

[Service Date September 11, 2014]

**BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION**

In the Matter of the Petition of)	DOCKET UE-132027
)	
PUGET SOUND ENERGY)	ORDER 04
)	
For an Accounting Order Approving the)	GRANTING, IN PART, AND
Allocation of Proceeds of the Sale of)	DENYING, IN PART, PETITION
Certain Assets to Public Utility District)	FOR ACCOUNTING ORDER
#1 of Jefferson County)	
)	
.....)	

***Synopsis:** The Commission grants Puget Sound Energy’s (PSE’s) Petition for an Accounting Order allocating the \$109,273,196 in proceeds from the Company’s sale of assets to Jefferson County Public Utility District No. 1, but rejects PSE’s proposed allocation. By this Order, the Commission allocates to the Company from the total proceeds of sale an amount of approximately \$56.6 million, including the \$46.7 million net book value of the assets (i.e., original costs minus accumulated depreciation), approved transaction costs of \$2.4 million, and an additional \$7.5 million from the remaining proceeds of \$60.2 million. The balance of the proceeds, \$52.7 million, is allocated to ratepayers. We require that PSE treat the \$52.7 million allocated to ratepayers, plus interest deemed accrued since the date of JPUD’s final payment to PSE, as a regulatory liability on PSE’s books. The regulatory liability account will accrue interest at the Company’s after-tax rate of return, grossed up for taxes. We further require PSE to establish a monthly bill credit that will result in full amortization over a four-year period of the amounts accrued in this regulatory liability account.*

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SUMMARY

- 1 **PROCEEDING:** On October 31, 2013, Puget Sound Energy (PSE), filed with the Washington Utilities and Transportation Commission (Commission) a petition for an accounting order allocating the proceeds of the sale of PSE's Jefferson County assets and service territory to the Public Utility District No. 1 of Jefferson County (JPUD). PSE seeks a specific allocation; other parties contest PSE's proposed allocation and propose alternatives.

- 2 PSE's sale of assets followed a November 2008 election in which the citizens of Jefferson County voted to approve Proposition 1, authorizing JPUD to construct or acquire electrical facilities for the generation, transmission or distribution of electric power in Jefferson County, as authorized by RCW 54.16.040. The statute empowers public utility districts to acquire assets from investor-owned utilities by eminent domain. PSE and JPUD, however, negotiated and entered into an Asset Purchase Agreement (APA) on June 11, 2010, that allowed them to avoid the condemnation process.

- 3 After the parties entered into the APA, the Commission responded to PSE's petition for a declaratory order and approved a multi-party settlement on February 11, 2011. The Commission determined that the transfer of assets in question was exempt from the requirements of RCW 80.12.020, governing transfers of assets by investor-owned utilities. It accordingly was unnecessary for the Commission to take any further action to approve the transfer of the assets to JPUD. The Commission also found that the purchase price of \$103 million was sufficient compensation for the sale of the assets, and that the agreement reached between PSE and JPUD providing for transition of the service territory was consistent with PSE's public service obligations. The Commission emphasized, however, that it reserved determination of appropriate accounting treatment of the proceeds of the sale to a future proceeding:

While we determine that the purchase price of \$103 million is an appropriate one and sufficient to fully compensate PSE for the sale of the assets, our determination does not affect the subsequent accounting treatment of the sale proceeds and does not affect an allocation of the sale proceeds as between PSE's customers and shareholders. Those questions will be finally determined in the context of a future

proceeding; most likely one initiated via an accounting petition or in PSE's next general rate case.¹

This Petition brings these unresolved questions to the Commission for determination.

4 **PARTY REPRESENTATIVES:** Markham A. Quehrn and Donna L. Barnett, Perkins Coie, Bellevue, Washington, represent PSE. Lisa Gafken, Assistant Attorney General, Seattle, Washington, represents the Public Counsel Section of the Washington Office of Attorney General (Public Counsel). Donald T. Trotter, Senior Assistant Attorney General, Olympia, Washington, represents the Commission's regulatory staff (Commission Staff or Staff).² Tyler C. Pepple, Davison Van Cleve, Portland, Oregon, represents the Industrial Customers of Northwest Utilities (ICNU).

5 **COMMISSION DETERMINATIONS:** We grant PSE's Petition to the extent of authorizing accounting and rate treatment of the sales proceeds, but reject in part PSE's proposed allocation of the proceeds. We agree with PSE's recommendation that we should follow the principles discussed in the Commission's March 2000 decision approving the sale by PSE and others of the Centralia coal generation plant by allocating to PSE an amount equivalent to the net book value of the assets it sold to JPUD.³ We likewise follow *Centralia* by allocating to PSE transaction costs it incurred in connection with this sale of assets.⁴ As to the unallocated balance – the gain on sale – we reject PSE's proposal that we should follow a rule adopted by the California Public Utilities Commission in 1989 that establishes a narrow exception to

¹ *In re Petition of Puget Sound Energy, Inc., for a Declaratory Order Regarding the Transfer of Assets to Jefferson County Public Utility District*, Docket No. U-101217, Order 03 ¶ 26 (February 1, 2011).

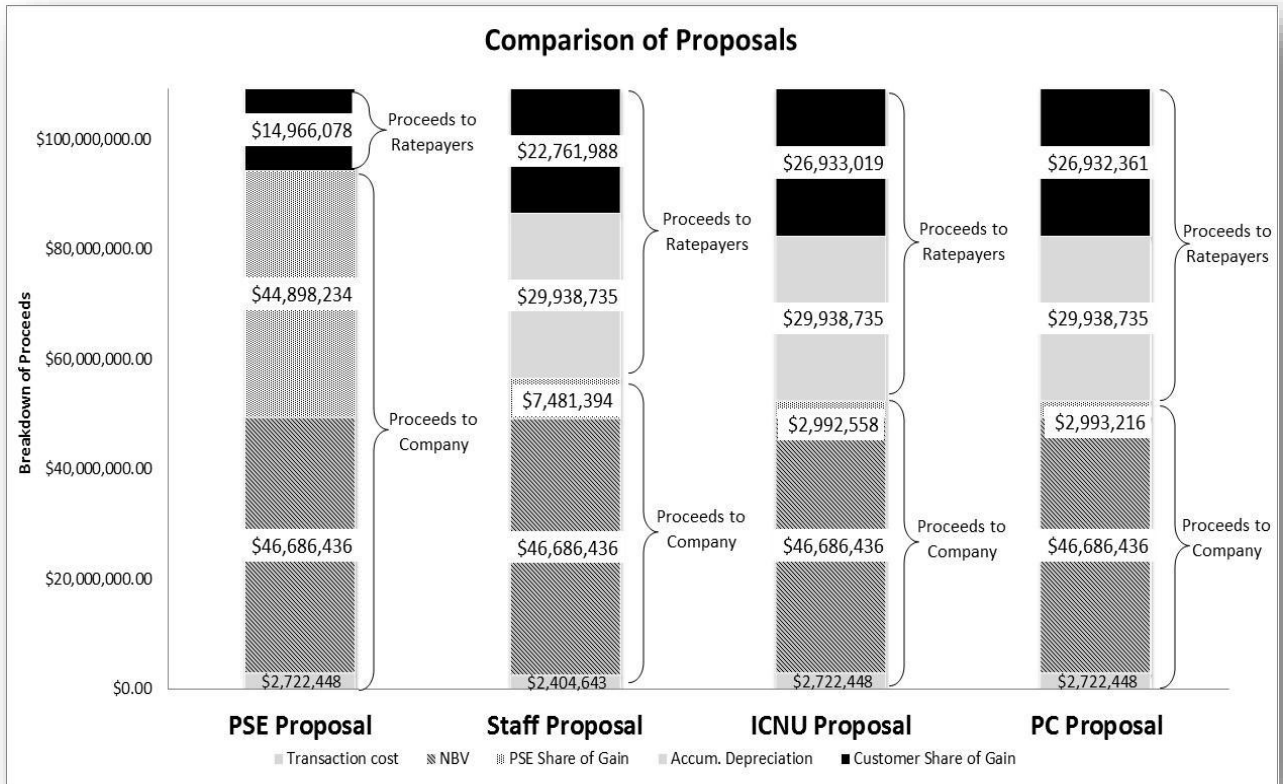
² In formal proceedings, such as this, the Commission's regulatory staff participates like any other party, while the Commissioners make the decision. To assure fairness, the Commissioners, the presiding administrative law judge, and the Commissioners' policy and accounting advisors do not discuss the merits of this proceeding with the regulatory staff, or any other party, without giving notice and opportunity for all parties to participate. *See* RCW 34.05.455.

³ *Application of Avista Corp. for Authority to Sell its Interest in the Coal-Fired Centralia Power Plant*, Docket No. UE-991255, *et al.*, 2nd Supplemental Order (March 6, 2000) (*Centralia*). *Centralia* relies in large part on what is generally regarded to the seminal case in this area of law, *Democratic Central Committee v. Washington Metropolitan Transit Area Authority Commission*, 485 F.2d 786, 806 (D.C. Cir. 1973) (*Democratic Central Committee*).

⁴ We determine below that the allowed transaction costs are \$2,404,643, which is \$317,805 less than what PSE requests.

the principles discussed in *Centralia* and *Democratic Central Committee*.⁵ The Commission has not previously applied this exception when allocating the proceeds from a sale of utility assets, and we find no reason to do so here. Instead, considering Staff’s legal and policy rationale, as well as similar proposals by Public Counsel and ICNU, we find it appropriate to adhere to the principles on which the Commission has consistently relied for many years when making such an allocation. The various results the parties propose are illustrated in Figure 1.

FIGURE 1



⁵ See *Ratemaking Treatment of Capital Gains from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity*, 104 Pub. Util. Rep. (PUR) 4th 157 (Cal. PUC 1989) (*Redding II*).

We determine, for the reasons discussed below, that we should allocate the gain on sale in a manner consistent with Staff’s recommendation, which adheres most closely to the principles discussed in *Centralia* and other prior Commission orders governing the allocation of proceeds from sales of utility assets. The results of our determination are portrayed in Figure 2.

FIGURE 2

**Puget Sound Energy
Sale of Assets to Jefferson PUD Docket No. UE-132027
Allocation of Proceeds/Gain**

Line #		Allocation to	
		PSE	Ratepayers
1	Proceeds		
2	Gross Plant		
3	Accumulated Depreciation		
4	Net Book Value (Line2-Line 3)		
5	Transaction Costs		
6	Internal Labor Adjustment		
7	Adjusted Transaction costs (Line5-Line 6)		
8	Gain on Sale (Line1-Lines 4&7)		
9	Allocated Total Proceeds		

		\$ 109,273,196		
	\$ 76,625,171			
	29,938,735			
		46,686,436	46,686,436	
	\$ 2,722,448			
	317,805			
		2,404,643	2,404,643	
		\$ 60,182,117	7,481,394	52,700,723
			\$ 56,572,473	\$ 52,700,723

MEMORANDUM

I. Background and Procedural History

6 In November 2008, the citizens of Jefferson County approved Proposition 1, authorizing JPUD to construct or acquire electrical facilities for the generation, transmission or distribution of electric power in Jefferson County. JPUD is authorized to do so pursuant to RCW 54.16.040.⁶ Under RCW 54.16.020, JPUD has authority to acquire by eminent domain PSE's assets providing service to Jefferson County customers. JPUD, considering this authority, initiated settlement negotiations with PSE in July 2009 to acquire PSE's transmission and distribution assets within Jefferson County. These settlement negotiations, after more than eight months of effort, led to a tentative settlement agreement memorialized in a Letter of Intent (LOI) dated April 30, 2010.

