

**Exhibit No. ECO-1THC
Dockets UE-151871/UG-151872
Witness: Elizabeth C. O'Connell
REDACTED VERSION**

**BEFORE THE WASHINGTON
STATE UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY,

Respondent.

**DOCKETS UE-151871 and
UG-151872 (*Consolidated*)**

TESTIMONY OF

Elizabeth C. O'Connell

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Rate Making, Accounting Treatment of Leases, and Asymmetry of Information

June 7, 2016

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1 **I. INTRODUCTION**

2

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

4 A. My name is Elizabeth C. O'Connell. My business address is The Richard Hemstad
5 Building, 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA
6 98504.

7

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

9 A. I am employed by the Washington Utilities and Transportation Commission
10 (Commission) as a Regulatory Analyst in the Energy Regulation Section of the
11 Regulatory Services Division. Among other duties, I am responsible for financial and
12 accounting analysis, auditing records of regulated companies, and reviewing
13 affiliated interest transactions.

14

15 **Q. How long have you been employed by the Commission?**

16 A. I have been employed by the Commission since November 2015.

17

18 **Q. Would you please state your educational and professional background?**

19 A. In 2009, I graduated from Universidad Central de Venezuela in Caracas, Venezuela
20 with a Bachelor of Science in Economics, specializing in Banking and Finance. In
21 2013, I graduated from the University of Dundee in Dundee, United Kingdom with a
22 Master of Business Administration in International Oil and Gas Management. In
23 2015, I graduated from the University of Washington in Seattle, Washington with an

1 Accounting Diploma. Before joining the Commission, I worked for three years in the
2 financial sector assisting with brokerage of agricultural securities. I also previously
3 worked for three years in the Real Estate sector as an Advisor, specializing in the
4 appraisal of realty. Lastly, I attended the New Mexico State University's rate case
5 basics workshop in May 2016.

6
7 **Q. Have you previously testified before the Commission?**

8 A. Yes. I presented testimony related to prudence, pro forma ratemaking policy,
9 property tax, and environmental remediation projects in Pacific Power's General
10 Rate Case in Docket UE-152253.

11
12 **II. SCOPE AND SUMMARY OF TESTIMONY**

13
14 **Q. Please explain the purpose of your testimony.**

15 A. My testimony addresses PSE's proposed ratemaking treatment of the electric and
16 natural gas appliances included in the Company's proposed leasing program.¹ I refer
17 to PSE's proposed equipment leasing service as the "leasing program" in my
18 testimony. The appliances included in the leasing program may be referred to as
19 "appliances" or "assets" throughout.

20 My testimony also presents Staff's analysis pertaining to PSE's proposed
21 accounting treatment for the appliances leased to customers under the leasing

¹ PSE's as-filed proposed Schedule 75, Equipment Lease Service, contains the Company's proposed terms and conditions of service.

1 program. Finally, I address concerns regarding asymmetry of information between
2 PSE's customers and PSE.

3
4 **Q. Please summarize your conclusions on the issues addressed in your testimony.**

5 A. Based on my review, I conclude that PSE's appliance leasing program does not
6 constitute a regulated utility service. In fact, the "services" PSE proposes to provide
7 are identical to those provided by unregulated financial institutions such as credit
8 unions and banks, and unregulated merchandising entities.

9 Further, PSE intends to administer the program through existing market
10 entities that will install, maintain, and repair the appliances that it finances through
11 the program. In the end, PSE will simply act as the program's financier and
12 administrator. Neither of these activities are "utility services" that require
13 Commission regulation.

14
15 **Q. Please provide a few examples of why PSE's appliance leasing program is not a**
16 **utility service.**

17 A. First, a basic tenet of utility regulation is that a service is not regulated just because it
18 is performed by a regulated utility. A true "utility service" is one that requires a
19 capital investment of such size and magnitude that the legislature finds it is in
20 society's best interest to allow only one provider.

