Exh. CRM-1T
Dockets UE-190529/UG-190530 and UE-190274/UG-190275 (*consolidated*)
Witness: Chris R. McGuire

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**DOCKETS UE-190529 and UG-190530 *(consolidated)***
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life UT/Technology Investment**	**DOCKETS UE-190274 and UG-190275 (*consolidated*)**

TESTIMONY OF

Chris R. McGuire

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Overview of Staff's Case and Policy Issues; Attrition Policy;
Recovery of Decommissioning and Remediation Costs for Colstrip Units 3 and 4;
Derivation of Staff's Modified Materiality Threshold for Plant

November 22, 2019

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Chris R. McGuire, and my business address is 621 Woodland Square Loop SE, Lacey, Washington, 98503. My business mailing address is P.O. Box 47250, Olympia, Washington, 98504-7250. My business email address is chris.mcguire@utc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I work in the Regulatory Services Division of the Washington Utilities and Transportation Commission (Commission) as Assistant Director of Energy Regulation. I have worked at the Commission since May 2012, and in my current position since April 2018.

Q. Would you please state your educational and professional background?

A. I graduated from the University of Washington in 2002 with a Bachelor of Science degree in Cell and Molecular Biology. I graduated from the University of Colorado in 2010 with a Master of Business Administration and a Master of Science in Environmental Studies. Prior to my employment with the Commission, I held various research and analytical positions at the University of Washington, the University of Colorado and the National Renewable Energy Laboratory.

Q. Have you previously testified before the Commission?

A. Yes. I testified previously on the following issues in Puget Sound Energy ("PSE" or "Company") rate cases: depreciation and cost recovery for Colstrip Units 1 and 2 in PSE's 2017 general rate case (GRC), Dockets UE-170033 and UG-170034; and testimony in support of settlement in PSE's 2018 expedited rate filing, Dockets UE-180899 and UG-180900. I have also testified on pro forma plant additions in Pacific Power's 2013 GRC, Docket UE-130043; the attrition studies in Avista's 2014 GRC, Dockets UE-140188 and UG-140189; policy and attrition studies in Avista's 2015 GRC, Dockets UE-150204 and UG-150205; revised attrition allowances in Avista's remanded 2015 GRC, Dockets UE-150204 and UG-150205; interest rate hedging in Avista's 2017 GRC, Dockets UE-170485 and UG-170486; and recovery of Colstrip costs and the company's rate plan proposal in Avista's 2019 GRC, Dockets UE-190334 and UG-190335.

II. SCOPE AND SUMMARY OF TESTIMONY

Q. Please describe the scope of your testimony.

A. My testimony first provides a broad overview of Commission Staff's (Staff's) case and identifies significant policy issues raised in the case. I also sponsor testimony on (1) Commission policy on attrition allowances, (2) implications of the Clean Energy Transformation Act (CETA)[1] for recovery of decommissioning and remediation

[1] Chapter 19.405 RCW.

(D&R) costs for Colstrip Units 3 and 4, and (3) the calculation of Staff's modified threshold for evaluating the materiality of plant additions.

Q. What has Staff concluded with respect to the application of the Commission's policy on attrition allowances to PSE's request for an attrition allowance in this case?

A. PSE's request for an attrition allowance falls short of the Commission's policy standards on attrition allowances. Most notably, PSE is not experiencing chronic under earning, and it does not provide persuasive evidence that the costs it identifies are due to factors outside of the Company's control. Further, the issues that the Company does identify as beyond the Company's ability to control, such as power costs and Tax Reform, largely are unrelated to attrition, as evidenced by the fact that those issues are not included in the Company's own attrition study.

Moreover, as demonstrated by the attrition studies sponsored by Staff witness Jing Liu, PSE is not likely to experience attrition in the rate year, even if PSE had shown that it meets the Commission's threshold criteria.

In other words, PSE has demonstrated neither the circumstances warranting nor the need for an attrition allowance.

Q. What have you concluded with respect to PSE's proposed recovery of D&R costs for Colstrip Units 3 and 4?

A. I recommend that, for this case only, the Commission allow D&R costs for Colstrip Units 3 and 4 to be recovered as proposed, which is through depreciation accelerated to 2025.

However, I also recommend that the Commission order PSE to file a proposed plan in its next GRC for the recovery of D&R costs for Colstrip Units 3 and 4 that complies with the D&R provisions of CETA, and to include in the plan an assessment of production tax credits (PTCs) available to offset D&R costs for Colstrip Units 3 and 4.

Q. What do you recommend with respect to the calculation of Staff's modified threshold for evaluating the materiality of plant additions?

A. When assessing whether a plant addition is "major" and therefore merits pro forma treatment, Staff recommends using a "gross cost" materiality threshold that reflects annual depreciation plus return on rate base. Staff recommends gross cost thresholds of $2.71 million for electric investments, $1.17 million for natural gas investments, and $3.89 million for combined electric and gas assets.

These modified materiality thresholds are applied by Staff witness Aimee Higby in her assessment of the materiality of (a) pro forma plant additions and (b) plant additions related to PSE's petition for deferred accounting treatment for its Get to Zero customer service initiative (GTZ).

Q. Have you prepared any exhibits in support of your testimony?

A. Yes. I prepared Exh. CRM-2.

Exh. CRM-2 is PSE's Annual Colstrip Report on Decommissioning and Remediation, dated November 30, 2018. CRM-2 is used to identify PSE's estimate of decommissioning and remediation costs at Colstrip.

III. INTRODUCTION OF STAFF WITNESSES

Q. Please introduce the other Staff witnesses testifying in this proceeding and the subjects of their testimony.

A. The following witnesses present testimony and exhibits for Staff:

- Jing Liu presents Staff's calculation of revenue requirements for PSE's electric and natural gas operations and on the baseline rate for PSE's Power Cost Adjustment (PCA) mechanism. Liu also presents Staff's attrition analysis and provides recommendations on temperature normalization, Colstrip maintenance expense, the Centralia PPA equity adder and power cost model issues.
- Jason Ball addresses cost of service, rate spread and rate design, and makes recommendations with respect to pilot programs on pricing.
- David Gomez addresses pro forma power costs, including PSE's wind capacity factors and gas pipeline transport costs. Gomez also addresses costs PSE includes in its revenue requirement calculations related to the Tacoma LNG project and Colstrip Units 3 and 4, including costs related to the 2018 forced outage, the Company's investment in SmartBurn, and the pending expiration of the fuel contract with Westmoreland Mining LLC.

- Aimee Higby addresses and applies the Commission's policy on pro forma plant additions, and proposes a modification to the materiality standard. Higby also addresses Dockets UE-190274 and UG-190275 regarding PSE's petition for deferred accounting treatment for GTZ investments, as well as PSE's proposed recovery of the associated deferral balance.
- David Parcell addresses cost of capital.
- Kathi Scanlan addresses various regulatory and accounting issues associated with PSE's Green Direct Program.
- Cristina Steward addresses excess deferred income tax (EDIT), working capital, and rate base adjustments related to PSE's sale of its Shuffleton property.
- I present an overview of Staff's case and the major policy issues raised in this filing. I also address the Commission's policy with respect to attrition allowances, recovery of decommissioning and remediation costs for Colstrip Units 3 and 4, and the calculation of Staff's modified materiality threshold.