7 On June 11, 2010, PSE and JPUD entered into an Asset Purchase Agreement (APA) as the definitive settlement agreement contemplated under the LOI. The parties' intent was that the APA would constitute a settlement between them and a disposal of property by PSE to a special purpose district as provided by RCW 80.12.020(2). This, among other things, would eliminate the risks PSE and its customers, and JPUD and its future customers, would face in a condemnation proceeding.

⁶ As discussed below, JPUD is a "special purpose district" as defined in RCW 36.96.010. RCW 54.16.040 provides, in relevant part, that:

A district may purchase, within or without its limits, electric current for sale and distribution within or without its limits, and construct, condemn and purchase, purchase, acquire, add to, maintain, conduct, and operate works, plants, transmission and distribution lines and facilities for generating electric current, operated either by water power, steam, or other methods, within or without its limits, for the purpose of furnishing the district, and the inhabitants thereof and any other persons, including public and private corporations, within or without its limits, with electric current for all uses, with full and exclusive authority to sell and regulate and control the use, distribution, rates, service, charges, and price thereof, free from the jurisdiction and control of the utilities and transportation commission, in all things, together with the right to purchase, handle, sell, or lease motors, lamps, transformers and all other kinds of equipment and accessories necessary and convenient for the use, distribution, and sale thereof.

8 The APA identifies certain regulatory approvals that PSE was required to obtain as conditions precedent to closing. PSE, in response to its obligations in this regard, filed on July 15, 2010, a Petition for Declaratory Order seeking Commission affirmation that:

- The transfer of the assets is authorized by RCW 80.12.020(2).⁷
- The purchase price of \$103 million is sufficient to fully compensate PSE for the sale of the assets.
- The provisions of the APA pertaining to PSE's transition of its responsibilities to provide electrical service to its customers in the Service Territory are consistent with PSE's public service obligations.

9 On February 1, 2011, the Commission granted PSE's Petition for a Declaratory Order in Docket U-101217, determining among other things that the purchase price of \$103 million is sufficient compensation for the acquisition by JPUD of PSE's assets in Jefferson County.⁸ The Commission's Declaratory Order also states that:

Our determination does not affect the subsequent accounting treatment of the sale proceeds and does not affect an allocation of the sale proceeds as between PSE's customers and shareholders. Those questions will be finally determined in the context of a future proceeding, most likely one initiated via an accounting petition or in PSE's next general rate case.

PSE brings the allocation question to the Commission via its accounting petition that is the subject of this docket.

⁷ The Company clarified during the prehearing conference on August 26, 2010, that this final declaration means simply that the transfer of assets from PSE to JPUD does not require Commission approval under RCW 80.12.020(1). Tr. 8:23-25. PSE confirmed this point in its memorandum filed in support of the Stipulation, as discussed below at ¶ 15.

⁸ The \$103 million agreed purchase price per the Asset Purchase Agreement (APA) increased to \$109 million at closing under the provisions of a subsequent Customer Transition Agreement (CTA). It is noteworthy that the APA requires WUTC confirmation that the price is sufficient to fully compensate PSE's *customers* for the sale of the assets. Keating, Exh. No. EJK-1T, 7:2-5. The Commission's order, however, finds that the price is sufficient to fully compensate PSE, which is the finding the Company requested in its petition for declaratory order.

10 The Commission convened a prehearing conference in this proceeding on December 17, 2013, and established a procedural schedule including opportunities for Staff, Public Counsel, and ICNU to file response testimony and exhibits, and for PSE to file rebuttal testimony and exhibits. The Commission gave notice it would conduct an evidentiary hearing, which it held on May 21, 2014. The record developed through the hearing process includes prefiled testimony and exhibits from nine witnesses and a significant number of exhibits introduced during cross-examination. All together, the record includes approximately 94 documents, including prefiled testimony and exhibits, and cross-examination exhibits. The evidentiary hearing transcript includes 250 pages. All parties filed briefs on June 10, 2014, and reply briefs on June 17, 2014.

II. Discussion and Decisions

A. Introduction

11 PSE seeks in this case an accounting order allocating the proceeds of sale of the Company's Jefferson County assets to JPUD. The proceeds of sale are \$109,273,196. The parties agree that the net book value (NBV) of the assets (*i.e.*, original cost less accumulated depreciation) is \$46,686,436, and that this amount should be allocated to PSE so the Company's shareholders realize the full *return of* their investment in these assets. The parties also agree that some amount of transaction costs should be allocated to PSE, but disagree on the precise number. For reasons we explain later, we accept Staff's figure: \$2,404,643. It follows that the transaction between PSE and JPUD resulted in a gain on sale of \$60,182,117. The allocation of this gain is the primary issue in dispute in this proceeding.

12 PSE contends that shareholders are entitled to 100 percent of the gain on sale. PSE proposes, however, that customers should be allocated 25 percent of the gain, or \$14,966,078, but only as a "voluntary sharing of the proceeds of this sale."⁹ PSE's

⁹ PSE *Petition* at 18, ¶ 37. We note that PSE's calculation is based on a gain on sale of \$59,864,312, reflecting the slightly higher (*i.e.*, \$317,805) transaction costs the Company advocated relative to what we approve.

case is premised on the assertion that shareholders alone bear the “risk of ownership” in the facilities.¹⁰

- 13 Staff, Public Counsel, and ICNU contend that PSE’s customers are entitled to 100 percent of the gain but propose, respectively, to share with PSE \$7,481,394 (*i.e.*, 25 percent of the amount of gain Staff identifies as “appreciation”), \$2,992,558 (*i.e.*, 10 percent of the appreciation), or \$2,993,216 (*i.e.*, 5 percent of the gain on sale).

B. Regulatory Principles

- 14 The parties’ arguments suggest that three options are available to determine the allocation of the sales proceeds at issue, including the gain on sale amount (*i.e.*, the sales proceeds minus the sum of NBV and transaction costs):

- Follow the established principles of regulatory economics as thoroughly analyzed and discussed in the seminal case of *Democratic Central Committee* and applied by the Commission, for example, in the *Centralia* decision in 2000.¹¹
- Follow the so-called *Redding II* exception to these principles established in a rulemaking before the California Public Utilities Commission (CPUC) in 1989 that the CPUC applies to municipalizations of utility assets.¹²

¹⁰ PSE *Petition* at 18, ¶ 37; Levin Rebuttal, Exh. No. SLL-1T at 11:14-20.

¹¹ The Commission has applied these same principles for many years in analyzing other sales of utility assets across the industries it regulates. *See, e.g., In the Matter of the Application of Qwest Corporation d/b/a CenturyLink QC for Order Approving an Agreement for Transfer and Sale of 1600 - 7th Avenue, Seattle, Washington*, Docket UT-120128, Order 01, Order Granting Application (March 21, 2012); *Amended Petition of Puget Sound Energy, Inc. for an Order Authorizing the Use of the Proceeds From the Sale of Renewable Energy Credits and Carbon Financial Instruments*, Docket UE-070725, Order 03, Final Order Granting, in Part, and Denying, in Part, Amended Petition; *Determining Appropriate Accounting and Use of Net Proceeds From the Sales of Renewable Energy Credits and Carbon Financial Instruments*, 282 PUR 4th 303 (2010); *WUTC vs. Puget Sound Power & Light*, Dockets U-89-2688-T and U-89-2955-T, Third Supp. Order (January 17, 1990).

¹² *Ratemaking Treatment of Capital Gains from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity*, 104 Pub. Util. Rep. (PUR) 4th 157 (Cal. PUC 1989) (*Redding II*). We discuss this case in more detail below, but note here that the rulemaking proceeding that led to this exception was expressly for the purpose of revisiting an adjudication order that followed principles discussed in *Democratic Central Committee* and

- Develop a Washington-specific policy and rationale for allocation in the case of forced sales to governmental entities that elect to own and operate their own electric utility.

Staff, Public Counsel, and ICNU all urge us to elect the first option, albeit with some modest differences in the details of their recommendations. PSE's primary argument urges us to elect the second option. The third option is suggested by PSE's alternative recommendation, which is to allocate a significant part of the gain on sale to PSE to compensate the Company for the sum of NBV and "a qualified appraiser[']s" estimate of alleged harm to shareholders due to "a loss of customers and future revenues."¹³

15 The arguments of Staff, Public Counsel and ICNU are grounded in the most basic underpinnings of utility regulation, sometimes referred to as the "regulatory compact."¹⁴ This compact, or understanding, between utilities and those who regulate them is necessary because utilities generally are regarded as being natural monopolies. They are capital intensive to the point that it is economically inefficient for more than one firm to build, operate and maintain the infrastructure necessary to provide service in the public interest. Monopolies, by their nature, are able to restrict output and charge prices higher than what is economically justified. Governmental oversight, such as provided by the Commission, prevents utilities such as PSE from exercising monopoly power, with regulation substituting for competition as the determiner of price. Thus, in its most basic form, the regulatory compact is that utilities have an obligation to provide all customers in their territory with safe and

allocated to ratepayers the gain on sale of utility assets acquired from PG&E by the City of Redding. *Re Pacific Gas and Electric Company*, 71 Pub. Util. Rep. (PUR) 4th 1, 7-13 (Cal. PUC 1985) (*City of Redding*).

¹³ PSE Initial Brief ¶ 3. While on the one hand this appears to be an alternative basis for allocating the sales proceeds, it also appears to be embedded in PSE's primary proposal that includes the Company's offer to share a portion of the gain on sale with ratepayers even though the Company claims to be entitled to the entirety of the sales proceeds. *Id.* ¶ 7. We do not discuss this alternative separately below because the discussion concerning fair market value in section III.B. of this Order establishes the reasons it should be rejected. Briefly, PSE's alternative theory confuses our role with that of a court in a condemnation proceeding in which a jury would determine the "fair value" the seller should receive when its assets are taken by eminent domain.