21 Here, the appliances PSE wishes to offer are already broadly available, sold
22 by numerous retail providers, and offered at a wide range of prices. These prices
23 vary from those offered by Best Buy, Home Depot, Lowe's and Costco to used

1 products sold on Craigslist. The interface surrogates PSE will use are undoubtedly
2 the same businesses that sell, install, and service appliances today. In fact, all aspects
3 of PSE's proposed business model duplicate products and services readily available
4 to all PSE customers who seek them. PSE's filing confirms that its leasing program
5 is not a utility service:

6 a) The economic transaction at the heart of PSE's proposal is, in substance, the
7 direct acquisition or purchase of an appliance by the customer. PSE presents
8 this proposed transaction as a lease. But the responsibilities and risks it would
9 impose on a lease customer are comparable to those imposed on a customer
10 financing the purchase of the asset. Thus, the Company's true role is that of a
11 retailer, and no different than other unregulated service providers currently in
12 the appliance market.²

13 b) The items that PSE proposes to include in rate base from this program do not
14 meet the requirements of electric plant under RCW 80.04.010(11) and
15 Federal Energy Regulatory Commission (FERC) accounting standards³.

16 c) PSE's proposed leasing rates⁴ are not calculated using known and measurable
17 acquisition and installation costs. Instead, they are based on approximations
18 and estimates. Consequently, the revenue requirement collected from
19 customers (or monthly "loan" payment) is not a true reflection of actual costs.
20 This is particularly problematic because the leasing rates will be fixed for the
21 entire leasing term, which matches the economic life of the appliances.

² See Cebulko, Exh. No. BTC-1T at 7:17-20.

³ Specifically referring to: Electric Plant Instructions on Defining Transmission and Distribution Plant, 18 C.F.R. Chapter 1, Subchapter C, Part 101, page 416, number 14, April 1, 2015.

⁴ As set forth in PSE's proposed Schedule 75.

- 1 d) PSE's surrogate service providers would be given three choices or
2 "acquisition paths" to provide leased appliances to the customer. This creates
3 a problem regarding the accuracy of the rates charged to the customer
4 because the unit and installation costs are different for all three acquisition
5 paths. The rates charged to the customer, however, would remain constant
6 regardless. This violates the principle of cost causation—rates should be
7 based on actual costs to the extent possible.
- 8 e) Staff believes that any assets used to provide a public service should be
9 subject to the same standards as other property included in rate base. This
10 Commission requires that the costs of a rate-based asset be known and
11 measurable—a critical standard for including any asset in rate base.
- 12 f) PSE leasing rates charges the customer an implicit interest rate which
13 includes PSE's Commission approved cost of capital. However, customers
14 have better options to finance their appliance purchases.
- 15 g) An asymmetry of information exists between PSE and its customers. Such
16 asymmetry can detrimentally impact a customer's rational decision making
17 process. The lack of an explicit relationship between PSE's rate and the cost
18 of appliances could inappropriately shape the customer's view of reasonable
19 options in the marketplace.

1 **III. SUMMARY OF PROPOSED LEASING PROGRAM**

2

3 **Q. Please describe PSE's Leasing Program.**

4 A. PSE leasing program would provide a new optional, tariff-based service to eligible
5 natural gas and electric residential and commercial customers for acquiring and
6 maintaining energy-related equipment.⁵ The Company proposes to initially offer a
7 variety of commercial and residential space and water heat appliances; however, it
8 designed a platform with the flexibility to support additional product offerings.⁶
9 Those customers who contract with PSE would pay for the water heater, furnace or
10 heat pump to be installed and maintained by PSE or its surrogates behind the
11 customer's meter.

12

13 **Q. Does PSE have the expertise to fulfill its lease contract obligations offered by the**
14 **program?**

15 A. No. [REDACTED]
16 [REDACTED]⁷
17 [REDACTED]
18 [REDACTED] Staff concludes that PSE cannot perform its lease contract obligations in-house.

⁵ O'Connell, Exh. No. ECO-2, (PSE Tariff Cover Letter at 2).

⁶ *Id.*

⁷ O'Connell, Exh. No. ECO-3, (Highly Confidential PSE Response to Public Counsel Data Request 019, Attachment A 11 at 17).

1 Staff's conclusion is supported by PSE's following testimony regarding how
2 the Company plans to implement its lease contract. To this point, PSE said it:

3 [W]ill engage its valued service partners to facilitate the equipment
4 distribution and in-home fulfillment tasks, including pre-installation
5 site checks, permitting, installation, maintenance, and repair services.⁸

6 While the term "valued service partners" is undefined, it is clear that PSE will use
7 surrogates to perform basic tasks required by contract. PSE's surrogates would likely
8 be comprised of a network of contractors, service providers, and manufacturers that
9 will provide the acquisition and technical support PSE's requires to implement the
10 leasing program.

