

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND	)	DOCKET NOS.
TRANSPORTATION COMMISSION,	)	UE-170033 & UG-170034 (Consolidated)
	)	
Complainant,	)	NORTHWEST INDUSTRIAL GAS
	)	USERS' INITIAL POST-HEARING
v.	)	BRIEF
	)	
PUGET SOUND ENERGY,	)	
	)	
Respondent.	)	
	)	

---

October 18, 2017

## I. INTRODUCTION

1. Pursuant to Administrative Law Judge Moss's ruling in this matter on September 29, 2017, Northwest Industrial Gas Users ("NWIGU") submits this Initial Post-hearing Brief.
2. NWIGU is a party to the multi-party Settlement Stipulation and Agreement ("Settlement") in this docket. NWIGU supports the Settlement as a fair resolution of the issues presented because it results in a net revenue requirement decrease of approximately 3.8% for gas services compared to rates paid by customers today.<sup>1</sup> The Settlement does not, however, resolve all of the issues NWIGU litigated during this proceeding. This Initial Post-hearing Brief addresses both (a) the Settlement and (b) the gas cost of service and rate spread issues that were not resolved as part of the Settlement.
3. The parties in this docket have presented the Washington Utilities and Transportation Commission ("Commission") with competing methodologies for performing a cost of service study. Puget Sound Energy ("PSE") and Commission Staff ("Staff") have conflicting cost of service studies in the record, and both request a rate spread that would shift the burden of cost recovery more heavily to large high load factor transportation customers. The conflicting cost of service studies PSE and Staff rely on, however, are flawed, double counting the average component of the Peak and Average allocator used to allocate costs to customer classes, and failing to recognize that industrial rate schedules are already out of parity and over-recover from some customers. In contrast, NWIGU presented to the Commission a cost of service study, through its expert witness Brian Collins, that is fair and better reflects traditional cost-causation principles of ratemaking. Although NWIGU's cost of service methodology and rate spread recommendation are defensible, NWIGU recommends the Commission not adopt any specific methodology in this

---

<sup>1</sup> Exhibit No. BMG-17T at 3.

case and, instead, apply any rate changes in this case on an equal percent of margin basis. Much of the disparity between the various cost of service studies in the record can be traced to the fact that it has been decades since this Commission has analyzed the principles that should be used for cost of service studies. NWIGU's suggested approach will maintain the status quo and allow all parties the opportunity to continue participating in the generic proceeding the Commission initiated last year to develop clear guiding principles for cost of service studies to be used in future rate cases.

4. A dispute also remains over whether the Commission should use this general rate case proceeding as a basis for dramatically altering the treatment of the Special Contract class of gas customers. Staff recommends that PSE shareholders absorb imputed revenue to bring the Special Contract class to "full cost of service," or, in the alternative, to increase Special Contract revenues by a staggering 58.83%.<sup>2</sup> Staff's recommendation is based on the assertion that the rates paid by the Special Contract class are not consistent with WAC 480-80-143, which Staff believes requires the Special Contract class to recover its full cost of service.<sup>3</sup>

5. Staff has not presented substantial evidence on which the Commission can rely to determine that the Special Contract class revenues are insufficient to yield reasonable compensation for the service rendered. Moreover, Staff's position misinterprets WAC 480-80-143 as requiring PSE to demonstrate that the Special Contract class achieves full cost recovery of all fixed and variable costs based on an embedded cost of service study. The applicable rule requires the Commission to evaluate Special Contracts during an approval process. Contrary to Staff's assertion, the rule does not require full cost recovery from Special Contract customers. Instead, as part of the contract approval process, the Commission must determine that a Special

---

<sup>2</sup> Exhibit No. JLB-8T at p.4-6.

<sup>3</sup> Exhibit No. JLB-8T at p.3.

Contract covers the variable (or incremental) cost to serve the customer, and in addition, makes some contribution to the local distribution company (“LDC’s”) fixed costs (those costs that exist independently of the Special Contract customer’s presence on the system). The contribution to fixed costs should be viewed over the entire term of the Special Contract.

6. Even if re-evaluation of the Special Contract class is appropriate for this proceeding, which it is not, the record is clear that the Special Contract class is recovering all of the variable costs to serve the class and is also providing a significant annual contribution to PSE’s fixed costs. The existence of the Special Contract class benefits all PSE customers, is in the public interest, and does not require modification by the Commission.

