

BEFORE THE WASHINGTON  
UTILITIES & TRANSPORTATION COMMISSION

In the Matter of the Petition of PUGET SOUND ENERGY, INC., and NORTHWEST ENERGY  
COALITION, For an Order Authorizing PSE To Implement Electric and Natural Gas  
Decoupling Mechanisms and To Record Accounting Entries Associated With the Mechanisms

DOCKETS UE-121697 & UG-121705

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WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

V.

PUGET SOUND ENERGY, INC.

DOCKETS UE-130137 & UG-130138

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DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1T)

ON BEHALF OF  
PUBLIC COUNSEL

APRIL 26, 2013

DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1T)  
DOCKETS-UE 121697 & UG-121705 AND UE-130137 & UG-130138

**TABLE OF CONTENTS**

		<u>PAGE</u>
I.	INTRODUCTION .....	1
II.	SUMMARY OF TESTIMONY .....	3
	A. Overview of Analysis and Recommendations .....	3
	B. The Impact Of The PSE Rate Plan Proposal Is Significant .....	6
III.	PSE’S EXPEDITED RATE FILING PROPOSAL .....	9
IV.	THE AMENDED “FULL DECOUPLING MECHANISM” PROPOSAL ...	20
V.	THE K-FACTOR .....	23
VI.	OTHER RATE PLAN CONCERNS .....	38
VII.	PUBLIC COUNSEL ALTERNATIVE RATE PLAN WITH ERF FILINGS .	41
VIII.	CONCLUSION .....	44

**TABLES**

Table 1	Summary of Revenue Impact of Decoupling with K-Factor .....	8
Table 2	Projected Year-Over-Year Percentage Increases in Number Of PSE Customers .....	31
Table 3	Analysis of K-Factor Cost Escalation Development and the Potential Offset Impact of Considering Customer Margin Growth .....	32

DIRECT TESTIMONY OF JAMES R. DITTMER (JRD-1T)  
DOCKETS-UE 121697, UG-121705 AND UE-130137 & UG-130138

**LIST OF EXHIBITS**

Exhibit No. JRD-2	Statement of Qualifications
Exhibit No. JRD-3	PSE Projected Decoupling with K-Factor Revenues
Exhibit No. JRD-4	Electric Operations Revenue Requirement Summary
Exhibit No. JRD-5	Gas Operations Revenue Requirement Summary
Exhibit No. JRD-6C	Response to Public Counsel Data Request No. 32 (Dockets UE-130137 and UG-130138)(confidential) and Public Counsel calculated Growth in Regulatory ADIT

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**I. INTRODUCTION**

**Q: Please state your name and business address.**

My name is James R. Dittmer. My business address is Post Office Box 481934, Kansas City, Missouri 64148.

**Q: By whom are you employed and in what capacity?**

A: I am a Senior Regulatory Consultant with the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate work. The firm's engagements include review of utility rate applications on behalf of various federal, state and municipal governmental agencies as well as industrial groups. In addition to utility intervention work, the firm has been engaged to perform special studies for use in utility contract negotiations.

**Q: On whose behalf are you testifying?**

A: I have been retained by the Public Counsel to review Puget Sound Energy's (PSE or Company) Expedited Rate Filings that have been designated as Dockets UE-130137 and UG-130138 for PSE's electric and gas operations, respectively. I have also been retained by Public Counsel to review PSE's and Northwest Energy Coalition's (NWEC) Amended Joint Petition for Approval of a Decoupling Mechanism that has been designated as Dockets UE-121697 and UG-121705 for PSE's electric and gas operations, respectively. The testimony I am presenting herein addressing all four noted PSE dockets is being filed on behalf of Public Counsel.

**Q: Please summarize your professional experience.**

A: My education and professional experience is summarized in Exhibit No. JRD-2.

1       **Q:    What exhibits are you sponsoring in this proceeding?**

2       A:    I am sponsoring the following exhibits:

3           Exhibit No. JRD-2    Statement of Qualifications

4           Exhibit No. JRD-3    PSE Projected Decoupling with K-Factor Revenues

5           Exhibit No. JRD-4    Electric Operations Revenue Requirement Summary

6           Exhibit No. JRD-5    Gas Operations Revenue Requirement Summary

7           Exhibit No. JRD-6C   Response to Public Counsel Data Request No. 32 (Dockets  
8                                    UE-130137 and UG-130138 (confidential) and Public  
9                                    Counsel calculated Growth in Regulatory ADIT

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11       **Q:    Have you previously filed testimony before the Washington Utilities and  
12           Transportation Commission?**

13       A:    Yes. I have filed testimony with the Washington Utilities and Transportation  
14           Commission (WUTC or Commission) on a few occasions over approximately the  
15           past 25 years. Most recently I participated in the 2012 Avista General Rate Case  
16           – Dockets UE-120436, *et al.*

17       **Q:    What is the purpose of your testimony?**

18       A:    I will address within this testimony my analysis and recommendations regarding  
19           PSE’s proposed Expedited Rate Filing (ERF), PSE’s proposed “full decoupling”  
20           mechanism, as well as PSE’s proposed K-Factor escalators and rate plan (K-  
21           Factor Rate Plan). I also recommend as an alternative to the K-Factor Rate Plan  
22           that PSE be permitted to undertake two additional ERFs before being required to  
23           make a general rate case filing no sooner than April 1, 2015 and no later than  
24           April 1, 2016.

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**II. SUMMARY OF TESTIMONY**

**A. Overview of Analysis and Recommendations.**

**Q: Please begin by stating any overall opinion you have regarding what is being proposed in the various dockets.**

A: PSE’s proposals in this case, supported in a non-unanimous stipulation, are unprecedented in Washington, to my knowledge. First, PSE seeks rate relief pursuant to a first-ever Expedited Rate Filing (ERF), which departs from the ERF approach recommended by Staff, and adopts a “new theory” of valuing rate base with test year-end data in violation of the “matching principle.” Next, PSE requests approval of full decoupling, with no evaluation of or reduction in the cost of capital to recognize the shift of risk to customers, as required by the Commission. Finally, after developing an ERF baseline revenue requirement using end-of-period rate base and a pre-decoupling rate of return, PSE further escalates its rate request based on a “K-Factor” not previously reviewed or approved by the Commission. Although expressly intended to address attrition, the K-Factor is not supported by any form of a comprehensive attrition study, contrary to Commission precedent. Moreover, the K-Factors are seriously flawed because their development omits key analyses of offsetting factors. The cumulative rate relief for the ERF and K-Factor increases for electric and gas operations is projected by PSE to collect approximately \$250 million in rates through the end of calendar year 2015. If the Rate Plan is extended to the maximum length, the cumulative revenue impact from the ERF and K-Factor increases through February 2017 could be approximately \$465 million. In short, the various rate proposals are new, very significant in impact, and have not been

1 sufficiently developed or supported. At the same time, the procedural time frame,  
2 in my opinion, has been too short to allow for adequate discovery, analysis, and  
3 preparation of a comprehensive response to these far-reaching proposals.

4 Notwithstanding these concerns, my testimony concludes that the ERF and  
5 decoupling aspects of the PSE filings could be approved, with modifications, as a  
6 basis for a more reasonable rate plan for PSE customers, if the Commission  
7 wishes to approve a rate plan at this time. The specifics of my analysis and  
8 alternative recommendation are discussed in detail below.

9 **Q: Please summarize your testimony with regard to PSE's ERF proposal.**

10 A: With regard to PSE's proposed electric and gas ERF, for purposes of these  
11 dockets, I conclude that in concept such a rate mechanism is reasonable. While  
12 supporting the ERF in concept, I am recommending modifications to the PSE-  
13 calculated ERF rate relief to reflect 1) the lower cost of equity capital sponsored  
14 by Public Counsel's cost of capital witness Mr. Stephen Hill, and 2) a test-year-  
15 end revenue adjustment that annualizes the impact of distribution margins that can  
16 be expected to be realized from serving end-of-test-year numbers of customers.  
17 The rationale for the noted test year-end revenue adjustment to the PSE-calculated  
18 ERF revenue requirement is discussed in detail in an ensuing section of my  
19 testimony.

20 **Q: Please summarize your testimony with regard to the full decoupling**  
21 **proposal.**

22 A: With regard to PSE's and NWECC's "full decoupling" proposal, adoption of such a  
23 mechanism in this case is reasonable, so long as the reduced return on equity  
24 reasonably expected to occur as a result of reduced shareholder risk is

1 incrementally reflected in the ERF-calculated revenue requirement. Specifically,  
2 Public Counsel’s cost of capital witness Stephen Hill, in addition to proposing a  
3 lower cost of equity capital to reflect today’s lower cost of money rates, as well as  
4 the shift in risk from shareholders to ratepayers stemming from the ERF, also  
5 provides the testimonial support for the further reduction in return on equity that  
6 should be reflected in the ERF-calculated revenue requirement *if* “full  
7 decoupling” as proposed by PSE and NWECA is adopted.

