

**EXHIBIT NO. ____ (KCH-5T)
DOCKET NO. UE-130137/UG-130138
& UE-121697/UG-121705**

**2013 PSE EXPEDITED RATE FILINGS
& DECOUPLING PROPOSALS
WITNESS: KEVIN C. HIGGINS**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-130137
Docket No. UG-130138
Docket No. UE-121697
Docket No. UG-121705**

**PREFILED RESPONSE TESTIMONY OF
KEVIN C. HIGGINS
ON BEHALF OF NUCOR STEEL SEATTLE, INC.**

April 26, 2013

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1 here, although several of my arguments have been condensed in the interest of
2 brevity.

3 **Q. Please describe your professional experience and qualifications.**

4 A. My academic background is in economics, and I have completed all
5 coursework and field examinations toward the Ph.D. in Economics at the
6 University of Utah. In addition, I have served on the adjunct faculties of both the
7 University of Utah and Westminster College, where I taught undergraduate and
8 graduate courses in economics. I joined Energy Strategies in 1995, where I assist
9 private and public sector clients in the areas of energy-related economic and
10 policy analysis, including evaluation of electric and gas utility rate matters.

11 Prior to joining Energy Strategies, I held policy positions in state and local
12 government. From 1983 to 1990, I was economist, then assistant director, for the
13 Utah Energy Office, where I helped develop and implement state energy policy.
14 From 1991 to 1994, I was chief of staff to the chairman of the Salt Lake County
15 Commission, where I was responsible for development and implementation of a
16 broad spectrum of public policy at the local government level.

17 **Q. Have you previously testified before this Commission?**

18 A. Yes. I testified in the PSE 2011, 2009, 2007, 2006, 2004, and 2001
19 general rate cases and participated in the settlement discussions that resulted in
20 partial settlement agreements pertaining to rate spread and rate design issues in
21 those proceedings. I also testified in the 2009 proceeding that addressed the
22 treatment of revenues from PSE's sales of Renewable Energy Credits ("RECs").

23 **Q. Have you testified before utility regulatory commissions in other states?**

1 A. Yes. I have testified in approximately 165 proceedings on the subjects of
2 utility rates and regulatory policy before state utility regulators in Alaska,
3 Arizona, Arkansas, Colorado, Georgia, Idaho, Illinois, Indiana, Kansas,
4 Kentucky, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New
5 York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina,
6 Texas, Utah, Virginia, West Virginia, and Wyoming.

7

8 **Overview and Recommendations**

9 **Q. What is the purpose of your testimony in this proceeding?**

10 A. My testimony responds to the Expedited Rate Filing (“ERF”) made by
11 PSE on February 1, 2013 in Dockets UE-130137 and UG-130138, and to the
12 Amended Decoupling Petition filed by PSE and the NW Energy Coalition (“Joint
13 Parties”) on March 1, 2013 in Dockets UE-121697 and UG-121705. My
14 understanding is that both of these filings are being supported by the three parties
15 to the Multiparty Settlement Agreement filed with the Commission on March 22,
16 2013. Consequently, my testimony is also responding to that Agreement.

17 **Q. Please summarize your conclusions and recommendations.**

18 (1) Nucor neither supports nor opposes the revenue requirement
19 provisions proposed by PSE in the ERF, except as it is necessary to modify the
20 return on equity (“ROE”) applicable to electric and gas delivery rate base as part
21 of any adoption of full revenue decoupling in these proceedings.

22 (2) PSE’s proposed gas rate spread approach in the ERF is reasonable and
23 I recommend that it be adopted if the ERF is approved.

1 (3) The K-factors proposed by the Joint Parties in the decoupling
2 proceeding would introduce an automatic, predetermined, cost escalator into rates.
3 The proposed K-factor rate increases are not known and measurable adjustments
4 presented in the context of a rate proceeding. Rather they are arbitrary and
5 unsubstantiated rate increases that should be rejected by the Commission.