¹⁴ Staff Initial Brief ¶¶ 2-3; Public Counsel Initial Brief ¶¶ 11-13.

reliable service in return for the regulator's promise to set rates that will compensate the utility for the costs incurred to meet that obligation.¹⁵

- 16 In Washington, and many other jurisdictions, the regulator fulfills its responsibility under the regulatory compact by using the rate base/rate of return approach to set rates. Rate base is a measure of the capital investors and lenders provide to a utility. Utilities use this capital to purchase or build assets, acquire property, and for other purposes such as maintenance of a working capital account from which short term obligations can be met. Most of the assets in rate base are infrastructure such as generation plant and distribution plant (*e.g.*, poles, transformers, wires, and associated hardware). These are so-called depreciable assets; due to wear, obsolescence and other reasons, they are expected to lose value over time. Such assets are included in rate base at their original cost and then depreciated over time in accordance with a Commission approved depreciation schedule. Rate base also may include non-depreciable assets, such as land, that is generally expected to increase in value over time, rather than lose value.
- 17 Using the rate base/rate of return approach, the Commission determines on the basis of evidence presented in a general rate case what levels of prudently incurred expenses the Company will experience prospectively, and allows for recovery of these expenses. In addition, the Commission determines the Company's rate base using the original cost less depreciation method and allows for an appropriate rate of return on that rate base.¹⁶ This is necessary to allow the Company to recover the costs of its investments in infrastructure, repay its lenders, and provide an opportunity for the Company to earn a reasonable return, or profit, some of which may be distributed to its equity investors in the form of stock dividends. The sum of the two figures – expenses and return on rate base – constitutes the company's revenue requirement

¹⁵ Public Counsel Initial Brief ¶ 12.

¹⁶ Reduced to a simple definition, rate base is the Commission-approved level of PSE's investment in facilities plus the cash, or "working capital" supplied by investors that is used to fund the Company's day-to-day operations. The Commission follows the original cost less depreciation method when determining the value of a utility's property that is used and useful in providing service to customers. *People's Organization for Washington Energy Resources v. Washington Utilities & Transportation Comm'n*, 104 Wn.2d 798, 828, 711 P.2d 319 (1985).

that we approve for recovery in rates.¹⁷ The Washington Supreme Court explained this rate-making formula as follows:

In order to control aggregate revenue and set maximum rates, regulatory commissions such as the WUTC commonly use and apply the following equation:

$$R = O + B(r)$$

In this equation,

R is the utility's allowed revenue requirements;
O is its operating expenses;
B is its rate base; and
r is the rate of return allowed on its rate base.

Although regulatory agencies, courts and text writers may vary these symbols and notations somewhat, this basic equation is the one which has evolved over the past century of public utility regulation in this country and is the one commonly accepted and used.¹⁸

- 18 Focusing on the rate base component in this formula, the utility's investors are entitled to a *return of* the original costs of the assets, which they receive in the form of depreciation expense included in customer rates during the depreciable life of the assets in service. The utility's investors are also entitled to the opportunity to earn a *return on* the undepreciated balance, or net book value, of the assets during their service lives. The level of the return on equity is set to fully compensate the utility's investors on a basis comparable to other enterprises facing similar levels of investment risk. Staff argues, following these principles, that upon the sale of assets:

The "regulatory compact" requires only that the Commission return to PSE shareholders the unamortized balance of utility plant on PSE's books (*i.e.*, the net book value of the assets sold), and nothing more. This treatment is fair and it does not harm PSE's owners. Net book value is the foundation of Commission regulation and investor

¹⁷ See *id.* at 807-09 (describing ratemaking principles and process).

¹⁸ *Id.* at 809.

expectations in this state. That is all that PSE shareholders may reasonably expect. They have no legal claim to any more than that.¹⁹

Stated somewhat differently, the only “legally protected interest [of the investor] resides in the capital he invests in the utility rather than in the items of property which that capital purchases for provision of utility service.”²⁰ Thus recognized in *Democratic Central Committee* in 1973, this principle was much earlier identified by Justice Brandeis, joined by Justice Holmes, in a landmark concurring opinion penned in 1923. In Justice Brandeis’s words: “The thing devoted by the investor to the public use is not specific property, tangible or intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return.”²¹

19 It follows that when assets are sold, the utility is generally entitled to recover the undepreciated balance, or NBV of the assets that have not been fully amortized, thus

¹⁹ Staff Initial Brief ¶ 2. Staff discusses the regulatory compact at length in its Initial Brief observing, among other things, that:

The regulatory compact inheres in the manner in which investor-owned electric utilities are regulated in this country in general, and regulated by the Commission in particular. Like almost every other regulatory commission, the Commission regulates PSE based on the value of its property the Company devotes to public service. Pursuant to the Commission’s valuation statute, RCW 80.04.250, the Commission values PSE’s utility property (rate base) at its original cost less accumulated depreciation, otherwise referred to as “net book value.”

As a result, the Commission provides PSE the opportunity to earn a fair return *on and of* rate base, no more and no less. In this case, giving PSE investors back the net book value of their investment is all the regulatory compact requires.

Id. ¶¶ 29-30. *See generally* ¶¶ 34-60.

²⁰ *Democratic Central Committee*, 485 F.2d at 801.

²¹ *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm’n*, 262 U.S. 276, 289, 43 S.Ct. 544, 67 L.Ed. 981 (1923). This case marked the beginning of the move by the courts and state regulatory commissions away from the era of “fair value” ratemaking, famously established in 1898 by *Smyth v. Ames*, 169 U. S. 466, 18 S.Ct. 418, 42 L. Ed. 819 (1898). The Supreme Court subsequently abandoned the reproduction cost method and the “fair-value” theory. The Supreme Court described the rationale for the shift away from fair value in *Federal Power Comm’n v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944) (*Hope Natural Gas*), where the Court said, “[T]he heart of the matter is that rates cannot be made to depend upon ‘fair value’ when the value of the ongoing enterprise depends on earnings under whatever rates may be anticipated.” 320 U.S. 591, 601.

ensuring a full *return of* the investors' money. That is, the sales proceeds are allocated to the utility up to the amount of the NBV, as the parties have agreed should occur in this case. Because the sold assets are no longer being used by the utility to provide service to customers, however, they are removed from rate base and the utility's opportunity earn a *return on* the assets is at an end.

20 These principles govern whether the sale produces exactly the net book value or produces a gain or loss relative to the NBV benchmark. Additional principles come into play if there is a gain or loss on the sale. If utility assets are prudently sold for less than NBV, the utility expects, and typically is authorized, to recover the deficit relative to net book value. In this situation, the sales proceeds are allocated fully to the utility and the unrecovered NBV becomes a regulatory asset on the utility's books. The utility may earn a *return on* the unrecovered balance of the regulatory asset until fully amortized and the utility been paid a full *return of* the original cost of its investment. This is what the utility is legally entitled to receive.²²

21 If utility assets are prudently sold for more than NBV, the sales proceeds again typically are allocated first to the utility, up to the amount of the net book value.²³ Additional proceeds may be allocated to the utility to cover transaction costs. When NBV plus any allowed transaction costs are subtracted from the full proceeds, the balance is "net gain" or "gain on sale." The allocation of this gain is a matter within the discretion of the regulatory authority.²⁴ The Commission's exercise of its

²² See, e.g., *Application of Puget Sound Energy, Inc. for an Order Authorizing the Sale of the Water Rights and Associated Assets of the Electron Hydroelectric Project*, Docket UE-131099, Order 02, Final Order (October 23, 2013) (*PSE Electron Case*). See also *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Cause U-82-38, 3rd Supplemental Order, 54 Pub. Util. Rep. (PUR) 4th 480, 494-97 (1983), *aff'd*, *People's Org. for Wash. Energy Res. v. Utilities & Transp. Comm'n*, 104 Wn.2d 798 711 P.2d 319 (1985); *Utilities & Transp. Comm'n v. Pacific Power & Light Co.*, Docket U-84-65, 4th Supplemental Order, 68 Pub. Util. Rep. (PUR) 4th 396, 404-05 (1984); *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Cause U-83-54, 4th Supplemental Order, 62 Pub. Util. Rep. (PUR) 4th 557, 587 (1984).

²³ See *Centralia*.

²⁴ In some jurisdictions, such as California, the regulatory authority has established by rules how gains on sales of utility assets are allocated. We note that the CPUC generally allocates 100 percent of any gains on the sale of depreciable assets to ratepayers, following the principles established in *Democratic Central Committee. Order Instituting Rulemaking on the Commission's own motion for the purpose of considering policies and guidelines regarding the allocation of gains from sales of energy, telecommunications, and water utility assets.*, Decision

discretion, however, is guided by yet additional principles that are widely followed by regulatory authorities throughout the United States.

- 22 Briefly, when an asset is sold for a gain, the policy principles guiding the disposition of the proceeds from sale of a utility asset that is in service, in rate base, and used and necessary for the provision of utility service are that the proper allocation of the gain between ratepayers and shareholders should be guided by the complementary equitable principles that “reward follows risk” and “benefit follows economic burden.”²⁵ In *Centralia* both the majority and the dissent recognize the seminal authority for these principles as being the D.C. Circuit’s 1973 decision in *Democratic Central Committee*, where the Court described them with the following:

One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom. The justice inherent in these principles is self-evident, and each already occupies a niche in the law of ratemaking; and their application, sometimes overlapping, to the problem at hand weighs the scale heavily in favor of consumers. For practice in the utility field has long imposed upon consumers substantial risks of loss and financial burden associated with the assets employed in the utility’s business. . .

[A]n investor can hardly muster any equitable support for a claim to appreciation in asset value where he has been shielded against the risk of loss on his investment, or has already been rewarded for taking that risk.²⁶

- 23 While these principles establish a presumption in favor of allocating gains on sale to customers, not shareholders, it is important to recognize that they only establish an analytic framework within which to adjudge an equitable allocation between them. Applied in the *Centralia*, for example, the Commission determined that both the

06-05-041 (May 25, 2006) (“In most cases, utility ratepayers should receive 100% of the gain from depreciable property.”). We discuss separately below the exception to this rule earlier established by the CPUC in *Redding II*.

²⁵ *Centralia* ¶ 183 (Hemstad dissent); see also *Centralia* ¶¶ 47-49 and *Democratic Central Committee*, 485 F. 2d 786 *passim*.

²⁶ *Democratic Central Committee*, 485 F. 2d at 806.

ratepayers and the shareholders had borne risks justifying a determination that they should share equally in a portion of the gain identified as “appreciation” in the value of the assets sold.²⁷ The equitable considerations that might support allocating a part of any gain on sale of assets to the shareholders vary from case to case and may weigh in favor of no such allocation, or a generous allocation, as in *Centralia*.

