Exhibit No.___(MPG-1T)
Docket Nos. UE-121697/UG-121705 and UE-130137/UG-130138
Witness: Michael P. Gorman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	Dockets UE-121697 and UG-121705 *(Consolidated)* Dockets UE-130137 and UG-130138 *(Consolidated)*

RESPONSE TESTIMONY OF MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

April 26, 2013

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Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a managing principal of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exhibit No.___(MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE SUBJECT OF YOUR TESTIMONY?

A. In my testimony, I will address the following concerning the Expedited Rate Filing ("ERF") proposed by Puget Sound Energy, Inc. ("PSE" or the "Company"). These issues include the following:

1. Is the revenue requirement included in the ERF reasonable and prudent?
2. Is the Company's decoupling mechanism appropriate and are the base rates consistent with the proposed decoupling mechanisms?

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS IN THIS REGULATORY PROCEEDING.

A. PSE's proposal for an ERF is not justified based on its own financial information. As set forth below, PSE's earned return on common equity in 2012 was 10.75%. This is higher than the 9.8% return on equity PSE was previously awarded as reasonable by the Washington Utilities and Transportation Commission ("Commission"). Hence, PSE's current cost of service is producing more than a fair return on equity, which casts significant doubt for the need of a rate increase, and discredits the settlement approval of an ERF that permits PSE to increase its rates and revenue by $32 million without a detailed and competent review of its cost of service.

Q. DO YOU BELIEVE THAT PSE'S PROPOSED ERF IS BASED ON REASONABLE COST OF SERVICE COMPONENTS?

A. No. Several adjustments are appropriate to modify the ERF revenue requirement. However, I have not done a detailed review of the Company's cost of service study, so a more complete review of PSE's cost of service may completely eliminate its claimed revenue deficiency. At a minimum, the Commission should consider the following adjustments:

1. PSE is determining its revenue deficiency based on an excessive overall rate of return of 7.80% approved in Order 08 in Dockets UE-111048 and UG-111049, filed on May 7, 2012. The proposed rate of return is excessive for at least three reasons:

    a. The most recently approved rate of return of 7.80% is based on a return on equity of 9.80%. This return on equity significantly exceeds PSE's current market cost of common equity.

    b. The overall return on equity is based on a capital structure with a common equity ratio of 48.00%. This common equity ratio exceeds PSE's actual common equity ratio in 2012, and common equity ratios that existed for at least the last two years. PSE's revenue requirement should be estimated using its actual capitalization mix which includes a common equity ratio of approximately 46.6%.

    c. PSE's cost of debt included in its last approved overall rate of return was 6.22%. This embedded cost of debt will decline as debt issues have retired since PSE's last rate case, and will continue to retire during the proposed four-year ERF period. This embedded cost of debt should be adjusted to reflect PSE's actual and expected cost of debt during the ERF period.

2. PSE is basing its calculation of pension expense on an average that includes significantly higher historical contribution levels than PSE is currently experiencing.

3. Other revenue requirement issues:

   a. PSE has adjusted federal income tax expense using an effective tax rate that is higher than the statutory federal income tax rate.

   b. PSE is proposing to include incentive compensation costs based on achieving financial goals.

4. PSE's proposed decoupling mechanism is not reasonable. The decoupling mechanism shifts operating risk from PSE to ratepayers. PSE is also proposing significant amounts of accounting deferrals during the four-year ERF period. These deferrals, plus the decoupling mechanism, substantially shift the operating risk of PSE to its customers and significantly erode PSE's necessity to aggressively manage its operating costs during the ERF period. The combination of a decoupling mechanism and accounting deferrals is a redundant and unjustified shift of operating risk to retail customers.

<u>EXPEDITED RATE FILING</u>

Q. HAVE YOU REVIEWED PSE'S ERF?

A. Yes.

Q. DO YOU BELIEVE THE COMPANY'S PROPOSAL FOR AN ERF IS APPROPRIATE?

A. No. PSE's earnings in 2012 were very strong. As shown below in Table 1, PSE's earned return on equity as recorded in its FERC Form 1 was 10.75%. This earned return on equity is 95 basis points higher than the 9.80% return on equity PSE was awarded in its last rate proceeding.

TABLE 1

PSE Earned Return on Equity
(Millions)

Description	**Amount**
Net Income	$ 356.17
Average Common Equity Balance	$3,313.18
Earned Return on Equity	10.75%

Source: PSE's FERC Form 1; December, 31, 2012 at 112 and 117.

While this reported earned return is not on a regulated cost of service basis for jurisdictional purposes, it reflects PSE's very strong earnings during 2012. This is clear evidence that an ERF is not justified, and customers should be protected from an unjustified rate increase and moratorium as proposed in this case.

Q. WILL THE PROPOSED SETTLEMENT UNDER THE ERF PROPERLY BALANCE PSE'S ENTITLEMENT TO PRUDENT, REASONABLE COST RECOVERY AND CUSTOMERS' NEED FOR JUST AND REASONABLE PRICES?