6 (4) I recommend that the entire revenue decoupling package proposed by
7 the Joint Parties be rejected. Failing that, I recommend that the proposal be
8 modified in several important ways. If full revenue decoupling is approved by the
9 Commission, the proposal by the Joint Parties should be modified as follows:

10 (a) The ROE applicable to electric and gas delivery rate base
11 should be reduced by 25 basis points in the ERF to reflect the reduction in
12 PSE's risk. This adjustment would reduce the ERF electric revenue
13 requirement by approximately \$5.1 million and the ERF gas revenue
14 requirement by approximately \$3.1 million.

15 (b) The decoupling mechanism proposed by the Joint Parties
16 should be modified to incorporate any found margin associated with
17 growth in customer count as a credit against the proposed RDA balancing
18 account.

19 (c) Decoupling should not be applicable to gas transportation
20 customers.

21 (d) The gas decoupling mechanism should be modified such that
22 100% of the contract firm revenues are excluded from the revenue

1 decoupling adjustment (i.e., are treated as unvarying with variations in Dth
2 per customer).

3
4 **Expedited Rate Filing - Dockets UE-130137 and UG-130138**

5 **Q. What is PSE seeking as part of its ERF?**

6 A. As explained in the direct testimony of PSE witness Katherine J. Barnard,
7 PSE is seeking approval of an ERF that would increase electric rates by \$32.2
8 million, or 1.6 percent on average,² and reduce natural gas rates by \$1.2 million,
9 0.1 percent on average (inclusive of gas costs).³

10 Gas supply costs and property tax-related costs are excluded from the
11 calculation of the gas revenue sufficiency because the former already has a
12 separate recovery mechanism and the latter is proposed to have a separate tracker
13 in this case. The template for determining the revenue deficiency is the
14 Commission Basis Report (“CBR”) filed by the Company, with certain
15 modifications. Chief among the modifications is PSE’s proposed use of end-of-
16 period rate base rather than average-of-period rate base.

17 **Q. What is Nucor’s position with respect to PSE’s proposed ERF revenue
18 requirement?**

19 A. Nucor does not oppose the core revenue requirement proposal associated
20 with the ERF. However, if full revenue decoupling is approved, I am
21 recommending an adjustment to PSE’s allowed return on equity (“ROE”), which
22 has implications for the ERF revenue requirement. As I explain later in my

² Supplemental direct testimony of Katherine J. Barnard, p. 7.

1 testimony, I am recommending that the Commission reject PSE's decoupling
2 proposal. If this recommendation is accepted, then my testimony would have no
3 impact on PSE's proposed ERF revenue requirement.

4 **Q. How does PSE propose to spread its proposed ERF gas rate decrease across**
5 **customer classes?**

6 A. As explained by PSE witness Janet K. Phelps, PSE proposes that all
7 customer classes receive an equal percentage reduction in rates, calculated as a
8 percent of margin.⁴

9 **Q. What is your assessment of PSE's proposed approach to rate spread?**

10 A. In my opinion, the Company's rate spread approach is reasonable and I
11 recommend that it be adopted if the ERF is approved.

12

13 **Revenue Decoupling - Dockets UE-121697 and UG-121705**

14 **Q. What have PSE and the NW Energy Coalition proposed with respect to**
15 **revenue decoupling?**

16 A. As discussed in the supplemental direct testimony of Mr. Piliaris, the Joint
17 Parties have put forth a rate plan and a pair of electric and gas decoupling
18 proposals. The rate plan is a series of predetermined annual rate increases
19 implemented through a metric that PSE calls the "K-factor". The proposed rate
20 plan would extend at least through March 2016 and possibly through March 2017.
21 As part of its proposal, and subject to certain caveats, PSE would not file its next
22 general rate case before April 1, 2015, but would file it no later than April 1,

³ Ibid., p. 11.

1 2016, unless otherwise agreed to by the parties in the Company's last general rate
2 case.

3 The decoupling proposal envisions full revenue decoupling applied to
4 fixed delivery costs for almost all electric and gas customer classes.⁵ The revenue
5 decoupling would be implemented through an "allowed revenue per customer"
6 metric. The decoupling proposal is tied to the proposed rate plan in that each
7 year's allowed revenue per customer would be increased via the K-factor. Thus,
8 the overall proposal should be viewed as a combination "predetermined rate
9 increase/decoupling" package extending over a multi-year period.

