> And, this harm is only for power supply costs. Staff also showed additional harm due to the experimental ERF/decoupling mechanism now in place for PSE.<sup>24</sup>

14           Second, in a partial liquidation scenario, PSE remains an ongoing business serving its remaining customers. PSE's fixed costs of service remain and all other customers continue to take service from PSE. It is axiomatic that all other customers are harmed because fewer customers remain to contribute to PSE's overheads and other fixed costs.

**D. PSE Shareholders Are Benefited, Not Harmed, from Staff's Proposal to Share the Gain with Customers**

15           PSE argues that its shareholders are harmed due to lost customers and lost revenue.<sup>25</sup> In fact, not only is there no harm to shareholders, they are benefited from Staff's gain-sharing proposal. There is no harm because the regulatory compact is fully satisfied when PSE receives the net book value of its investment, which all parties propose in this case; the regulatory compact does not offer PSE a guaranteed revenue stream.<sup>26</sup>

16           Staff's proposal benefits shareholders through a significant accretion to shareholders' equity investment in utility assets. Using PSE's 48 percent equity ratio, the \$46.7 million net book value in assets sold to JPUD was financed with around \$22.5 million of equity.<sup>27</sup> Staff's proposal provides PSE's shareholders an additional \$7,481,394 over net book value, delivering a full 33 percent<sup>28</sup> increase to PSE's equity investment in those assets. Applying PSE's argument that the Commission should balance the equities, Staff's proposal meets that test, and then some.

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<sup>23</sup> *Id.*

<sup>24</sup> Keating Direct, Exh. No. EJK-1T at 28:19 to 32:14, and related exhibits.

<sup>25</sup> *E.g.*, PSE Post-Hearing Brief at 21, ¶ 35.

<sup>26</sup> Staff Initial Brief at 10-18, ¶¶ 28-58.

<sup>27</sup> Keating, TR. 236:14-21 (48% \* \$46.7m = 22.5m).

<sup>28</sup> \$7.481m ÷ \$22.5m = 33.2 percent.

The Commission should also recognize that PSE fares far better under regulation than it would if it had to compete for customers. In a competitive market, shareholders bear the risk that the firm will lose customers or market share. Because a competitive firm's prices are set by the market; it cannot raise its prices to restore the lost revenue that former customers paid for the assets necessary to deliver service.<sup>29</sup> By contrast, under regulation, PSE's shareholders are not harmed when customers are lost due to municipalization, because the remaining investment on the Company's books necessary to serve those customers is returned to shareholders - there is no loss of capital. In other words, if equity be the consideration, then PSE and its shareholders must recognize they are protected by the regulatory compact from loss of capital, through the rate setting process. Staff's proposal in this case provides that protection. Staff presented several other previous examples in which customers provided PSE that protection.<sup>30</sup>

#### **E. PSE's Customer Benefit Analysis is Seriously Flawed**

PSE alleges \$103 million in power supply benefits to customers as a result of the sale, based on the Company's 20-year forecast. PSE then criticizes as "cherry picking" Staff's choice to focus on near-term impacts rather than the speculative out years of the 20 year forecast.<sup>31</sup> However, what PSE now calls "cherry picking" is exactly what PSE itself urged the Commission to accept in the *Centralia Case*.<sup>32</sup> In that case, PSE chose not to rely on the "speculative" out years of the forecast. PSE is wrong to give full effect to the out years of the forecast now.

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<sup>29</sup> Dr. Levin wrongly suggested that a firm in a competitive market could simply add the risk of a capital loss due, for example, to storm damage, through an "add-on to the price [of its product]." Levin, TR. 138:7-10. In fact, if the market truly is competitive, the market sets the price. Any firm that feels compelled to increase its prices due to "add-ons" does so at the risk of losing sales and market share as a result. By contrast, "PSE is not a competitive business," (Marcelia, TR. 102:22 to 103:1), and it faces no such risk; \$709 million in regulatory assets is full proof.

<sup>30</sup> Staff Initial Brief at 21-28, ¶¶ 67-89.

<sup>31</sup> PSE Post-Hearing Brief at 10, ¶16.

<sup>32</sup> *Application of Puget Sound Energy, Inc. for Approval of the Proposed Sale of PSE's Share of the Centralia Facilities, and Authorization to Amortize Gain Over a Five-Year Period*, Docket UE-991409 et al., 2<sup>nd</sup> Supplemental Order, Order Approving Sale with Conditions (March 6, 2000) (*Centralia Case*).