11
12 **Q. How will PSE engage its "valued service partners"?**

13 A. It is Staff's understanding that the Company will use three different methods to
14 engage contractors. PSE refers to each method as an "acquisition path." Each
15 "acquisition path" would offer a different level of involvement and responsibilities
16 for PSE in the process of [REDACTED]

17 [REDACTED]⁹

18
19 **Q. What are PSE's "acquisition paths"?**

20 A. The "acquisition paths" set up PSE's interface or relationship with its surrogates.
21 PSE intends to offer three "acquisition paths." PSE's duties will vary with each, and

⁸ McCulloch, Exh. No. MBM-IT at 15:4-6.

⁹ O'Connell, Exh. No. ECO-4 (Highly Confidential PSE response to Public Counsel Data Request 016. Attachment A1 at 6, 7).

1 it is unclear as to what percentage of its leasing program would be assigned to each
2 path. However, the common duty performed by PSE under each option is that of a
3 financier. I have set forth a brief description of PSE's "acquisition paths" below:

4 a) PSE Path - Here, the Company would be responsible for customer

5 [REDACTED]

6 [REDACTED] PSE would also manage its warranty obligations. On the
7 other hand, PSE's "service partner" would provide on-site inspection,
8 permitting, installation, maintenance/repair services (as well as providing
9 needed parts), and removal services.¹⁰

10 b) Hybrid Path - Here, [REDACTED]
11 [REDACTED]¹¹ but will perform the other activities included in the PSE Path.

12 PSE will manage the customer acquisition, lease financing and
13 administration activities.¹²

14 c) Partner Path - Here, PSE will only serve as financier. In this role, PSE
15 would simply manage the lease financing and administration activities,¹³

16 [REDACTED]¹⁴

¹⁰ McCulloch, Exh. No. MBM-IT at 16:9-13.

¹¹ O'Connell, Exh. No. ECO-4 (Highly Confidential PSE response to Public Counsel Data Request 016. Attachment A1 at 6, 7).

¹² McCulloch, Exh. No. MBM-IT at 17:3-4.

¹³ *Id.* at 17:14-15.

¹⁴ O'Connell, Exh. No. ECO-4 (Highly Confidential PSE response to Public Counsel Data Request 016. Attachment A1 at 6, 7).

1 As noted above, PSE will act as the financier under all of its “acquisition paths.”
2 Under no circumstance will the service partner or manufacturer participate in lease
3 financing or its administration. PSE’s fundamental role is the administration and
4 financing of the lease program—activities more in common with a financial
5 institution than a utility company.
6

7 **Q. Please describe PSE’s proposed lease terms.**

8 A. Under PSE’s proposed leasing program, customers would be required to sign a
9 contract that commits the customer to make defined monthly payments to PSE over
10 the lease term, which coincides with the economic life of the appliance. PSE
11 identifies the contract as a typical lease; however, it will perform more like a
12 purchase agreement with two parts: the contract to purchase the appliance and an
13 associated maintenance agreement. The key terms of PSE’s proposed agreement are
14 set forth below:

- 15 1. Customers make a financial commitment to pay PSE over the life of the
16 agreement in monthly installments.¹⁵
- 17 2. Customers maintain the equipment and perform filter replacement.¹⁶
- 18 3. Customers insure the appliance against all risk of loss or damage from every
19 cause.¹⁷

¹⁵ [Proposed] Schedule 75, Sheet 75-C. Clause 3.2.

¹⁶ *Id.* Sheet 75-I. Clause 5.4.e. and 5.4.f.

¹⁷ *Id.* Sheet 75-U. Clause 13.

1 4. Customers carry general liability and property damage insurance covering
2 the appliance, and name PSE as an additional insured.¹⁸

3 5. Customers acknowledges and agrees that during the term of the lease term
4 PSE is and will remain the owner of the equipment.¹⁹

5 6. Customer has the opportunity to purchase the appliance at any time.

6 PSE's proposed agreement is more akin to a purchase contract than an equipment
7 lease.

8 IV. FINANCING ACTIVITIES

9
10 **Q. Please describe the Company's role as financier of its lease program.**

11 A. As previously noted, PSE's fundamental role in this program would be to finance
12 appliance acquisition and administer the contracts. Recall that PSE is the sole
13 provider of financing under all of its acquisition paths.