24 Despite this rich history of precedent, PSE contends that its sale of assets to JPUD is unique, or nearly so, and argues: “There are no Commission decisions addressing the legal and equitable principles that should guide the Commission's decision in this context. PSE urges the Commission to apply a rule specifically crafted and limited to this context by the California Public Utilities Commission.”²⁸ The “context” to which PSE refers is “a forced sale, where the regulated utility loses a portion of its service territory as a result of a municipalization”, which both PSE and the authority on which it relies regard as a “partial liquidation.”²⁹ PSE represents in its Petition in this matter that:

The unusual and extraordinary circumstances presented in this case are the unique and harsh circumstances of the liquidation of the entire business enterprise in a given locality. The rule generally applied to the

²⁷ Although PSE objects to the concept of appreciation as a component of gain on sale and to consideration of accumulated depreciation as an equivalency measure for purposes of determining equitable allocation of gain, we find its arguments wide of the mark. The Commission’s description of the amount of gain that exceeded the asset’s original costs (*i.e.*, the sum of net book value and accumulated depreciation) in *Centralia* as “appreciation” is an easily understood and common use of language. Mr. Marcellia’s objection that it has no place in the accounting literature (Exh. No. MRM 5T at 9:9-16) does not undermine its descriptive value as applied in the *Centralia*, or in Staff’s advocacy in this case. PSE’s arguments objecting to allocating to ratepayers a share of the gain *equivalent* to accumulated depreciation do no more than artfully obfuscate the point that in so doing the Commission in the *Centralia* did not *return* depreciation expense already paid by customers in rates and in the hands of PSE’s investors. The Commission there, and Staff in its advocacy here, merely use the amount of accumulated depreciation paid as a measure of an amount of gain that should equitably be allocated to ratepayers. There is no serious question that the investors retain every penny they have received over the years in depreciation expense included in customers’ rates.

²⁸ PSE Initial Brief ¶ 4.

²⁹ See *Id.* ¶¶ 4, 11, 12, and 36. See also *Redding II*, 104 P.U.R. 4th at 160 (“[The] circumstances contemplated in this rulemaking [are] the sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system.”)

allocation of gain under these circumstances has been stated by the California Public Utilities Commission:

[T]he capital gain or loss, net of costs of sales, realized from the sale of a distribution system, under the circumstances described in Ordering Paragraph 1, shall accrue to the utility and its shareholders to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the ratepayers have not contributed capital to the distribution system.³⁰

25 PSE's main line of argument in this case is that the "general rule" the CPUC established in *Redding II* should be followed in the circumstances of its sale of assets to JPUD.

26 Staff responds that while this may be a "general rule" in California, it is not the rule historically applied in Washington.³¹

PSE's case is premised on the assertion that shareholders alone bear the "risk of ownership" in the facilities. However, that is a false premise. In this state, PSE customers bear the risk of ownership, and remaining customers continue to bear that risk through the rate setting process. This confirms that customers are entitled to receive the gain on sale of the JPUD assets.

PSE's theory of risk/reward heavily relies on a decision of the California commission in *City of Redding II*. However, like PSE here, *City of Redding II* was based on the assumption that investors bear the risk of ownership. While that may be the situation in California, it is not the situation here. Here, customers bear that risk because the Commission's rate setting practices place the risk of capital loss on

³⁰ PSE Petition for Accounting Order ¶ 35 (citing *Redding II*). See *Redding II*, 104 P.U.R. 4th at 160.

³¹ Staff Initial Brief ¶¶ 18-19 (citing *Utilities & Transp. Comm'n v. Am. Water Res.* Docket UW-031284, *et al.*, Order 08, Final Order Dismissing Complaint Against Rates in Part, Ordering Refund of "Docket Account" Set Aside, and Denying Application for Mitigation of Penalties (November 1, 2004) in which the Commission allocated a share of the gain on the sale of parts of American Water's water system to a water district and a water and sewer district stating: "the allocation between shareholders and ratepayers of the gain on sale of in-service utility assets rests essentially on equitable considerations." *Id.* Order 08 ¶ 60.

customers. Accordingly, PSE's customers are entitled to the gain on sale of the JPUD assets.³²

- 27 Staff later responds to PSE's "partial liquidation" argument 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 and allocate all of the gain on sale to shareholders, because remaining customers allegedly are unaffected.³³ Staff argues that "there is indeed harm to remaining customers" including near-term increases in power costs to remaining customers that PSE does not dispute and "additional harm due to the experimental ERF/decoupling mechanism now in place for PSE."³⁴ Staff argues, in addition, that:

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.³⁵

- 28 Public Counsel argues directly that "[t]he sale in this case was not a liquidation"³⁶ and "[a]lthough the sale resulted in a reduction of service territory and customers, PSE continues to operate as the same entity it operated as prior to the sale."

III. Discussion and Determinations

A. Should the Commission apply the principles it followed in *Centralia*, and other precedential authorities, or apply the narrow exception to these principles established by the CPUC in *Redding II*?

- 29 To restate the obvious: the issue before us is one of policy. We agree with Commission Staff, Public Counsel, and ICNU that PSE is entitled as a matter of law only to the return of the NBV of the property. This amount reflects the remainder of

³² Staff Initial Brief ¶¶ 5-6.

³³ See PSE Post-Hearing Brief ¶ 12.

³⁴ Staff Initial Brief ¶ 13.

³⁵ *Id.* ¶ 14.

³⁶ Public Counsel Initial Brief ¶ 55.

the capital invested by the owners in the Jefferson County facilities and on which the investors have earned a return over the useful life of those facilities. The allocation of any gain then is a matter of policy. And, as a matter of policy, the Commission has consistently followed the regulatory principles discussed above when allocating proceeds derived from the sale of utility assets under a wide range of circumstances.³⁷ These principles are grounded in the very bedrock of rate regulatory theory and law.

30 The question placed before us by PSE is whether we should depart from this analytic framework in the context of this sale after the Jefferson County voters approved the takeover of PSE’s Jefferson County facilities by JPUD. We are not willing to do so.

31 Even if we concede that this transaction is “forced,” we fail to see how this changes our historic reward/risk and benefit/burden calculus used to allocate proceeds of sale that result from property transfers. While threats of condemnation by public utility districts and municipalities may not occur very often, the risk of these occurring has been present for decades and PSE’s investors are compensated for this risk through the rates of return the Commission approves in the Company’s regular rate proceedings. Were we to accept the proposition that the forced nature of the sale somehow alters the equities when utility assets are sold, the Commission undoubtedly would face in the future arguments that the sale of a coal-fired power plant was “forced” by the federal government’s imposition of more stringent carbon emissions standards or the sale of a hydroelectric dam and power plant was “forced” by more stringent relicensing requirements and, therefore, the utility is entitled to 100 percent of the sales proceeds, as PSE argues here. We will not take the first step down such a path here.

32 Thus, we adhere in this case to an allocation of proceeds from PSE’s sale of assets to JPUD that is guided by the complementary equitable principles that “reward follows risk” and “benefit follows economic burden.”³⁸ All of PSE’s ratepayers, through generally applicable rates, bore the risks of the Company’s capital investments in Jefferson County. PSE’s customers, consistent with the regulatory compact, paid in rates a reasonable return on the capital invested and depreciation expense that

³⁷ See *supra* n. 22.

³⁸ *Centralia* ¶ 183 (Hemstad dissent); see also *Centralia* ¶¶ 47-49 and *Democratic Central Committee*, 485 F. 2d 786 *passim*.

provided to shareholders over time a return of the capital they invested, or at least a portion of it.³⁹ In addition, all of PSE's ratepayers bore the burdens of operating and maintaining the utility's Jefferson County assets through the operating expense component included in PSE's general rates. Because PSE's customers, and not PSE's shareholders, bore these risks and burdens, PSE's customers, absent countervailing policy arguments that we address later, are entitled to the gain on sale.

33 We are not persuaded that we should import into Washington the exception to these settled principles that the CPUC established by rule in *Redding II*.⁴⁰ The decision in *Redding II* was a policy determination effected into law as a Commission rule by a majority of the CPUC, reversing such legal authority as existed at the time and was considered controlling by the CPUC in *City of Redding*. The exception remains controversial in California and was strenuously contested in formal proceedings before the CPUC as recently as 2006.⁴¹

³⁹ The investors will receive the balance as a result of this order, which allocates to PSE the net book value of the assets at the time they were sold.

⁴⁰ We noted earlier that in *Redding II* the CPUC used the rulemaking process essentially for the purpose of reconsidering and reversing its earlier decision in *City of Redding* to follow the principles of *Democratic Central Committee* under the circumstances presented; principles that the CPUC did then, and does now, follow in cases involving asset sales that are not the result of municipalization.

⁴¹ In 2004, the CPUC entered its *Order Instituting Rulemaking [OIR] on the Commission's Own Motion for the Purpose of Considering Policies and Guidelines Regarding the Allocation of Gains from Sales of Energy, Telecommunications, And Water Utility Assets*, Rulemaking 04-09-003, (Filed September 2, 2004). The CPUC published its Decision 06-05-041 in the matter, titled "Opinion Regarding Allocation of Gains on Sale of Utility Assets," on May 25, 2006. *Allocation of Gains from Sales of Energy, Telecomm., and Water Util. Assets*, Rulemaking 04-9-3, 249 Pub. Util. Rep. (PUR) 4th 478 (Cal. PUC 2006). The CPUC relates in its Opinion that "The OIR proposed that the decision issued here supersede all previous decisions, including *Redding II* and its ratepayer harm standard." *Id.* at 488. Considering arguments from the California utilities that *Redding II* had been for many years "established Commission precedent" and from Aglet Consumer Alliance that *Redding II* "is a matter of policy, not law, and there is good cause for reassessment of prior Commission policies," the CPUC majority concluded it "should continue to apply *Redding II* principles in the narrow circumstances to which they were designed to apply." *Id.* at 499, 516. The only rationale given, however, is that "We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope." *Id.*

In its decision in response to petitions for rehearing of its 2006 Opinion, the CPUC justifies continuing the *Redding II* exception to the risk/reward test generally governing the allocation of proceeds from sales of utility assets not because it is soundly reasoned but because:

34 However, here, we have a history of development of policy that is inconsistent with the California approach.

35 In our view, with all due respect to the *Redding II* majority, the rationales nominally supporting the outcome of the rulemaking are flawed. We discuss individually below the two principal rationales for the *Redding II* exception:

- Municipalization is a “partial liquidation” and the allocation of proceeds should be the same as in the case of a total liquidation.
- Investors bear the financing risk in the case of public utilities and therefore, following traditional risk/reward analysis, the gains of an asset sale should be allocated to investors.

The record supports the continuation of the *Redding II* precedent not because the analysis that led to its adoption in 1987 is necessarily correct but because that decision's allocation of gain meets the need to provide certainty in the unique circumstances to which *Redding II* applies. The record contains comments supporting the continuation of a long-standing rule that is well-understood in the industry, and can be easily applied by the Commission.

Re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets, Rulemaking Proceeding 04-09-003, Decision 06-12-043, California Public Utilities Commission (December 14, 2006), 2006 WL 3831392 (Cal.P.U.C.) at 6.

The CPUC again stresses that *Redding II*'s departures from risk-based standards “raise policy, not legal questions.” *Id.* Avoiding substantive discussion of the legal arguments, the CPUC's order on rehearing, ignoring that *Redding II* itself is the product of a rulemaking instituted expressly to reconsider, and ultimately reverse, the adjudicative decision in *City of Redding*, dismisses the petitioners' legal claims on the basis that:

Those wishing to make a legal challenge a Commission decision must do so by filing an application for rehearing within the prescribed time period. (citation omitted). Subsequent proceedings should not be used to make a collateral attack on previously rendered decisions.