19 In short, while PSE urges the Commission to focus on “reasonable assumptions and probable outcomes,”<sup>33</sup> PSE’s use of speculative forecasts fails that standard.<sup>34</sup>

**F. The Record Refutes PSE’s Suggestion that the Sale to JPUD should be Treated “Just Like Conservation”**

20 PSE argues that the Commission should treat the load lost through the sale to JPUD the same as if that load were lost due to conservation, because, according to PSE, there is “*simply no rational basis to support such a distinction in regulatory treatment ...*”<sup>35</sup> In fact, there are several obvious reasons to support different treatment. For one thing, *no electricity actually has been conserved here*, because people in Jefferson County are still using electricity. Perhaps that explains why PSE does not model loss of service territory as a conservation strategy,<sup>36</sup> and why PSE has not presented such an option to the conservation resource advisory group.<sup>37</sup>

21 Moreover, conservation is considered one of a variety of resource options, and PSE is statutorily required to consider conservation in developing a mix of resources that are the “lowest reasonable cost.”<sup>38</sup> The law also requires PSE to pursue “all available conservation that is cost-effective, reliable and feasible.”<sup>39</sup> None of these statutory requirements apply to PSE’s sale of its distribution system to JPUD. Each of these differences justify different regulatory treatment.

22 Finally, PSE’s own hypothetical example proves that a sale of a distribution system places much more of a financial burden on customers than conservation. In PSE’s rebuttal testimony, Mr. Piliaris offered a hypothetical example in which a utility had one million

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<sup>33</sup> PSE Post-Hearing Brief at 9, ¶ 14.

<sup>34</sup> In any event, if in fact it is undisputed that customers will benefit by \$103 million, the Commission should question why PSE is not offering to record a regulatory liability guaranteeing that benefit to customers. Piliaris, TR. 73:24 to 74:3.

<sup>35</sup> PSE Post-Hearing Brief at 15, ¶ 22, quoting Piliaris Rebuttal, Exh. No. JAP-9T at 10:7-14 (emphasis in text of PSE’s brief).

<sup>36</sup> Piliaris, TR. 90:12-15.

<sup>37</sup> Piliaris, TR. 90:16-25.

<sup>38</sup> RCW 19.280.030 (integrated resource plan required) and RCW 19.280.010(9) (defines integrated resource plan).

<sup>39</sup> RCW 19.285.040(1). In fact, if loss of customers is to be treated as conservation, PSE would be encouraging all of its customers in areas contiguous to electric cooperatives to change electricity providers. That PSE has not adopted that strategy exposes the fallacy of the Company’s argument.

customers, \$500 million in fixed power costs and sales of 20 million MWh, for a cost of \$25 per MWh per customer.<sup>40</sup> PSE then chose a Municipalization Scenario and a Conservation Scenario, and assumed the same loss of 1,000,000 MWh in each. In the Conservation Scenario, the MWh loss was due to conservation; the number of customers stayed the same. In the Municipalization Scenario, the MWh loss was due to the loss of 50,000 customers.<sup>41</sup>

23 In fact, this hypothetical proves customer harm in the Municipalization Scenario compared to the Conservation Scenario, because, though the usage change is the same in each scenario (usage changed from 20 million MWh to 19 million MWh), the revenues paid by customers is much higher in the Municipalization Scenario: \$526 per customer,<sup>42</sup> compared to \$499.70 per customer under the Conservation Scenario.<sup>43</sup> In the end, PSE's own numbers sound the death knell for its theory.

#### **G. PSE's Accumulated Depreciation Argument Misses the Point**

24 PSE offers a belabored discussion of depreciation,<sup>44</sup> but the Company simply misses the point. The Accumulated Depreciation issue arises because Staff and ICNU followed this Commission's order in the *Centralia Case*, in which the Commission used Accumulated Depreciation as a way to evaluate how to apportion the gain on sale to customers. In doing so, the Commission observed:

The fact that the facilities are selling for an amount greater than original cost is evidence that the facilities have an increasing, not a decreasing, value, as an asset in a competitive wholesale generation market. This increased value is greater than the depreciation paid by ratepayers. Thus, a portion of the gain equivalent to the difference between net book

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<sup>40</sup> Piliaris, Exh. No. JAP-9T at 13:1-16; [ $\$500\text{m} \div 20\text{m MWh}$ ]  $\div 1\text{m} = \$25$  per MWh per customer.