A. No. The proposed ERF distorts the transparency of PSE's earnings during the ERF period. The settlement allows for waiving the requirement to file a general rate case within three years as required by the Purchase Cost Adjustment ("PCA") mechanism and allows PSE to forgo filing a rate case before April 1, 2015. However, the settlement also includes provisions for decoupling mechanisms, power cost only rate filings, and allows PSE to continue approved cost deferrals and to also seek new deferrals as needed.

Combined, the rate moratorium and these settlement regulatory mechanisms do not provide for a transparent assessment of PSE's earned return on equity nor cost of service during the rate moratorium. This lack of assurance that rates are no higher than necessary to permit PSE to recover its reasonable and prudent cost of service, is a material deficiency in the proposed ERF settlement.

Q. DO YOU BELIEVE THAT THE COMPANY'S PROPOSED REVENUE DEFICIENCY IS REASONABLE?

A. No. Table 2 below summarizes the necessary adjustments that will reduce the Company's proposed ERF revenue deficiency from $32.2 million to $11.9 million.

TABLE 2

ERF Revenue Deficiency
(Electric)
(Millions)

Description	**Amount**
PSE	$32.20
Adjustments:	
Rate of Return	$11.00
Pension Expense	2.60
Incentive Compensation	3.24
Effective Tax Rate	3.45
Total Adjustments	$20.29
Revised Increase	$11.91

Source: Exhibit No.___(KJB-3), p. 1.

Rate of Return

Q. PLEASE DESCRIBE YOUR PROPOSED RATE OF RETURN FOR PSE IN THESE PROCEEDINGS?

A. I am proposing several adjustments to the development of PSE's rate of return. These adjustments include: (1) capital structure adjustments to reflect the Company's actual capital structure for regulated utility operations; and (2) a proposed return on equity of 9.30%, which is a reduction from PSE's requested 9.80% return on equity approved in PSE's last general rate case.

Q. WHAT IS THE REVENUE REQUIREMENT IMPACT OF THESE RATE OF RETURN ADJUSTMENTS?

A. PSE's rate of return is reduced from its proposed 7.80% to 7.60%. This reduced return reduces PSE's claimed electric revenue requirement by $11.0 million (as developed on my Exhibit No.___(MPG-4)).

Capital Structure

Q. WHAT CAPITAL STRUCTURE IS THE COMPANY PROPOSING TO USE IN THIS REGULATORY PROCEEDING?

A. PSE's ERF revenue requirement is based on the capital structure approved in its last rate case – Order 08, in Dockets UE-111048 and UG-111049. This capital structure is shown below in Table 3.

TABLE 3

PSE's Proposed
Capital Structure

Description	**Percent of Total Capital**
Short-Term Debt	4.0%
Long-Term Debt	48.0%
Common Equity	48.0%
Total Regulatory Capital Structure	100.0%

Sources: Dockets UE-111048 and UG-111049 (consolidated); Order 08; May 7, 2012 at 34.

Q. DOES THE CAPITAL STRUCTURE LAST USED TO SET PSE'S RATE OF RETURN REFLECT ITS ACTUAL CAPITALIZATION MIX IN THIS PROCEEDING?

A. No. PSE's actual common equity ratio has been approximately 46% for the last two years. The capital structure used to set rates in PSE's last rate case was a hypothetical capital structure that included a larger common equity ratio than PSE's actual capital structure mix. PSE has not increased its common equity ratio during the period rates were in effect since the last rate case. In its final order the Commission stated the following:

> We dispense with this second line of argument by observing that there is a range of reasonable outcomes within which PSE's current, hypothetical capital structure may fall, as Staff and ICNU contend. PSE's proposed hypothetical capital structure in this case also falls within what we determine to be a reasonable range. Moreover, we have no reason to doubt at this juncture Mr. Gaines's testimony that what the Company proposes here is the most likely actual capital structure during the rate year. Should this turn out not to be true, a contrary

> result may be taken into account when the Commission evaluates evidence presented in PSE's next general rate case.[1/]

Since PSE failed to increase its common equity ratio, I believe it is inappropriate to continue to use a hypothetical capital structure to set its rate of return. Therefore, I recommend the use of PSE's actual capital structure to set its rates.

Q. WHY DO YOU BELIEVE THAT PSE HAS NOT INCREASED ITS COMMON EQUITY RATIO SINCE ITS LAST RATE CASE?

A. My Exhibit No.___(MPG-5) shows PSE's historical capital structure on a quarterly basis as recorded on its FERC Form 1 over the period March 31, 2011 through December 31, 2012. During this time period, PSE increased its common equity ratio from 45.7% at year-end 2011, up to 46.07% at year-end 2012. The only exception is the second quarter of 2011, when the common equity ratio reached 48.07%. This increase reflected an approximate $182 million increase in common equity.

During this same time period, PSE's long-term debt balance did not increase, and its short-term debt balance increased by approximately $156 million. PSE's balance sheet indicates that the increase in common equity was attributable almost exclusively to retained earnings, as shown on my Exhibit No.___(MPG-6). During that time period, PSE's retained earned balance increased by $186.7 million.