14
15 **Q. Does Staff agree that PSE's role as a financier is a utility function?**

16 A. No. PSE intends to act as a lease financier. It is a stretch to find the Commission
17 should regulate this activity. Furthermore, PSE has not demonstrated that its program
18 will produce system benefits for all customers. Even if it could, the Company would
19 have to show that the program's costs are both commensurate with the level of
20 investment and the least cost option. PSE has not even attempted to do either.

¹⁸ *Id.* Sheet 75-K. Clause 5.5.d.

¹⁹ *Id.* Sheet 75-J. Clause 5.5.a.

1 Given the lack of utility purpose or function, PSE's proposal resembles one
2 that might be offered by a financial institution. It has purposefully limited its role to
3 either providing direct financing or administration or preparation work. Staff also
4 believes that the economic transaction sought by PSE has the economic effect of a
5 sale. As such, PSE would also be acting as a rate-regulated retailer of merchandise,
6 which is specifically prohibited by statute.²⁰

7
8 **V. RATEMAKING TREATMENT**

9
10 **Q. Please explain the rate components of PSE's proposed tariff.**

11 A. PSE proposed rates are based upon a revenue requirement for each appliance it
12 intends to offer. This revenue requirement includes a return on and return of the
13 estimated appliance and installation costs, plus operation and maintenance expenses,
14 taxes and permits, and a provision for the unit replacement due to product failure.

15 PSE's inclusion of investment return and depreciation in rates would treat
16 these appliances as rate base even though they do not contribute directly or indirectly
17 to the delivery of electric service to customers. It is undeniable that all appliances
18 offered by PSE will be located on the customer-side of the meter. Therefore, they
19 cannot be distinguished from any other appliance or tool plugged into a customer's
20 circuitry.

²⁰ RCW 80.04.270.

1 To be rate based, a generator, transmission line, or any other equipment must
2 be found used and useful to the provision of electric service.²¹ To Staff's knowledge,
3 the distribution of everyday appliances behind-the-meter has never been considered a
4 utility service in and of itself. What PSE is proposing here is an appliance service.
5 Without question, this appliance is *connected* to PSE's network by way of the
6 electric circuits owned by and on the customer-side of the meter. However, these
7 appliances will not and cannot provide electric service to the customer or any other
8 customer on PSE's system. Nor can it be considered a conservation investment.

9 PSE goes to great lengths to separate its appliance service from a utility
10 conservation service and rightfully so. PSE's appliance service is about delivering
11 heated or cooled air as desired by the customer. It is not about delivering
12 conservation to its system, whether to reduce system load or to send electrons
13 unneeded by one customer to one who needs them. Conservation *may* be a by-
14 product of PSE's appliance service, but it is not the *intent or purpose* of the program.
15 If it were, PSE would be offering only high-efficiency appliances to its customers. It
16 certainly makes no promise to do so, as demonstrated by its intent to install standard-
17 efficiency units.²²

18 In the end, Staff looks to the utility service provided by a Company's
19 investment before judging it to be used and useful. To Staff, this means a service
20 providing benefits to the utility and all of its customers—not just the customers who

²¹ RCW 80.04.250.

²² See [Proposed] Schedule 75. Sheet 75-B. Clause 5.2.a. (Two Stage Natural Gas Furnace \geq 80% Annual Fuel Utilization Efficiency).

1 opt-in to the service. Here, the Company would treat the leased appliances as
2 delivering an investment to be included in rate base.²³ It does not provide a utility
3 service.

4
5 **A. PSE's New Idea Of What Retail Products Constitute Utility Rate Base**

6
7 **Q. Please give a brief overview of what you discuss in this section**

8 A. In this section, I compare the Commission's treatment of Company property placed
9 into utility service with PSE's proposal to rate base behind-the-meter leased
10 appliances.

11
12 **Q. Please define the term rate base.**

13 A. Simply stated, rate base represents Commission-approved equipment and facilities
14 used by a utility to provide electric service to its customers.²⁴

15
16 **Q. Is PSE asking the Commission to expand the definition of electric plant in
17 service to customers?**

18 A. Absolutely. PSE is asking the Commission to look past the meter and make common
19 appliances utility rate base. As discussed earlier, PSE's "service" is largely providing
20 financing and administrative functions. The appliance leased by a customer will
21 certainly "serve" the customer, but it will not serve the utility or its ratepayers.