IV. OVERVIEW OF STAFF'S CASE AND POLICY ISSUES

Q. Please provide an overview of PSE's direct case.

A. PSE begins with a traditional case, following the Commission's standard formula for the derivation of revenue requirement, beginning with a modified historical test year and adding restating and pro forma adjustments. PSE does not request a multi-year rate plan.

PSE requests increases in revenue of $139.9 million for electric operations and $65.5 million for natural gas operations, which include attrition allowances of $38.5 million for electric and $11.8 million for natural gas. PSE requests a rate of return of 7.62 percent, which includes a return on equity of 9.8 percent and an equity layer of 48.5 percent.

Before the addition of an attrition allowance, PSE produces revenue requirements of $101.4 million for electric and $53.7 million for natural gas.

PSE's revenue requirement also includes recovery of deferral balances related to PSE's GTZ initiative. PSE's request for deferred accounting treatment for past depreciation expense for GTZ is consolidated with this rate case.

Q. Please provide an overview of Staff's revenue requirement calculation.

A. As presented in the testimony of Liu, Staff recommends the Commission authorize revenue increases of $50.0 million for electric operations and $38.4 million for natural gas operations. These revenue requirements use Staff's recommended rate of return of 7.33 percent, which is based on a return on equity of 9.2 percent and an equity layer of 48.5 percent.

Q. Do Staff's revenue requirements include attrition allowances?

A. No, they do not. As demonstrated by Liu's attrition analyses, PSE is not likely to experience attrition in the rate year. Further, as described in my testimony, PSE's circumstances do not meet the Commission's threshold criteria for considering attrition allowances.

Q. Does this rate case present the Commission with any major policy issues?

A. Yes. This case raises significant policy issues associated with:

1. Attrition allowances;
2. Deferred accounting petitions;
3. Pricing pilots;
4. Materiality; and
5. Colstrip decommissioning and remediation costs.

Q. Please describe the policy issue related to attrition allowances.

A. PSE includes attrition allowances in its electric and natural gas revenue requests. Notably, PSE's proposed attrition allowances are derived from mathematical projections of costs in the rate year, including costs associated with projections of rate base.

In section V, below, I explain how PSE's circumstances do not meet the Commission's threshold criteria for considering attrition allowances. However, even if the Commission concludes that consideration of an attrition allowance is appropriate, PSE's attrition allowance should still be rejected because, as shown by Staff witness Liu, the results of Staff's attrition analysis does not support the need for allowances in this case. Moreover, the Company's calculations are problematic. In particular, by calculating attrition allowances using mathematical extrapolation of costs, and in particular by using projections of rate year rate base before the Commission has provided forthcoming guidance on the matter puts the cart before the horse. The Commission's Order 05 in Avista's 2015 GRC was reversed and remanded for this very reason, and that case remains unresolved. Further, the legislature amended the property valuation statute, RCW 80.04.250, and the Commission initiated Docket U-190531 to consider how the revisions impact its administration of the statute. The Commission has yet to publish rules or a policy statement.

Through its request for an attrition allowance, PSE moves forward a proposal that presumes the Commission's policy with respect to revisions to the used and useful standard, and requires parties to respond to the Company's proposal before the Commission has had an opportunity to provide guidance on the matter.

Q. Please describe the policy issue related to deferred accounting petitions for utility investments in plant.

A. PSE requested deferral of depreciation expenses for investments associated with the Get to Zero initiative. Typically, the Commission authorizes deferred accounting treatment to help mitigate the financial impact to a utility of large, unexpected costs that could not have been considered when setting rates. Thus, deferred accounting typically is reserved for extraordinary events. The Commission generally has concluded that extraordinary events are those that 1) are beyond the regulated company's control;[2] and 2) generate costs that have a material impact on the utility's financial results.[3]

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[2] *Wash. Utils. & Transp. Comm'n. v. Pacific Power and Light Co.*, Docket UE-140762, Order 08, 107, ¶ 251 (Mar. 25, 2015). The Commission states "We emphasize, then, that the treatment we allow is in this instance is exceptional and turns on the unusual nature of the project involved."

[3] *Wash. Utils. & Transp. Comm'n. v. Northwest Natural Gas Company*, Docket UG-080519, Order 01, 3, ¶ 7 (May 2, 2008).

Thus, PSE's petition asks that the Commission determine that utility investments are extraordinary events. Although, as Staff witness Higby explains, it is possible that rapid depreciation associated with short-lived assets could create extraordinary circumstances for the utility, the Commission should not take lightly the decision to repurpose accounting petitions for depreciation expense.

Further, it is important for the Commission to understand that, in authorizing deferred accounting treatment, it is agreeing that the rates that it previously authorized by order were insufficient for the utility to recover its costs. Much of the depreciation expense for which PSE seeks deferred accounting treatment was incurred shortly after the Commission authorized increases to PSE's rates. Importantly, authorizing recovery of depreciation expense that was incurred in the past is tantamount to determining that *past rates* were insufficient to cover the utility's costs, which raises questions of retroactive ratemaking.

Staff encourages the Commission to offer guidance on the purposes for which, and the circumstances in which deferred accounting should be used. In this GRC, Staff recommends limited authorization for deferred accounting related to the Company's investments in GTZ, as described by Staff witness Higby. Staff's approach attempts to place parameters on deferred accounting for plant investments while the Commission considers offering guidance on this matter.

Q. Are there any other issues related to PSE's request for deferred accounting treatment for GTZ?

A. Yes. In its petition, PSE requests open-ended, "on-going" authority to defer depreciation for "any future qualifying GTZ investment placed in service after the establishment of rates."[4]

PSE is requesting deferred accounting treatment for hypothetical expenses, for projects that have not been identified, and during a period for which rates have not yet been set. It is not possible to assess whether extraordinary circumstances will exist at that time such that to-be authorized rates will be rendered insufficient. Moreover, PSE's petition asks that the Commission accept that the revenues it authorizes through this GRC will be insufficient the moment they are authorized.

Staff strongly recommends the Commission deny this portion of the petition. The rates authorized by the Commission through this proceeding will be sufficient to cover the Company's cost in the rate year, as the Commission will determine by order, and as is the purpose of setting rates through a general rate case.

Q. Please describe the policy issue related to pricing pilots.

A. As utilities consider options for compliance with new legislative mandates and to take advantage of advances in grid digitization, they likely will need to begin treating new rate structures as viable resources. However, prior to doing so, utilities will need to gain experience with options provided by new technologies. Pilots can provide that experience. Pricing pilots can allow utilities to experiment with various rate

[4] *In re Puget Sound Energy Petition for an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life IT/Technology Investment,* Dockets UE-190274 & UG-190275, Petition, 5–6, ¶ 10 (April 10, 2019).

structures, such as time-of-use rates, and gather data on program costs and benefits, price responsiveness, and administrative complexity.