While PSE did increase its common equity ratio by retaining earnings, it is important to note that this buildup in retained earnings was accomplished while PSE was paying out approximately 80% of its earnings during this time period. Hence, while it was retaining some earnings, its payout ratio to its holding company was still relatively high. PSE's detail of its common equity component and its cash flow

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[1/] WUTC v. PSE, Docket Nos. UE-111048/UG-111049, Order 08 ¶ 55 (May 7, 2012) (emphasis added).

statements supporting the buildup in its common equity and its retained earnings are shown on pages 1 and 2 of my Exhibit No. ___(MPG-6).

Q. DID PSE PROVIDE ITS CURRENT CAPITAL STRUCTURE BASED ON THE MOST RECENT DATA AVAILABLE?

A. Yes. Ms. Katharine J. Barnard provided a capital structure consisting of 2.2% short-term debt, 49.1% of long-term debt and 48.7% common equity. This capital structure is based on PSE's Commission-Basis Report ("CBR") for the 12-month average period ending December 31, 2011, which is presented on page 3 of her Exhibit No.___(KJB-7).

Q. IS THIS COMMISSION-BASIS REPORT BASED ON PSE'S ACTUAL CAPITAL STRUCTURE?

A. Yes. However, there is a mismatch between page 3 and page 8 of Ms. Barnard's Exhibit No.___(KJB-7). On Ms. Barnard's Exhibit No.___(KJB-7), page 3, she includes $3,476 million of common equity at year-end 2011. However, on page 8, where she presents PSE's balance sheet, it shows a common equity balance of $3,220 million at year-end 2011.[2/] As such, the year-end capital structure presented by Ms. Barnard reflects approximately $255.8 million <u>more</u> common equity than PSE has actually recorded on its 2011 balance sheet.

Q. HOW WILL THE CAPITAL STRUCTURE PRESENTED ON PAGE 3 OF EXHIBIT NO.___(KJB-7) CHANGE IF THE CORRECT COMMON EQUITY BALANCE IS APPLIED?

A. Reflecting the amount of common equity supported by FERC Form 1 financials which also matches the balance sheet presented on page 8 of Exhibit No.___(KJB-7) will result in a capital structure consisting of 46.7% common equity, which is very close to PSE's actual common equity ratio in 2012.

[2/] Exhibit No.___(KJB-7), page 8.

Q. WHAT CAPITAL STRUCTURE DO YOU PROPOSE IN THIS REGULATORY PROCEEDING?

A. As shown in Exhibit No.___(MPG-7), my proposed capital structure reflects PSE's actual capital at December 31, 2012. However, PSE's short-term debt amount tends to fluctuate throughout the year. Therefore, I used the four quarters average for 2012.

My recommended capital structure is shown in Table 4 below.

TABLE 4

ICNU Proposed Capital Structure
(December 31, 2012)

Description	Percent of Total Capital
Short-Term Debt	1.65%
Long-Term Debt	51.71%
Common Equity	46.64%
Total Regulatory Capital Structure	100.00%

Source: Exhibit No.___(MPG-7).

Cost of Debt

Q. WHAT IS THE COMPANY'S PROPOSED COST OF DEBT?

A. PSE's approved cost of debt for short-term and long-term debt is 2.68% and 6.22%, respectively.[3/] However, it is my understanding that the Company is proposing to update its costs of borrowing, which should be reflected in the overall rate of return used to determine the revenue requirements in this regulatory proceeding.[4/]

[3/] Order 08 ¶ 92.
[4/] Exhibit No.___(KJB-1T) at 2.

Q. DOES PSE'S PROPOSED OVERALL RATE OF RETURN OF 7.80% REFLECT ITS ACTUAL COST OF DEBT AT YEAR-END 2012?

A. No. Since the ERF is based on a four-year period, there are several debt issuances which will mature and be refinanced at a lower market cost of debt during these time periods. These debt issuances include the following:

1. A $10 million series with an interest rate of 7.35% which will mature in September 2015.
2. A $2 million debt issue with an interest rate of 7.36% which will also mature in September 2015.
3. A $150 million debt issue with an interest rate of 5.197% that will retire in October 2015.
4. A $3 million issue that will retire in August 2013.
5. A $10 million issue that will retire in October 2013.

Q. WHAT EMBEDDED COST OF DEBT DO YOU PROPOSE TO USE TO SET PSE'S RATE OF RETURN FOR THE ERF?

A. I have not reprised the projected debt maturities, but I strongly recommend that the Commission request the Company to present supporting documentation on how it intends to replace the maturing debt issuances and update its embedded cost of long-term debt. In addition, the Commission should direct the Company to update its cost of short-term debt.

Return on Equity

Q. WHAT IS THE COMPANY'S PROPOSED RETURN ON EQUITY?

A. PSE is proposing to use a return on equity of 9.80% as approved in its last rate case, which is above its current market costs.

Q. WHY DO YOU BELIEVE THAT THE APPROVED RETURN ON EQUITY OF 9.80% EXCEEDS THE CURRENT MARKET COST FOR PSE?

A. Market costs of capital have declined since PSE's last general rate case. This is illustrated by a comparison of bond yields in this case and in PSE's last rate case. In Table 5 below, I show the change in utility bond yields.