10 **Q. What is your assessment of the Joint Parties' decoupling proposal?**

11 A. I recommend that the entire package be rejected. Failing that, I
12 recommend that the proposal be modified in several important ways.

13 **Q. Please explain your reasons for recommending that the decoupling proposal
14 be rejected.**

15 A. Taken as a whole I do not believe this proposal constitutes good
16 ratemaking, nor do I believe it is in the public interest. For purposes of this
17 discussion, it is useful to separate the K-factor component of the rate plan from
18 the rest of the decoupling proposal. Even though these components are tied
19 together in the Joint Parties' proposal, decoupling does not require adoption of
20 predetermined annual rate increases nor does a rate plan consisting of
21 predetermined annual rate increases require decoupling. Indeed, the proposed K-

⁴ Direct testimony of Janet K. Phelps, p. 8.

1 factor scheme and the proposed decoupling mechanism are conceptually distinct,
2 independent features that should be evaluated on their own merit.

3 **Q. What is your assessment of the K-factor proposal?**

4 A. The K-factor proposal is an attempt to introduce an automatic,
5 predetermined cost escalator into rates. The proposed K-factor for gas service is
6 1.022 and would apply to all revenue requirements except gas supply costs and
7 property taxes. Essentially, the K-factor hardwires a 2.2 percent annual cost
8 increase into the applicable cost components, which would then automatically
9 flow into customer rates. Extended over the potential term of the proposed rate
10 plan (which could extend beyond the start of 2017), the revenue requirement for
11 the affected gas cost components would increase 11.5 percent.

12 The proposed K-factor rate increases are not known and measurable
13 adjustments presented in the context of a rate proceeding. Rather they are
14 arbitrary and unsubstantiated rate increases that should be rejected by the
15 Commission. PSE justifies the proposed level of these factors by referencing a
16 calculation prepared by Ms. Barnard that results in a gas K-factor of 1.038
17 measured over the period 2006-2011.⁶ Ms. Barnard's calculation was prepared
18 using rate base and depreciation expense increases over that time period
19 combined with a projection of O&M inflation that includes a small productivity
20 adjustment. However, a trend line of past cost increases (blended with an
21 inflation forecast) does not constitute a reasonable basis for locking in broadly

⁵ The proposed exceptions are gas lighting, gas water heater rental, electric lighting, and electric retail wheeling. The rates for these classes, however, would be subject to the proposed K-factor increases. Gas customers served under special contracts are also excluded from the decoupling proposal.

1 applicable rate increases in the future, particularly over a multi-year period.
2 Moreover, Ms. Barnard's K-factor results are very sensitive to the time period
3 selected. Selecting a time period that starts just one year later (2007-2011)
4 reduces her calculation of the gas K-factor from 1.038 to 1.0299.⁷

5 More generally, the Commission should be concerned about regulatory
6 pricing formulations such as the K-factor proposal that reinforce inflation. This
7 occurs when projections of inflation are built into formulas that are used to set
8 administratively-determined prices, such as utility rates. Such pricing
9 mechanisms help to make inflation a self-fulfilling prophecy. Regulators should
10 use extreme caution before approving prices that guarantee inflation before it
11 occurs.

12 A related, but distinct, concern involves the building of a K-factor "cost
13 cushion" into the Company's base period costs. The cost increases represented by
14 escalation factors may or may not come to fruition. In any case, PSE should be
15 expected to strive to improve the efficiency of its operations on a continuous
16 basis, and thereby lessen the net impact of inflation on its costs. It is not
17 reasonable to gross up the Company's base period costs by an arbitrary escalation
18 factor and pass these costs on to customers. As I pointed out above, there is
19 nothing inherent in revenue decoupling that calls for this type of underlying cost
20 escalation. If the Commission is inclined to approve revenue decoupling (my
21 discussion below notwithstanding), the K-factor portion of the Company's filing
22 can be readily excised and discarded.

⁶ Supplemental direct testimony of Katherine J. Barnard, p. 7.