Id.

1. Municipalization as “Partial Liquidation”

36 In *Redding II*, the majority discusses as a basic part of its policy rationale for creating an exception to the usual rules for allocating proceeds from utility asset sales the point that the CPUC “always allocate[s] to shareholders the gains or losses from the total liquidation of a public utility.”⁴² Reasoning that the transfer of distribution facilities to a municipality, together with the municipality’s assumption of the responsibility to serve customers, is tantamount to a “partial liquidation” of the public utility, the CPUC majority concludes that “the rules on liquidation logically should cover the narrowly defined circumstances we have described.”⁴³ The CPUC purports to base this conclusion on a two-step analysis that focuses on the welfare of the ratepayers, both those being transferred out of the CPUC’s jurisdiction, and those who remain. It is unclear, however, how this has any connection to the concept of partial liquidation, and, further, why this makes any difference in the analysis of who should, as a matter of policy, be allocated gains on sale of property.⁴⁴

37 Even if the concept of “partial liquidation” is relevant, the Jefferson County situation is factually different. Jefferson County and its 18,000 former PSE customers are simply one relatively small part of the Company’s overall business. Converting the Jefferson County assets to cash was not alleged to have changed the value of PSE’s stock. There was no return of capital to the investors. Indeed, “PSE will reinvest an amount equivalent to the proceeds of this sale in property that is similar or related in service or use to the property that was converted.”⁴⁵ The business of the corporation remained the same, in its general character and purposes, and it continues today as a going concern. There was no separate supervision or control of the Company’s operations in Jefferson County. Indeed, PSE acknowledges that it operates as a single entity and determines customer rates on a uniform system wide basis:

⁴² 104 P.U.R. 4th 157, 160.

⁴³ *Id.*

⁴⁴Challenged on this point by participants in the rulemaking, the CPUC is at pains to avoid the question, rather than to answer it: “We believe that a lengthy discussion of the various comments on what is or is not a liquidation or a partial liquidation would be merely an exercise in legalisms.” *Id.* at 161.

⁴⁵ PSE Petition ¶ 42.

The Company's rates are uniform throughout its service area. As such all customers share in the recovery of PSE's overall depreciation expense. The amount paid by any given customer or group of customers is not tied to specific assets used to provide service within any particular city or county within PSE's service area.⁴⁶

In sum, PSE has not experienced a partial liquidation of its business; PSE simply sold assets to JPUD at a negotiated fair market value, as required under statutes that have been part of the Revised Code of Washington for many years.

2. Financial Risk

38 The CPUC's decision in *Redding II* was based on the premise that utility investors bear "general financial risk" of making the investment in utility property, and thus, "they should be assigned the rewards."⁴⁷ This ignores the fundamental, constitutionally-based precept of utility regulation, discussed above, that "the investor's legally protected interest resides in the capital he invests in the utility rather than in the items of property which that capital purchases for provision of utility service."⁴⁸ It is "[u]pon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return."⁴⁹ And, as discussed earlier, the investors are assured the return of their invested capital and the opportunity to earn a return on that investment at the so-called rate of return.⁵⁰ So, the shareholders do not

⁴⁶ PSE: Piliaris Direct, Exh. No. JAP-1T at 9:14-17; *Accord*: ICNU: Gorman Direct, Exh. No. MPG-1T at 4:21-23: "it is appropriate to conclude that PSE recovered the JPUD costs from system-wide cost recovery and not only from JPUD customers." Staff: Keating Direct, Exh. No. EJK-1T at 9:17-18: "The Commission sets rates on a system-wide basis rather than by individual sections of PSE's service territory." and at 10:14-15: "... Jefferson County was not a stand-alone system for ratemaking purposes."

⁴⁷ 104 Pub. Util. Rep. (PUR) 4th 157. The CPUC itself later recognized this premise is flawed in its 2006 rulemaking proceedings, noted above. There, the CPUC justified its policy decision to give customers 100 percent of the gain on sales of depreciable utility property on the basis that "ratepayers . . . bear the burden of the financial risk of the investment." *Allocation of Gains from Sales of Energy, Telecomm., and Water Util. Assets*, Rulemaking 04-9-3, 249 Pub. Util. Rep. (PUR) 4th 478, 493 (Cal. PUC 2006).

⁴⁸ *Democratic Central Committee* at 801.

⁴⁹ *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. at 289.

⁵⁰ *See supra* ¶¶17-19.

face the sort of risk that an investor in an unregulated market faces where there is no “regulatory compact.”

39 It is elemental to our regulatory discipline that rates must be sufficient to enable the utility to finance its regulated operations on reasonable terms.⁵¹ Indeed, the Supreme Court recognized nearly 100 years ago in the *Bluefield Water Works* decision that a public utility, as a regulated monopoly, is entitled to reasonable treatment of its capital, to the end that the utility remains creditworthy and able to properly discharge its public duties:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties, but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.⁵²

40 Two decades later, in the *Hope Natural Gas* decision, the Court emphasized that the result of regulation of monopoly enterprises such as PSE must be to “enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to *compensate investors for the risks assumed*”⁵³ Investors are compensated fully for the capital they invest via return on and return of their capital. Their investments are not risk free, but the risks are slight relative to what investors bear in

⁵¹ See Staff Initial Brief ¶36, quoting *Hope Natural Gas*.

⁵² *Bluefield Water Works & Improvement Co. v. Public Service Commission (Bluefield Water Works)*, 262 U.S. 679, 692. The Washington Supreme Court noted its approval of this language two decades later, in *Pacific Telephone & Telegraph Co. v. Department of Public Service*, 19 Wn.2d 200, 266, 142 P.2d 498 (1943), and again in the much cited POWER case, *People’s Organization for Washington Energy Resources v. Utilities & Transportation Commission*, 104 Wn.2d 798, 813, 711 P.2d 319 (1985).

⁵³ *Hope Natural Gas*, 320 U.S. at 605 (emphasis added). The Washington Supreme Court noted its approval of this language in *POWER*, 104 Wn.2d at 811.

competitive enterprises because rates are set to be fully compensatory; rates are required to be fair, just, reasonable, and *sufficient*. Such risks as the investors do bear are recognized and compensated through the rate of return.

41 The CPUC in *Redding II* makes no effort to explain its fundamental departure from the legal and economic principles discussed in *Bluefield Water Works* and *Hope Natural Gas*. Nor does PSE in this case offer any satisfactory rationale for doing so. Indeed, PSE does not even mention these authorities in its initial brief. In its reply brief, PSE avows that it “agrees with the principles articulated” in these cases “and their applicability to ratemaking, including the relevance of ‘net book value’ for purposes of determining the value of rate base for ratemaking purposes.”⁵⁴ PSE concludes its argument with the observation that: “[t]his is not a ratemaking case.” This marginalizes and understates the overarching significance of the principles established in *Bluefield Water Works* and *Hope Natural Gas*. Again, PSE’s investors are entitled to the return of (net book value) and a return on exactly what they invest and nothing more:

[A]n investor can hardly muster any equitable support for a claim to appreciation in asset value where he has been shielded against the risk of loss on his investment, or has already been rewarded for taking that risk.⁵⁵

B. Should PSE be compensated for the fair market value of the assets?

42 The CPUC’s decision in *Redding II*, and what PSE urges in this case, depart from the original cost less depreciation approach to valuing utility property that is central to the regulatory compact. PSE would have us return to use of the much criticized and long discredited “fair value” or “fair market value” approach.⁵⁶ This is an appropriate concept of value in the context of a condemnation proceeding and, in fact, the measure of what a seller is entitled to receive when a municipality, PUD, or other public entity exercises its power of eminent domain. It is not an appropriate concept

⁵⁴ PSE Reply Brief ¶ 16.

⁵⁵ *Democratic Central Committee*, 485 F. 2d 786, 806.

⁵⁶ Commissioner Hemstad, in his dissent to the *Centralia* order, shared his concerns about utilities arguing in the case of asset sales they are entitled to a share of, if not the full, fair value approach. *Centralia* ¶¶ 216-18.

of value in the context of applying appropriate regulatory treatment to utility property that is subject to rate base rate of return regulation.

- 43 The era of fair value ratemaking based on reproduction costs and other approaches to estimation following the early case of *Smythe v. Ames*⁵⁷ began to fade in 1923 when Justice Brandeis wrote a detailed critique of the use of these methodologies to determine the “fair value” of utility property.⁵⁸ Acknowledging that state utility commissions had followed the dictates of *Smythe v. Ames* for many years, allowing evidence of fair value based on reproduction cost in case after case, Justice Brandeis said that the state commissions during the early decades of the 20th century:

Failed, in ever-increasing numbers, to pay heed to it in fixing the rate base. The conviction is widespread that a sound conclusion as to the actual value of a utility is not to be reached by a meticulous study of conflicting estimates of the cost of reproducing new the congeries of old machinery and equipment, called the plant, and the still more fanciful estimates concerning the value of the intangible elements of an established business.⁵⁹

- 44 Over the next two decades, there continued to be considerable debate about how a regulatory agency lawfully could value rate base for ratemaking purposes. In *Hope Natural Gas*, the Court finally and unequivocally approved original cost less depreciation (*i.e.*, net book value) as the appropriate valuation method for utility property devoted to public use: “By such a procedure [valuing rate base at net book value] the utility is made whole and the integrity of its investment is maintained.”⁶⁰

⁵⁷ *Smyth v. Ames*, 169 U. S. 466, 18 S.Ct. 418, 42 L. Ed. 819 (1898).

⁵⁸ *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm’n.*, 262 U.S. 276, 43 S.Ct. 544, 67 L.Ed. 981 (1923).

⁵⁹ 262 U.S. 276, 301. Justice Brandeis notes in this connection that:

The Public Utility Reports for 1920, 1921, 1922, and 1923 (to March 1) contain 363 cases in which the rate base or value was passed upon. Reproduction cost at unit prices prevailing at the date of valuation appears to have been the predominant element in fixing the rate base in only 5. In 63 the commission severely criticized, or expressly repudiated, this measure of value. In nearly all of the 363 cases, except 5, the commission either refused to pay heed to this factor as the measure of value, or indeed as evidence of any great weight.

Id. n. 14.

⁶⁰ *Hope Natural Gas*, 320 U.S. at 606.

Leonard Saul Goodman writes in his treatise, *The Process of Ratemaking*, that after *Hope Natural Gas*, “many state commissions turned to original cost.”⁶¹ By 1954, the majority of state commissions surveyed followed the original cost approach and in 1998 only six states continued to give weight to any factors other than original cost.⁶² In Washington, and most other states, net book value is the bedrock of shareholder expectations regarding treatment of the capital they invest in utility property. Thus,

It is now clear that the utility is not entitled to have its rate base established at the value which the assets would command on the current market, although that market value exceeds original cost. This can mean only that the investors’ legally protected interest in such assets does not inexorably extend to the increment in value.⁶³

That is, when fair market value, as established in a condemnation proceeding or by other means, exceeds net book value, the investor has no protected interest in the increment greater than original cost less depreciation. It is in the Commission’s discretion to allocate such excess and ratepayers should receive 100 percent of it, subject only to an amount the Commission may decide on equitable grounds should be allocated to the investors.