## II. ARGUMENT

### A. The Commission Should Approve the Settlement.

With respect to gas service, NWIGU is supportive of the Settlement because it results in a reasonable resolution of revenue requirement issues. The Settlement will result in a net revenue requirement decrease of approximately 3.8% for gas services, compared to current rates. In contrast, PSE’s supplemental filing requested a decrease of only 3.2%, compared to current rates. The larger rate reduction proposed in the Settlement represents approximately \$5 million in savings to gas customers, and NWIGU is supportive of the reasonableness of that result.<sup>4</sup> NWIGU respectfully requests that the Commission approve the Settlement as the resulting rates are fair, just and reasonable.

---

<sup>4</sup> Exhibit BGM-17T at 3.

**B. Cost of Service.**

7. A fundamental principle of setting rates is to design rates that accurately reflect the actual cost to serve customers consistent with principles of cost causation. An appropriate rate will provide customers with clear price signals for making economic consumption decisions.
8. In support of its proposed rates, PSE developed a proposed class rate spread based on a class cost of service study as described in the testimony of PSE witness Mr. Jon Piliaris.<sup>5</sup> PSE uses the “Peak and Average” distribution main cost allocation method in its proposed class cost of service study. Based on that cost allocation method, PSE asserts that the Commercial and Industrial class (Schedule 31, 31T), the Large Volume class (Schedule 41, 41T), the Interruptible class (Schedule 85, 85T), the Non-Exclusive Interruptible class (Schedule 87, 87T) and the Special Contract class are providing margin revenue to PSE at less than their respective costs of service, and that other customer classes (Residential Schedules 16, 23, 53, Limited Interruptible Schedules 86, 86T, and Rentals) are subsidizing that service.<sup>6</sup> PSE’s proposed rate spread, however, does not attempt to bring all customer classes to cost of service and, instead, moves Schedules 31, 31T, 41, 41T, 85, 85T, 87, 87T, and Special Contracts closer to their calculated costs of service, while maintaining calculated “subsidies” for other classes as measured by its flawed cost of service study.<sup>7</sup>
9. Staff also performed a class cost of service study. Staff rejected PSE’s use of design day demand for the peak component of PSE’s peak and average allocation factor used in its class cost of service study to allocate the costs of distribution mains.<sup>8</sup> This approach, however, makes

---

<sup>5</sup>Exhibit No. JAP-54T at p.7, line 20 to p.8, line 10.

<sup>6</sup>Exhibit No. JAP-1T at p.43, lines 6-18.

<sup>7</sup> Exhibit No. JAP-1T at p88; *see also* BCC-4.

<sup>8</sup> Exhibit No. JLB-1T at p10, line 20 to p.12, line 8.

the flawed peak and average methodology worse. Under Staff's approach, Staff would replace class design day demands used in the cost allocation process with actual class loads, to allocate peak demand costs.<sup>9</sup> According to the rebuttal testimony of Mr. Piliaris, such an approach

“would tip the scales strongly in favor of allocating substantially all of PSE's distribution mains costs solely on the way the system is currently being used, rather than on the basis of how the cost were incurred in the first place (i.e., based on design day planning criteria). One only has to note that actual peak demands have recently been approximately one-third lower than design day peak levels to realize that PSE is not planning, nor investing, on these historically low actual levels.”<sup>10</sup>

By not using design day demands for allocating the costs of distribution mains, Staff's approach does not best reflect cost causation because it does not reflect how PSE incurs the cost of distribution mains. PSE incurs these costs by designing and constructing its system of mains to meet the coincident system design day demand of its classes.

10. PSE's and Staff's cost of service studies each are flawed. As described in the testimony of NWIGU expert Mr. Collins, PSE used a methodology, the Peak and Average method, that overstates the cost to serve industrial customers. NWIGU's expert utilized a methodology that more appropriately ties the cost to serve industrial customers to their actual use of PSE's system. Specifically, NWIGU's expert allocated the cost of distribution mains based on class peak responsibility, which allocates capacity-related costs based on the coincident demands of the various classes expected on the design day peak.<sup>11</sup> Such an allocation more accurately reflects cost causation, and as a result, produces better price signals and encourages customers to make economic consumption decisions.<sup>12</sup>

---

<sup>9</sup> *Id.*

<sup>10</sup> Exhibit No. JAP-46T at p.76, line 11 to p.77, line 1.

<sup>11</sup> Exhibit No. BCC 1-T at p.3, lines 12-27.

<sup>12</sup> Exhibit No. BCC 1-T at p.16, lines 3-14.