8 **Q: Please summarize your testimony with regard to the K-Factor Rate Plan.**

9 A: With regard to the proposed implementation of periodic rate increases, driven by  
10 escalation factors underlying the proposed K-Factor, I recommend that no rate  
11 increases based on the K-Factor should be granted at this time. In opposition to  
12 PSE’s K-Factor Rate Plan, I offer arguments that: (1) Although designed to  
13 address attrition, PSE has not supported its proposed K-Factor Rate Plan with the  
14 quality of data the Commission has required for attrition-based rate relief; (2) The  
15 K-Factor Rate Plan calculations do not include an appropriate offset for revenue  
16 growth based upon either historic or forecasted increases in number of customers;  
17 (3) PSE’s projections for rate base growth purportedly supporting the K-Factor  
18 Rate Plan do not take into account the mitigating effect of growth in the  
19 Accumulated Deferred Income Tax (ADIT) balance; and (4) The K-Factor Rate  
20 Plan is inflated due the compounding effect that results from the timing of the two  
21 increases designed to reflect “annual cost escalation” in a time span of less than  
22 two annual periods.  
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1       **Q: Do you have other concerns with PSE’s proposed rate plan?**

2       A: Yes. As explained more fully below, I do not believe that the rate cap and  
3       earnings “test” provide any substantial protection for ratepayers. I also have a  
4       concern that because there is no limitation on the number of Power Cost Only  
5       Rate Cases (PCORCs) that can be filed during the rate plan, customers will not  
6       necessarily receive the rate stability or rate case relief protection that PSE has  
7       suggested within its various applications.

8       **Q: Do you have an alternative rate plan recommendation?**

9       A: While I do not support PSE’s application of K-Factor escalators to the ERF-  
10       calculated delivery rates, I propose that, if needed, PSE be allowed to file up to  
11       two additional ERF filings to address increasing costs to provide delivery service.  
12       However, any further delivery service base rate relief after the filing of the current  
13       plus two additional ERFs would need to occur as a result of filing a general rate  
14       case. My recommendations herein also incorporate the PSE proposed “full  
15       decoupling” mechanism, but without the K-Factor automatic rate increases.

16       **B. The Impact Of The PSE Rate Plan Proposal Is Significant.**

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18       **Q: Before delving into the various issue areas you intend to address, could you**  
19       **please summarize your understanding of the revenue impact of the various**  
20       **rate mechanisms being proposed.**

21       A: Additional electric revenues to be collected under the decoupling and K-Factor  
22       Rate Plan are projected by PSE to be approximately \$227 million and the  
23       additional natural gas revenues to be collected under the decoupling and K-Factor  
24       Rate Plan are projected by PSE to be approximately \$122 million, in the event

1 PSE chooses to file its next rate case at the end of the stay out period.<sup>1</sup> Certainly,  
2 these potential revenue impacts, which do not even consider the additional ERF  
3 rate relief concurrently being proposed, are substantial.

4 Table 1 below summarizes the additional revenue PSE projects it will  
5 realize as a result of the K-Factor Rate Plan proposals in each year of the plan.  
6 The revenue projections resulting from the decoupling with K-Factor Rate Plan  
7 were prepared by PSE, and reflect projected revenues to be collected from  
8 residential and non-residential customers. These PSE revenue projections are  
9 summarized in Exhibit No. JRD-3 attached to my testimony, and show  
10 projections by customer class (residential and non-residential). My understanding  
11 is that these projections, provided in Mr. Piliaris' Exhibit Nos. JAP-22 and JAP-  
12 23 do not include revenue projections for the customer classes such as electric  
13 retail wheeling and lighting customers and natural gas lighting and rental  
14 customers that will also be incurring Schedule 139 K-Factor increases. Therefore,  
15 the total maximum revenue impact from these proposals would actually be  
16 slightly higher than amounts provided on Exhibit Nos. JAP-22 and JAP-23 and

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<sup>1</sup> PSE is permitted under the plan to stay out in 2015, but must file a new general rate case no later than April 1, 2016. This would result in new GRC-based rates going into effect in early 2017.

1 summarized within Table 1 below.

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<b>Table 1</b>		
<b>Summary of Revenue Impact of Decoupling with K-Factor</b>		
<b>Rate Plan – PSE Projections</b>		
	<b>Electric</b>	<b>Natural Gas</b>
Decoupling w/K-Factor 2013 <sup>2</sup>	\$12.9 M	\$4.8M
Decoupling w/K-Factor 2014	\$29.9 M	\$22.3 M
Decoupling w/K-Factor 2015	\$61.5 M	\$38.4 M
Decoupling w/K-Factor 2016 <sup>3</sup>	\$100.2M	\$43.6 M
Decoupling w/K-Factor Jan-Feb, 2017	\$22.8 M	\$13.0 M
<b>TOTAL</b>	<b>\$227.3 M</b>	<b>\$122.1 M</b>

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As noted, PSE will also receive additional revenues, above and beyond the projections shown in Table 1 above, as a result of the ERF. Per the global settlement<sup>4</sup> the changes to base rates from the ERF would remain in effect through the duration of the K-Factor Rate Plan. Therefore, in addition to the amounts shown in Table 1 above, the ERF would annually increase revenues by \$32 million for electric operations while annually decreasing natural gas revenues

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<sup>2</sup> Source for Decoupling with K-Factor Rate Plan increases for years 2013 – 2015 is Exhibit Nos. JAP-22 and JAP-23 for electric and gas operations, respectively. Mr. Piliaris states that these exhibits provide “an illustration of how the mechanism[s] would work for electric [and gas] customers over time.” Exhibit No. JAP-8T, p. 2, ll. 10-14.

<sup>3</sup> Source for Decoupling plus K-Factor Rate Plan revenues for years 2016 and 2017 is PSE’s response to Public Counsel Data Request No. 22, Attachment A (electric) and B (gas).

<sup>4</sup> *In the Matter of Puget Sound Energy Inc. Petition for Approval of a Power Purchase Agreement for Acquisition of Coal Transition Power, as Defined in RCW 80.80.010, and the Recovery of Related Acquisition Costs*, Docket UE-121373, *In the Matter of the Petition of Puget Sound Energy Inc. and NW Energy Coalition For an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and To Record Accounting Entries Associated With the Mechanisms*, Dockets UE-121697 & UG-121705, *In the Matter of Puget Sound Energy, Inc.’s Expedited Rate Filing*, Dockets UE-130137 & UG-130138, Multiparty Settlement Re: Coal Transition PPA and Other Pending Dockets, March 22, 2013, ¶¶ 11-13.

1 by \$1.2 million overall.<sup>5</sup> It is my understanding based on a review of company-  
2 provided information, that the cumulative revenue impact of the ERF and K-  
3 Factor increases for electric and gas operations is projected by PSE to be  
4 approximately \$250 million through the end of calendar year 2015. If the Rate  
5 Plan is extended to the maximum length, the cumulative added revenue generated  
6 from ERF and K-Factor rate increases through February 2017 could be  
7 approximately \$465 million.

8 **Q: Do you have any other preliminary comments regarding your analysis in this**  
9 **case?**

10 A: Yes. The procedural schedule in the case has not been adequate to conduct a  
11 complete review of the ERF and K-Factor Rate Plan proposals which are both  
12 being presented for the first time as formal rate applications. The limited  
13 information initially filed in support of the proposals and the unusually short  
14 timeline, including limited time for discovery, has not been adequate to allow me  
15 to conduct a full analysis of the proposals. Accordingly, my testimony has been  
16 developed using “best efforts” given the discovery and analysis time constraints  
17 imposed.

18 **III. PSE’S EXPEDITED RATE FILING PROPOSAL**

19 **Q: Please provide a summary of your understanding of PSE’s proposal to**  
20 **modify base rates pursuant to its ERF application.**

21 A: PSE proposes to increase base electric “delivery” rates by \$32,163,102 and  
22 proposes to decrease base gas “delivery” rates by \$1,240,137. The support for the

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<sup>5</sup> *In the Matter of Puget Sound Energy, Inc.’s Expedited Rate Filing*, Dockets UE-130137 & UG-130138, Direct Testimony of Katherine J. Barnard on behalf of PSE, Exhibit No. KJB-1T, p. 7, ll. 1-4 and p. 11, ll. 1-4.

1 changes in base electric and gas operations' rates are revenue requirement  
2 calculations derived from PSE's Commission Basis Report (CBR), but with a test  
3 year for the twelve months ending June 30, 2012. The CBR for the twelve  
4 months ending June 30, 2012, was prepared by PSE reflect most, though not all,  
5 the "restating" adjustments adopted by this Commission in PSE's most recently  
6 completed electric and gas rate case – Dockets UE-111048 and UG-111049. The  
7 revenue requirement derived from the noted CBR also reflects this Commission's  
8 findings on costs of capital from Dockets UE-111048 and UG-111049, including  
9 the proportion of each security group in the capital structure and the related cost  
10 rate of each security group.

11 **Q: Please summarize your understanding of the origin of the ERF approach.**

12 A: My understanding is that the ERF concept was suggested for the first time in  
13 PSE's last general rate case. In that case, the Company alleged attrition and PSE  
14 proposed several remedies to address the alleged earnings erosion. Staff did not  
15 accept PSE's claim of attrition or any of the PSE-suggested remedies, but did  
16 propose an alternative to address "regulatory lag" through the testimony of Mr.  
17 Kenneth Elgin. Specifically, Mr. Elgin proposed that PSE "could file an  
18 'expedited' rate case using an updated test year." The prominent features or  
19 characteristics of the expedited rate filing envisioned by Mr. Elgin included:

- 20 • The filing would basically update the relationships between rate base,  
21 revenues and expenses.
- 22 • The revenue requirement calculation should consider only restating  
23 adjustments – including Commission approved normalization restating  
24 adjustments for components such as weather.