²³ O'Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: line 57).

²⁴ These facilities are also known as "electric (or gas) plant in service."

1 Specifically, PSE seeks Commission consent to create a new class of rate
2 base, consisting of the variety of appliances identified in its leasing program. For the
3 purpose of developing its proposed rates, PSE has identified these appliances as rate
4 base and included the return on and of as a tariffed rate.²⁵

5 PSE has confessed that its new rate base program could be expanded to
6 include solar panels, electric vehicles, batteries, and generators.²⁶ Of course, it could
7 also be expanded to include refrigerators, electric lighting, or televisions. Two
8 common threads bind these products: all appliances and equipment use electricity or
9 natural gas supplied by some source; and, they are easily available from a multitude
10 of unregulated sources—from the specialty shops to the big box store. These energy-
11 related products are not in short supply or otherwise controlled by a monopoly. In
12 other words, these products easily and regularly make their way into people’s homes
13 and lives at prices determined by the market without Commission intervention. This
14 is because they are consumer goods. They are not utility assets and do not provide
15 utility service.

16
17 **Q. What facilities does the Commission currently include in rate base?**

18 **A. Primarily, the Commission’s statutes and practices limit rate base to electric plant. It**
19 **does, however, make explicit exceptions for items such as regulatory assets. The**
20 **definition of electric plant is set forth in the public service laws. RCW 80.04.010(11)**
21 **defines electric plant as:**

²⁵ O’Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: line 59 and line 73).

²⁶ O’Connell, Exh. No. ECO-5 (PSE Tariff Cover letter at 2).

1 All real estate, fixtures and personal property operated, owned, used
2 or to be used for or in connection with or to facilitate the generation,
3 transmission, distribution, sale or furnishing of electricity for light,
4 heat, or power for hire; and any conduits, ducts or other devices,
5 materials, apparatus or property for containing, holding or carrying
6 conductors used or to be used for the transmission of electricity for
7 light, heat or power.²⁷
8

9 **Q. What is the standard generally applied by the Commission when determining**
10 **whether to include electric plant in rate base?**

11 A. The Commission generally applies the known and measurable standard. The known
12 and measurable standard is one of the foundations used to set rates in Washington.
13 Of course, the other is the Commission's continued adherence to a modified
14 historical test year. In application, once the test year has been defined, the known and
15 measurable costs during that period can then be identified and properly allocated.
16

17 **Q. How has the Commission defined the terms "known" and "measurable"?**

18 A. In a recent PSE case, the Commission elaborated on its view of the terms "known"
19 and "measurable." Here, it stated:

20 The known and measurable test requires that an event that causes a
21 change in revenue, expense or rate base must be *known* to have
22 occurred during, or reasonably soon after, the historical 12 months of
23 actual results of operations, and the effect of that event will be in
24 place during the 12-month period when rates will likely be in effect.
25 Furthermore, the actual amount of the change must be *measurable*.
26 This means the amount typically cannot be an estimate, a projection,
27 the product of a budget forecast, or some similar exercise of judgment
28 – even informed judgment – concerning future revenue, expense or
29 rate base. There are exceptions, such as using the forward costs of gas

²⁷ Gas plant is similarly defined in RCW 80.04.010(15).

1 in power cost projections, but these are few and demand a high degree
2 of analytical rigor.²⁸
3

4 **Q. Why should the Commission be concerned about application of the known and**
5 **measurable standard in this case?**

6 A. Simply stated, PSE's Schedule 75 is based entirely on estimates. No costs included
7 in PSE's proposed rates are known and measurable by even a liberal interpretation of
8 the intent of the standard.

9
10 **Q. Can you provide some examples of how PSE is using estimates to make rates?**

11 A. Absolutely. There are many to choose from, so I will focus on program
12 fundamentals. PSE uses estimates to set rates in many aspects of the leasing
13 program. All of its program development costs are estimated, as the program does
14 not yet exist. As to the program's hypothetical implementation, PSE uses estimates
15 for its installation costs, appliance costs, operation and maintenance costs, and its
16 servicing costs. Taking the unit equipment pricing scheme, PSE amplifies the cost
17 uncertainty associated with its line of consumer equipment by averaging the range of
18 appliance cost estimates to reach a single proposed rate. As a result, PSE's
19 equipment cost rate would be based on a range of high and low cost estimates that
20 would average one rate for an appliance line.²⁹

21 To cure the mismatch between an appliance's actual cost and the rates
22 charged to a consumer, PSE proposes to "true up" its estimated appliance cost in the

²⁸ *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy*, Docket UE-090704, Order 11, ¶ 26 (Apr. 2, 2010) (internal citation omitted).