11. NWIGU's methodology allocates a significant portion of the total fixed cost of the gas distribution system based on design peak day contribution because the size of the distribution system is dictated by the expected peak demand.<sup>13</sup> That is, PSE incurs costs by building its system to meet its expected peak demand, which typically occurs on cold winter days. The allocation method used by Staff and PSE masks the reality of cost causation by instead allocating a significant portion of fixed costs based on the volumetric take of each customer class.<sup>14</sup> Because the distribution system is planned to meet the expected class peak demands for gas supply, Staff's and PSE's approach understates the cost of actually serving low load factor customers on those peak cold winter days.<sup>15</sup>

12. Although NWIGU's cost of service methodology is defensible, NWIGU recommends the Commission not adopt any specific methodology in this case and, instead, apply any rate changes in this case on an equal percent of margin basis. In the last Avista general rate case, the Commission agreed to open a generic proceeding to investigate the appropriate methodology the Commission should use for cost of service.<sup>16</sup> This generic proceeding is ongoing and the parties are committed to participating in that docket. NWIGU's suggested approach will maintain the status quo and allow all parties the opportunity to continue participating in the generic proceeding to help develop clear guiding principles for cost of service studies to be used in future rate cases. NWIGU urges the Commission to therefore rely on the generic proceeding to determine cost of service methodology for Washington LDCs, and not make a decision based on the limited record in this case. This litigated case did not fully explore all the alternative cost of service methods

---

<sup>13</sup> Exhibit No BCC 1-T at p.10, lines 18-27.

<sup>14</sup> Exhibit No. BCC 1T at p.6, line 26 to p.7, line 7.

<sup>15</sup> Exhibit No. BCC 1T at p.13, lines 19-26.

<sup>16</sup> *Washington Utilities and Transp. Comm'n v. Avista Corp.*, Dockets UE-160228 and UG-160229, Order 06 (Dec. 15, 2016) at ¶¶94-100.

employed to allocate fixed costs in the natural gas distribution business. Because of the disparities in the methodologies and the dispute over the outcome of PSE's cost of service study, which informed the proposed rate spread, the most reasonable approach for the Commission in this case is to maintain the status quo and apply rate changes on an equal percent of margin basis.

**C. The Commission Should Reject Staff's Proposed Treatment of Special Contract Customers.**

**1. Legal Standard**

13. The Commission is charged by statute with the responsibility of regulating in the public interest. In the context of setting rates for electric and natural gas companies, this responsibility is reflected by the Commission's specific obligation to set rates that are fair, just, reasonable and sufficient.<sup>17</sup> The fair, just, reasonable and sufficient standard requires the Commission to strike a balance between providing customers the lowest reasonable rates while providing the utility with rates sufficient to cover its prudently incurred costs and an opportunity to recover a return on its investment. In a ratemaking proceeding, the Commission's decisions must be based on substantial evidence in the record.<sup>18</sup> Substantial evidence is "evidence sufficient to persuade a fair-minded person of their truth."<sup>19</sup>

14. The existence of the Special Contract class is a result of WAC 480-80-143, which allows a utility, upon Commission approval, to contract for the retail sale of regulated utility services directly with a customer. Importantly, Commission rules require that Special Contracts: "Demonstrate, at a minimum, that the contract charges recover all costs resulting from providing

---

<sup>17</sup> See e.g. *Washington Utilities and Transp. Comm'n v. Avista Corp.*, Docket UE-050482 and UG-050483, Order No. 05 (Dec. 21, 2005) ("Avista Order 05") at ¶22.

<sup>18</sup> See *Id.*

<sup>19</sup> *PacifiCorp v. Washington Utilities & Transp. Comm'n*, 194 Wash. App. 571, 586 (2016).



the service during its term, and, in addition, provide a contribution to the gas, electric, or water company's fixed costs."<sup>20</sup>

15. RCW 80.28.020 sets forth the specific standard for approving or modifying a Special Contract:

Whenever the commission shall find, after a hearing ... that the rates or charges ... or that the rules, regulations, practices or contracts affecting such rates or charges are unjust, unreasonable, unjustly discriminatory or unduly preferential, or in any wise in violation of the provisions of the law, or that such rates or charges are insufficient to yield a reasonable compensation for the service rendered, the commission shall determine the just, reasonable, or sufficient rates, charges, regulations, practices or contracts to be thereafter observed and in force, and shall fix the same by order.

To satisfy this standard allowing modification of existing Special Contract rates, the Commission must rely on substantial evidence in the record that the existing rates do not yield a reasonable compensation for the service rendered. Pursuant to Commission rules, a Special Contract provides reasonable compensation for the service rendered if it recovers all costs resulting from providing the service during its term, and, in addition, provides some contribution to the gas company's fixed costs.