- 1                   • The “books” or test year operating results should be “clean” in order to  
2                   reflect proper ratemaking.
- 3                   • The ERF would be filed almost immediately following the conclusion  
4                   of the then-current general base rate proceeding (presumably no later  
5                   than early June 2012) would be reviewed and processed over a five to  
6                   six month period so that new rates could become effective on  
7                   November 1, 2012.

8                   Advantages of the expedited rate process suggested by Mr. Elgin included:

- 9                   • The new rates would be based upon known costs – not budgets.
- 10                  • The process would capture changes to test year customer growth and  
11                  load in a timely manner.
- 12                  • The process would provide a mechanism to implement rate changes to  
13                  maximize the impact on financial results, and
- 14                  • The process would be transparent and retain the self-regulating aspects  
15                  of historical test-period ratemaking which dampen the Company’s  
16                  incentive to overinvest in new infrastructure.<sup>6</sup>

17                  The Commission’s final order in the docket referenced Mr. Elgin’s alternative  
18                  with preliminary interest and approval.<sup>7</sup>

19                  **Q:    What approach was taken by PSE in developing the ERF proposal filed on**  
20                  **February 1, 2013?**

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<sup>6</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 and UG-111049, Direct Testimony of Kenneth Elgin, Exhibit No. KLE-1T, pp. 80-84.

<sup>7</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 and UG-111049, Order 08 (May 7, 2012), ¶¶ 505-507.

1       A:     The revenue requirement presented within PSE’s ERF was developed utilizing the  
2             following approach:

- 3             •     The starting point was a Commission Basis Report prepared for  
4                 PSE’s electric and gas operations for the twelve months ending  
5                 June 30, 2012.
- 6             •     No “proforma” adjustments for typical cost of service  
7                 components such as wage rates, insurance premiums, or other  
8                 well documented price changes occurring during or within a  
9                 few months following the end of the historic test year were  
10                calculated or proposed.
- 11            •     A number of Commission-ordered “restating” adjustments  
12                adopted by this Commission in Dockets UE-111048 and UG-  
13                111049 were considered in the development of the ERF revenue  
14                requirement model. However, some “restating” adjustments  
15                were omitted because of claimed immateriality.
- 16            •     The revenue requirement calculation employed an end-of-test-  
17                year rate base valuation rather than the average-of-monthly-  
18                averages rate base approach reflected in the PSE general rate  
19                order pursuant to long-standing Commission policy.
- 20            •     The ERF reflected the return on equity as well as overall cost of  
21                capital authorized by this Commission in PSE’s last base rate  
22                order.
- 23            •     With two exceptions, the ERF increase is purported to be spread  
24                on the basis of “ERF margins,” or the non-production/non-

1 property tax cost of service, embodied within each existing rate  
2 class' base rates. The two "exceptions" were made so as to  
3 limit two rate classes' increase to 2.9 percent - or an amount  
4 below the 3.0 percent of total revenues limitation for non-  
5 general rate case proceedings such as is occurring within these  
6 dockets.

7 **Q: Please summarize your concerns with PSE's ERF filing.**

8 A: First, PSE proposes to employ an end-of-test-period method to value rate base,  
9 rather than the average-of-monthly-averages valuation as was previously adopted  
10 in PSE's last rate order. Such approach represents a "new theory" that is not  
11 permitted when preparing CBRs per the Washington Administrative Code, and  
12 further, is the type of modification precluded in Staff's proposed approach for an  
13 ERF in PSE's last general rate case.

14 Second, as discussed by Public Counsel witness Mr. Stephen Hill, for a  
15 number of reasons the cost of capital reflected in the development of the ERF  
16 revenue requirement, which was based upon the Commission's findings in PSE's  
17 last base rate order, is overstated.

18 Third, and finally, PSE's treatment of restating adjustments is not  
19 consistent with the ERF approach proposed by Staff in the 2011 PSE GRC, which  
20 contemplated that all Commission-ordered "restating" adjustments from PSE's  
21 previous general rate should be calculated and posted to the ERF historic test year  
22 results of operation.



1       **Q:     Please expand upon your statement that PSE has introduced a “new theory”**  
2       **for valuing rate base when developing its proposed ERF revenue**  
3       **requirement.**

4       A:     As noted within the testimony of Ms. Katherine Barnard, the ERF revenue  
5       requirement calculation reflects employment of a year-end rate base rather than  
6       the average-of-monthly average rate base valuation as was employed in the last  
7       PSE GRC, and as is used in the preparation of the Commission Basis Reports.

8       **Q:     Why is this a concern?**

9       A:     As I understand it, the CBRs are prepared so that the Commission and interested  
10      parties can observe what Washington utilities are earning on a “regulatory”  
11      adjusted basis, which in some instances, can be significantly different than what  
12      must be reported per public financial statements pursuant to Generally Accepted  
13      Accounting Principles. Further, the purpose of an ERF, as described in testimony  
14      presented by Staff in PSE’s prior general rate case, was to have the utility file a  
15      non-controversial “update” of the Commission’s last ordered retail cost of service  
16      based upon a more recent reporting period. The “expedited” procedural schedule  
17      was specifically proposed because it was envisioned that the utility applicant  
18      would not introduce new theories that require additional analysis. Such analysis  
19      would ordinarily occur with the full record of a general rate case.<sup>8</sup> Adoption in  
20      this context and without application of the matching principle (see discussion

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<sup>8</sup> I testified in the last Avista general rate case, that post-test year end rate base valuation would be an acceptable method to address earnings attrition, preferable to employment of attrition adjustments, under certain conditions. That testimony was based on the availability of a full rate case record. *WUTC v. Avista Corporation d/b/a Avista Utilities*, Dockets UE-120436 et. al., Direct Testimony of James R. Dittmer, Exhibit No. JRD-10T, pp. 42-45.

1 below) is likely to create a bias in the ERF in favor of the utility, and accordingly  
2 is not a sound basis for ratemaking.

3 **Q: Are you opposing the reflection of an end-of-period rate base valuation in the**  
4 **ERF?**

5 A: No, not necessarily. On behalf of Public Counsel I recommended adoption of test  
6 year-end valuation of rate base in the last Avista rate case as an alternative to  
7 Avista's request for adoption of an attrition adjustment. However, in that case I  
8 also recommended a partially offsetting adjustment to reflect the annualized level  
9 of revenue margins. These margins could be expected to be received from  
10 customers taking service at test year end as if all of those customers had taken  
11 service for the entire test year rather than, in some instances, for just a portion of  
12 that historic test year. Similarly, I am recommending in this proceeding that if  
13 rate base is valued in the ERF by considering test year end data, then, the  
14 corollary "revenue annualization" to consider growth in customers throughout the  
15 historic test year should also be considered. In that event, use of end-of-period  
16 rate base in the ERF would be acceptable.

17 **Q: Why is such an end-of-period revenue annualization adjustment appropriate**  
18 **when establishing ERF rates?**

19 A: This is a proper "matching" adjustment routinely employed in jurisdictions that  
20 utilize a test-year-end approach to valuing rate base. Since the test year end Plant  
21 in Service has been designed and constructed to facilitate service for customers  
22 taking service at test year end, and the revenue requirement includes a full  
23 "annual" return on such test-year-end rate base value, it is a proper "matching"  
24 adjustment to reflect the "annualized" margins associated with test-year-end

1 customers – even though a portion of those customers added “during the test  
2 year” did not take service throughout the entire historic test year. This adjustment  
3 simply goes hand in hand with the “new approach” or “new theory” being  
4 proposed by PSE to value rate base at test year end rather than the traditional  
5 average-of-monthly-averages approach historically ordered for PSE. I again  
6 emphasize, this is a standard adjustment that is routinely undertaken and posted in  
7 jurisdictions that value rate base by considering test year end Plant in Service.

8 **Q: If the Commission were to reject your proposal to reflect the test-year-end**  
9 **revenue annualization adjustment, should it also reject the Company’s**  
10 **proposed test-year-end rate base valuation?**

11 A: Yes. Adoption of test-year-end valuation of rate base must be accompanied by an  
12 adjustment to annualize revenues associated with test year end numbers of  
13 customers to achieve the proper matching I have described. If the “revenue  
14 annualization” adjustment that I am recommending is rejected, I would argue that  
15 the Company’s test year end valuation of rate base should, likewise, be rejected as  
16 violating the matching principle and therefore not a balanced basis for  
17 establishing a fair rate.

18 **Q: Please expand upon your concerns regarding PSE’s omission of certain**  
19 **Commission approved restating adjustments, when preparing its ERF**  
20 **revenue requirement calculation.**

21 A: As noted above, the Staff’s ERF proposal in the prior GRC contemplated that all  
22 Commission ordered restating adjustments from PSE’s most recent GRC would  
23 be calculated and posted to the ERF historic test year results of operation. In  
24 response to Public Counsel discovery, PSE identified six restating adjustments

1 ordered in the previous PSE rate case that were not calculated or presented in the  
2 ERF revenue requirement determination.<sup>9</sup> PSE indicated these were not  
3 presented because such adjustments purportedly had “historically been immaterial  
4 and therefore was not compiled for this expedited filing.” While I have  
5 concluded, based on discovery that this omission probably does not have a  
6 material revenue impact, this does raise important concerns about the proper  
7 approach to an ERF filing. This may be significant in future such cases.