TABLE 5

Capital Costs – PSE's Rate Cases

Description	Current Case [1/]	Docket No. UE-111048	Yield Change
"A" Rated Utility Bond Yields	4.14%	4.40%	-0.26%
"Baa" Rated Utility Bond Yields	4.67%	5.08%	-0.41%
13-Week Period Ending	04/19/2012	05/04/2012	

Source:
[1/] Exhibit No.___(MPG-20), page 1.

As shown in the table above, the current market cost of debt for "A" and "Baa" (by Moody's) rated utility bond yields has decreased in this case relative to PSE's last rate case. The current "A" rated utility bond yields is approximately 25 percentage points lower now than it was in PSE's last rate case. Similarly, the current "Baa" rated utility yield is approximately 40 basis points lower today.

Hence, the decline in utility bond yields suggests that PSE's current capital cost should be much lower today than it was at the time the final order in the last rate case was issued.

Q. HAVE YOU ESTIMATED PSE'S CURRENT MARKET COST OF COMMON EQUITY?

A. Yes. I estimate PSE's current market cost of equity to be 9.30%. In determining PSE's current market cost of capital, I developed a proxy group of comparable risk electric utility companies to that of PSE. From this proxy group, I estimated a discounted cash flow ("DCF"), capital asset pricing model ("CAPM") and risk premium market return estimate based on today's market conditions. As part of my estimated return on equity, I also looked at current interest rates and considered the Company's credit standing. All of this information allowed me to reasonably estimate PSE's current market cost of equity. My return on equity study is provided in my Exhibit No.___(MPG-3) to this testimony.

Q. PLEASE DESCRIBE THE RETURN ON EQUITY STUDY INCLUDED IN YOUR EXHIBIT NO.___(MPG-3).

A. I have separated my return on equity study from my response testimony to allow for a more direct flow of my comments concerning the ERF. In Exhibit No.___(MPG-3), I perform a rate of return study used to estimate PSE's current market cost of equity. In that study, I identify a group of publicly traded proxy companies reasonable in investment risk to PSE. I then perform three versions of the DCF study, a risk premium study and a CAPM study. The results of these studies are summarized in Table 6 below, which is also offered in Exhibit No.___(MPG-3).

TABLE 6

Return on Common Equity Summary

Description	**Current Results**
DCF	9.30%
Risk Premium	9.30%
CAPM	8.40%

As shown above in the table, based on these methodologies, PSE's current market cost of equity is approximately 9.30%.

Pension

Pension Expense

Q. HOW HAS PSE DETERMINED THE LEVEL OF PENSION EXPENSE?

A. PSE has determined its pension expense based on an average of the actual cash contributions for the four years ending June 30, 2009, through 2012.

Q. DO YOU BELIEVE THE USE OF THIS FOUR-YEAR AVERAGE RESULTS IN A REASONABLE LEVEL OF PENSION EXPENSE?

A. No. As shown in the table below, the 2009 and 2010 contribution levels are significantly higher than the 2011 and 2012 amounts. The four-year average amount during the 2009 through 2012 period of $17.8 million is over 50% higher than the current 2012 level. As a result, the amount proposed by PSE is overstated and is not indicative of the current contribution levels.

TABLE 7

Pension Contribution

Year	Contribution ($ Million)
2009	$30.5
2010	$24.4
2011	$ 5.0
2012	$11.4

Source: Exhibit No.___(KJB-1T) at 25.

Q. HAS PSE PROVIDED AN EXPLANATION FOR WHY THE SIGNIFICANTLY HIGHER LEVELS OF PENSION CONTRIBUTION IN 2009 AND 2010 SHOULD BE CONSIDERED?

A. No.

Q. WHAT RECOMMENDATIONS ARE YOU MAKING REGARDING THE APPROPRIATE LEVEL OF PENSION EXPENSE?

A. I recommend using the most current level of contributions and have reduced PSE's pension expense calculations to reflect the amount experienced in 2012. The result of this calculation is a $2.6 million reduction to the revenue requirement for electric and a reduction of $1.3 million for gas.

Other Revenue Requirement Issues

Incentive Compensation

Q. HOW HAS PSE DETERMINED THE LEVEL OF INCENTIVE COMPENSATION?

A. PSE restated expense based on a four-year average of the incentive compensation payouts during 2009 through 2012. In addition, PSE removed the incentive compensation payouts for executives.

Q. DO YOU HAVE CONCERNS ABOUT THE LEVEL OF INCENTIVE COMPENSATION?

A. Yes. Both PSE and the Staff have provided testimony regarding lower levels of earnings. In addition, the Global Settlement Agreement includes non-traditional measures that attempt to improve earnings. However, the amount of the incentive compensation payout during 2012 is the highest level experienced during the 2008 through 2012 period. I do not believe it is reasonable or consistent to express concerns regarding earnings and propose a new regulatory scheme to address the situation, while increasing discretionary incentive compensation expense to the highest levels in recent history.