## **2. Application of Commission Rules**

The Commission originally approved the Special Contract at issue in this case in 1995 as part of Docket UG-950392. Since that time, PSE has filed multiple general rate cases. In all of PSE's general rate case proceedings, which were reviewed by Staff, the Commission's final orders implemented rates charged to the Special Contract class that recovered less than would be recovered if the Special Contract was reviewed under a traditional embedded cost of service analysis. However, in all cases, Special Contract revenues exceeded the variable costs to serve

---

<sup>20</sup> WAC 480-80-143(5)(c).

the customer and also contributed to PSE's fixed costs. Any contribution to PSE's fixed costs is in the public interest because it benefits all other customers on PSE's system.<sup>21</sup>

On May 4, 2009, PSE filed in Docket UG-950392 to extend the term of its gas Special Contract. The Commission approved the extended term on June 11, 2009.<sup>22</sup> The Commission determined that the contract is "fair, just reasonable and sufficient and meets the special contract provisions specified in WAC 480-80-143" and is "consistent with the public interest."<sup>23</sup>

16. Despite these earlier reviews of the rates applicable to the Special Contract class, and the Commission's prior approval after review, Staff now seeks to change the standard applied to the Special Contract class and urges the Commission to either (a) penalize PSE for entering into the Special Contract by forcing PSE shareholders to absorb the difference between the special contract rate and full cost of service, or (b) drastically increase the rates in the contract approved as part of Docket UG-950392.<sup>24</sup> If Staff had any concerns about cost recovery, the most recent docket in which the Commission extended the term of the contract would have been the appropriate time to raise that issue. As explained below, Staff has not presented substantial evidence the Commission can rely on to conclude the Special Contract is not reasonable or in the public interest. Additionally, Staff has not provided any reasonable explanation for its sudden departure from its previous position on Special Contracts in past proceedings. The evidence in the record demonstrates that the Special Contract class still satisfies, and exceeds, the minimum requirements set forth in WAC 480-80-143.

---

<sup>21</sup> In UG-072301, UG-090705, UG-101644, UG-111049 and UG-170034 the Parity Ratio resulting from the final rates approved in each case since PSE's general rate case for the Special Contract class were 95%, 78%, 79%, 72% and 59%, respectively (i.e. the Special Contract class was contributing to fixed costs but not covering its fully allocated costs). *See Exhibit No. JAP-54T at p.9.*

<sup>22</sup> *Washington Utilities and Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket UG-950392, Order Approving Contract (June 11, 2009) ("Puget Order").

<sup>23</sup> *Id.* at ¶6,7.

<sup>24</sup> Exhibit No. JLB-8T at p.4-6.

**a) Standard and Purpose of Special Contracts**

17. The purpose of a Special Contract is to address the unique situation where a customer has a competitive alternative to service from a regulated utility. In the gas context, this usually arises when the customer can bypass the LDC's system and connect directly to the interstate pipeline.<sup>25</sup> By offering a discount from traditional tariff service, the rule recognizes a public benefit to the LDC and its other customers that results from keeping the customer on the system. That benefit is largely in the form of some contribution to fixed costs because the LDC would otherwise have to recover those costs from the rest of the customers on its system.<sup>26</sup> Here, the annual contribution to fixed cost is significant and helps lower the rates for PSE's other customers.
18. The rule expressly requires a showing that some (not all) fixed costs will be recovered in a Special Contract, and it requires the Commission to acknowledge that fact if it approves a contract. Specifically, the Commission must find that the contract demonstrates, "at a minimum, that the contract charges recover all costs resulting from providing the service during its term, and, in addition, provide a contribution to the gas, electric, or water company's fixed costs."<sup>27</sup> Under the plain language of the rule, this standard is met and every other customer on PSE's system is better off if there is even one dollar contributed to fixed costs over the life of the contract.
19. Although Staff relies on this rule to recommend a change in the treatment of the Special Contract class, Staff simply ignores the entirety of the rule which shows the rule applies when the Special Contract is approved or renewed. The preamble to WAC 480-80-143 begins: "[e]ach application filed for commission approval of a contract must..."<sup>28</sup> Similarly, the other sections in part (5) of this rule address the application filed with the Commission to approve a Special

---

<sup>25</sup> Exhibit No. EAF-1T at p. 6.

<sup>26</sup> Exhibit No. EAF-1T at p.2, lines 12-17.

<sup>27</sup> WAC 480-80-143(5)(c) (emphasis added).

<sup>28</sup> WAC 480-80-143(5).

Contract. The rule language does not explicitly state that the standard for initial approval or renewal is an ongoing condition, subject to continuing evaluation during the term of the Special Contract. Therefore, contrary to Staff's testimony, evaluation of the Special Contract class pursuant to the conditions imposed by WAC 480-80-143(5) is not appropriate for this general rate case proceeding. Rather, the issue of Special Contract rates should be addressed when the Commission initially approves or considers renewal of those contracts.