8 Whether or not a restating adjustment will be “material” in an ERF test  
9 year will be dependent upon what level of costs being “restated” was recorded  
10 during the ERF historic test year. Just because a restating adjustment happened to  
11 have been “immaterial” or “relatively immaterial” when adjusting starting point  
12 actual recorded results of operation presented within a prior rate case test year  
13 does not necessarily mean or imply that a comparably calculated adjustment for  
14 an ERF test year would, likewise, be immaterial.

15 The issue is that unless PSE at least undertakes and presents the  
16 calculation with the filing, it is not possible for the Commission or other parties to  
17 know whether an adjustment that happened to be “immaterial” in a prior base rate  
18 case proceeding will have a similar “immaterial” impact in the current ERF test  
19 year revenue requirement development. PSE did not transparently present this  
20 information as part of its ERF filing and therefore Public Counsel was required to  
21 pursue such information in discovery. Further, only the summary results of  
22 restating adjustment calculations eventually undertaken after PSE made its ERF  
23 were provided, but the underlying support, analyses and calculations were

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<sup>9</sup> PSE Response to Public Counsel Data Request No. 4, Dockets UE-130137 & UG-130138.

1 omitted.<sup>10</sup> Based on PSE responses to Public Counsel discovery, it is not  
2 apparent that PSE performed any meaningful analysis of this issue prior to the  
3 filing of its ERF. This is not consistent with the intended transparency or  
4 efficiency of the ERF mechanism.

5 **Q: How do you recommend this issue be addressed?**

6 A: I would recommend that in future ERFs the Company be required to calculate all  
7 such restating adjustments and provide *all* support for such restating adjustments  
8 concurrent with the filing. PSE or another utility should not be able to  
9 unilaterally decide what previously authorized restating adjustments might be  
10 omitted, or unilaterally declare what restating adjustments might be “immaterial”  
11 in the then-current test year without providing data and calculations supporting  
12 such claim. Further, I would recommend that the utility be required to provide  
13 evidence of the review that was undertaken to determine that “any material out-  
14 of-period, nonoperating, nonrecurring, and extraordinary items or other items that  
15 materially distorts reporting period earnings and rate base”<sup>11</sup> have been eliminated  
16 when preparing the CBR results of operation. These are analyses that should have  
17 been undertaken, and resulting adjustments posted, when preparing the CBRs  
18 pursuant to the WAC for electric and gas operations.

19 **Q: Do you have any other concerns with the ERF?**

20 A: One issue that needs to be clearly addressed in any rate plan adopted is how the  
21 sale of PSE’s Jefferson County service territory will be treated. There is little  
22 information in the settlement or testimony on the issue as filed, except that  
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<sup>10</sup> PSE Response to Public Counsel Data Request No. 57, Dockets UE-130137 and UG-130138.

<sup>11</sup> WAC 480-90-257(2)(b), 480-100-257(2)(b).

1 settlement briefly addresses the issue of PSE’s gain from the sale. Disposition of  
2 the gain has not yet been determined. The Commission’s final determination in  
3 this case must ensure that customers’ ability to receive their share of the gain on  
4 the sale, once determined, is not impaired by the rate plan.<sup>12</sup>

5 **Q: Have you prepared an exhibit that calculates the impact of the “revenue**  
6 **annualization” adjustment you have proposed, as well as the cost of capital**  
7 **recommendations being proposed by Public Counsel witness Stephen Hill?**

8 A: Yes. Exhibit No. JRD-4 and Exhibit No. JRD-5 reflect the results of the revenue  
9 adjustment that I am proposing as well as the cost of capital recommendations of  
10 Mr. Hill for electric and gas operations, respectively. I would note that Mr. Hill’s  
11 9.0 percent return on equity recommendation is a result of a combination of the  
12 lower overall capital costs being experienced since PSE’s last general rate case as  
13 well as the reduced risk to shareholders expected to be experienced as a result  
14 implementing a “full decoupling mechanism.” As noted within the immediately  
15 following section of testimony, Public Counsel is not opposing a “full  
16 decoupling” mechanism for PSE, provided the attendant reduction in risk to  
17 shareholders is reflected in the development of ERF rates being established within  
18 these dockets.<sup>13</sup>

19 / /

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<sup>12</sup>It is my understanding that the rate base used by PSE in calculating the ERF in this case includes the Jefferson County service territory which has now been sold. It is not clear that the evidence filed by PSE addresses this issue, or the effect the sale will have on revenues. I have not had the opportunity to examine that issue and do not know what such an analysis would show.

<sup>13</sup> As discussed below, Public Counsel does not support the K-Factor Rate Plan component of the amended decoupling proposal.

1       **Q:     What ERF revenue requirement are you recommending as a result of**  
2       **reflecting adjustments being sponsored by you and Mr. Hill?**

3       A:     As shown on summary revenue requirement Exhibit Nos. JRD-4 and JRD-5,  
4       Public Counsel positions and adjustments for electric and gas operations,  
5       respectively, results in an ERF increase for electric operations in the amount of  
6       \$14,838,021 and an ERF *reduction* for gas operations in the amount of  
7       \$13,024,871. These ERF rate changes would be effective in 2013 following the  
8       issuance of a Commission order within these proceedings.

9       **IV.     THE AMENDED “FULL DECOUPLING MECHANISM” PROPOSAL**

10  
11       **Q:     Please briefly summarize your understanding of the amended “full**  
12       **decoupling mechanism” that has been proposed by PSE.**

13       A:     PSE’s amended application provides for the “full decoupling” of delivery margin  
14       revenues resulting from deviations in “normalized” energy consumption levels  
15       that have been considered in the development of ERF rates on a “per customer”  
16       basis. More specifically, under the amended “full decoupling” proposal the  
17       Company is guaranteed a level of delivery service margins on a “per customer”  
18       basis regardless of energy usage that may be influenced by conservation efforts,  
19       economic downturns, abnormal weather, or any other influencing event or  
20       condition. Arguably under the “full decoupling” mechanism the customer is  
21       protected from “over payment” of delivery service revenues in the event actual  
22       usage per customer happens to be higher than that estimated and assumed-to-be-  
23       “normal” usage calculated when designing ERF base rates due to events such  
24       abnormal weather or increased usage associated with further appliance saturation  
25       that might actually exceed reductions stemming from conservation efforts.

1 PSE's amended full decoupling proposal does not contain all elements that  
2 the Commission stated should be included in a full decoupling proposal.<sup>14</sup>

3 Specific elements not included in PSE's amended proposal are the impact on rate  
4 of return, and an accounting for off-system sales and avoided costs.<sup>15</sup>

5 **Q: Please briefly summarize your understanding of how the “full decoupling**  
6 **mechanism” proposed in the amended petition is different than the**  
7 **decoupling mechanism originally proposed within Dockets UE-121697 and**  
8 **UG-121705.**

9 A: My understanding of the decoupling proposal recommended by PSE and NWECC  
10 in the original October 25, 2012, filing is that it was essentially a weather  
11 normalization clause that was combined with a mechanism that was designed to  
12 identify, quantify and defer for future recovery from ratepayers “lost margins”  
13 resulting *only from conservation*. In my opinion, the original “decoupling”  
14 proposal was one-sided with an obvious bias to favor utility shareholders. My  
15 understanding is that the conservation-based K-Factor included in the original  
16 proposal was similar to the Conservation Savings Adjustment (CSA) proposed by  
17 PSE and rejected in the Company's last general rate case. Specifically, the  
18 original decoupling mechanism was designed to identify and calculate “lost  
19 margins” estimated to be associated with conservation while ignoring “offsets” in  
20 the form of increasing usage per customer potentially stemming from events such

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<sup>14</sup> *In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives*, Docket U-100522, Report and Policy Statement on Regulatory Mechanisms, Including Decoupling, to Encourage Utilities to Meet or Exceed Their Conservation Targets, November 4, 2010, ¶ 28. (hereafter, “Decoupling Policy Statement”).

<sup>15</sup> See Exhibit No. JAP-8T, p. 30, ll. 14-17. PSE does not believe any adjustments are necessary to address rate of return or off-system sales and avoided costs. Exhibit No. JAP-1T, p. 33 (rate of return) and pp. 34-35 (off-system sales and avoided costs).



1 as greater appliance saturation and/or more hours of usage of existing appliances.  
2 Under the Company's and NWECA's original decoupling proposal, it was possible  
3 that "lost margins" associated with estimated conservation savings would be  
4 "deferred" for future recovery from ratepayers even though, overall, usage per  
5 customer may have actually increased since base rates were last established, due  
6 to the "offsetting" events suggested. In my opinion, this would have been an  
7 unreasonable outcome that could have been facilitated by the originally proposed  
8 decoupling mechanism.