Utilities need to begin offering pricing pilots immediately, or they will be unprepared to make informed decisions on effective and efficient rate structures when it becomes imperative that they do. With adequate preparation, new rate structures could provide substantial value to the utility and its ratepayers. Additionally, since pricing pilots generally need a few years to complete, it is better that PSE begin them now rather than wait until they are needed as resource options.

However, absent Commission guidance with respect to pricing pilots, utilities might perceive pricing pilots as risky endeavors. This issue is discussed in detail by Staff witness Ball. Ball recommends that the Commission offer policy guidance with respect to pilot programs on pricing. Ball also recommends that PSE begin implementing pricing pilots immediately, and that the Commission provide encouragement for them to do so.

Q. Please describe the policy issue related to the materiality threshold?

A. Traditionally the Commission has determined that a plant addition is material (or "major") if it represents at least 0.5 percent of the utility's net plant in service. As Staff witness Higby explains, a materiality threshold that is 0.5 percent of net plant in service is agnostic to a project's book life and, therefore, does not account for a project's contribution to depreciation expense. As a result, short-lived assets are disadvantaged under the traditional materiality standard, creating pressure for utilities to file serial rate cases and proposals for extraordinary rate treatment.

Building upon her recent testimony in Avista's 2019 general rate case, Staff witness Higby presents a new criterion for evaluating the financial materiality of post-test year plant additions. Rather than continuing to rely on the traditional threshold of 0.5 percent of net plant-in-service, Higby recommends using a gross-cost threshold that includes depreciation expense as well as return on rate base. I also discuss this modified materiality threshold in Section VII, below.

Higby's testimony is of significant policy relevance as it presents a novel solution to a developing ratemaking problem: utilities that are investing in short-lived plant – such as information technology and grid modernization – struggle to cope with regulatory lag. Thus, Higby proposes a surgical policy solution to what is likely a significant driver of serial utility rate case filings.

Q. Please describe the policy issue related to D&R at Colstrip Units 3 and 4.

A. PSE includes in proposed rates accelerated recovery of decommissioning and remediation (D&R) costs associated with Colstrip Units 3 and 4. However, it is not clear that PSE's proposed rates conform to the requirements of the Clean Energy Transformation Act (CETA). Specifically, the law provides for recovery of D&R costs that are "prudently incurred," calling into question the utility practice of recovering D&R costs through rates prior to those costs being incurred, and especially without a mechanism to track and true up for actual D&R expenditures.

Although the Commission need not interpret the statute to resolve this case, the issue will need to be addressed in PSE's next GRC, preferably through a proposed D&R recovery plan produced by PSE.

I discuss this issue in Section VI, below.

V. ATTRITION POLICY

A. Summary and Recommendation

Q. Please summarize your conclusion on PSE's request for an attrition allowance as it relates to the Commission's policy on attrition.

A. PSE's request for an attrition allowance falls short of the Commission's policy standards on attrition allowances. Most notably, PSE is not experiencing chronic under earning and it does not provide persuasive evidence that the costs it identifies are due to factors outside of the Company's control. Further, the issues that the Company does identify as beyond the Company's ability to control, such as power costs and Tax Reform, largely are unrelated to attrition, as evidenced by the fact that those costs are not included in the Company's own attrition study.

Moreover, as demonstrated by the attrition studies sponsored by Staff witness Jing Liu, PSE is not likely to experience attrition in the rate year, even if PSE had met the Commission threshold criteria.

In other words, PSE has demonstrated neither the circumstances warranting nor the need for an attrition allowance.

Q. What has Staff done to address PSE's concern with respect to the pressures regulatory lag places on the recovery of short-lived plant?

A. In its modified historical test year – pro forma approach, Staff has taken several measures to reduce the burden of regulatory lag for short-lived assets, including allowing end-of-period (EOP) rate base, modifying the materiality threshold to accommodate short-lived plant, and supporting recovery of deferred depreciation expense (from prior periods) for AMI investments as well as several GTZ investments.

These measures increase revenue requirement by approximately $60 million for electric operations and $35 million for natural gas operations. Absent these increases to revenue requirement, PSE would have a revenue *sufficiency* of approximately $10 million for electric operations and a revenue deficiency of approximately $3 million for gas operations. The end result is that Staff's modified historical test year–pro forma approach is sufficient to cover the attrition study's statistically escalated rate year costs.

Further, Staff requested information regarding additional short-lived plant with the intention of including additional projects in the pro forma plant adjustment, but PSE indicated that no additional short-lived plant met Staff's modified materiality threshold. As discussed in Section VII, below, Staff proposes a modification to the materiality standard that accounts for depreciation expense, effectively lowering the bar for short-lived assets.

B. Commission Policy on Attrition

Q. What is earnings attrition?

A. As the Commission has observed, ratemaking rests on the key assumption that the test-period relationships between rate base, expenses and revenues will accurately represent relationships during the prospective rate-effective period. If this assumption fails and cost of service increases more rapidly than revenues, rates based on test period conditions may not be adequate for the utility to achieve the allowed level of return under future conditions.[5] If utility costs are rising more rapidly than revenues, causing test period relationships to not hold into the rate year, the resulting erosion of earnings is referred to as earnings "attrition."

Q. What are common sources of earnings attrition?

A. High inflation and high levels of plant additions are common sources of earnings attrition,[6] though the Commission also has identified low load growth as a potential contributing factor.[7]

Q. Please summarize the Commission's recent history granting attrition allowances.

A. The Commission has expressly approved an attrition allowance once and only once since 1992: in Order 05 of Avista's 2015 GRC.[8]

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[5] *Wash. Utils. & Transp. Comm'n. v. Puget Sound Energy, Inc.*, Dockets UE-111048 & UG-111049, Order 08, 180, ¶ 490 (May 7, 2012) (PSE 2011 GRC Order).
[6] *Id.* at 180–181, ¶ 491.
[7] *Wash. Utils. & Transp. Comm'n. v. Avista Corp.*, Dockets UE-150204 & UG-150205, Order 05, 40, ¶ 109 (January 6, 2016) (Avista 2015 GRC Order).
[8] *Id.* at 37–52, ¶¶ 96–141.

Although Commission authorization of attrition allowances was relatively common in the 1980s, the Commission's rejection of Washington Natural Gas's request for an attrition allowance in Docket UG-920840[9] marked the beginning of a two-decade period devoid of attrition allowances. Although serious contemplation of attrition allowances reemerged in PSE's 2011 GRC, no attrition allowance was authorized in that case. [10]

Public Counsel appealed Order 05 of Avista's 2015 GRC to the Court of Appeals, Division II, arguing that the attrition allowance granted by the Commission violated the "used and useful" provision of the property valuation statute, RCW 80.04.250, because the allowance was based on a projection of rate base. The Court agreed, and reversed and remanded Order 05 to the Commission, striking all portions of the attrition allowance attributable to rate base.[11] The case currently is being litigated before the Commission.