20. Even if WAC 480-80-143(5)(c) subjects Special Contracts to an ongoing review requirement, compliance with that requirement should be based on an evaluation of the fixed cost contribution of the Special Contract during the entire term of the contract. Staff's analysis, in contrast, is based on a single point in time, arbitrarily chosen simply because PSE filed a general rate case in 2017. Nowhere in Staff's analysis does it consider the Special Contract class's contribution to PSE's fixed cost recovery over the term of the contract. Rather, Staff relies exclusively on a single disputed cost of service study which provides only a snapshot of PSE's rate base and Special Contract revenues without considering the full benefits of the Special Contract to PSE and its other customers.<sup>29</sup> Staff uses its disputed cost of service study as the entire basis for its recommendation to fundamentally change the treatment of the Special Contract class, ignoring all other studies in the record. Staff's approach does not provide the Commission with substantial evidence to determine that the Special Contract class does not currently yield a reasonable compensation for the service rendered as required by RCW 80.28.020, much less any evidence that it will not yield such compensation over the life of the contract.

---

<sup>29</sup> See Exhibit No. JLB-8T at Table 10.

**b) Cost Recovery by Special Contracts**

21. Staff errs primarily by presupposing the statute and rule require the Special Contract class to recover all fixed costs in the same manner that rates are designed for other customer classes served under standard tariffs.<sup>30</sup> In doing so, Staff ignores the express language of WAC 480-80-143, which gives LDCs the authority to enter into Special Contracts for discounted rates. Staff's recommendation equates Special Contracts with standard tariff rates and also fails to properly distinguish between variable and fixed costs – an essential requirement for assessing the performance of Special Contracts under the requirements of WAC 480-80-143. Under Staff's reasoning, there would be no need for a Special Contract class if the end goal was full cost recovery, and all Special Contract customers would simply take service under standard tariffs.
22. WAC 480-80-143 refers to two distinct types of costs associated with a Special Contract customer's cost of service: (1) costs resulting from providing the service during the term of the Special Contract, and (2) the gas company's fixed costs.
23. The "costs resulting from providing the service" during the term of the Special Contract, known as incremental or variable costs, are those costs directly attributable to the specific Special Contract customer.<sup>31</sup> In other words, variable costs are the cost of adding the Special Contract customer to the system; costs the LDC would not incur but for the Special Contract customer being connected to the system. PSE's operation and maintenance expense associated with serving the Special Contract class is a proxy for the entirety of the variable cost to serve the Special Contract class.<sup>32</sup>

---

<sup>30</sup> Exhibit No. JLB-8T at p.3.

<sup>31</sup> Piliaris, TR 276:15-277:4.

<sup>32</sup> Exhibit No. JAP-54T at p.6, lines 9-11.

24. In contrast, fixed costs are those costs the utility will incur regardless of whether a given customer joins or leaves the system and, therefore, do not “result from” providing service to the Special Contract customer under WAC 480-80-143. At a minimum, fixed costs include sunk costs (such as infrastructure not associated with an individual customer), return on rate base, depreciation, income tax expense, and a substantial portion of other taxes that are indirectly related to the recovery of fixed costs. Fixed costs should also include a portion of PSE’s other operation and maintenance expenses that are fixed in nature and unaffected by the presence or absence of the Special Contract class.<sup>33</sup>

25. Absent the Special Contract class’s contribution to fixed costs, other customers would be required to pay this amount in the event a Special Contract customer left the system. LDCs enter into Special Contracts to retain large customers and the entire system benefits as a result.<sup>34</sup> In furtherance of this policy, the Commission created WAC 480-80-143, which explicitly authorizes Special Contracts at discounted rates.

**c) Staff’s argument is not supported in the Record**

26. Staff urges the Commission to modify the treatment of the Special Contract class. Staff argues that PSE does not “achieve full recovery of costs” to serve the Special Contract class and that the Special Contract class contributes “less than nothing” to PSE’s fixed costs.<sup>35</sup> Staff’s argument, however, has no basis in the record. The cost of service studies relied on by NWIGU, PSE, and Staff each show that the Special Contract class covers all variable costs of service and contributes substantially to PSE’s fixed costs.<sup>36</sup>

---

<sup>33</sup> Exhibit No. JAP-54-T at p.5, lines 13-19.

<sup>34</sup> Exhibit No. EAF1T at p.3, lines 12-21.

<sup>35</sup> Exhibit No. JLB-8T at p.3, line 3 to p.4, line 5.