²⁹ O'Connell, Exh. No. ECO-8 (Highly Confidential PSE unit cost chart).

1 future. However, the new rate will only apply going forward to new customers, post-
2 Commission approval. The rate for the *already subscribed* customer will not change.
3 Once approved, the existing customer could be getting a better or worse deal than a
4 new customer. Either way, a customer purchasing from the same PSE appliance line
5 will be getting a *different deal* after a rate true up. The Commission could then face
6 complaints based upon its undue preference or discrimination statutes.

7 This illustrates the problem with trying to force a square peg into a round
8 hole—that is, applying statutes and rules meant for regulated monopolies to an
9 unregulated, fully established, and mature market-based service or product. They
10 simply do not and should not fit. In summary, PSE’s estimated costs are not known
11 and measurable by any stretch, but under its proposal they would be transformed into
12 estimated rates that, once approved by the Commission, would affect every customer
13 that leases an appliance from PSE.

14
15 **B. Rate Base Included In Leasing Program**

16
17 **Q. How did PSE calculate the electric plant for leasing to be included in rate base?**

18 A. PSE estimated both: (1) the initial purchase costs of the appliances to be installed in
19 the customer’s premises; and, (2) the appliance’s installation costs. PSE accounts for
20 these estimated costs as “gross plant” in service.

21

1 **Q. Would the leased appliances now included in Schedule 75, qualify as electric**
2 **plant under RCW 80.04.010?**

3 A. No. PSE's leased appliances do not constitute "electric or gas plant." These
4 appliances are consumer products that do not "facilitate the generation, transmission,
5 distribution, sale or furnishing of electricity for light, heat, or power." As Staff's
6 testimony points out, customer appliances are located behind the meter and should
7 not be considered electric plant.³⁰

8
9 **Q. Would any of the appliances included in Schedule 75 or any of the leasing**
10 **program's installation, maintenance, or servicing activities meet the standard**
11 **for known and measurable costs?**

12 A. No. The tariff's unit, installation, maintenance, and servicing costs are all based upon
13 estimates. To obtain the tariff estimates, PSE used bidder responses received through
14 a Request for Qualifications (RFQ)³¹ to establish average costs for each product and
15 the associated services for each of the three acquisition paths.³² PSE then used the
16 average of multiple cost estimates to come up with its tariff. As the Commission is
17 aware, tariff rates based upon estimates are likely to be inaccurate in one way or
18 another. However, by using an average of estimates, PSE nearly *guarantees* that the
19 rates will be inaccurate for a large percentage of customers acquiring an appliance
20 from PSE. Each appliance line is populated with appliances that cost PSE more or

³⁰ Cebulko, Exh. No. BTC-1THC at 19:16-18.

³¹ O'Connell, Exh. No. ECO-4HC (Highly Confidential PSE response to Public Counsel Data Request 016, Attachment A1); McCulloch, Exh. No. MBM-IT at 17:17-18.

³² McCulloch, Exh. No. MBM-IT at 19:19-21; O'Connell, Exh. No. ECO-6HC (Highly Confidential PSE response to Staff Data Request 59, Attachment A).

1 less to acquire. By using average costs to price each appliance, PSE will invariably
2 give one customer a better or worse deal when considering the size or quality of the
3 machine. In summary, PSE's estimated costs are not known and measurable, and its
4 average of estimated costs makes it impossible for the Commission or customer to
5 know whether PSE's proposed appliance deal is fair, just or reasonable.

6
7 **Q. Can you give the Commission specific examples of how PSE's proposed tariff**
8 **would misrepresent the relationship between true costs and rates?**

9 A. Yes, PSE proposed rates would misrepresent the relationship between true costs and
10 revenues generated from rates for the following reasons:

- 11 a) The Company has not signed any commitments to purchase appliances.
12 More to the point, PSE does not plan to select the equipment until after
13 the Commission approves Schedule 75.³³ This means that there is no
14 guarantee of the validity of the data that was used to construct the tariff,
15 as service providers and manufacturers could change their prices. Finally,
16 if the tariff were approved, PSE could then select less expensive service
17 providers or install the least expensive appliances. While such actions
18 would drive down PSE's costs, the customer's rates would remain fixed.