Q. ARE INCENTIVE COMPENSATION PAYOUTS CERTAIN TO EXIST AS AN ONGOING EXPENSE?

A. No. In its 2011 rate case, UE-111048/UG-111049, PSE witness Thomas M. Hunt discussed the Company's incentive compensation plan and its reliance on both operational and service quality goals and financial performance goals. Thresholds for both types of goals must be met to trigger any incentive compensation funding. Therefore, the ongoing existence of incentive compensation expense is not certain to occur in the future.

Q. IN YOUR PREVIOUS ANSWER YOU REFERRED TO FINANCIAL GOALS. DO YOU HAVE ANY CONCERNS REGARDING INCLUDING INCENTIVE COMPENSATION EXPENSES IN RATES WHICH ARE BASED ON ACHIEVING FINANCIAL GOALS?

A. Yes. A company's profits are the property of its shareholders, and management has a fiduciary duty to shareholders. These types of incentives may lead to decisions which are contrary to providing safe and adequate service in the pursuit of boosting company profits. Therefore, financial goals are generally seen as much more beneficial to shareholders.

In addition, PSE's overall financial results can be significantly influenced by situations that are far beyond the control of individual, or teams of employees. Examples of these items are variations in weather, as well as changes in the national economy.

Q. DOES PSE RECOGNIZE THE BURDEN INCENTIVE COMPENSATION PLACES ON CUSTOMERS?

A. Yes. In recognition of the hard economic times in the communities it serves, PSE has eliminated incentive compensation paid to officers from the cost of service.[5/]

Q. WHAT IS YOUR RECOMMENDATION REGARDING INCENTIVE COMPENSATION?

A. I believe that the uncertainty of the ongoing existence of incentive compensation expense and the burden this type of expense places on customers support the total elimination of incentive compensation expense from the cost of service. However, in addition to eliminating the officers' incentive compensation, I recommend eliminating all awards which are the result of achieving financial goals. This recommendation recognizes the portion of the plan that rewards employees for achieving specific operational and service quality goals and further reduces the burden on customers.

Eliminating incentive compensation in its entirety reduces the electric revenue requirement by $6.5 million and $3.3 million for gas. As a placeholder, I recommend reducing revenue requirement by 50% of these levels.

[5/] Exhibit No.___(KJB-1T) at 24.

Effective Tax Rate

Q. PLEASE EXPLAIN THE EFFECTIVE TAX RATE ISSUE.

A. PSE has increased its cost of service to recognize a 36% effective tax rate. However, the net operating income for all of its adjustments, as well as the tax conversion factor have been calculated using the statutory marginal federal income tax rate of 35%.

Q. HAS PSE ADEQUATELY EXPLAINED THE USE OF THIS EFFECTIVE TAX RATE?

A. No. Company witness Katherine J. Barnard's testimony at page 21, regarding the impact of flow through taxes, does not explain the use of a rate that is higher than the statutory marginal federal income tax rate of 35%.

Q. ARE YOU PROPOSING AN ADJUSTMENT TO PSE'S CALCULATIONS?

A. Yes. I have reduced the tax rate used in PSE calculation to 35% to reflect the statutory marginal federal income tax rate. This adjustment to PSE's calculations reduces the electric revenue requirement by $3.45 million for electric and $1.66 million for gas.

Global Settlement Components

Q. PLEASE EXPLAIN THE RATE CHANGES THAT CAN OCCUR ACCORDING TO THE GLOBAL SETTLEMENT.

A. The Global Settlement includes a rate plan that allows an annual increase in electric and gas delivery revenues of 3% and 2.2%, respectively. In addition, a decoupling component allows deferral of any over or under collection of electric and delivery charges. According to the Global Settlement, PSE will not file a general rate case before April 1, 2015, and will file a rate case no later than April 1, 2016, unless agreed to by the parties. PSE may file sooner than April 1, 2015, as a result of circumstances beyond its control.

Q. ARE EARNINGS REVIEWED ANNUALLY?

A. Yes. Earnings are reviewed annually in comparison to PSE's authorized rate of return. If this review shows that PSE is earning .25% over its authorized rate of return, the Company is required to refund half of the overearnings.

Q DOES THE GLOBAL SETTLEMENT ALLOW PSE THE ABILITY TO SEEK RATE INCREASES THROUGH EXISTING RIDERS AND TRACKERS AND CONTINUE ALL APPROVED DEFERRAL MECHANISMS?

A. Yes. In addition to continuing the tracker, rider and deferral mechanisms already in place, the Global Settlement authorizes a new tracker for property taxes. The Global Settlement also waives the requirement for PSE to file a general rate case within three months of the effective date of any rate increase resulting from a Power Cost Only Rate Case ("PCORC").

Q. DO YOU HAVE CONCERNS WITH THE PROVISIONS OF THE GLOBAL SETTLEMENT?

A. Yes. I believe the Global Settlement does not maintain adequate consumer protections and shifts additional risk from shareholders to ratepayers. In addition, while the Global Settlement may reduce the number of general rate cases, it may result in more rate increases.