C. What amount of transaction cost should be allocated to PSE?

45 Though PSE’s entitlement to the proceeds of its sale of assets to JPUD is limited to the NBV, the parties agree that PSE should also recover its transaction costs. This is reasonable, and the Commission approves the allocation in principle. There is a dispute, however, concerning the amount of these costs.

46 PSE claims the amount is \$2,722,448. Staff argues, in contrast, that PSE’s “provable transaction costs are \$2,404,643.”⁶⁴ Staff argues succinctly that:

⁶¹ Leonard Saul Goodman, *The Process of Ratemaking* (1998) at 777.

⁶² *Id.* Mr. Goodman explains that at the time he wrote his treatise, “fair value decisions may be found in only a handful of states governed by statutory or judicial decisions resting on pre-*Hope* criteria.”

⁶³ *Democratic Central Committee, supra*, 485 F.2d at 805.

⁶⁴ Staff Initial Brief ¶ 105.

Staff discovered that \$317,805 of this amount “duplicated costs that are already included in rates from the ERF and [the] most recent PCORC.” Accordingly, Staff removed that amount. On rebuttal, while PSE insisted there was no duplication, the Company had the burden to prove that the labor costs actually contained in the PCORC and ERF cases contained no labor costs related to the JPUD sale. This the Company did not demonstrate. Therefore, the Commission should allow \$2,404,643 in transaction costs, and no more.⁶⁵

47 PSE’s only response to this argument is that WUTC Staff, in arguing that the Company did not carry its burden of proof on this issue “apparently overlooks the rebuttal testimony of Mr. Marcelia, at Exh. No. MRM-5T 36:1-14. The correct number is \$2,722,448.”⁶⁶ It is clear from the internal citations omitted from the quote above from Staff’s Initial Brief that Staff did not overlook Mr. Marcelia’s testimony. Nor have we.

48 Mr. Keating testified that “[t]he difference between PSE and Staff is due to an Internal Labor adjustment proposed by Staff.” It is entirely possible that in charging the costs of its own employees to the JPUD transaction, PSE included small amounts that also are included in its internal labor costs as approved in the ERF proceeding and the Company’s PCORC.

49 We are not persuaded that Mr. Macelias’s description of PSE’s accounting and work order system is adequate proof that there is no duplication of labor costs. Double recovery could occur if an internal labor resource tracked in a JPUD sale work order is the same labor resource that may have been tracked under a different work order in the test years used when ERF or PCORC rates were set. Mr. Marcelia’s testimony does not acknowledge the sources of Staff’s concern and show that the Company properly accounted for the challenged internal labor costs. We find PSE failed to carry its burden of proof. We accept Staff’s transaction costs in the amount of \$2,404,643.

⁶⁵ Staff Initial Brief ¶107 (citing Keating Direct, Exh. No. EJK-1T at 36:15-17; Marcelia, Rebuttal, Exh. No. MRM-5T at 36:1-14).

⁶⁶ PSE Reply Brief ¶ 12 n. 21.

D. What part, if any of the gain on sale, should the Commission allocate to PSE?

50 We turn finally to the main contested issue in this case: in addition to NBV and transaction costs, should PSE be allocated any part of the gain on sale of the Jefferson County facilities? If the answer to this question is “yes,” how should the Commission determine the appropriate allocation? Absent some policy reason to allocate some portion of the gain to PSE, the ratepayers would receive all the gain. Accordingly, we look to those advocating allocating some portion of the gain to PSE to come forward with evidence and argument justifying such an allocation.

51 Staff, Public Counsel, and ICNU, consistent with the principles we discuss above, all reach the conclusion that, based on a correct understanding of the regulatory compact and a risk/reward, benefit/burden analysis such as applied in *Centralia*, ratepayers are entitled to 100 percent of the gain on sale (*i.e.*, sales proceeds that exceed total proceeds minus the sum of net book value and transaction costs). Each of these parties, however, recommends that a portion of the gain on sale be allocated to PSE as a reward for negotiating a good price or an incentive to negotiate responsibly to achieve fair market value in future asset sales.⁶⁷

52 Staff recognized that the Commission in *Centralia*, after allocating to investors an amount equal to net book value, allocated to ratepayers an amount equivalent to accumulated depreciation, and then addressed the remaining amount of proceeds, which the Commission termed “appreciation.”⁶⁸ In *Centralia* the Commission

⁶⁷ In previous orders involving the sale of utility assets, the Commission has allocated between 0 and 50 percent of the appreciation to shareholders. *See* Keating Direct, Exh. No. EJK-1T at 19 - 20.

⁶⁸ Keating Direct, Exh. No. EJK-1T at 15-23. A perhaps more straightforward description of “appreciation” is the amount of sales proceeds that exceed the sum of original cost plus certain transaction costs. *See* Exh. No. EJK-2. This description relies on the fundamental principle under the regulatory compact that all investors are entitled to receive on the sale of assets is the amount of their original investment. This understanding helps avoid the confusion caused by PSE’s arguments that mischaracterize what the Commission said in *Centralia* and what Staff proposes here in using accumulated depreciation to evaluate how to apportion the gain on sale to customers. In *Centralia*, the Commission observed in this connection:

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

majority decided to allocate 50 percent of the appreciation to the utilities, considering specifically the circumstances of the case, which the Commission described as presenting “a new, and highly distinctive, fact situation.”⁶⁹ Explaining its decision, the Commission majority said:

In determining the fair allocation of the appreciation, we must consider in particular the uncertain future of the electricity industry and new opportunities for both shareholders and ratepayers in a competitive wholesale generation market. In light of that uncertainty and those opportunities, regulators must be cautious not to apply precedent in a way that could inhibit utilities from pursuing opportunities beneficial to both ratepayers and shareholders. We must be flexible enough to allow managers of regulated utilities to exercise sound judgments regarding the restructuring of their portfolios of assets so as to maximize the value of their entire systems, minimize rates, and best serve both ratepayers and shareholders.⁷⁰

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 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.

Centralia ¶ 82 (emphasis added).

While the situation is the same here (*i.e.*, PSE sold Jefferson County assets at a greater value than original cost), there is nothing to suggest that the Commission in *Centralia* intended anything more than a conceptual method for determining how to share the gain, as Staff and ICNU propose in this case. All of PSE’s arguments in this case regarding accumulated depreciation, including what depreciation expense was “in rates” and “not in rates” are simply irrelevant for this, and other reasons, as explained in Staff’s Initial Brief ¶¶ 111-16. We endorse Staff’s arguments on this point without repeating them here.

⁶⁹ *Centralia* ¶ 55, n. 8. *See also Id.* ¶ 11 (“this transaction presents a set of circumstances that may well prove to be unique.”).

⁷⁰ *Id.* ¶ 54. The *Centralia* decision was made in the context of partial deregulation of the electric industry both at the federal level and in certain states. As part of this regulatory change California required its regulated utilities to divest their generation assets and participate in the developing, presumptively competitive wholesale market for power. This opened the door to the Western Energy Crisis in 2000 that resulted largely from the manipulation of the emerging wholesale market for power by traders, particularly Enron Corporation. California utilities were especially hard hit by the market manipulation, but the impact was felt throughout the western states, including in Washington.

53 Staff and ICNU, following the principles discussed in *Centralia*, take similar approaches in analyzing the question whether we should allocate to PSE a share of the sales proceeds in addition to NBV and transaction costs. They take a “bottoms up” approach that starts with original costs (net book value plus accumulated depreciation), which is then subtracted from the total sales proceeds to develop an amount of “appreciation”, about \$30 million in this case.⁷¹ Their specific proposals for sharing, however, are different.

54 Staff would have us allocate 25 percent of that amount to shareholders as a reward for PSE’s efforts in negotiating:

PSE’s negotiating plan ultimately resulted in a sales price that included significant appreciation above NBV and the accumulated depreciation of the assets in Jefferson County. Such prowess should not be overlooked as the Company represented ratepayer’s interests fairly throughout the settlement negotiations.

Staff’s proposal to provide shareholders 25 percent of the appreciation from the JPUD Sale rewards that prowess and provides an incentive to PSE to pursue a vigorous negotiating plan in any other condemnation proceedings or asset sales.⁷²

55 Staff offers two rationales for its recommendation. One is based on Mr. Keating’s review of previous Commission cases that establish a range of allocations to utilities from zero to fifty percent of any amount greater than net book value and his judgment about the appropriate amount here based on the facts and circumstances of this sale. Mr. Keating testifies that this case presents “different circumstances, risks and benefits” than did *Centralia*, justifying the smaller allocation.⁷³ Indeed, the circumstances important to the majority’s decision in *Centralia*, are not present in this case. The utilities represented to the Commission that increasing competition in the industry at the time meant that there were opportunities to sell assets such as the *Centralia* coal generation facility at a premium. The utilities argued that they were proactively taking advantage of an opportunity that would benefit ratepayers.

⁷¹ See *supra* n. 26.

⁷² Keating Direct, Exh. No. EJK-1T at 35:5-12.

⁷³ *Id.* at 21:1-3

Ultimately, this led to a generous allocation to the utilities of the gain that exceeded the sum of original costs and transaction costs. However, the Commission in *Centralia* recognized that allocation is a case-specific determination that turns on the equities of each distinctive case and that it is necessary when making an allocation decision “in the public interest” to “look both at the particular asset and also at the broader context in which the asset is being sold.”⁷⁴

56 Here, in contrast to *Centralia*, PSE sold assets because it was required by law to do so. PSE did not engage in this sale of assets to protect proactively either the Company or its ratepayers, as it did in *Centralia*. PSE was not required in this case, as it was in *Centralia*, to achieve results that satisfy the Commission’s “no harm” standard as applied in cases involving a voluntary sale of assets. Nor was PSE required to delicately balance its interests with those of seven other utility owners of the assets being sold, as was the case in *Centralia*.⁷⁵

57 PSE’s efforts in negotiating with JPUD were to protect defensively both its interests, and the interests of its ratepayers, only to the extent of ensuring that the required sale of assets was at fair market value. No one disputes the Commission’s determination in its declaratory order that the sale price achieved through negotiation was sufficient to meet this requirement.⁷⁶ This, however, is all PSE was required to do. PSE was not required in this case to structure a transaction to be fully protective of its customers’ interests. There is evidence, in fact, that PSE’s customers are harmed by this sale, at least in the near term, “because existing fixed production costs remain constant, while the number of ratepayers contributing to that fixed cost recovery has decreased with the departure of Jefferson County ratepayers from PSE’s system.”⁷⁷ Mr. Keating testifies to additional financial impacts on PSE’s remaining customers in connection with rates set for 2013 and subsequent periods through the expedited rate filing process and decoupling.⁷⁸

⁷⁴ *Centralia* ¶ 54.