³³ O'Connell, Exh. No. ECO-7 (PSE response to Staff Data Request 65).

1 b) [REDACTED]
2 [REDACTED]³⁴ For

3 example, actual unit costs for heat pumps could vary from almost [REDACTED]
4 [REDACTED] used to calculate rates.³⁵ PSE
5 informed Staff that a heat pump could cost anywhere from [REDACTED]

6 [REDACTED]
7 [REDACTED]³⁶

8 Despite this vast spread of unit costs, two customers would pay the same
9 monthly payment of \$116 to PSE, even though they would have different
10 units with significantly different unit costs. To Staff, this rate would be
11 unfair and unjust. Moreover, such a situation presents the threat of cross-
12 subsidization between customers and customer price discrimination.

13 c) Unit, installation, maintenance, and servicing costs³⁷ vary significantly
14 between service providers and acquisition paths. This translates into
15 different cost relationships, leading to additional problems of cross-
16 subsidization within the leasing program. This also gives the Company an
17 incentive to install appliances that are less expensive than what was
18 assumed.

³⁴ O'Connell, Exh. No. ECO-6 (Highly Confidential PSE response to Staff Data Request 59, Attachment A).

³⁵ O'Connell, Exh. No. ECO-8 (Highly Confidential PSE Unit Cost Chart).

³⁶ O'Connell, Exh. No. ECO-6 (Highly Confidential PSE response to Staff Data Request 59, Attachment A).

³⁷ *Id.*

1 In summary, PSE's proposed tariff is based on costs averages, and would effectively
2 guarantee the Company a level of revenue that is divorced from the actual unit and
3 installation costs PSE would incur to serve leasing customers. If costs are over the
4 average the Company will under earn, incenting the Company to purchase and install
5 less expensive units. And, if costs are under the average, then the Company will over
6 earn. Here again PSE would be given the incentive to reduce costs, but to leave the
7 tariff rate intact. While regulation favors incentives to reduce costs, the fact that PSE
8 would "lock in" appliance rates over the life of the contract blunts any customer
9 benefit from reduced costs. To Staff, the very real mismatch between actual costs
10 and rates provides ample reason to reject PSE's proposed tariff.

11
12 **Q. Please elaborate on your concerns of cross-subsidization.**

13 A. As noted above, when two customers pay the same monthly lease payment but
14 receive products with different costs, what results is both cross-subsidization
15 between customers and customer price discrimination. In other words, the customer
16 with the less expensive appliance is subsidizing the customer with the more
17 expensive appliance. Further, the customer receiving a more expensive and powerful
18 machine at the same price is getting a benefit that burdens a similarly situated
19 customer. As a result, the burdened customer is facing price discrimination and the
20 benefitted customer is receiving an undue preference. Both are prohibited by
21 statute.³⁸

³⁸ RCWs 80.28.100 and 80.28.090.

1 A similar situation would likely occur when PSE charges its installation
2 costs. Like its appliance costs, PSE averages its installation costs, and then uses these
3 average costs to set rates. Again, a customer's rate to install an appliance will not
4 reflect the actual cost to perform the installation. Unlike the appliance costs, PSE has
5 no real idea what the range of its actual costs will be.

6 The installation costs used to determine the tariffs are simply estimations. It
7 is Staff's understanding that PSE has not agreed to a price for the installation costs
8 for each appliance with its possible contractors. As the Commission can envision,
9 appliance installation costs are highly variable from case to case due to lack of
10 control over the premises. For example, [REDACTED]

11 [REDACTED]
12 [REDACTED]³⁹. Of course, PSE has not yet selected or executed material or service contracts
13 with any potential service partners in support of this proposed schedule.⁴⁰ So, there is
14 no certainty that this contractor would be used by PSE. Staff is also concerned that
15 the chosen installers will have little incentive to control their own pricing, which will
16 disrupt the existing competitive market.

³⁹ O'Connell, Exh. No. ECO-6 (Highly Confidential PSE response to Staff Data Request 59, Attachment A, Tab "partner path input data" cell AH11).