1 **Q. Putting aside the matter of the proposed K-factor, what is your**
2 **recommendation with respect to the revenue decoupling proposal being**
3 **advanced by the Joint Parties?**

4 A. I recommend that the revenue decoupling proposal be rejected, even if the
5 K-factor component is removed. Failing that, I recommend that it be modified in
6 several material ways.

7 **Q. What are the reasons for your recommendation to reject the decoupling**
8 **proposal?**

9 A. I present a full explanation of the reasons for my recommendation in my
10 prefiled response testimony submitted on behalf of Kroger. I will provide a brief
11 summation of those reasons here:

- 12 • The proposal by the Joint Parties fails to reduce the cost of PSE's equity that
13 flows through to customers in exchange for the assumption of greater
14 ratepayer risk.
- 15 • The proposal does not provide for full recognition of found margin to offset
16 the lost margin that would be charged to customers, and thus, is deficient in
17 fully providing this offset that is highly emphasized in the Commission's
18 report and policy statement issued in Docket No. U-100522.
- 19 • Decoupling is sure to capture a much wider range of effects than just customer
20 responses to utility-sponsored energy efficiency programs, even though the
21 latter constitutes the underlying justification for its adoption.

⁷ This can be calculated from the information in PSE Exhibit No. __ (KJB-3).

- 1 • Decoupling provides unwarranted insulation to the utility from the effects of
2 price elasticity, representing an undue transfer of risk from utilities to
3 customers.
- 4 • To the extent that customers reduce usage in response to economic conditions
5 or otherwise practice self-funded energy conservation, these behaviors will be
6 captured in the decoupling adjustment and unduly increase rates to customers.
- 7 • Full revenue decoupling also suffers from the infirmities of single-issue
8 ratemaking, which occurs when utility rates are adjusted in response to a
9 change in a single cost or revenue item considered in isolation.

10 In short, the Joint Parties' proposal is a one-sided proposition that burdens
11 customers with the negative characteristics of full revenue decoupling without
12 providing the key benefits that the Commission stressed in its report and policy
13 statement. In light of these drawbacks for customers, if full revenue decoupling is
14 imposed on customers, then it is essential that the benefit of lower equity costs be
15 recognized in customer rates. Failure to adjust ROE would ignore one of the
16 central tenets in the Commission's report and policy statement.

17 **Q. How is ROE addressed in the Joint Parties' decoupling proposal?**

18 A. The proposal contains no adjustment in the Company's ROE to reflect full
19 revenue decoupling. Rather, the Joint Parties propose to allow PSE to continue to
20 earn the 9.8% ROE ordered by the Commission in Docket Nos. UE-111048 and
21 UG-111049, subject to an earnings test. The earning test would allow PSE to earn

1 up 25 basis points above its overall rate of return on rate base before rebating to
2 customers 50 percent of the earnings in excess of this level.⁸

3 **Q. What is your recommendation to the Commission regarding the treatment of**
4 **PSE's ROE if full revenue decoupling is adopted?**

5 A. If full revenue decoupling is adopted, I recommend that PSE's ROE be
6 reduced by 25 basis points for the functions subject to the decoupling mechanism
7 (i.e., electric and gas delivery). This adjustment lies well within the range of
8 ROE adjustments adopted by other commissions and is reasonable in light of the
9 mitigation of earnings volatility that the mechanism would provide for PSE. The
10 support for this recommendation is presented in detail in the response testimony I
11 filed on behalf of Kroger in this proceeding.

12 **Q. How should a 25 basis point ROE adjustment be applied in this proceeding**
13 **if full revenue decoupling is adopted?**

14 A. The adjustment should be applied as part of the ERF proceeding. The
15 adjustments result in a reduction in the ERF electric revenue requirement of
16 approximately \$5.1 million and in the ERF gas revenue requirement of
17 approximately \$3.1 million.

18 **Q. Previously in your testimony you stated that the proposal by the Joint Parties**
19 **does not provide for full recognition of found margin to offset the lost margin**
20 **that would be charged to customers. Please explain.**

21 A. The concept of found revenue is discussed at some length in the
22 Commission's report and policy statement. The Commission's statement

⁸ Supplemental direct testimony of Jon A. Piliaris, p. 19.