9 **Q: What is your opinion with respect to the amended "full decoupling**  
10 **proposal?"**

11 A: In my opinion, adoption of the amended "full decoupling proposal" would be  
12 reasonable so long as the reduced cost of equity capital reflecting the shift of risk  
13 from shareholders to ratepayers described by Mr. Hill is adopted in the  
14 development of ERF delivery rates. In addition, consistent with the  
15 Commission's Decoupling Policy Statement, I recommend the Commission adopt  
16 an earnings test if a full decoupling mechanism is approved for PSE. I  
17 recommend an earnings test of 25 basis points above the overall rate of return  
18 with decoupling as outlined by Mr. Hill.<sup>16</sup>

19 Lastly, I also recommend that PSE be required to provide sufficient  
20 reporting to allow the Commission to monitor the impact of the full decoupling  
21 mechanism, as contemplated by the Decoupling Policy Statement.<sup>17</sup> Those  
22 reports should include an accounting of financial benefits related to off-system

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<sup>16</sup> Mr. Hill outlines an overall rate of return of 7.42 percent with decoupling, and therefore, the earnings test would be applied at an overall rate of return of 7.67 percent.

<sup>17</sup> Decoupling Policy Statement, at 19, criterion 6, ¶ 28.

1 sales and avoided costs. They should also include service quality information to  
2 provide assurance that the mechanism is not having any unintended consequences  
3 regarding restoration of service outages.

4 **V. THE K-FACTOR**  
5

6 **Q: Please summarize your understanding of the K-Factor Rate Plan mechanism**  
7 **that is included in PSE's amended decoupling proposal.**

8 A: After first developing a baseline delivery-service revenue or margin for electric  
9 and gas customers within ERF Dockets UE-130137 and UG-130138, PSE  
10 proposes the application of "K-Factor" cost escalation percentages to such ERF-  
11 calculated delivery service revenues-per-customer (RPC) values. The escalation  
12 rates underlying the K-Factor increases are purportedly designed to address the  
13 growth in non-production costs that PSE has historically experienced, and expects  
14 to continue to experience, over the next few years.<sup>18</sup> The K-Factor cost escalation  
15 factors would immediately be applied to the calculated base revenue-per-customer  
16 values being derived within the ERF dockets.

17 **Q: What is the magnitude of the electric and gas K-Factors?**

18 The K-Factor escalators proposed are 3.0 percent and 2.2 percent for PSE electric  
19 and gas operations, respectively. Under PSE's rate plan proposal, the K-Factor  
20 escalators first applied concurrently with the ERF rate changes would again be  
21 applied to delivery service revenues on January 1, 2014, January 1, 2015, and  
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<sup>18</sup> Dockets UE-121697 and UG-121705, Direct Testimony of Katherine Barnard, Exhibit No. KJB-1T, p. 2, ll. 7-11.

1 potentially January 1, 2016 and 2017.<sup>19</sup>

2 **Q: What is the asserted basis for the K-Factor escalators?**

3 A: According to the testimony of PSE witness Katherine Barnard, the preliminarily  
4 calculated K-Factor escalators were based upon historic trends for non-production  
5 rate base and non-production depreciation. The K-Factor component for non-  
6 production O&M expense was assumed to rise at the projected change in the  
7 Consumer Price Index less an expected productivity “offset” of 0.50 percent.  
8 PSE’s initial escalation calculations project it would expect to experience a  
9 weighted average increase in the cost of providing delivery service of 4.06  
10 percent and 3.80 percent per year for electric and gas operations, respectively.

11 **Q: Given these projections, why does PSE use K-Factors of 3 percent and 2.2**  
12 **percent for electric and gas operations, respectively?**

13 A: The preliminary calculations were apparently modified in favor of the lower K-  
14 Factor escalators in settlement negotiations between Staff and PSE. The agreed  
15 upon lower escalation rates purportedly represent “stretch” goals that the parties  
16 indicate that PSE is now expected to pursue.

17 **Q: What is your opinion regarding the “stretch” goals rationale offered for the**  
18 **proposed K-Factor levels?**

19 A: While the approach could make sense in theory if the underlying K-Factor  
20 escalators were determined to be accurate and reasonable, as I discuss below, that  
21 is not the case in these proceedings. Because of the methodological flaws with

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<sup>19</sup> It is noted that the second and third K-Factor rate per customer adjustments become effective on January 1, 2014 and January 1, 2015. Under the terms of the stipulation, additional increases could also be permitted to occur on January 1, 2016 and January 1, 2017. However, while the new K-Factor rates become effective on January 1 of each noted year, they are initially deferred with interest until May 1 of each year, at which time they are fully implemented and become effective.

1 PSE’s proposal, it is not possible to determine that the “stretch” goals themselves  
2 represent a reliable basis for setting rates merely because they are lower than  
3 PSE’s initial K-Factor escalation calculations.

4 **Q: Please state your concern with PSE’s K-Factor escalators.**

5 A: First, although the K-Factor escalators are specifically designed to “address  
6 attrition,”<sup>20</sup> they are not supported by a complete or even a reasonably  
7 comprehensive attrition study submitted by PSE or any other party.

8 Second, the K-Factor escalator development completely fails to consider  
9 revenue growth to be expected from growth in numbers of customers as a  
10 significant offset to K-Factor “cost escalation.” This customer growth can  
11 reasonably be expected to occur based on PSE’s own forecasts.

12 Third, PSE’s supporting analysis does not consider the mitigating impact  
13 of significant growth in the Accumulated Deferred Income Tax balance (i.e.,  
14 reduction to rate base value) that can reasonably be expected to occur over the  
15 term of the rate plan. For this reason, the historic growth in rate base underlying  
16 or supporting the preliminary K-Factor escalators is not necessarily a reliable  
17 predictor of future rate base growth.

18 Fourth, there is an implicit compounding of escalation resulting from a  
19 proposed May 1, 2013, K-Factor increase followed by the application of a  
20 subsequent January 1, 2014 increase that considers “annual” escalation rates even  
21 though the initial K-Factors will have only been in place for only six months.<sup>21</sup>

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<sup>20</sup> Dockets UE- 121697 and UG-121705, Direct Testimony of Deborah Reynolds, Exhibit No. DJR-1T, p. 4, ll. 5-9.

<sup>21</sup> Order 02 issued with Dockets UE-130137 and UG-130138 provides for post-hearing briefs in these dockets to be filed on May 30, 2013. A filing date for briefs of May 30, 2013 would indicate that a rate effective date of approximately July 1, 2013 for rates resulting from these dockets to now go into effect.

1       **Q:    Taking your objections to the K-Factor escalators one at a time, please**  
2       **expand upon your point that the K-Factor escalators are not supported by a**  
3       **sufficient attrition study.**

4       A:    The Commission was presented with a request for an attrition adjustment in the  
5       last 2012 Avista General Rate Case, the first such request in many years.<sup>22</sup> In that  
6       docket, Avista prepared and filed a detailed attrition study that supported a  
7       specific attrition adjustment.<sup>23</sup> Further, Avista’s attrition study was supported by  
8       “cross check” analyses and adjustments that went into specific detail of  
9       projections for plant additions, depreciation expense, and Accumulated Deferred  
10      Income Taxes through the first rate effective period which for that case was  
11      approximately calendar year 2013.<sup>24</sup> Staff did substantial discovery and analysis  
12      in the case, and ultimately presented its own attrition study and attrition  
13      adjustment.<sup>25</sup> As a general proposition, the Avista attrition studies examined  
14      historic revenues, expenses, and rate base, and also future budgeted or forecasted  
15      revenues, expenses, and rate base.<sup>26</sup>

16               PSE does present some historic trends in revenues, expense and rate base.  
17      However, as also described elsewhere, the historic trends in revenues initially  
18      identified and quantified are later disregarded. Due to the omission of analysis of  
19      either historic or projected changes in growth in revenues upon the development  
20      of the K-Factor escalator, the remaining analysis of rate relief purportedly needed

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<sup>22</sup> *WUTC v. Avista Corporation d/b/a Avista Utilities*, Dockets UE-120436 et. al., Order 09 (December 26, 2012).

<sup>23</sup> Dockets UE-120436 et. al., Direct Testimony of Mark N. Lowry, Exhibit No. MNL-1T.

<sup>24</sup> Dockets UE-120436 et. al., Direct Testimony of Elizabeth M. Andrews, Exhibit No. EMA-1T, pp. 34-36.

<sup>25</sup> Dockets UE-120436 et. al., Direct Testimony of Kathryn H. Breda, Exhibit No. KHB-1TC, pp. 19-36.

<sup>26</sup> Dockets UE-120436 et. al., Direct Testimony of Kathryn H. Breda, Exhibit No. KHB-1TC, p. 27.

1 to address cost escalation is one-sided and falls far short of a detailed and  
2 reasonably comprehensive attrition study.

3 Finally, PSE offers only a short one-page summary estimate of projected  
4 changes in Net Plant in Service for the period ending December 2015.<sup>27</sup> This  
5 analysis is far short of the voluminous information and multiple layers of  
6 spreadsheets containing projected rate base data that were offered as a “cross  
7 check” for Avista’s attrition recommendation. Most importantly, PSE’s summary  
8 level of projected rate base is incomplete in that it does not consider the impact of  
9 a growing Accumulated Deferred Income Tax balance that will serve to at least  
10 partially offset the implied growth in rate base suggested by PSE’s one page  
11 summary cited above. PSE’s omission of evaluation of the projected growth in  
12 the Accumulated Deferred Income Tax reserve upon projected rate base growth  
13 represents another serious departure from the type of analysis offered in the  
14 Avista case.