<sup>36</sup> Exhibit No BCC-6T at Table 1.

27. Staff incorrectly attempts to hold Special Contracts to the same cost-recovery requirements as required under a standard tariff, ignoring the purpose and express language of WAC 480-80-143. Staff argues that because the Special Contracts do not earn a positive rate of return on the total revenue requirement, other customers are subsidizing the Special Contract class.<sup>37</sup> As previously stated, Special Contracts benefit the LDC and all other customers when they recover their variable or incremental cost of service and contribute some amount to the LDC's fixed costs. Depreciation expenses, income tax, return on rate base, and the conversion factor, as explained below, are fixed costs and not costs resulting from providing service to the Special Contract class.<sup>38</sup>

28. NWIGU, PSE, and Staff agree that the Special Contract class margin revenues are approximately \$1,369,462.<sup>39</sup> As shown in the testimony of Brian Collins, this is more than sufficient for PSE to recover the Special Contract class' \$1,365,507 total cost of service (all fixed and variable costs), and would actually warrant a small decrease of 0.29% under general ratemaking methodologies (which is not applicable to special contracts).<sup>40</sup> Mr. Collins determined that the Special Contract's allocated operation and maintenance costs are \$393,478, which are the incremental or variable cost to service the class.<sup>41</sup> Accordingly, PSE currently recovers \$975,984 annually in fixed costs from the Special Contracts.<sup>42</sup> Without the Special Contracts, the \$975,984 would need to be allocated to the remainder of PSE's customers.

29. Even Staff and PSE's cost of service studies demonstrate that Special Contract revenues recover all variable costs to serve the class and make some contribution to fixed costs. PSE

---

<sup>37</sup> Exhibit No. JLB-8T at 4, lines 1-5.

<sup>38</sup> Piliaris, TR 278:14-22.

<sup>39</sup> Exhibit No BCC-6T at Table 1.

<sup>40</sup> Exhibit No. BCC-6T at 3, lines 5-8.

<sup>41</sup> Exhibit No. BCC-6T at Table 1.

<sup>42</sup> Exhibit No. BCC-6T at Table 1.

estimates that the variable cost to serve the Special Contract class is between \$670,229<sup>43</sup> and \$800,000.<sup>44</sup> This would mean that PSE recovers between \$570,000 and \$700,080 in fixed costs annually from Special Contracts. Even under Staff's cost of service study, costs resulting from providing service to the Special Contract class is \$804,228, which provides for a \$565,862 contribution to PSE's fixed costs.<sup>45</sup>

30. Staff's analysis identifies \$1,221,903 in operating and maintenance and "other" expenses, \$720,275 in depreciation expenses, \$861,939 for a return on rate base, and a revenue conversion factor of \$53,896.<sup>46</sup> Together, these expenses equal Staff's purported revenue requirement for the Special Contract class. But in Staff's operating and maintenance and other category, it includes income tax expense as a variable cost.<sup>47</sup> NWIGU agrees that at least a portion of the operations and maintenance cost is a variable cost, but income tax expense should not be considered a variable cost. While Staff admits that income taxes are associated with rate base, Staff argues that income taxes would go away if the Special Contract customer bypassed the system, because PSE could hypothetically sell some of its assets to the bypassing customer and the rate base associated with those assets would also go away.<sup>48</sup> Not only does this argument not make any sense, it is not supported by any evidence in the record. Staff does not identify what utility assets could be sold to the bypassing customer or whether it is even possible because the assets are also serving other customers. Instead, Staff assumes all utility assets associated with the Special Contract class

---

<sup>43</sup> Representing the allocated operation and maintenance expenses for the Special Contract class. *See* Exhibit No. BCC-6T at Table 1.

<sup>44</sup> Exhibit No. JAP-54T at 6, lines 9-12.

<sup>45</sup> Supplemental Testimony of Jason L. Ball, Staff COS Workpaper, August 7, 2017.

<sup>46</sup> Exhibit No. JLB-8T at Table 10.

<sup>47</sup> Exhibit No. JLB-8T at Table 10.

<sup>48</sup> Ball, TR 356:25, 357:1-4.



would be sold to the special contract customer and the income tax expense would go away. Staff's argument should be rejected.

31. Income taxes are considered a fixed cost for rate making purposes and are derived from rate base. Indeed, Staff has made similar arguments in the past, recognizing that costs driven by rate base, like income tax, are fixed costs.<sup>49</sup> If the Special Contract customer bypassed the system by building its own facilities to connect to the interstate pipeline, PSE distribution facilities and rate base would remain part of its system along with the income tax expense, depreciation expense and other fixed costs associated with those facilities.