⁷⁵ *See Id.* ¶ 46.

⁷⁶ *See Final Order Approving and Adopting Settlement Agreement, Granting Petition for Declaratory Judgment, Docket UE-101217, ¶ 18 (Feb. 1, 2011) (citing Exhibit EJK-1T at 4:19-21).*

⁷⁷ Exh. No. EJK-1T at 26:1-3.

⁷⁸ *Id.* at 29:12 - 32:14.

58 Considering these facts as they relate to the Commission’s determinations in *Centralia* and other cases discussed in his testimony, Mr. Keating testifies to his informed judgment as a regulatory analyst that it is appropriate to allocate to PSE 25 percent of the amount by which the sales proceeds exceed the sum of original cost plus transaction costs (*i.e.*, appreciation). He observes that this is in the mid-range of what the Commission previously has approved, providing “a good cross-check to determine the reasonableness of Staff’s proposal.”⁷⁹

59 Staff’s second rationale is that 25 percent of the appreciation (*i.e.*, sales proceeds minus the sum of original costs and transaction costs) “is approximately \$7.5 million or about 7 percent of the gross proceeds from the JPUD Sale.” Staff states that “[t]his approximates the standard fee applied by brokerage firms in negotiating real property transactions between two parties. It is reasonable to use a similar benchmark for PSE in this case.”⁸⁰ We find that Staff’s analogy to a brokerage commission in a real estate transaction comes too close to suggesting that ownership of the assets is a factor relevant to our determination. We reject this idea. It is not ownership *per se*, but the risk of ownership that matters. Ratepayers of utilities subject to the Commission’s jurisdiction bear most, if not all, of the risk of ownership.⁸¹

⁷⁹ *Id.* at 24:21-22.

⁸⁰ *Id.* at 35:13-16.

⁸¹ Staff makes this very point forcefully and convincingly in its Initial Brief ¶¶ 63-93 offering among other arguments five examples that show customers in our jurisdiction bear the risk of ownership as PSE defines that risk (*i.e.*, the risk of asset value change) under a variety of circumstances. We note, too, that the CPUC, to whom PSE would have us turn for guidance, rejects the idea that ownership is relevant to asset allocation determinations. *See Allocation of Gains from Sales of Energy, Telecomm., and Water Util. Assets*, Rulemaking 04-9-3, 249 Pub. Util. Rep. (PUR) 4th 478, 496 (Cal. PUC 2006) (“Nor are we persuaded by arguments that utility shareholders are entitled to all of the gain because they “own their own property” While it is true that payment of rates does not transfer ownership of property to ratepayers, such ownership is not necessary in order for ratepayers to be entitled to the gain.”); *see also id.* at 493-94. Finally, we note the situational ethics associated with PSE’s arguments here juxtaposed against the completely contradictory arguments the Company in made in *Centralia*. *See* Staff Initial Brief ¶¶ 63-66 (“PSE’s brief to the Commission in the *Centralia Case* strongly urged the Commission to accept the fact that customers bore the risk of ownership. For example, PSE argued that the sale of the plant would place the risk of “potentially enormous environmental costs” and the cost of extending the plant’s life “on the new owners, instead of [PSE] customers. . . .” PSE concluded that keeping the plant would “force customers to continue bearing the risks of ownership of the *Centralia* facilities.”” *Id.* ¶ 65, (citing Marcelia, Exh. No. MRM-

60 ICNU recommends that we allocate 10 percent of the net gain (*i.e.*, appreciation in Staff’s terms) to PSE as “an appropriate incentive payment,” reasoning that “it is sensible to use a similar percentage” to PSE’s current authorized rate of return on equity, 9.8 percent.⁸² ICNU fails to establish satisfactorily any connection between PSE’s authorized rate of return on equity and the allocation of proceeds from the sale of these assets. Once the assets were sold, they lost their status as being used and useful in providing service to PSE ratepayers. Hence, they are removed from rate base and no longer entitled to earn any return.

61 Public Counsel, like Staff and ICNU, would have us continue to follow the principles discussed in *Centralia* and *Democratic Central Committee*. However, in contrast to Staff and ICNU, Public Counsel uses a different allocation methodology following a “top down” approach that focuses on the gain on sale (*i.e.*, sales proceeds minus the sum of NBV and transaction costs leaving “net gain” of about \$60 million). Public Counsel observes that:

The Commission has acknowledged that it is in the public interest to encourage utilities to pursue strategies that benefit both ratepayers and shareholders. To encourage utilities to pursue such strategies, the Commission has exercised its discretion to allow PSE retain monies that would otherwise be allocated to ratepayers.⁸³

Public Counsel suggests that the Commission could, in this case:

Exercise its discretion to allocate a small portion of the gain to shareholders. Because the balance of risks and equities shows that shareholders are largely insulated from risk and substantial risk of ownership is placed on ratepayers, the balance tips in favor of ratepayers. Therefore, the majority of the gain should be allocated to ratepayers.⁸⁴ It is with these considerations in mind that Public

9CX at 1:9-24, Puget Sound Energy’s Post Hearing Brief, *Centralia Case*, Docket UE-991409, *et al.*, (January 28, 2000).)

⁸² ICNU Initial Brief ¶¶ 21-22.

⁸³ Public Counsel Initial Brief ¶ 38 (citing *In re PSE REC Petition*, Docket UE-070725, Order 03 at ¶ 47 and n.56).

⁸⁴ *Id.* ¶ 38, n. 83 (“This is also consistent with *In re Sale of Centralia Steam Plant*, Second Supplemental Order (Order Approving Sale with Conditions). Even though the Commission split

Counsel submits a recommendation that equitably balances the interests of shareholders and ratepayers and divides the gain five percent to shareholders and 95 percent to ratepayers.⁸⁵

Public Counsel supports its proposal as being consistent with *Centralia*⁸⁶ and an Oregon PUC case in which the Oregon Commission approved a settlement agreement that allocated 95 percent of the gain to ratepayers and 5 percent to shareholders.⁸⁷

62 Mr. Dittmer, testifying for Public Counsel testified candidly at hearing that his proposed 95/5 sharing is simply an exercise in judgment.⁸⁸ He shares with the other parties the view that providing PSE an incentive justifies allocating a small share of the gain on sale to the Company:

As far as the 5 percent going to the utility, the primary reason for that is just to make sure there is an incentive for them to maximize the price in the future, and, you know, to give some weight to prior Commission precedent in the *Centralia* case of some gain going to the shareholders.⁸⁹

63 Mr. Dittmer applied no formula for his recommendation. His logic is simple: PSE is entitled to nothing, it seems that it would be good policy to give PSE something, and 5 percent of the net gain is, in his judgment, an appropriate amount.

64 Though Staff, Public Counsel, and ICNU all struggled to find fully articulated bases for their recommendations, they had no difficulty agreeing that the principles firmly established in *Democratic Central Committee* and implemented in *Centralia* show that the ratepayers are entitled to receive up to 100 percent of the gain on sale from the JPUD transaction subject to an equitable allocation to the shareholders. All three

the appreciation 50/50 between the ratepayers and shareholders, ratepayers received between 86.7 percent to 92.9 percent of the overall gain for each of the three utilities.”) (citation omitted). We note in this connection that the result of this Order is to allocate 87.6 percent of the gain to ratepayers

⁸⁵ *Id.*

⁸⁶ *See supra* n. 71.

⁸⁷ Public Counsel Initial Brief ¶ 38 n. 84.

⁸⁸ Dittmer, TR. at 217:12-20; 218:8-15.

⁸⁹ *Id.* at 215:7-12.

of these parties base their proposed allocations on an incentive or reward to the company to reach a reasonable result in the negotiating process. As illustrated by the discussion above, and in the varied proposals by Staff, Public Counsel, and ICNU there is no mathematical formula prescribed for determining the percentages allocated.⁹⁰ The Commission must exercise its discretion and judgment in balancing ratepayer and shareholder interests in each case.⁹¹

65 At the end of the hearing, we asked the Company to weigh in on what an appropriate allocation would be following the general incentive or reward rationales offered by the other parties. Clearly, this was an invitation to PSE to articulate a rational alternative to its primary argument that would support a reasonable number for the allocation under the *Centralia* framework. However, surprisingly and apparently contrary to its own interests, PSE elected to not address the matter, arguing that for the Commission to consider an incentive payment rather than allocating to PSE “the full amount of ‘just compensation’ due a property owner for the deprivation of its property by the exercise of the authority of eminent domain” is to embark “down . . . a road that is fraught with legal pitfalls.”⁹²

66 PSE confuses our role. We are not a court making a determination of fair market value and an award to a private entity in a condemnation proceeding. We are a regulatory body making a determination of how to allocate the proceeds from a sale of public utility assets consistent with longstanding regulatory theory and practice.

67 PSE inappropriately conflates the issue of determining fair market value⁹³ with the issue of who is entitled to the gain on sale of regulated utility property. These are different issues. Indeed, PSE recognized this in bringing the JPUD matter to us in two separate proceedings. In the first, PSE requested and the Commission entered a

⁹⁰ See Gorman, TR. at 208:20 to 210:14; Dittmer, TR. at 213:15 to 217:20; Keating, TR. at 242:18 to 246:5; see also *Centralia* ¶ 86 (“This is not based on a preconceived formula, but on the equities of this distinctive case.”)

⁹¹ See *Centralia* ¶¶ 81-86; see also *In re Petition of PSE for Order Authorizing Use of Proceeds from the Sale of RECs*, Docket UE-070725, Order 03 at ¶¶ 46-47 (May 20, 2010).

⁹² PSE Initial Brief ¶ 42.

⁹³ 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).

declaratory order that determined, among other things, that the \$103 million PSE agreed to accept for the Jefferson County assets was adequate compensation. The Commission's approval was based in part on Staff's testimony that "\$103 million is a 'fair' and 'reasonable' purchase price because it is a price that might be reasonably expected to result between a willing buyer and a willing seller, *i.e.*, a fair market value."⁹⁴

68 As Mr. Keating's earlier testimony implies, fair market value can be determined in the context of an arm's length transaction between a willing buyer and a willing seller who have relied on a variety of methods to arrive at their respective views of the current market value of assets and negotiated an agreed amount. In the context of a threatened condemnation, the parties may similarly evaluate fair market value and negotiate a result, as in the case of the JPUD sale, or present the results of their evaluations to a jury that will determine fair market value for them based on the evidence. The Commission expects the utilities it regulates to make any sale of assets, under threat of condemnation or otherwise, at fair market value. The utility has a duty to thus protect not only its shareholders who are entitled to receive the net book value of the assets, but also its customers. Following the risk/reward principle the customers are entitled to receive all, or at least an equitable share of, the net gain, including any appreciation.