Q. HOW DOES THE GLOBAL SETTLEMENT REDUCE CONSUMER PROTECTION?

A. The Global Settlement reduces consumer protection by creating a regulatory scheme that increases and/or allows for increases in rates without using the following established procedures. The Global Settlement provides for automatic increases in rates without the examination conducted during a general rate case. The Global Settlement also waives the requirement for PSE to file a general rate case within three months of the effective date of any rate increase resulting from a PCORC.

Q. HOW DOES THE GLOBAL SETTLEMENT SHIFT RISK?

A. The Global Settlement establishes a new tracker for property taxes and places no restrictions on PSE from seeking to establish other new cost recovery mechanisms. Such mechanisms shift the risk of non-recovery of cost from the shareholder to the ratepayer by establishing a process that allows future recovery of costs incurred between general rate cases through tracking and deferral with interest.

Q. HOW WILL THE GLOBAL SETTLEMENT POTENTIALLY RESULT IN MORE RATE INCREASES?

A. The Global Settlement provides for automatic annual rate increases. It also does not restrict the ability of PSE to increase rates through the currently approved deferrals and trackers, or to seek new mechanisms which allow recovery of costs between general rate cases. In addition, waiving the general rate case restriction invites additional PCORC filings.

DECOUPLING MECHANISM PETITION

Q. HAVE YOU REVIEWED PSE'S AMENDED PETITION FOR DECOUPLING MECHANISMS?

A. Yes.

Q. PLEASE SUMMARIZE THE MODIFIED REVENUE DECOUPLING MECHANISM ("RDM") PROPOSED BY PSE IN THIS CASE.

A. First, PSE's RDM multiplies the Company's rate year allowed delivery revenue per customer (which is increased annually by a pre-established K-factor) by the forecasted number of customers to derive the rate year allowed delivery revenue. After adding decoupling deferrals from prior periods and subtracting basic charge revenues, this figure is divided by projected rate year sales to calculate the rate year allowed revenue per unit ("RPU"). The rate year RPU is then subtracted from the test year RPU to develop the decoupling charges. Under PSE's proposal, separate RDM charges would be calculated on an annual basis for two distinct rate groups: residential and non-residential. The RDM would also allow PSE to reconcile and defer the difference between actual and allowed RDM revenues (plus interest) for recovery in future decoupling charges.

Other noteworthy elements of PSE's proposal include a 3% "soft cap" on total annual rate increases by rate group (residential and non-residential), along with an earnings test that provides for an earnings rebate to customers if the Company's actual rate of return exceeds its approved rate of return by more than 25 basis points.[6/]

Q. SHOULD THE COMMISSION APPROVE PSE'S RDM PROPOSAL?

A. No. For the reasons described in the balance of my testimony, the Commission should reject revenue decoupling in this proceeding. If the Commission allows PSE to implement the RDM, it should only allow recovery of volumetric base revenues that are lost due to the Company's mandated energy efficiency programs.

Q. AS A MATTER OF POLICY, DO YOU BELIEVE REVENUE DECOUPLING IS WARRANTED FOR PSE?

A. No. Revenue decoupling is an inappropriate and unwarranted departure from traditional ratemaking principles. In addition, revenue decoupling should be rejected because it would:

- Frustrate the voluntary efforts of customers to reduce energy consumption;
- Transfer traditional utility business risks to customers;
- Reduce the Company's motivation to be responsive to the needs of its customers; and

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6/ WUTC v. PSE, Docket Nos. UE-121697/UG-121705, Exhibit No. __(JAP-9) (Mar. 1, 2013); Exhibit No. __(JAP-10).

- Create unnecessary rate volatility and uncertainty

I will elaborate on each of these points in the balance of my direct testimony on this topic.

Q. PLEASE EXPLAIN WHY THE RDM REPRESENTS A DEPARTURE FROM TRADITIONAL RATEMAKING PRINCIPLES.

A. Under the traditional ratemaking process, the Commission establishes the Company's revenue requirement in a base rate case by relying on a snapshot of the Company's costs and revenues for a given test year. The revenue levels are derived using the Company's test year sales levels, adjusted for weather and other known and measurable changes.

Once base rates are set to recover the allowed test year revenue requirement, these rates traditionally remain fixed until the next base rate case. The Company's shareholders bear the risk that earnings could be adversely impacted between base rate cases due to increases in costs or a reduction in revenues. Conversely, the Company's shareholders benefit if PSE can successfully reduce costs or increase revenues between base rate cases. This creates a powerful incentive for the Company's management to operate cost-effectively and to promote economic development in its service area, because economic growth results in increased revenues that improve the Company's bottom line between base rate cases.

Revenue decoupling dramatically alters the traditional ratemaking process by allowing the Company to automatically adjust its base rates outside of a base rate case to reflect the impact of changing sales levels over time. In contrast to the strong economic incentives associated with sales growth that are created by the traditional ratemaking process, full revenue decoupling would essentially make the Company's shareholders indifferent to the impact of fluctuations in sales levels in its service area.