32. Depreciation is used to recognize the limited lifespan of infrastructure investments and allocate infrastructure costs over their useful life.<sup>50</sup> Utilities treat annual depreciation as an expense and the recovered investment is no longer considered invested capital and no longer included in rate base upon which the utility earns a rate of return.<sup>51</sup> Because depreciation expenses are calculated on a system-wide basis, PSE incurs the same depreciation expense costs regardless of whether Special Contract customers are on the system.<sup>52</sup> Again, Staff has not placed any evidence in the record to demonstrate that PSE's investments in infrastructure or otherwise are directly attributable to Special Contracts. If the Special Contract class did not exist, the same depreciation costs would simply be spread amongst a smaller pool of customers, resulting in higher rates. Therefore, depreciation is a fixed cost.<sup>53</sup>

---

<sup>49</sup> See, e.g. *Washington Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket UE UE-090704 and UG-090705, Final Order (April 2, 2010) at ¶242 (Summarizing Staff's argument that "a portion of Mint Farm fixed costs is return on net rate base consisting of plant balance, accumulated depreciation, and deferred income tax").

<sup>50</sup> Leonard Saul Goodman, *THE PROCESS OF RATEMAKING*, 2005 WL 998302 (Public Utilities Reports, Inc., 2d ed. 1998).

<sup>51</sup> Ball, TR 358:3-25.

<sup>52</sup> Piliaris, TR 278:13-22; Ball, TR 358:3-11.

<sup>53</sup> Exhibit No. EAF-1T at p.3, lines 12-21.

33. The return on rate base is the profit a utility is allowed to earn which is calculated as a percentage of the utility's rate base.<sup>54</sup> Staff argues that if the Special Contract class ceased to be PSE customers, PSE would likely sell the facilities used to serve the Special Contract class to the customer and the rate base would simply go away (along with the associated depreciation and income tax expense).<sup>55</sup> Again, this is a hypothetical and not based on any facts in the record. Further, facilities serving the Special Contract customer which also serve other customers could not be sold. And, even if there are dedicated facilities used to serve the Special Contract customer, the Special Contract customer may wish to build new facilities instead of purchasing facilities from PSE. Staff simply has not identified what facilities serving the Special Contract customer could or could not be sold, much less which ones actually would be sold, and has failed to establish any record showing that the sale of facilities exclusively dedicated to the Special Contract class would result in a change in rate base. Rather, without revenue derived from the Special Contract class, the same rate base (or substantially the same rate base) would be spread amongst a smaller pool and overall rates would be appreciably higher.<sup>56</sup> Therefore, return on rate base is a fixed cost.

34. The revenue conversion factor is an addition to the rate base and rate of return used to account for the utility's income tax liability.<sup>57</sup> PSE's income, and the tax thereon, is not a cost of providing service solely to the Special Contract class. PSE's income tax is only marginally affected by the Special Contract class. If the Special Contract class did not exist, the revenue conversion factor would still be included in the total revenue requirement for other customers.

---

<sup>54</sup> Leonard Saul Goodman, THE PROCESS OF RATEMAKING, 2005 WL 998304 (Public Utilities Reports, Inc., 2d ed. 1998).

<sup>55</sup> Ball, TR 356:25, 357:1-4.

<sup>56</sup> Exhibit No. EAF-1T at p.3, lines 12-21.

<sup>57</sup> Washington Utilities & Transportation Comm'n v. Avista, 279 P.U.R.4th 77 (Dec. 22, 2009) ("The revenue conversion factor translates net operating income (which is after tax) to revenue requirement (which includes income tax and other revenue sensitive taxes.").

Interestingly, Staff states that the Special Contract produces no income because it is “contributing less than nothing toward return on rate base,”<sup>58</sup> but also concludes that income tax, as an expense to the utility included in the revenue requirement, is a cost of serving the Special Contract class.<sup>59</sup> These irreconcilable statements reflect Staff’s fundamental confusion regarding fixed costs and the standard set forth in WAC 480-80-143. Because the revenue conversion factor is incurred regardless of services provided to Special Contracts, it is a fixed cost.

35. In sum, Staff inappropriately inflates the incremental cost of service attributable to Special Contracts by incorrectly categorizing fixed costs as variable costs. Staff places no evidence in the record supporting a conclusion that any costs, except a portion of operating and maintenance expenses, are variable costs of providing service to Special Contracts. Contrary to Staff’s recommendation, the cost of service studies relied on by NWIGU, PSE, and Staff show that the Special Contract class covers all costs resulting from PSE providing service to that class and contributes substantially to PSE’s fixed costs. Therefore, the Special Contracts meet and exceed the minimum requirements of WAC 480-80-143 and no changes to the rates for that customer class are warranted.