15 I would also note and emphasize that in PSE’s last general rate case, the  
16 Company’s allegation of failure to earn its authorized rate of return due to  
17 attrition was rejected by the Commission Staff, and ultimately the Commission,  
18 because PSE had filed no attrition study to support its claims.<sup>28</sup> No party within  
19 these proceedings has represented that what was provided as support for the K-  
20 Factor escalators in these dockets can be considered a reasonably comprehensive  
21 attrition study.<sup>29</sup> Accordingly, just as the Commission rejected PSE’s proposals

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<sup>27</sup> Exhibit No. KJB-5, Dockets UE-121697 and UG-121705.

<sup>28</sup> *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-111048 and UG-111049, Order 08 (May 7, 2012) ¶¶ 483-491.

<sup>29</sup> Deposition of Thomas Schooley, (April 10, 2013), TR. 40 ll. 5-10.

1 in its last general rate case to remedy attrition because PSE had filed no attrition  
2 study, PSE's request for a K-Factor Rate Plan in the instant dockets undertaken to  
3 address attrition, without actually undertaking a comprehensive attrition study,  
4 should likewise be rejected.

5 **Q: Please discuss in more detail your concern that the K-Factor escalator fails to**  
6 **consider revenue growth as a significant offset to increasing costs?**

7 A: Although the specific calculation and quantification of "matching" is often  
8 vigorously disputed, it is not in dispute that a fundamental and generally accepted  
9 principle of rate development is the proper matching of revenues, expenses, and  
10 rate base over a similar measurement period.

11 **Q: Was the matching principle applied in the Avista attrition studies?**

12 A: Yes. At least in theory, Avista's and Staff's attrition studies attempted to look at  
13 changes in expected revenue levels to the time period that costs or expenses were  
14 proposing to be escalated (i.e., the "rate effective year"). In other words, within  
15 their respective attrition analyses both Avista and Staff attempted to look at  
16 revenue growth as an offset to the projections being made for expense and rate  
17 base growth from the test period in that case (2011) through the first annual rate  
18 effective period in that case (2013).<sup>30</sup>

19 **Q: Does PSE properly employ the matching principle in this case?**

20 No. In developing its K-Factor escalators in this case, PSE follows elements of  
21 the Avista attrition study when examining historic escalation for non-production

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<sup>30</sup> In fact, upon updating its load forecast during the middle of the discovery phase of the Avista docket, Avista downwardly revised its load forecast to the point that it was predicting little, if any, load growth between the test period and the first rate effective period increasing the revenue requested under the attrition adjustment. *See*: Dockets UE-120436 et. al., May 29, 2012 Supplemental Filing and Revised Testimony and Exhibits of Mark N. Lowry, MNL-1T and Elizabeth M. Andrews, Exhibit No. EMA-1T.

1 rate base and expenses. The historically-derived cost escalators used as a starting  
2 point were subsequently lowered, such that in theory PSE will need to “stretch” or  
3 beat prior escalation experience to have any chance to earn its authorized rate of  
4 return. However, when first considering needed rate relief by reviewing historic  
5 rate base and expense escalation, PSE failed to consider how such preliminary or  
6 “first cut” escalators would be impacted by offsets in the form of revenue growth.  
7 This is a significant omission from any attrition analyses. In my opinion, this  
8 omission represents a fatal flaw in determining the starting point for evaluating  
9 the need for, or quantification of a proper amount of, periodic rate relief.

10 **Q: Given that PSE has proposed, and you are conditionally accepting “full**  
11 **decoupling,” how can you reasonably conclude that there might be growth in**  
12 **revenues to offset part of the cost escalation?**

13 A: It might be argued that when a full decoupling mechanism as proposed here is  
14 implemented, revenues to be collected are effectively disassociated from customer  
15 usage – leaving the utility immune to over or under-collection of revenues that  
16 might otherwise occur with varying usage. It must be remembered, however, that  
17 the mechanism being proposed decouples or disassociates “usage per customer”  
18 from “revenues per customer.” In other words, the amended “full decoupling”  
19 mechanism ensures that, on average and in total, customers will provide the  
20 Company with the same amount of “revenues per customer” regardless of the  
21 consumption or “usage per customer.” The full decoupling mechanism does not,  
22 however, decouple or return to retail customers growth in revenues or margins  
23 that is forecasted to occur as a result of expected growth in *numbers of customers*.



1       **Q:     In developing the K-Factor, did PSE calculate the offsetting effect of revenue**  
2       **growth based on growth in the number of customers?**

3       A:     No, not that I have been able to determine. In response to Public Counsel  
4       discovery, PSE agreed that growth in revenues stemming from customer growth  
5       would be available to at least partially offset some of the cost increases being  
6       projected for providing delivery service.<sup>31</sup> Although PSE argued that historically  
7       growth in revenue margins had not kept pace with cost increases in providing  
8       delivery service, there are no calculations provided that demonstrate that an  
9       attempt was made when developing the K-Factor escalators to consider, much less  
10      quantify, the specific projected offsetting impact of growth in delivery margins  
11      stemming from growth in numbers of customers.

12      **Q:     Is PSE projecting growth in the number of electric and gas customers?**

13      A:     Yes. In response to Public Counsel Data Requests PSE provided recent actual as  
14      well as budgeted 2013 through 2016 numbers of electric and gas customers. This  
15      data was further broken down into the subcomponents for each utility operation  
16      between “Residential” and “Non-Residential” customers along the lines that the  
17      decoupling mechanism has been designed.<sup>32</sup> My analysis of the actual and  
18      projected numbers of customers from the noted response yields the projected year  
19      end-over-year end percentage increases in numbers of electric and gas customers

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<sup>31</sup> PSE Response to Public Counsel Data Request No. 6, Docket Nos. UE-121697 and UG-121705.

<sup>32</sup> Public Counsel Data Request Nos. 25 through 28, Docket Nos. UE-121697 and UG-121705.

1 reflected within Table 2:

<b>Table 2</b>				
<b>Projected Year-Over-Year Percentage Increases in Number of PSE Customers</b>				
	Electric Operations % Increase		Gas Operations % Increase	
Period	Residential	Non-Residential	Residential	Non-Residential
2013 Budget Over 2012 Actual <sup>33</sup>	1.6%	.9%	1.5%	2.4%
2014 Budget Over 2013 Actual	1.9%	1.6%	1.9%	1.4%
2015 Budget Over 2014 Actual	2.0%	1.7%	2.2%	1.6%

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As can be gleaned from a cursory review of Table 2, PSE is generally predicting annual growth in number of customers in the range of 1.0 percent to 2.0 percent for the next three years – depending upon which year and which subset of electric and gas customers one focuses upon.

7

**Q: What are the implications of the forecasted growth in customers?**

8

A: The forecasted customer growth and attendant margin growth should be able to significantly offset forecasted cost escalation. For example, if delivery costs were projected to escalate 4.0 percent - including the cost to serve new customers, and if delivery service revenues were projected to increase 4.0 percent due to customer growth, it logically follows that the utility should not need to raise rates, nor should it be expected, in theory, to “over” or “under” earn.

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<sup>33</sup> In April 2013 PSE’s forecast reflected the loss in number of electric customers due to a sale of distribution plant to Jefferson County PUD. With the noted loss of customers to Jefferson County PUD, PSE actually forecasts a reduction in budgeted 2013 year end numbers of electric customers. The aberration caused by the loss of customers from the sale to Jefferson County PUD expected to occur in

1 **Q: Will the growth in margins that can be expected to result from PSE’s**  
 2 **forecast of customer growth fully offset the estimated escalation in costs?**

3 A: No, PSE’s forecasted customer growth does not fully offset the preliminary cost  
 4 escalation calculation or the “stretch” factors ultimately used to underlie the  
 5 stipulated K-Factor increases. Nonetheless, such revenue offsets can be expected  
 6 to be significant. PSE’s failure to incorporate the revenue growth offset in its  
 7 analysis demonstrates a serious flaw in the K-Factor escalation development.

8 **Q: How much might the growth in customer margins negate or offset the need**  
 9 **for K-Factor escalators?**

10 A: On Table 3 below I reflect the preliminarily calculated K-Factor escalators  
 11 included within Exhibit No. KJB-4, the “stretch” K-Factors ultimately agreed to  
 12 by PSE and Staff, and the impact of the offset for revenue growth to each listed  
 13 cost escalation factor under varying revenue growth assumptions.

<b>Table 3</b>		
<b>Analysis of K-Factor Cost Escalation Development and the Potential Offset Impact of Considering Customer Margin Growth</b>		
	Electric Operations	Gas Operations
Preliminary K-Factor Calculated by PSE	4.06%	3.80%
Stipulated K-Factor “Stretch” Escalation Rates	3.00%	2.20%
<b>Preliminary K-Factor Reduced for Customer Growth:</b>		
Assuming 1.0% Customer Growth	3.06%	2.80%
Assuming 1.5% Customer Growth	2.56%	2.30%
Assuming 2.0% Customer Growth	2.06%	1.80%
<b>Stipulated K-Factor Escalation Reduced for Customer Growth</b>		
Assuming 1.0% Customer Growth	2.00%	1.20%
Assuming 1.5% Customer Growth	1.50%	0.70%
Assuming 2.0% Customer Growth	1.00%	0.20%

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2013 have been eliminated from calculations above so as to not distort PSE’s true projection of customer growth.