In other words, the only attrition allowance authorized by the Commission in the last quarter century was determined by the Court of Appeals to be unlawful.

Q. Has the Commission provided recent policy guidance on attrition allowances?

A. Yes. The Commission provided substantial policy guidance on attrition allowances in Order 06 of Avista's 2016 GRC, which drew upon and reinforced policies outlined in Order 08 of PSE's 2011 GRC and Order 05 of Avista's 2015 GRC. Order

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[9] *Wash. Utils. & Transp. Comm'n. v. Wash. Natural Gas*, Docket UG-920840, Fourth Supp. Order (September 27, 1993).

[10] PSE 2011 GRC Order at 177–181, ¶¶ 483–491.

[11] *Wash. Att'y Gen.'s Office, Pub. Counsel Unit v. Wash. Utils. & Transp. Comm'n*., 4 Wn. App. 2d 657, 688–89 (2018).

06 of Avista's 2016 GRC remains the Commission's most recent order describing its policy on attrition allowances.

Q. Please summarize the Commission's threshold criteria for assessing the need for an attrition allowance.

A. The Commission has established that a utility requesting an attrition allowance must demonstrate:

1. A showing of chronic under-earning; and
2. Circumstances giving rise to claimed attrition are beyond the utility's ability to control.

Both criteria must be satisfied.

Q. When has the Commission identified chronic under earnings as one of the threshold criteria for considering authorization of an attrition allowance?

A. In Order 06 of Avista's 2016 GRC, the Commission indicated that "a showing of chronic under earnings" was a prerequisite for authorization of an attrition allowance.[12] Referring to its discussion of attrition in PSE's 2011 GRC, the Commission reinforced the notion that attrition allowances could be used to address "a demonstrated inability of a utility to earn at or near its authorized return <u>over a period of years</u>."[13] Additionally, the Commission also established, rather forcefully,

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[12] *Wash. Utils. & Transp. Comm'n. v. Avista Corp.,* Dockets UE-160228 & UG-160229, Order 06, 38, ¶ 66 (December 15, 2016) (Avista 2016 GRC Order).
[13] *Id*. at 15, n.44 (emphasis added)(citing PSE 2011 GRC Order at 177–181, ¶¶ 483–491).

that a utility earning at or near its authorized return "militates against the use of an attrition allowance."[14]

Thus, the utility must demonstrate substantial, persistent, and prolonged under earning.

Q. Where does the Commission identify circumstances beyond the utility's ability to control as one of the threshold criteria for considering authorization of an attrition allowance?

A. The Commission discussed this as a criterion in Order 08 of PSE's 2011 GRC, identifying an attrition allowance as a possible response to "a demonstrated trend of under earning due to circumstances beyond the Company's ability to control."[15]

The Commission firmly established the control factor as a threshold criterion in Order 05 of Avista's 2015 GRC.[16] In later characterizing its Order 05, the Commission noted that it "unequivocally emphasized . . . that the record must demonstrate persuasively that the attrition occurring is outside of [the utility's] control,"[17] and further that it "require[s] that utilities requesting an attrition adjustment demonstrate that the cause of the mismatch between revenues, rate base and expenses is not within the utility's control."[18]

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[14] *Id.* at 38, ¶ 66.
[15] PSE 2011 GRC Order at 180, ¶ 489.
[16] *See* Avista 2015 GRC Order at 41, ¶ 110, 43–44, ¶ 119.
[17] Avista 2016 GRC Order at 27–28, ¶ 52.
[18] *Id.* (citing Avista 2015 GRC Order at 41, ¶ 110) (emphasis added).

Q. Has the Commission identified any other factors important to its consideration of attrition allowances?

A. Yes. In PSE's 2011 GRC, the Commission identified breaking the pattern of annual rate filings as an important consideration when authorizing an attrition allowance,[19] and in Order 06 of Avista's 2016 GRC indicated that "[t]his remains an important policy goal today."[20]

Q. Has the Commission discussed its methodological preferences when calculating an attrition allowance (if the threshold criteria have been met)?

A. To some extent yes, though Commission policy with respect to projections of rate base should be considered to be in flux, owing in part to the Court's remand of the attrition allowance calculation in Avista's 2015 GRC and owing in part to recent revisions to the Commission's property valuation statute, RCW 80.04.250.

With that caveat aside, the Commission recently has expressed concern regarding the practice of setting rates using projections of future costs.[21] The Commission has noted that "statistical analyses do not identify or establish causal relationships,"[22] and "do not demonstrate the *existence* of attrition in the rate year and the need for an attrition adjustment."[23]

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[19] PSE 2011 GRC Order at 187, ¶ 507.
[20] Avista 2016 GRC Order at 44–45, ¶ 75.
[21] Avista 2015 GRC Order at 43–44, ¶ 119.
[22] Avista 2016 GRC Order at 42–43, ¶ 71.
[23] *Id.* at 34, n.119.

In certain respects, the Commission's own criticisms of statistical trending in Order 06 of Avista's 2016 GRC parallel the Court's conclusion in its remand of Order 05. The Commission stated:

> [I]t is clear that a regression analysis performed on historical data projected into future years, no matter how statistically significant the results may be, simply will tell us nothing that would help determine whether some unspecified future investment will meet the used and useful test. Similarly, such a statistical analysis can tell us nothing about prudence, which is not a general, abstract inquiry, but rather one tied to individual projects the Company decides to, and does, undertake.[24]

In sum, the Commission has recognized that statistical extrapolations of costs are chintzy.

Q. Has the Commission commented on circumstances where it may be appropriate to use statistical trending?

A. Yes. The Commission has indicated that escalation factors based on statistical trending could be accepted for multi-year rate plans.[25] Indeed, in Order 07 of PSE's 2013 decoupling case, the Commission stated that a "general rate case stay-out period was critical to the Commission's decision to approve an escalation factor for PSE."[26]

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[24] *Id*. at 42–43, ¶ 71.
[25] *Id*. at 44–45, ¶ 75.
[26] *In re Puget Sound Energy and Northwest Energy Coalition Petition for an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms*, Dockets UE-130137 & UG-130138, Order 07, 74, ¶ 171 (June 25, 2013).

C. Response to PSE's Claims of Earnings Attrition

Q. Can you please restate the Commission's threshold criteria for assessing the need for an attrition allowance?

A. Yes. The Commission has established that a utility requesting an attrition allowance must demonstrate:

1. A showing of chronic under-earning; and
2. Circumstances giving rise to claimed attrition that are beyond the utility's ability to control.

I refer to these as Threshold Criterion 1 and Threshold Criterion 2, below.

Once the utility has made those showings, it then must demonstrate through an attrition study that, absent an attrition allowance, the company is likely to experience earnings erosion.