69 In making its determination that PSE negotiated a sales price at fair market value, the Commission expressly reserved the question of how to account for and allocate the sales proceeds. The parties agreed that:

A determination that the purchase price of \$103,000,000 is "fair, reasonable and sufficient" does not and is not intended to affect the accounting treatment of the sale proceeds, and is not and does not affect an allocation of the sale proceeds as between PSE's customers and shareholders. The Parties understand and agree that such accounting treatment and allocation of the sale proceeds as between PSE's customers and shareholders are matters to be determined by the Commission in a subsequent proceeding. For avoidance of doubt, the \$103,000,000 purchase price sets a ceiling for ratemaking purposes,

⁹⁴ *Final Order Approving and Adopting Settlement Agreement, Granting Petition for Declaratory Judgment*, Docket UE-101217, ¶ 18 (Feb. 1, 2011) (citing Exhibit EJK-1T at 4:19-21).

without prejudice to any subsequent allocation of such sale proceeds to be recommended by any party or to be ordered by the Commission as between PSE's customers and shareholders.⁹⁵

The Commission emphasized in its declaratory order the point that allocation of the proceeds of sale is an entirely separate question from the question whether PSE negotiated adequate compensation for the assets, saying in the next paragraph following the quoted Stipulation:

We emphasize that the Stipulation asks the Commission to determine *only* that the \$103 million purchase price sets a financial ceiling for subsequent ratemaking purposes. Thus, while we determine that the purchase price of \$103 million is an appropriate one and sufficient to fully compensate PSE for the sale of the assets, our determination does not affect the subsequent accounting treatment of the sale proceeds and does not affect an allocation of the sale proceeds as between PSE's customers and shareholders. Those questions will be finally determined in the context of a future proceeding, most likely one initiated via an accounting petition or in PSE's next general rate case.⁹⁶

70 PSE characterized our request that it address an equitable allocation of proceeds as one leading to “legal pitfalls.” It was not that; rather, it was an attempt to coax out of PSE a rationale that would support an equitable allocation of proceeds – consistent with past Commission and legal precedent. We are left in the awkward position of looking for a rationale for allocating some portion of the proceeds to PSE with no help from the Company in response to a specific request from the Bench.

71 Given the state of the record, we could conclude that all the gain in this case should be allocated to the ratepayers. We determine, however, that a more sound policy in this case is to provide for some allocation to the Company recognizing its efforts on behalf of its customers. Faced with the prospect of a condemnation proceeding and jury trial, PSE undertook a careful analytical approach to determine the fair market value of its assets in Jefferson County, reached a negotiated agreement on the terms of the sale consistent with its fair market value analysis, and avoided the risks and costs of litigation. If the parties had not reached an agreement and litigated this

⁹⁵ *Id.* ¶ 25 (citing Stipulation ¶ 15).

⁹⁶ *Id.* ¶ 26.

matter, both PSE and JPUD, and their respective ratepayers, would have borne significant costs and risks. This successful effort accordingly deserves some reward.⁹⁷

72 In the final analysis, we give significant weight to Staff’s proposed allocation (*i.e.*, 25 percent of the appreciation, or 12.4 percent of the gain on sale), as a reasonable amount to give PSE for its success in avoiding condemnation proceedings. In reaching this decision we are mindful that we must rely on the record before us. Mr. Keating’s proposal is based on his professional judgment following his careful study of the facts relevant to this specific transaction considered in the context of what the Commission has done in previous cases. Staff’s proposal allocates a reasonable amount to reward PSE for its efforts on behalf of its ratepayers, without being such a large amount as to constitute a windfall financed by ratepayers.⁹⁸

IV. Conclusion

73 Based on the preceding discussion, the Commission determines that it should allocate to the Company the \$46,686,436 net book value of the assets (*i.e.*, original costs less

⁹⁷ Staff, Public Counsel, and ICNU all agree. *See* Staff Initial Brief ¶ 119 (quoting Keating Direct, Exh. No. EJK-1T at 35:5-12: “Staff’s proposal to provide shareholders 25 percent of the appreciation from the JPUD Sale rewards that prowess and provides an incentive to PSE to pursue a vigorous negotiating plan in any other condemnation proceedings or asset sales.”); Public Counsel Initial Brief ¶ 38 (“The Commission has acknowledged that it is in the public interest to encourage utilities to pursue strategies that benefit both ratepayers and shareholders. To encourage utilities to pursue such strategies, the Commission has exercised its discretion to allow PSE to retain monies that would otherwise be allocated to ratepayers.”); ICNU Initial Brief ¶ 21 (“ICNU recommends that ... an appropriate incentive payment for PSE is at or near the Company’s authorized return on equity.”). To be clear, we are not suggesting that any reward be for getting the most money possible out of the purchasing public entity. The goal should be for the selling utility to receive fair market value, nothing more and nothing less. To the extent that the utility extracts more than fair market value, that would be to the detriment of the ratepayers of the purchasing utility.

⁹⁸ In so concluding, we emphasize that we are not endorsing as a matter of policy going forward the specific percentage contained in Staff’s recommendation. The fact that the 25 percent allocation is the midpoint of a range of past gain sharing decisions is at most, as Staff suggests, a “cross-check” on the reasonableness of the allocation. *See* Exh. No. EJK-1T at 24:21-22; *see also, Id.* ¶121 (Staff’s allocation to PSE of 25 percent of the appreciation “is based on informed judgment and is reasonable. Allocating additional amounts of appreciation to shareholders would be overly generous.”)

accumulated depreciation) and approved transaction costs of \$2,404,643. We determine in addition that of the remaining gain on sale, \$60,182,117 (*i.e.*, sales proceeds less the sum of net book value and approved transaction costs), \$7,481,394 should be allocated to PSE. We allocate to PSE \$56,572,473 from the proceeds of sale. The balance, \$52,700,723, should be allocated to ratepayers. Thus, we allocate approximately 52 percent of the sales proceeds to PSE and 48 percent to the Company's ratepayers. Following Staff's proposal, we require PSE to place the ratepayers' share in a regulatory liability account, where the declining balance will earn interest at the Company's after-tax rate of return, grossed up for taxes. We will require PSE to return the gain to ratepayers via pro rata monthly bill credits until the full balance plus interest is amortized at the end of four years (*i.e.*, 48 months from the effective date of this Order). We also accept Staff's proposed allocation among PSE's customers, which PSE accepted via its rebuttal testimony.⁹⁹

FINDINGS OF FACT

74 Having discussed above in detail the evidence received in this proceeding concerning all material matters, and having stated findings and conclusions upon issues in dispute among the parties and the reasons therefore, the Commission now makes and enters the following summary of those facts, incorporating by reference pertinent portions of the preceding detailed findings:

- 75 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including electrical and gas companies.
- 76 (2) PSE is a "public service company" and an "electrical company," as these terms are defined in RCW 80.04.010 and as these terms otherwise are used in Title 80 RCW. PSE is engaged in Washington State in the business of supplying utility services and commodities to the public for compensation.
- 77 (3) On February 18, 2010, JPUD made its best and final offer to purchase PSE's assets and facilities in Jefferson County for \$103 million. The terms of

⁹⁹ See Piliaris Rebuttal, Exh. No. JAP-9T at 34:21 - 35:2.

JPUD's final offer were memorialized and accepted by PSE in a Letter of Intent dated April 30, 2010.

- 78 (4) PSE and JPUD negotiated an Asset Purchase Agreement to memorialize the proposed settlement. The parties subscribed to the APA by signatures on June 11, 2010.
- 79 (5) In April 2013, JPUD acquired PSE's electric facilities and began providing retail electric service to PSE's former customers in Jefferson County, Washington.
- 80 (6) The final amount PSE received from JPUD, \$109,273,196, represents the negotiated fair market value of the assets.
- 81 (7) The net book value of the assets sold to JPUD is the sum of the net book value of the assets in service as of June 11, 2010, the day following execution of the APA, plus the net book value of additions and betterments added during a subsequent "Transition Period." At closing, the net book value of the assets in service as of June 11, 2010 was \$41,324,184. The net book value of additions to or betterments of the assets placed in service during the Transition Period was \$5,362,251. The total net book value of the assets is \$46,686,435.
- 82 (8) The record in this proceeding supports transaction and transition costs incurred in connection with the negotiation and the closing of the transaction in the amount of \$2,404,643.

CONCLUSIONS OF LAW

- 83 Having discussed above all matters material to this decision, and having stated detailed findings, conclusions, and the reasons therefore, the Commission now makes the following summary conclusions of law, incorporating by reference pertinent portions of the preceding detailed conclusions:
- 84 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to, these proceedings.

- 85 (2) PSE should be authorized to retain the net book value of the assets,
\$46,686,435.
- 86 (3) PSE should be authorized to retain its transaction costs in the amount of
\$2,404,643.
- 87 (4) PSE should be authorized to retain 12.4 percent of the \$60,182,117 gain on
sale, or \$7,481,394.
- 88 (5) PSE should be required to record on its books a regulatory liability in favor of
ratepayers in the amount of \$52,700,723 (*i.e.*, sales proceeds less the sum of
net book value and authorized transaction costs), plus interest. PSE should be
required to allocate the balance among customers as Staff recommends and
return this gain to ratepayers via pro rata monthly payments until the full
balance plus interest is amortized at the end of four years (*i.e.*, 48 months from
the effective date of this Order). The declining balance in the regulatory
liability account will earn interest at the Company's after-tax rate of return,
grossed up for taxes.
- 89 (6) The Commission Secretary should be authorized to accept by letter, with
copies to all parties to this proceeding, a filing that complies with the
requirements of this Order.
- 90 (7) The Commission should retain jurisdiction over the subject matters and the
parties to this proceeding to effectuate the terms of this Order.

ORDER

THE COMMISSION ORDERS THAT:

- 91 (1) Puget Sound Energy is authorized to retain the net book value of the assets
sold to Jefferson County Public Utility District, \$46,686,435.
- 92 (2) Puget Sound Energy is authorized to retain its transaction costs in the amount
of \$2,404,643.

- 93 (3) Puget Sound Energy is authorized to retain \$7,481,394 from the \$60,182,117 gain on sale.
- 94 (4) Puget Sound Energy is required to record on its books a regulatory liability in favor of ratepayers in the amount of \$52,700,723 plus interest deemed accrued since the date of Jefferson County Public Utility District's final payment to Puget Sound Energy. Puget Sound Energy is required to allocate the gain among customer classes as Staff recommends and to provide ratepayers pro rata monthly bill credits until the full balance plus interest is amortized at the end of four years (*i.e.*, 48 months from the effective date of this Order). The declining balance in the regulatory liability account will earn interest at the Company's after-tax rate of return, grossed up for taxes.
- 95 (5) The Commission Secretary is authorized to accept by letter, with copies to all parties to this proceeding, a filing that complies with the requirements of this Final Order.
- 96 (6) The Commission retains jurisdiction to effectuate the terms of this Final Order.

Dated at Olympia, Washington, and effective September 11, 2014.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DAVID W. DANNER, Chairman

PHILIP B. JONES, Commissioner

JEFFREY D. GOLTZ, Commissioner

NOTICE TO PARTIES: This is a Commission Final Order. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-07-850, or a petition for rehearing pursuant to RCW 80.04.200 and WAC 480-07-870.