Q. CAN REVENUE DECOUPLING DISCOURAGE INDEPENDENT CUSTOMER EFFORTS TO PURSUE ENERGY EFFICIENCY?

A. Yes. The irony of revenue decoupling is that it penalizes customers for undertaking successful, voluntary energy efficiency efforts by increasing their distribution charges when their retail consumption levels decline between base rate cases. This result should be rejected because it creates a disincentive for customers to pursue voluntary energy efficiency measures.

Q. PLEASE EXPLAIN WHY REVENUE DECOUPLING TRANSFERS TRADITIONAL UTILITY BUSINESS RISKS FROM SHAREHOLDERS TO CUSTOMERS.

A. As I discussed above, the traditional base ratemaking process sets a utility's revenue requirement based on the weather-normalized level of test year sales. This approach puts the Company's shareholders at risk for any decline in sales levels between rate cases. This is the case because, all else being equal, a decline in sales translates into reduced revenues relative to the amounts calculated for the test year. Under traditional ratemaking, a decline in sales levels is not recognized in the ratemaking process until the next base rate case.

Revenue decoupling eliminates this traditional business risk by making PSE revenue neutral with respect to fluctuations in sales levels between base rate cases. If sales levels decline between base rate cases, the Company is guaranteed to receive revenues that are based on test year rather on actual sales levels. This approach places customers at risk for rate surcharges due to events that may be entirely outside of their control, such as abnormal weather conditions or a general economic downturn in PSE's service area.

Q. ARE THE UTILITY'S SHAREHOLDERS COMPENSATED FOR BEARING THE RISK OF FLUCTUATING SALES LEVELS UNDER TRADITIONAL RATEMAKING?

A. Yes. Through the Company's allowed rate of return, the Company's shareholders are compensated for the business risks of operating the utility. Among these risks is the exposure to fluctuations in sales levels between base rate cases due to rising electricity prices, abnormal weather, changing economic conditions or other factors. Absent an adequate downward adjustment to the Company's return on equity to reflect the reduced business risks that revenue decoupling would place on PSE, the Company's allowed rate of return would overcompensate the Company's shareholders.

Q. WHY WOULD REVENUE DECOUPLING MAKE THE COMPANY LESS RESPONSIVE TO THE NEEDS OF ITS CUSTOMERS?

A. Revenue decoupling would reduce the Company's financial incentive to promote economic development in its service territory. If the Company is financially neutral with respect to the sales volumes for its product, it follows that it would be less focused on providing quality customer service and accommodating the needs of its customers. Moreover, the Company's management would have a reduced impetus to control its operating costs, because PSE would be fully compensated for any decline in sales that resulted from escalating tariff rates.

Q. PLEASE EXPLAIN HOW REVENUE DECOUPLING WOULD CREATE INCREASED RATE VOLATILITY AND UNCERTAINTY RELATIVE TO TRADITIONAL RATEMAKING.

A. The RDM proposal would calculate the revenue impact of any decline in sales levels and defer these amounts for collection through rate surcharges. Moreover, the proposal would compensate PSE if sales levels decline for any reason, including an economic recession or abnormal weather. If such events produce a dramatic decline in sales levels between base rate cases, this could result in the accumulation of significant deferrals that would be surcharged to customers in future years. Thus, the RDM would expose customers to the risk of significant rate increases, potentially on an annual basis. This contrasts with the situation under traditional ratemaking, in which a retail customer's base rates are fixed between base rate cases.

The rate uncertainty created by the RDM proposal would adversely impact customers by exposing them to a significantly higher level of financial risk, making it much more difficult for them to manage their energy budgets and plan for future power requirements.

Q. HAS THIS RATE VOLATILITY MANIFESTED ITSELF IN PREVIOUS REVENUE DECOUPLING EXPERIMENTS IN WASHINGTON?

A. Yes. Washington experienced problems with rate volatility resulting from the decoupling program it implemented in October 1991 for PSE. The program led to annual rate surcharges in the tens of millions of dollars for each of the five years of program implementation, until the Commission cancelled the program in September 1995.[7/] This experience highlights the significant financial harm that could be produced by the RDM and the magnitude of financial risk that the Company's proposal would transfer to ratepayers.

Q. WOULD THE RATE INCREASE CAP PROPOSED BY PSE IN THIS PROCEEDING FULLY REMEDY THE RATE VOLATILITY CONCERN?

A. No. First, the proposal to cap RDM-driven rate increases at 3% annually by rate group would simply set a ceiling on the magnitude of annual rate increases. While this cap

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7/ WUTC, Docket No. UE-950618, Third Suppl. Order at 3-5 (Sept. 21, 1995).

might limit a customer's maximum exposure to rate increases in a given year, RDM rate increases could nevertheless fluctuate from year to year subject to the cap, resulting in continued exposure to rate volatility. More importantly, PSE's proposed rate cap is a "soft cap," meaning that any RDM surcharge amounts not recovered in a given year due to the operation of the cap would remain in the RDM balancing account and be deferred for recovery in future RDM surcharge filings.[8/] Therefore, PSE's proposal would not limit a customer's true exposure to rate increases resulting from the RDM, but would instead spread the pain of such rate increases over a longer period of time.