<sup>41</sup> Piliaris, Exh. No. JAP-9T at 13:11. PSE concluded that the power cost from each scenario was the same: \$26.3 per MWh.

<sup>42</sup> Municipalization Scenario:  $19\text{m MWh} \div 950,000$  customers = 20 MWh/customer;  $20 \text{ MWh/customer} * \$26.3/\text{MWh} = \$526/\text{customer}$ .

<sup>43</sup> Conservation Scenario:  $19\text{m MWh} \div 1\text{m customers} = 19 \text{ MWh per customer}$ .  $19 \text{ MWh/customer} * \$26.3/\text{MWh} = \$499.7/\text{customer}$ .

<sup>44</sup> PSE Post-Hearing Brief at 16-21, ¶¶ 25-34.

value and original cost should be returned to ratepayers, as they have, *in effect*, overpaid necessary depreciation. This amount would be equivalent to accumulated depreciation.<sup>45</sup>

25 While the situation is the same here (PSE sold Jefferson County assets at a greater value than net book), there is nothing to suggest that the Commission in the *Centralia Case* intended anything more than a conceptual method for determining how to share the gain. All of PSE's arguments in this case regarding Accumulated Depreciation, including what depreciation expense was "in rates" and "not in rates" were irrelevant in the *Centralia Case*.

26 If the Commission chooses the same approach as in the *Centralia Case*, it should use Accumulated Depreciation as a basis for an equitable sharing, and nothing more.

#### H. PSE's Argument on Regulatory Assets Confirms Staff's Risk/Reward Analysis

27 According to PSE, the \$709 million in regulatory assets on its books have no particular relevance to this case. PSE thinks these deferrals exist simply for "customer benefit" as a "means [for PSE] to recover ... prudently incurred costs" and "to avoid rate volatility."<sup>46</sup>

28 In fact, this PSE argument confirms Staff is correct that creating these regulatory assets places cost responsibility to PSE customers, and thus places upon PSE customers the risk of loss.<sup>47</sup> It also proves just how desensitized PSE has become regarding regulatory assets, which should be the exception, rather than the norm. Take, for example, extraordinary storm damage expenses. Some commissions have allowed recovery of only a normal level of storm damage expenses, and have disallowed recovery of extraordinary storm damage expenses.<sup>48</sup> A Rhode Island utility had to go to its state supreme court to recover past extraordinary storm damage expenses, and the court had to create an exception to the retroactive ratemaking rule to provide

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<sup>45</sup> *Centralia Case*, *supra*, 2<sup>nd</sup> Supplemental Order at 28, ¶ 82 (emphasis added).

<sup>46</sup> PSE Post-Hearing Brief at 31, ¶ 49.

<sup>47</sup> Initial Brief on Behalf of Commission Staff at 21-23, ¶¶ 67-74.

<sup>48</sup> *E.g.*, *Application of Cent. Maine Power, Inc.*, 26 Pub. Util. Rep. (PUR) 4<sup>th</sup> 388, 413-14 (Maine PUC 1978).

such recovery.<sup>49</sup> In stark contrast is PSE, who obtains an accounting order, defers extraordinary storm damage expenses, and from then on, the Company enjoys guaranteed, dollar for dollar cost recovery from customers.

29 The fact is, PSE's regulatory assets provide at least "709 million reasons" why customers have borne the risk of loss regarding PSE's utility property in this state. While PSE has chosen to disregard that reality, the Commission must not. By shouldering these substantial risks, customers are entitled to the gain on sale in this case.

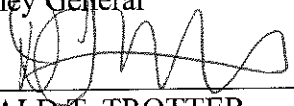
### III. CONCLUSION

30 For the reasons stated in this brief and in Staff's Initial Brief, of the \$109,273,196 proceeds PSE received from the sale of its distribution system in Jefferson County, the Commission should allocate \$56,572,473 to PSE and \$52,700,723 to customers. This result reflects a correct application of the "regulatory compact," and the risk/reward principle.

DATED this 17<sup>th</sup> day of June 2014.

Respectfully submitted,

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<sup>49</sup> *Narragansett Elec. Co. v. Burke*, 415 A.2d 177 (R.I. 1980).