1                   As a review of Table 3 will quickly reveal, consideration of some level of  
2 customer growth significantly reduces the implied need for K-Factor cost  
3 escalation. Under many scenarios, merely reflecting assumed revenue growth as  
4 an offset to presumed cost escalation requirements brings the preliminarily  
5 calculated K-Factor escalation rate below the lower stipulated “stretch” K-Factor  
6 rates.

7       **Q.   Doesn’t the analysis included within Table 3 arguably validate the need for**  
8       **some amount of K-Factor escalation?**

9       A.   No, for several reasons. Table 3 is not a presented as a calculation of the  
10       “correct” K-Factor. Table 3 only demonstrates the significant magnitude of  
11       omitting the impact of considering customer growth in the K-Factor development.  
12       However, as other portions of my testimony demonstrate, neither the  
13       “preliminary” nor the “stipulated” K-Factor escalators are themselves reliable  
14       numbers supported by careful or complete analysis. Moreover, my analysis  
15       identifies other problems with the K-Factor, such as failure to consider rate base  
16       offsets (discussed below). Taken together, these factors show that the K-Factor is  
17       very likely overstated and that there is no sound basis for the Commission to  
18       approve the K-Factors presented in this case.

19       **Q:   Is it possible that the revenue growth offset that you highlight was an**  
20       **underlying input considered when the stipulating parties lowered the**  
21       **preliminary K-Factor escalators down to the stipulated “Stretch” K-Factors?**

22       A:   To my knowledge, that theory or argument has never been asserted in testimony  
23       or in discovery responses by PSE or any other party. Further, as shown on Table  
24       3 above, under a number of customer growth scenarios assumed, there would be

1 no real “stretch” to achieve the net K-Factor escalation values ultimately agreed to  
2 by the stipulating parties. Therefore, a conclusion that revenue growth was  
3 considered when developing stipulated “stretch” factors seems very unlikely.

4 . **Q: Please expand on your concern that PSE’s historic growth in rate base that is**  
5 **heavily weighted in the development of the K-Factor escalators is not**  
6 **necessarily a good predictor of future rate base growth.**

7 A: As previously noted, PSE began its development of a K-Factor escalator by first  
8 calculating historic percentage changes in non-production rate base, depreciation  
9 and other O&M expenses. It is noteworthy that historic rate base growth has the  
10 greatest weight in the development of the factor. To provide some added support  
11 for the K-Factor escalation ultimately proposed, PSE offers a projection of growth  
12 in Gross and Net Plant in Service for the period June 30, 2012, through December  
13 31, 2015.<sup>34</sup>

14 As shown on Ms. Barnard’s exhibit, this Company forecast analysis does  
15 not consider the impact of the growth in plant-related Accumulated Deferred  
16 Income Tax reserve that can be expected to occur during this same three and one-  
17 half year period. Further, this analysis fails to consider the probable significant  
18 growth in the “regulatory” ADIT balance that can be expected as PSE is able to  
19 utilize its current Net Operating Loss (NOL) Carryforward federal corporate  
20 income tax position.

21 **Q: Please explain how or why the “regulatory” ADIT balance can be expected to**  
22 **grow significantly in ensuing years.**

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<sup>34</sup> Specifically, PSE’s estimate of growth in Gross and Net Plant in Service can be found in Katharine Barnard’s Exhibit No. KJB-5, Dockets UE-121697 and UG-121705.

1       A:     As the Commission may recall from the last PSE general rate case, PSE was  
2             already in an NOL Carryforward position during the 2011 test year employed in  
3             that proceeding.<sup>35</sup> As a result, PSE had claimed federal income tax deductions  
4             that were causing it to calculate “negative” current taxable income. The ability to  
5             “carry back” an NOL to prior tax years is very limited, and accordingly, any  
6             calculated NOL is largely carried forward until the corporate taxpayer generates  
7             enough current taxable income so as to be able to fully utilize the NOL  
8             carryforward amount experienced in prior tax years. As a result of PSE’s NOL  
9             carryforward position, Accumulated Deferred Income Tax balances generated by  
10            deductions claimed on PSE’s corporate tax return, but not yet fully “utilized”  
11            because of PSE’s NOL position, were *not* fully reflected as a rate base deduction.

12                    The practical implications of PSE’s NOL carryforward position is that for  
13                    a period of a few years, PSE can be expected to pay *no* corporate federal income  
14                    taxes. However, under the “normalization” procedures adopted by this  
15                    Commission for regulating PSE, rates developed in PSE’s last general rate case,  
16                    and which are being developed in the current ERF proceeding, nonetheless reflect  
17                    a significant level of “deferred” income tax expense. In a nutshell, and stated  
18                    very simply, every dollar of income tax expense collected within PSE rates over  
19                    the next two-to-three years will cause PSE’s available “regulatory” ADIT balance  
20                    to grow. I expect this growth to be significant.

21       **Q:     Do you have an opinion as to what has contributed to the large NOL**  
22             **carryforward position that existed at the time of PSE’s last general rate case**  
23             **as well as today?**

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<sup>35</sup> Dockets UE-111048 and UG-111049, Order 08 (May 7, 2012), ¶¶ 177-186.

1       A:     While the procedural schedule provided for in these proceedings did not provide  
2             for adequate time to delve into all elements that might have contributed to PSE’s  
3             NOL carryforward position, almost assuredly a large contributor, and probably  
4             the single largest contributor, is varying forms of federal tax legislation that  
5             provided for “bonus depreciation” that permitted corporate tax payers to instantly  
6             deduct between 50 percent and 100 percent of plant investments made for the  
7             years 2010 through 2013.

8       **Q:     How or why do you conclude that you expect PSE’s “regulatory” ADIT rate**  
9             **base offset value to grow significantly over the next few years?**

10      A:     In response to a Public Counsel Data Request PSE provided its estimate of its  
11             ability to utilize its NOL carryforward position.<sup>36</sup> The confidential response has  
12             been affixed as Exhibit No. JRD-6C to this testimony. I have also attached a  
13             spreadsheet calculation to the noted response that provides the estimated  
14             significant total PSE growth in “regulatory” ADIT that can be expected to be  
15             realized as it is able to utilize its NOL carryforward position. It should be noted  
16             that such estimated total PSE changes in its “regulatory” ADIT balance would be  
17             additive to, or subtractive from, other plant-related changes in ADIT balances.

18                     In the noted response the Company adds the disclaimer that it is “nearly  
19             impossible to predict with any level of certainty” its ability to use its NOL  
20             carryforward. Notwithstanding this disclaimer, it is clear from the magnitude of  
21             NOL carryforward predicted to be utilized sometime in the very near future that  
22             PSE’s “regulatory” ADIT balance can be expected to grow significantly in  
23             ensuing years. In fact, based upon responses received to Public Counsel’s

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<sup>36</sup> PSE Response to Public Counsel Data Request No. 32, Dockets UE-130137 and UG-130138.

1 discovery, I cannot determine how the Company's projected growth in the  
2 depreciation-related *and* NOL Carryforward ADIT can be as low as PSE has  
3 predicted when responding to data requests. In other words, while in responding  
4 to discovery in these dockets the Company has provided projections for  
5 significant growth in its ADIT reserve, I arrive at estimates of even larger ADIT  
6 growth when I consider PSE's estimates of Bonus Depreciation to be taken in  
7 2012 or forecasted to be taken in 2013.

8 **Q: When Avista offered a "cross check" for its proposed rate base escalation**  
9 **developed within its attrition study, did Avista offer a similar "proof" or**  
10 **support for its attrition claim by pointing to projected growth in rate base?**

11 A: Yes. However, Avista offered a much more detailed analysis of its expected  
12 growth in rate base than has been offered by PSE in these dockets. Importantly,  
13 Avista's "cross check" analyses or adjustments included consideration of  
14 projected growth in ADIT as a rate base offset or reduction – a projection that has  
15 not been offered by PSE in support of its historic K-Factor rate base escalation.

16 **Q: Do you have any other concerns with PSE's rate base calculation?**

17 A: Yes, PSE calculated a three-year average increase in Net Plant in Service that  
18 appears to be offered as a proxy to suggest that PSE's historic rate base growth  
19 can be expected to continue to occur during the rate effective period. I first note  
20 that PSE calculates a "three-year average" of "annual" Net Plant in Service  
21 growth by dividing Net Plant in Service forecasted to occur over a three and one-  
22 half year period by three years. This appears to be a clear error that has  
23 overstated the true "average annual" increase in forecasted Net Plant in Service  
24 that can be expected to occur over ensuing years.





1 inclusive of embedded production costs. Per PSE's ERF, production costs  
2 embedded within current base rates represents approximately two-thirds of PSE's  
3 total base rates cost of service. For electric operations, the underlying K-Factor  
4 escalator will be applied to ERF delivery service rates only— or roughly speaking,  
5 the remaining one-third of PSE's total electric cost of service. Using simple  
6 math, if one applies a 3 percent escalation rate to one-third of PSE's total base  
7 rates (production plus delivery service), one would expect the annual impact on  
8 PSE's *total* base rates to be approximately one percent per year.