Q. Regarding Threshold Criterion 1, is PSE experiencing chronic under earning?

A. No. PSE's earnings results are shown in Tables 1 and 2, below. These data were provided by PSE in its direct case in these dockets.[27]

[27] Doyle, Exh. DAD-1T at 14:1–16.

Table 1. Electric Results – PSE's Rate of Return, 2013-2018

	Rate of Return		
Year	Adjusted Actual	Normalized CBR	Authorized
2018	7.49%	7.12%	7.60%
2017	8.66%	8.11%	7.77%
2016	7.90%	8.06%	7.77%
2015	7.52%	8.05%	7.77%
2014	7.53%	7.74%	7.77%
2013	7.50%	7.56%	7.77%

Table 2. Natural Gas Results – PSE's Rate of Return, 2013-2018

	Rate of Return		
Year	Adjusted Actual	CBR Normalized	Authorized
2018	5.94%	5.64%	7.60%
2017	8.09%	8.16%	7.77%
2016	7.80%	7.93%	7.77%
2015	7.62%	8.17%	7.77%
2014	7.80%	7.87%	7.77%
2013	7.22%	7.34%	7.77%

These tables show that, with the exception of 2018, on a normalized basis PSE has earned at or above its authorized return for every year since 2014, which, in the Commission's words, "militates against the use of an attrition allowance."[28]

Q. You note that 2018 is an exception. Has the Commission provided PSE with additional revenues since 2018?

[28] Avista 2016 GRC Order at 38, ¶ 66.

A. Yes. On February 21, 2019, the Commission entered Order 05 in the case involving PSE's 2018 expedited rate filing (ERF), approving a settlement agreement for rates effective March 7, 2019. The settlement agreement provided for an increase in electric base revenues of $25.9 million and an increase in gas base revenues of $27.6 million.[29]

Thus, PSE's 2018 earnings reflect revenues generated from rates that were in effect *prior to* the ERF rate increase.

Q. Did the Company comment on the sufficiency of rates authorized in PSE's 2018 ERF, effective March 7, 2019?

A. Yes. In its testimony in support of the 2018 ERF settlement agreement, PSE stated that "[t]he resulting rates are fair, just, reasonable and sufficient and consistent with the public interest."[30] The Commission interprets "sufficient" rates to mean rates that are sufficient to cover the utility's costs and provide the utility with an opportunity to earn its authorized rate of return.[31]

Thus, per PSE's own testimony, the ERF rates that went into effect on March 7, 2019, were sufficient for the utility to cover its costs, including its authorized return on rate base.

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[29] *Wash. Utils. & Transp. Comm'n. v. Puget Sound Energy, Inc.*, Dockets UE-180899 & UG-180900, Order 05 (February 21, 2019) (PSE ERF 2018 Order). The settlement agreement presented the revenue increase net of amounts owed to customers for protected EDIT reversals, and returned to customers via Schedule 141X.

[30] Dockets UE-180899 & UG-180900, Joint Testimony of Katherine J. Barnard, Susan E. Free and Jon A. Piliaris on Behalf of Puget Sound Energy in Support of the Settlement Stipulation and Agreement at 4:4–5. Although PSE assets that it could have justified even a larger increase for its natural gas business, the Company nevertheless testified the agreed upon revenues are sufficient.

[31] *See*, *e.g.*, Avista 2016 GRC Order at 47, ¶ 79.

Q. Regarding Threshold Criterion 2, does PSE provide examples of costs that it claims are outside of the utility's ability to control?

A. Yes. However PSE does not explain how most of the costs it identifies are related to attrition or remedied by an attrition allowance. In responding to the question of "[w]hat cost increases . . . are out of the company's control," PSE witness Doyle lists three broad categories:

1. Increase to power costs;
2. Reduced cash flows due to the Tax Cuts and Jobs Act (TCJA); and
3. Increased investment in information technology.[32]

With respect to item (1), power costs, the Commission has provided PSE with a power cost deferral mechanism to capture variances in cost above (or below) the authorized baseline. Moreover, PSE itself removes power supply costs from the attrition model, thereby assuring that no portion of PSE's projection of attrition is related to power costs.

With respect to item (2), cash flow related to the TCJA, this item has no relationship to the Company's earnings or pro forma cost of service. Excess deferred income tax (EDIT) is an amount that formerly was owed to the IRS but is now owed to ratepayers. Moreover, it represents *an amount that already has been collected from ratepayers*. It is not a cost in the first place, let alone a cost PSE expects to grow between the test year and the rate year and ask ratepayers to pay for. It is unrelated to the assessment of rate year earnings attrition.

[32] Doyle, Exh. DAD-1T at 21:1–22:4.

Q. What about item (3), increased investment in information technology?

A. This item is worthy of deeper exploration. Although the extent and timing of investments are predominantly within the control of the utility, a utility's decision to forego investment in information technology (IT) and technological transformation more generally (especially transformation driven by customer demand), at some point could become imprudent in and of itself. Moreover, due to the short-lived nature of IT assets, regulatory lag could force the utility to absorb a large portion of those assets' costs. This issue is discussed in additional detail in the testimony of Staff witness Higby.

Q. Does this mean that you agree that circumstances giving rise to attrition are beyond the Company's ability to control?

A. No. First off, Staff rejects the claim that absent an attrition allowance PSE is likely to experience earnings attrition in the rate year. Further, where there is no attrition, there are no circumstances giving rise to attrition. My response to the previous question is meant only to give credence to the notion that investments in IT create pressures on the utility that investments in longer-lived assets do not. Recognizing these specific pressures can allow us all to be a little more precise in how and where we flex our traditional ratemaking paradigm.

In other words, if the problem relates to short-lived plant, the regulatory solution should be targeted to short-lived plant.

Q. There is a problem then?

A. Maybe. Likely, even. However, that problem still does not necessitate an attrition allowance in PSE's case. In this case the problem (to the extent that there is in fact a problem) has been mitigated by a number of items Staff includes in its pro forma revenue requirement calculation, as explained below.

Q. How has Staff in its revenue requirement calculations attempted to address the issue of short-lived assets and mitigate the possibility of attrition in the rate year?

A. Staff's revenue requirements include several progressive measures aimed at easing the burden of regulatory lag for short-lived assets, including:

1. Allowing EOP rate base;
2. Modifying the materiality threshold to accommodate short-lived plant placed in service in the pro forma period;
3. Supporting recovery of deferred depreciation expense (from prior periods) for GTZ investments that meet Staff's materiality threshold; and
4. Supporting recovery of deferred depreciation expense *and* deferred return on net plant (from prior periods) for AMI investments.

Collectively, these measures increase revenue requirement by approximately $60 million for electric operations and $35 million for natural gas operations. The EOP adjustment alone increases revenue requirement by $39 million for electric operations and $27 million for natural gas operations.

Q. What do you make of PSE's use of statistically derived escalators and its assessment that projections of rate year costs, including projections of rate base, are appropriate within the current policy context?