1 emphasizes that a properly constructed full decoupling mechanism would balance
2 out both lost and found margin from *any* source. [Report at Par. 27. Emphasis
3 added.] The full revenue decoupling proposal advanced by the Joint Parties
4 recognizes found margin only to the extent that it may affect allowed revenue per
5 customer. The proposal provides no recognition of found revenue that would be
6 associated with growth in the number of customers. Under the terms of the
7 proposal, the full benefit of incremental fixed cost recovery associated with new
8 customers accrues solely to PSE.

9 If full revenue decoupling is approved by the Commission, the mechanism
10 proposed by the Joint Parties should be modified to incorporate any found margin
11 associated with growth in customer count as a credit against the RDA balancing
12 account.

13 **Q. If full revenue decoupling is adopted should it apply to all gas rate schedules?**

14 A. No. The Joint Parties have already proposed to exclude gas lighting, gas
15 water heater rentals, and special contracts. I have no objections to these
16 exclusions. However, the Joint Parties improperly include gas transportation
17 customers in the proposed decoupling mechanism.

18 **Q. Why is it inappropriate to include gas transportation customers in the
19 proposed PSE decoupling mechanism?**

20 A. There are several reasons. First, maintaining a “fixed-cost recovery per
21 customer” target – as incorporated into the Joint Parties’ proposal – is not an
22 appropriate rate design objective for classes of customers that have heterogeneous
23 populations, and/or whose class composition shows a wide range of usage levels,

1 such as occurs with gas transportation customers. Given the tremendous diversity
2 among gas transportation customers, targeting “average fixed-cost recovery per
3 customer” as a ratemaking metric for these customers is without merit. Changes
4 in the overall economy are far more likely to influence fixed-cost recovery per
5 customer for gas transportation customers than energy conservation programs.
6 Application of decoupling to these customers would result in undue changes in
7 rates in response to factors that are unrelated to energy conservation.

8 Second, gas transportation customers do not take their gas supply service
9 from PSE. In this sense, they are comparable to PSE’s electric retail wheeling
10 customers, who are properly excluded from the Joint Parties’ revenue decoupling
11 proposal. Consistent with this theme, gas transportation customers were not
12 included in PSE’s Conservation Savings Adjustment Rate proposal filed in its last
13 general rate case, nor were gas transportation customers included in PSE’s initial
14 decoupling proposal filed in this proceeding. The inclusion of gas transportation
15 customers in the proposed decoupling mechanism did not surface until the Joint
16 Parties made their supplemental filing.

17 Third, and most fundamentally, gas transportation customers are not even
18 eligible to participate in PSE’s energy efficiency programs.⁹ Subjecting these
19 customers to revenue decoupling under the guise of “removing PSE’s disincentive
20 to support energy efficiency” is patently absurd.

⁹ PSE Response to Nucor Data Request 2.5.

1 **Q. In addition to these fundamental disagreements with the Joint Parties'**
2 **proposal, do you have any technical concerns with proposed implementation**
3 **of the revenue decoupling mechanism?**

4 A. Yes. PSE's non-residential gas rate schedules provide an option for
5 contract firm demand, for which customers pay a demand charge. It is my
6 understanding that customers subscribing to this option must contract on an
7 annual basis. Rather than treat contract firm demand revenues as fixed revenues,
8 PSE includes these revenues in determining the "volumetric delivery revenue,"
9 and will impute a reduction in these revenues whenever average throughput per
10 customer declines – irrespective of the fact that customers have contracted for a
11 fixed amount of firm service. This treatment will assuredly overstate the imputed
12 revenue impact of a change in average throughput per customer.

13 If a revenue decoupling mechanism is approved, it should be modified
14 such that 100% of the contract firm revenues are excluded from the revenue
15 decoupling adjustment (i.e., are treated as unvarying with variations in Dth per
16 customer).

17 **Q. Does this conclude your response testimony?**

18 A. Yes, it does.