9 Admittedly, there are some decoupling and K-Factor delayed  
10 implementation deferrals that could impact the actual rate increase imposed by  
11 year – above or below the 3.0 percent K-Factor escalation applied to delivery  
12 service revenues-per-customer. However, even considering such possible deferral  
13 impacts, it is just very difficult to envision a scenario where the three percent cap  
14 would ever come into play. More importantly, however, even in what appears to  
15 be a highly unlikely scenario, the three percent cap results in no permanent cost to  
16 PSE shareholders or rate relief to customers. Specifically, should the three  
17 percent cap be reached and imposed, the K-Factor revenues that, but for the three  
18 percent limitation would have been immediately and fully implemented, will  
19 simply be deferred and later recovered with interest when the cap is no longer  
20 limiting. In short and in sum, while the three percent cap might, upon first  
21 impression, appear to provide ratepayer protection, I conclude that it provides no  
22 meaningful, and certainly no permanent, protection for ratepayers.

23 **Q: Is the earnings sharing proposal, in the event of excess earnings result from**  
24 **the multi-year rate plan, sufficient to adequately protect ratepayers?**

1 A: No. First, the sharing proposal only becomes effective after PSE has earned more  
2 than 25 basis points above its overall weighted cost of capital from the  
3 Company's prior general rate case. As discussed in the testimony of Mr. Hill,  
4 PSE's proposal fails to recognize the substantial risk shifted to ratepayers as a  
5 result of full decoupling, and would represent an inflated overall rate of return.  
6 Such PSE proposed overall cost of capital threshold equates to an earned return  
7 on common equity sharing threshold of 10.33 percent.<sup>37</sup> Thus, the over-earnings  
8 threshold, as more appropriately stated on a return on equity basis, is quite high.  
9 Further, the sharing proposal limits ratepayer participation to 50 percent - even  
10 after the fairly high earnings-sharing threshold is met. Accordingly the relatively  
11 high sharing threshold combined with only the 50/50 sharing split between  
12 shareholders/ratepayers provides relatively little protection to ratepayers.

13 Second, if the K-Factor escalators are approved, effectively "the self-  
14 regulating aspects of historical test-period ratemaking which dampen the  
15 Company's incentive to overinvest in new infrastructure"<sup>38</sup> that Mr. Elgin first  
16 espoused when suggesting an ERF would be removed. While PSE may argue that  
17 it would never over-invest or imprudently invest in new infrastructure, it may be  
18 difficult to determine whether the utility is comprehensively undertaking all  
19 efforts to become efficient and provide utility service at the lowest long term cost  
20 possible consistent with reasonable safety and reliability standards. I have on  
21 occasion reviewed utility witnesses' testimony and/or discovery responses that

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<sup>37</sup> The cost of equity capital underlying an assumed overall cost of capital threshold can be easily calculated by first deriving the maximum "weighted cost of equity" implicit in overall cost of capital threshold, and dividing such amount into the equity ratio determined to be reasonable in PSE's last rate order.

<sup>38</sup> Dockets UE-111048 and UG-111049, Direct Testimony of Kenneth Elgin, Exhibit No. KLE-1T, p. 82, ll. 10-13.

1 describe the purported pressure that upper management or executives place on  
2 mid-to-lower management to reduce or contain costs. Such pressure causes  
3 management to attempt to distinguish between a true need versus what might be  
4 considered a highly desirable or potentially advantageous expenditure. I expect  
5 that distinction can be grey at times. With the abandonment of historic test year  
6 regulation and/or movement toward more attrition or “cost trend” regulation, the  
7 decisions on “true need” versus “highly desirable” expenditures could be  
8 influenced by a relatively high earnings threshold combined with only a 50  
9 percent proportional sharing of excess earnings once the excess earnings threshold  
10 is met. Accordingly, I conclude that the earnings sharing mechanism does not  
11 provide adequate ratepayer protection.

12 **VII. PUBLIC COUNSEL ALTERNATIVE RATE PLAN WITH ERF FILINGS**

13 **Q: Please describe your alternative to the K-Factor Rate Plan.**

14 A: On behalf of Public Counsel, I recommend, as an alternative to the K-Factor Rate  
15 Plan, that PSE be permitted to file up to two additional ERFs during the rate plan  
16 period and no more than one additional PCORC.<sup>39</sup> The alternative rate plan, like  
17 that proposed by PSE, would prohibit the Company from filing a general rate case  
18 before April 1, 2015, and require that it file a GRC no later than April 1, 2016.  
19 Therefore, in addition to the ERF filed in this proceeding, the Company would be  
20 permitted to file two additional ERFs during the rate plan period, and one  
21 additional PCORC. The Company would have the discretion to determine the  
22 specific timing for each filing during the rate plan period. As described in earlier  
23

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<sup>39</sup> I understand that PSE filed a PCORC at the Commission on April 25, 2013. Under Public Counsel’s alternative recommendation, the allowed PCORC during the rate plan would be in addition to this PCORC.

1 sections of my testimony, any future ERF filings should calculate all restating  
2 adjustments with necessary support and evidence to show that a review was done  
3 to determine that any items that materially distort reporting period earnings have  
4 been eliminated when preparing the CBR results of operations. In addition, if a  
5 future ERF is based on test-year-end valuation of rate base, it must be  
6 accompanied by an adjustment to annualize revenues associated with year-end  
7 number of customers.

8 **Q: Why is your alternative rate plan preferable to the K-Factor Rate Plan**  
9 **proposed by the Company?**

10 A: The alternative rate plan would allow PSE to address earnings shortfall  
11 attributable to providing delivery service in between rate cases on an expedited  
12 basis without the cost of preparing a full general rate case. Such a series of ERF  
13 proceedings is preferable to the K-Factor escalator approach as, in the words of  
14 Mr. Elgin in the prior PSE general rate case:

- 15 • The new rates would be based upon known costs.
- 16 • The process would capture changes to test year customer growth and  
17 load in a timely manner.
- 18 • The process would provide a mechanism to implement rate changes to  
19 maximize the impact on financial results, and
- 20 • The process would be transparent and retain the self-regulating aspects  
21 of historical test-period ratemaking which dampen the Company's  
22 incentive to overinvest in new infrastructure.<sup>40</sup>

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<sup>40</sup> Dockets UE-111048 and UG-111049, Direct Testimony of Kenneth Elgin, Exhibit No. KLE-1T, p. 82.

1           In addition, the rate plan would allow PSE to file one additional PCORC,  
2 if necessary, during the rate plan period which would preserve the Company's  
3 ability to seek recovery for any power-cost related capital additions but would  
4 also protect customers from unlimited power cost only rate cases. This  
5 recommended PCORC limitation contrasts with the Company's proposal that  
6 does not put any limitation on the number of power cost only rate cases that can  
7 be filed during the rate plan period. Without such a PCORC limitation, the rate  
8 stability or rate case relief which PSE purports to offer under the rate plan will be  
9 reduced.

10   **Q: Please describe how full decoupling would be treated under your alternative**  
11   **rate plan.**

12   A: Full decoupling, with the proposed modifications discussed in my testimony and  
13 Mr. Stephen Hill's testimony, would also be permitted under Public Counsel's  
14 alternative rate plan. The modifications include the following:

- 15   • Reflection of the reduced cost of equity capital to reflect the shift of risk from  
16       shareholders to ratepayers that can be expected to occur with decoupling and  
17       would be adopted in the development of ERF delivery rates.
- 18   • An earnings test of 25 basis points above the overall rate of return would be  
19       included. Mr. Hill recommends an overall rate of return of 7.42 percent, and  
20       therefore the earnings test I recommend would be applied at an overall rate of  
21       return of 7.67 percent.

22   Consistent with the Commission's Decoupling Policy Statement, PSE should be  
23   required to provide sufficient reporting to allow the Commission to monitor the  
24   impact of the full decoupling mechanism. Those reports should include an

1 accounting of financial benefits from off-system sales and avoided costs, as well  
2 as service quality information, as discussed earlier in my testimony.

3 **VIII. CONCLUSION**  
4

5 **Q: Please summarize your testimony.**

6 A: I recommend that PSE be permitted to implement rate changes upon conclusion of  
7 these dockets to reflect the ERF revenue requirement that I present on Exhibit No.  
8 JRD-4 and Exhibit No. JRD-5 for electric and gas operations, respectively. I  
9 further recommend adoption of the full decoupling mechanism as set forth within  
10 PSE and NWECC's amended petition filed within Dockets UE-121697 and UG-  
11 121705 on March 1, 2013, so long as the reduced risk in cost of equity discussed  
12 by Mr. Hill is considered in the development of the ERF revenue requirement.  
13 Finally, I urge complete rejection of the K-Factor escalators being proposed by  
14 the PSE, but support PSE's ability to file two additional ERFs before being  
15 required to file a general rate case no sooner than April 1, 2015, and no later than  
16 April 1, 2016.

17 **Q: Does this conclude your direct testimony?**

18 A: Yes, it does.