A. First, PSE relies on the Commission's Order 05 in Avista's 2015 GRC, even though the Commission's Order 06 in Avista's 2016 GRC discusses and adds further clarity to certain concepts identified in Order 05. I discuss Order 06 at some length above, so I will not elaborate here. Suffice to say, Order 05 does not provide the Commission's most recent policy guidance on attrition allowances. Moreover, Order 05 was reversed and remanded by the Court of Appeals, and the Commission has yet to render a decision in the remand proceeding. PSE's reliance on Order 05 is misplaced.

Second, PSE cites the recent legislative revisions to the used and useful provisions of the property valuation statute, RCW 80.04.250, as justification for using projections of costs and rate base. However, the Commission has initiated Docket U-190531 to consider how it will identify and review property that becomes used and useful during the rate-effective period. Given that the Commission has yet to provide rules or a policy statement on this matter, PSE's portrayal of what the revised statute means for PSE's request for an attrition allowance is premature and unfounded.

At this point, it simply is not possible to predict how the Commission's policy guidance on projections of rate base will evolve given the remand and the revisions to RCW 80.04.250.

Q. Could the Commission still find justification for providing PSE with an attrition allowance in this case?

A. Yes. It is important to recognize that the purpose of an attrition study is to evaluate whether the modified historical test year–pro forma approach is likely to provide revenues that will be sufficient during the rate-effective period. It is possible that a properly performed attrition study could supply convincing evidence that the modified historical test year approach produces revenues insufficient to cover costs in any given rate year.

Q. Does PSE's attrition study suggest that the Commission *should* provide an attrition allowance in this case?

A. No, it does not. As Staff witness Jing Liu explains, PSE's attrition studies use exponential growth curves, which assume that the growth in expenses and rate base will *accelerate* between the test year and the rate year. As a result, PSE inflates its projected rate base and expenses, and overstates earnings attrition in the rate year.

As Staff's attrition studies demonstrate, the modified historical test year–pro forma approach produces revenues that are reasonably close to the attrition results. In fact, Staff's standard pro forma approach produces electric revenues that are *greater than* the revenue requirement produced using Staff's attrition studies.

If the Commission determines that consideration of attrition allowances is appropriate for PSE, the Commission should reject PSE's attrition studies in favor of Staff's attrition studies. If the Commission provides an attrition allowance for PSE's natural gas operations, it should also provide a *negative* attrition allowance for PSE's electric operations, meaning the Commission should decrease the electric revenue requirement relative to the pro forma results.

Q. What do you conclude about PSE's request for an attrition allowance in this case?

A. PSE's request for an attrition allowance falls short of the Commission's policy standards on attrition allowances. PSE is not experiencing chronic under earning and it does not provide persuasive evidence that costs are due to factors outside of the Company's control, or even relevant to the assessment of attrition.

But even if the Commission were to relax its own policy standards on attrition allowances and ignore the absence of a showing of chronic under earnings due to circumstances beyond the Company's ability to control, Staff's attrition studies show that earnings attrition in the rate year is unlikely, and revenues produced using a modified historical test year–pro forma approach are sufficient to provide PSE an opportunity to earn its authorized return, without an attrition allowance.

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VI. DECOMMISSIONING AND REMEDIATION
VII. FOR COLSTRIP UNITS 3 AND 4

A. Summary and Recommendation

Q. Can you please summarize Staff's recommendation with respect to the recovery of decommissioning and remediation (D&R) costs for Colstrip Units 3 and 4?

A. Yes. I recommend, for this case only, that the Commission allow D&R costs for Colstrip Units 3 and 4 to be recovered as proposed, which is through depreciation accelerated to 2025.

However, I also recommend that the Commission order PSE to file a proposed plan for the recovery of D&R costs for Colstrip Units 3 and 4 that complies with the D&R provisions of CETA in its next GRC, and to include in the plan an assessment of PTCs available to offset D&R costs for Colstrip Units 3 and 4.

B. New CETA requirements

Q. Can you please summarize how CETA affects the recovery of costs associated with Colstrip Units 3 and 4?

A. Yes. The Clean Energy Transformation Act (CETA) requires costs associated with coal-fired generation facilities to be removed from rates by a date no later than December 31, 2025.[33] For PSE, this pertains to Colstrip Units 3 and 4.

[33] RCW 19.405.030(1).

However, the law differentiates between, and has different requirements for, certain categories of costs. As one example, depreciation schedules for coal-related transmission plant are not required to be accelerated to 2025. In fact, it appears that absent a Commission finding that those assets are no longer used and useful, coal-related transmission plant cannot be accelerated to 2025.[34]

Q. What does CETA say about decommissioning and remediation costs?

A. The CETA requirement that coal-fired generation costs be eliminated from rates by the end of 2025 "does not include the costs associated with decommissioning and remediation."[35] More importantly, CETA states that "[t]he commission shall allow in electric rates all decommissioning and remediation <u>costs prudently incurred</u> by an investor-owned utility for a coal-fired resource."[36]

This requires a reassessment of how and when D&R costs should be recovered in rates.

Q. In what way does this require a reassessment of how and when D&R costs should be recovered in rates?

A. On the one hand, there is merit to the idea that expected D&R costs should be paid for by the ratepayers who benefit from the asset, arguing that the full balance of

[34] RCW 19.405.030(2). "The commission may accelerate the depreciation schedule for any qualified transmission line owned by an investor-owned utility when the commission finds the qualified transmission line is no longer used and useful and there is no reasonable likelihood that the qualified transmission line will be utilized in the future."
[35] RCW 19.405.030(1)(a).
[36] RCW 19.405.030(1)(b) (emphasis added).

expected Colstrip D&R costs be recovered through rates between now and 2025. But on the other hand, the law refers to the costs in the past tense, specifying "costs prudently incurred," and the vast majority of D&R costs for Colstrip Units 3 and 4 will not be incurred until after the facility is closed.

This statutory language raises the question of whether D&R costs can be recovered at all until the costs are incurred, given the need to establish prudency. If the answer is no, D&R costs would need to be removed from revenue requirement in this case.[37]

Q. Does Staff recommend the Commission interpret CETA to prohibit recovery of D&R expenses until after they have been incurred and deemed prudent?

A. No. Although the Commission does not need to provide an interpretation of this statute in this case, Staff believes that RCW 19.405.030(1)(b) should not be read as restricting the recovery of D&R costs until after the utility has incurred the costs and the Commission has determined they are prudent. Instead, a more reasonable reading of the statute is that it requires that the amount recovered from ratepayers is *ultimately* no more or less than the actual, prudently incurred D&R costs. Staff suggests approaching this issue practically and maintaining a holding pattern at this point until PSE's next GRC. I discuss this in the next section.

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[37] A more nuanced interpretation would assume the bill's authors did not appreciate the difference between "incurred cost" and "booked expense," and did not intend to exclude booked expenses from cost recovery. Therefore booked depreciation, amortization and accretion expenses associated with D&R assets could be recovered in rates prior to the utility actually paying for the decommissioning and remediation work.