Q. IF THE COMMISSION APPROVES THE RDM DESPITE THE CONCERNS DISCUSSED IN YOUR TESTIMONY, WOULD IT BE APPROPRIATE TO EXCLUDE LARGE INDUSTRIAL CUSTOMERS FROM THE OPERATION OF THE MECHANISM?

A. Yes. Large industrial companies operate in competitive global markets and therefore already have a strong economic incentive to pursue independent energy efficiency efforts to reduce their operating costs. Moreover, many industrial companies function in cyclical industries in which sales levels are highly susceptible to shifts in global market prices for commodities or raw materials. These commodity price fluctuations can lead to significant declines in retail electric sales volumes to industrial customers that are independent of any energy efficiency programs implemented by PSE. Thus, there is no reason to include large industrial customers in the RDM.

[8/] Exhibit No. __(JAP-9); Exhibit No. __(JAP-10) at 5-6.

Q. DO YOU HAVE ANY OTHER RECOMMENDATIONS IN THE EVENT THE COMMISSION APPROVES PSE'S RDM?

A. Yes. If the Commission approves the RDM proposal, the resultant lowering of PSE's business risk profile should translate into a reduction in the authorized return on equity that the Commission approves in this proceeding.

Q. HAVE OTHER STATE REGULATORY COMMISSIONS RECOGNIZED THAT A DOWNWARD ADJUSTMENT TO A UTILITY'S RETURN ON EQUITY IS APPROPRIATE IF REVENUE DECOUPLING OR SIMILAR POLICIES ARE IMPLEMENTED?

A. Yes. The Connecticut Department of Public Utility Control issued an order which found that the implementation of a revenue decoupling proposal permitted the Department to lower the allowed return on equity for United Illuminating Company.[9/] Moreover, the Missouri Public Service Commission applied an explicit reduction to Missouri Gas Energy's allowed return on equity to recognize the reduced risks associated with the adoption of a straight-fixed variable rate design, which is an alternative approach to achieving the results sought by PSE through the RDM.[10/] Finally, the Indiana Utility Regulatory Commission issued an Order that stated the following on this issue:

> Further, we agree with the OUCC's comments that decoupling mechanisms clearly shift risk from the utility to ratepayers, and that reduction of risk should be considered in determining the appropriate return on equity of for-profit gas utilities.[11/]

9/ Connecticut Department of Public Utility Control, Docket No. 08-07-04, *Application of the United Illuminating Company to Increase its Rates and Charges*, Decision at 123 (Feb. 4, 2009).

10/ Missouri Public Service Commission, Case No. GR-2006-0422, *In the Matter of Missouri Electric Energy's Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area*, Report and Order at 31 (Mar. 22, 2007).

11/ Indiana Utility Regulatory Commission, Cause No. 43180, Order at 10 (Oct. 21, 2009).

Q. IF THE COMMISSION ALLOWS PSE TO IMPLEMENT REVENUE DECOUPLING, SHOULD IT ALSO LIMIT THE NUMBER OF OTHER RATE ADJUSTMENT MECHANISMS THAT THE COMPANY CAN APPLY?

A. Yes. Rate adjustment mechanisms increase financial risk and rate volatility for customers by giving the Company additional avenues to increase customer rates between base rate cases. Thus, additional adjustment mechanisms would only heighten the already high level of risk that would be imposed on customers via the RDM. Therefore, it is vital to control the proliferation of other rate mechanisms that could impose additional rate surcharges on the Company's customers outside of a base rate case.

Q. DO YOU HAVE A RECOMMENDED DECOUPLING RELATED REDUCTION FOR PSE'S RETURN ON EQUITY?

A. I have testified in the past that a .25% return on equity reduction is at minimum appropriate. Given the expedited nature of this case, time did not permit a thorough analysis.

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS WITH RESPECT TO THE REVENUE DECOUPLING PROPOSAL SUBMITTED BY PSE IN THIS CASE.

A. The Commission should reject PSE's RDM proposal. Revenue decoupling should be rejected because it unjustifiably departs from traditional ratemaking principles, frustrates voluntary conservation efforts, transfers business risks to customers, makes the Company less responsive to customer needs and increases rate volatility and uncertainty. In addition, ICNU witness Michael Deen provides further testimony of why this decoupling proposal should be rejected.

If the Commission nevertheless determines that a revenue decoupling mechanism is warranted, RDM surcharges should be permitted only where there is evidence of a decline in the absolute level of PSE's sales by rate class. Furthermore, the mechanism should exclude the revenue impact of voluntary customer efforts to reduce load and the impact of any voluntary Company expansion of its energy efficiency programs beyond the levels required by the Commission.

If the RDM is authorized, the Commission should also reduce PSE's allowed return on equity to recognize the lower business risks that the Company's shareholders face when revenues are decoupled from sales levels. Finally, as Mr. Deen explains, a well-crafted, balanced, limited decoupling mechanism could be supported by ICNU.

Q. DOES THIS CONCLUDE YOUR RESPONSE TESTIMONY?

A. Yes, it does.