#### **D. Public Interest**

36. Staff’s recommendation is also contrary to the public interest. In approving Special Contracts, the Commission must determine if the agreement is fair, just, reasonable and sufficient and consistent with the public interest.<sup>60</sup> Further, the Commission must make its decision based on substantial evidence that the contracts meet the requirements of WAC 480-80-143 – including that “the contract charges recover all costs resulting from providing the service during its term,

---

<sup>58</sup> Exhibit No. JLB-8T at 3, lines 7-9.

<sup>59</sup> See Exhibit No. JLB-8T at Table 10; Ball, TR 359:6-8.

<sup>60</sup> See e.g. Avista Order 05 at ¶22.

and, in addition, provide a contribution to [PSE's] fixed costs."<sup>61</sup> The Commission previously made these findings when it approved the Special Contract at issue in this case in Docket UG-950392 and again in 2009 when the Commission extended the term of the Special Contract.<sup>62</sup> If the Commission materially modifies material terms of the Special Contract class, as Staff recommends, the Commission will signal that customers cannot rely on a Special Contract approved by the Commission. A customer in the future would be very unlikely to forego a competitive alternative if there was a risk that the Special Contract rate will not be honored over the term of the contract.<sup>63</sup> This undermines the regulatory goal of maximizing fixed cost recovery for Washington LDCs.<sup>64</sup>

37. Special Contracts are expected to depart from traditional tariff service. Any suggestion that PSE is losing money or that other customers are harmed by serving the Special Contract class is wrong. As explained above, the Special Contract class covers its incremental cost of service and provides a significant contribution to PSE's fixed costs. Therefore, PSE and its customers are receiving a substantial benefit from the Special Contract class, which results in lower rates for other customers. This is in the public interest.<sup>65</sup> Staff's proposal undermines the purpose of Special Contracts and is inconsistent with WAC 480-80-143.

### III. CONCLUSION

38. NWIGU urges the Commission to approve the Settlement in this docket as a fair resolution of the issues presented. The Settlement results in a net revenue requirement decrease of approximately 3.8% for gas services compared to current rates.

---

<sup>61</sup> *See id.*

<sup>62</sup> *Puget* Order at ¶¶6,7.

<sup>63</sup> Exhibit No. EAF-1T at p.8, line 4 to p9, line 13.

<sup>64</sup> *Id.* at p.2, lines 12-17.

<sup>65</sup> *Id.* at p.3, lines 12-21.

39. There are three contested cost of service studies in the case presented by PSE, Staff and NWIGU. NWIGU urges the Commission to not adopt any specific cost of service methodology in this case and, instead, apply any rate changes in this case on an equal percent of margin basis. This approach will allow all parties the opportunity to continue participating in the generic proceeding the Commission opened last year to develop clearer guiding principles for cost of service studies to be used in future rate cases. It has been decades since this Commission has analyzed the guiding principles that should be used for cost of service studies.

40. The Commission should reject Staff's recommendation that PSE absorb imputed revenue to bring the Special Contract class to full cost of service, or, in the alternative, to increase Special Contract revenues by 58.83%, because such action is inappropriate for this proceeding. Staff simply has not presented substantial evidence on which the Commission can rely to determine that the Special Contract class revenues are insufficient to yield reasonable compensation for the service rendered. Moreover, Staff's position misinterprets WAC 480-80-143 as requiring PSE to demonstrate that the Special Contracts must result in full cost recovery of all fixed and variable costs based on an embedded cost of service study. The three contested cost of service studies relied on by NWIGU, PSE, and Staff each show that the Special Contract class covers all costs resulting from PSE providing service to that class and contributes substantially to PSE's fixed costs. Therefore, the Special Contracts meet and exceed the minimum requirements of WAC 480-80-143 and no changes to the rates for that customer class are warranted.

///

///

///

Dated: October 18, 2017

Respectfully submitted,

A handwritten signature in blue ink, appearing to be 'Chad M. Stokes' or similar, written over a horizontal line.

---

Chad M. Stokes, WSB 37499, OSB 004007  
Tommy A. Brooks, WSB 40237, OSB 076071  
Cable Huston LLP  
1001 SW Fifth Avenue, Suite 2000  
Portland, OR 97204-1136  
Telephone: (503) 224-3092  
Facsimile: (503) 224-3176  
E-mail: [cstokes@cablehuston.com](mailto:cstokes@cablehuston.com)  
[tbrooks@cablehuston.com](mailto:tbrooks@cablehuston.com)

Of Attorneys for  
Northwest Industrial Gas Users