However, it is important to note that if the Commission accepts PSE's rates as currently proposed (or accepts the rates proposed by Staff), D&R costs will be included in authorized rates, consistent with historical practice.

C. Response to PSE's Proposed Recovery of Colstrip D&R Costs

Q. How does PSE propose to recover D&R costs for Colstrip Units 3 and 4 in this case?

A. PSE proposes rates that recover Colstrip Units 3 and 4 D&R costs through depreciation expense for those units. More specifically, PSE includes a negative net salvage of 13 percent for steam production plant in accounts 314.00, 315.00, and 316.00, and 14 percent for accounts 311.00 and 312.00. The total dollar amount for negative net salvage is $73.2 million.

As I discuss below, PSE estimates $36.8 million in remediation expense for Colstrip Units 3 and 4. It is not clear how the negative net salvage of $73.2 million comports with PSE's estimate of the costs. Nevertheless, PSE's proposed rates include recovery of $73.2 million in D&R costs over the remaining book life of Colstrip Units 3 and 4, adding $10.8 million to annual depreciation expense.

Q. Is this consistent with the requirements of CETA?

A. Probably not. CETA discusses "costs prudently incurred," calling into question the historical practice of recovering estimated D&R costs through depreciation expense over the remaining useful life of the underlying generation asset, before the D&R

costs have even been incurred and without a guarantee that the amount recovered will ultimately be trued up to match the amount incurred. PSE does not address this issue in its direct case.

Q. Could CETA change how the Commission balances its policy objectives regarding depreciation?

Yes it could. The CETA requirement that coal-fired generation costs be eliminated from rates by the end of 2025, "does not include the costs associated with decommissioning and remediation."[38] Therefore, PSE was not *required* to propose accelerated recovery of projected decommissioning and remediation costs to 2025, but it did anyway, potentially aggravating intergenerational inequity (do the next five years of ratepayers really deserve to pay all of the costs of remediation?). This accelerated recovery would be standard under the traditional method of recovering D&R costs, which is over the useful life of an asset. But the passage of CETA calls for a reevaluation of whether accelerated recovery of D&R costs properly balances policy objectives.

Q. What are the practical implications of the D&R provisions of CETA?

A. CETA requires that the actual prudently incurred D&R costs be recovered in rates, effectively requiring revenues collected from customers to cover the cost of remediation. However, most of the remediation costs will not be incurred until after the facility is closed, with remediation work likely to continue over several decades.

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[38] RCW 19.405.030(1)(a).

We have an estimate of D&R costs for Colstrip Units 3 and 4, we have an estimated timeframe over which the D&R work will be performed, and we have a requirement that only prudently incurred D&R costs can be recovered from ratepayers. The practical implication is that a tracking and true-up mechanism is needed for D&R costs.

Q. How would a tracking and true-up mechanism function?

A. Much like it functions for other tracking and true-up mechanisms. The utility would estimate future costs, and rates would be set to recover those estimated costs ratably over the life of the expected work (i.e., through the remediation period). Estimated costs can be trued up to actuals, and rates can be adjusted to reflect these actuals as well as changes to projected costs.

Q. Are there any other factors that would weigh against accelerating recovery of D&R costs for Colstrip Units 3 and 4?

A. Yes. In Dockets UE-170033/UG-170034, the Commission authorized PSE to repurpose its production tax credits (PTCs) and, to the extent that they are monetized, use them to offset Colstrip-related costs. Monetized PTCs were to be applied first to the $5 million Colstrip community transition fund, second to unrecovered plant balances for Colstrip, and third for Colstrip D&R costs.[39] The Commission already has allowed PSE to repurpose treasury grants to cover D&R

[39] *Wash. Utils. & Transp. Comm'n. v. Puget Sound Energy, Inc.*, Dockets 170033 & 170034, Order 08, 40–41, ¶ 112 (December 7, 2017) (PSE 2017 GRC Order).

costs for Colstrip Units 1 and 2,[40] and those treasury grants appear to be more than sufficient to cover D&R costs for Colstrip Units 1 and 2.[41]

Basically, if there are monetized PTCs remaining after covering unrecovered plant balances, those funds would be available to offset D&R costs for Colstrip Units 3 and 4.

Q. Is PSE proposing to use PTCs to offset projected unrecovered plant balances for Colstrip Units 3 and 4?

A. No. In this rate case PSE is proposing to collect the remaining net plant balance for Colstrip Units 3 and 4 through depreciation by 2025. That is, PSE is *not* proposing to use PTCs for unrecovered plant balances for those units. Therefore, if there is a PTC balance remaining after offsetting unrecovered plant balances for Colstrip Units 1 and 2, that balance can be used to cover D&R costs at Units 3 and 4.

Q. Will there be PTCs remaining after covering unrecovered plant balances, and available to offset D&R costs for Colstrip Units 3 and 4?

A. It appears so. Using the net plant balance for Colstrip Units 1 and 2 from PSE's 2017 GRC ($158.2 million) and the annual depreciation expense recovered through rates ($18.5 million) over the 2.33 years those rates will have been in effect ($43.2

[40] *Id.* at 50–51, ¶ 136.

[41] McGuire, Exh. CRM-2 at 9. The retirement account contains $95.9 million in repurposed treasury grants, and PSE estimates D&R costs for Colstrip Units 1 and 2 to be $74.6 million (adjusted for inflation).

million), the unrecovered plant balance for Colstrip Units 1 and 2 will be approximately $115 million.

In its testimony in support of settlement in PSE's 2017 GRC, the Company estimated available PTCs at $280 million.[42] Applying $115 million to the estimated unrecovered balance of Units 1 and 2 and $5 million to Colstrip community transition leaves $160 million available for D&R costs for Units 3 and 4.

To be conservative, assuming the unrecovered balance of Units 1 and 2 will be somewhat higher than $115 million and monetized PTCs will be somewhat lower than $280 million, it is plausible that 50 percent of the estimated available PTCs would be available for D&R costs for Units 3 and 4.

Under those assumptions, roughly $80 million in PTCs would be available to offset costs associated with Colstrip Units 3 and 4. PSE estimates remediation costs for Units 3 and 4 to be approximately $36.8 million.[43] It is not clear that PSE needs to recover D&R costs for Units 3 and 4 through rates at all.

Q. What do you recommend?

A. I recommend that, for this case only, the Commission allow D&R costs to be recovered as proposed, which includes those costs in Colstrip Units 3 and 4 depreciation accelerated to 2025.

However, I also recommend that the Commission order PSE to file a proposed plan for the recovery of D&R costs for Colstrip Units 3 and 4 that complies

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[42] Dockets UE-170033 & UG-170034, PSE Testimony in Support of Settlement at 5:17–20 (citing Marcelia, Exh. MRM-1T at 9:Table 1).
[43] McGuire, Exh. CRM-2 at 9.

with the D&R provisions of CETA in its next GRC, and to include in the plan an assessment of PTCs available to offset D&R costs for Colstrip Units 3 and 4. Staff suggests that PSE propose a tracking and true-up mechanism for those costs in case the available PTCs do not cover the ultimate D&R costs for Units 3 and 4.

Alternatively, the Commission could order PSE to remove D&R costs for Units 3 and 4 from rates now, given the likely availability of PTCs to offset those costs. Staff does not offer this as its primary recommendation because there is substantial uncertainty with respect to when Units 3 and 4 will actually close. If those units close before 2025, and PSE has unrecovered net plant on its books, the available PTCs would be used to offset that unrecovered balance, per the PTC prioritization in the 2017 GRC settlement (described above). In that case, PTCs might not be available for D&R costs for Units 3 and 4. Staff suggests a tracking and true-up mechanism for this circumstance as well.

Q. Do you have any other recommendations for Colstrip D&R Costs?

A. Yes. In Docket UE-161123, the Commission stated that the settlement agreement reached on the Microsoft Special Contract did not address the allocation of Colstrip remediation costs owed by Microsoft.[44] The Commission concluded definitively that Microsoft did have a responsibility to pay a fair share of those costs,[45] but left determining the allocation to a future case. Given CETA's requirements, the Commission should announce that it will address this matter in PSE's next GRC.

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[44] *Wash. Utils. & Transp. Comm'n. v. Puget Sound Energy Inc.*, Docket UE-161123, Order 06, 27–28, ¶ 72, 33, ¶ 86, 38, ¶ 110 (July 13, 2017).
[45] *Id*. at 29–30, ¶ 78.

This would ensure that the parties are on notice and that the Microsoft Special Contract will be considered when drafting a proposed plan for the recovery of Colstrip D&R costs.

VIII. DERIVATION OF STAFF'S MODIFIED MATERIALITY THRESHOLD

A. Summary and Recommendation

Q. Please summarize Staff's recommendation with respect to the Materiality Threshold.

A. Staff proposes to modify the threshold used to determine whether a plant addition has a material effect on a company's financial results. When assessing whether a plant addition is "major" and therefore merits pro forma treatment, Staff recommends using a "gross cost" materiality threshold that reflects annual depreciation plus return on rate base.

Given that the sizes of PSE's gas and electric business are different, the gross cost that is material is different for each business. Staff recommends gross cost thresholds of $2.71 million for electric investments, $1.17 million for natural gas investments, and $3.89 million for combined electric and gas assets. To determine whether an investment meets the modified materiality standard, simply sum its annual depreciation expense and return on rate base.

These modified materiality thresholds are applied by Staff witness Higby in her assessment of the materiality of (a) pro forma plant additions and (b) plant additions related to PSE's petition for deferred accounting treatment for GTZ. Higby also discusses why this modification to the materiality standard is appropriate and helps ameliorate the effect of regulatory lag on short-lived assets.

B. Derivation of Gross Cost Materiality Threshold

Q. Typically, how does the Commission assess the materiality of plant additions for which utilities request pro forma treatment?

A. Traditionally the Commission has determined that a project is "major" if represents at least 0.5 percent of the utility's net plant in service.

Q. Why is this no longer sufficient?

A. As Staff witness Higby explains, a materiality threshold that is 0.5 percent of net plant in service does not allow for consideration of annual depreciation expense, for which short-lived assets can be the primary cost affecting the utility's financial results. As a result, short-lived assets that do not meet the traditional materiality threshold may impact a utility's financial results more than a long-lived asset that does meet the threshold. As utilities begin investing more in short-lived assets, such as IT assets, a materiality threshold that disadvantages those assets becomes more problematic.

The Commission needs a materiality threshold that takes into account the book life of the asset.

Q. How do you recommend the materiality threshold be modified?

A. I recommend moving from a gross plant threshold (i.e., 0.5 percent of net plant in service) to a "gross cost" threshold. Whereas a gross plant threshold measures only an investment's proportional contribution to rate base, a gross cost threshold measures an investment's contribution to overall cost, including depreciation expense and return on rate base.

Q. How did you decide what constitutes a material gross cost?

A. I simply translated the traditional materiality threshold (i.e., 0.5 percent of net plant in service) into gross-cost terms. For PSE, the traditional materiality threshold defined projects as "major" if they are larger than $32.3 million for electric operations, $13.3 million for natural gas operations, or $45.6 million for combined operations.

Translating those amounts into gross-cost terms involves making an assumption about the typical book life of a traditional, major utility investment. For a traditional, major utility investment I assumed a book life of 50 years for electric assets and 40 years for gas assets. Thus, the calculation of the depreciation component of the gross cost threshold involves dividing the gross investment by the book life. For example, the depreciation component of the electric threshold is $32.3 million divided by 50 years, or $0.65 million per year.

The calculation of the return-on component of the gross cost threshold involves multiplying the gross investment by the rate of return.[46] For example, the

[46] In its response case, Staff recommends a rate of return of 7.33 percent.

return-on component of the electric threshold is $32.3 million multiplied by 7.33 percent, or $2.37 million.

The sum of these two components provides the materiality base in gross-cost terms. For electric service, the amount is $3.0 million ($2.37 million plus $0.65 million). To allow for the inclusion of investments that are *close* to meeting the threshold, to account for the fact that one could make the case for a different book life assumption for traditional, major plant, and to avoid being called a stick in the mud, I added a 10 percent tolerance to the threshold.

As shown in Table 3, below, I calculate gross cost thresholds of $2.71 million for electric investments, $1.17 million for natural gas investments, and $3.89 million for combined electric and gas operations

Table 3. Components of Gross Cost Threshold

	Electric		Natural Gas		Combined	
Return on - major	$	2,368,418	$	976,059	$	3,344,477
Depreciation - major	$	646,226	$	332,899	$	979,125
Gross cost - major	$	3,014,644	$	1,308,957	$	4,323,602
Gross Cost Threshold	**$**	**2,710,000**	**$**	**1,170,000**	**$**	**3,890,000**

Q. Can you please explain how to assess the materiality of an investment using the gross cost threshold?

A. Simply calculate the two basis elements of the threshold for that investment (i.e., return on and depreciation). For example, for an electric investment of $25 million with a book life of 20 years, the depreciation component is $1.25 million (i.e. $25 million divided by 20), and the return-on component is $1.83 million (i.e. $25 million times 7.33 percent). The sum of those two numbers is $3.08 million. That number, $3.08 million, represents the gross cost of the asset in question. And since it was an electric-only asset, it qualifies as material because the gross cost ($3.08 million) is greater than the materiality threshold ($2.71 million).

Notably, using a gross cost materiality threshold, this investment of $25 million qualifies as material. Under the traditional materiality threshold, only electric investments greater than $32.3 million would qualify as material. This example demonstrates how an asset's book life contributes to the materiality of the investment, and how Staff's proposed modification of the materiality threshold can allow smaller but shorter-lived assets to qualify as a material.

IX. CONCLUSION

Q. Does this conclude your testimony?

A. Yes.