⁴⁰ O'Connell, Exh. No. ECO-7 (PSE response to Staff Data Request 65); O'Connell, Exh. No. ECO-7 (PSE response to Staff Data Request 66).

1 **Q. Does PSE propose to true-up its estimates with actual values once those costs**
2 **become known and measurable?**

3 A. Yes and no. PSE intends to update the rates annually, or as the Company deems
4 appropriate to ensure accurate monthly lease prices.⁴¹ However, any rate change
5 would only apply to new customers; customers already in the program would
6 continue to pay their inaccurate “locked in” rates for the duration of the fixed term
7 (10 to 18 years depending on the appliance).⁴² PSE implicitly assumes that over time
8 the rates for leased products will better reflect the relationship between revenues,
9 expenses, and rate base. Yet, these more accurate rates would only apply to new
10 customers, and likely would not remain more accurate for those customers’ entire
11 lease term. PSE’s fixed-price proposal attempts to replicate financing products
12 available to customers in the unregulated markets, but does not comport with
13 ratemaking standards for regulated, tariff-based services.

14
15 **C. PSE’s Calculation of Rates for Schedule 75**

16
17 **Q. Please describe the elements included in Schedule 75’s rates.**

18 A. PSE calculates the monthly lease payments based on the following estimated costs:
19 a) Revenue Requirement on Plant: This represents revenue authorized by the
20 Commission to recover from the investment on the appliance and installation.

⁴¹ McCulloch, Exh. No. MBM-IT at 20:6 - 21:2.

⁴² *Id.*

- 1 **Q. Has Staff identified any program costs that PSE has not accounted for?**
- 2 A. Yes, PSE has failed to account for costs created by non-standard installations,⁴⁶
- 3 disposal of the appliance at the end of the lease,⁴⁷ and program insurance.⁴⁸ Each of
- 4 these exclusions is addressed below.
- 5 a) Non-Standard Installation Costs – Here, PSE’s proposed tariff assigns any
- 6 additional non-standard installation to the customer.⁴⁹ This may place significant
- 7 additional burdens on customers.
- 8 b) Disposal Costs – The tariff places removal and disposal costs on PSE, but these
- 9 costs are not accounted for by PSE. Here, customers that decide not to renew the
- 10 lease agreement would not be responsible for removal and disposal of the
- 11 appliance. PSE would pay these costs. However, these disposal costs were not
- 12 included in the lease pricing worksheet. It is not clear to Staff how PSE intends
- 13 to recover these removal and disposal costs.
- 14 c) Insurance – The tariff requires the commercial customer to purchase insurance
- 15 for the appliance. This insurance purchase obligation burdens the customer in
- 16 two ways; the added cost for the insurance product and the time and effort to
- 17 solicit information on how to insure for the appliance.

⁴⁶ [Proposed] Schedule 75, Sheet 75-L, Clause 5.6.

⁴⁷ O’Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: line 67).

⁴⁸ [Proposed] Schedule 75, Sheet 75-K, Clause 5D.

⁴⁹ *Id.* Sheet 75-L, Clause 5.6.

1 **D. Maintenance and Servicing Costs**

2
3 **Q. Please describe the maintenance and servicing costs associated with this tariff.**

4 A. PSE will have a predetermined maintenance schedule for each installed appliance.
5 However, the Company can only estimate the maintenance schedule's potential cost.
6 Again, PSE attempts to derive the tariff's maintenance costs from information
7 obtained from its RFQ process. PSE informed Staff that it developed the
8 maintenance schedule for each appliance by collaborating with internal and external
9 subject matter experts, including PSE Gas First Response, PSE Energy Efficiency
10 staff, and HVAC equipment and distribution service partners.⁵⁰ How it performed
11 this task is uncertain, as PSE has not acquired (or committed to acquire) the
12 appliances, brands and models it plans to offer customers.

13 Appliance servicing adds another layer of uncertainty to the tariff's cost
14 structure, as PSE's proposed [REDACTED]⁵¹ [REDACTED]

15 [REDACTED] It is unclear to Staff how the Company
16 developed the frequency of service for each appliance.

17
18 **VI. LEASING PROGRAM RISKS**

19
20 **Q. In Staff's opinion, what risks are associated with PSE's leasing program?**

⁵⁰ O'Connell, Exh. No. ECO-12 (PSE response to Staff Data Request 72).

⁵¹ O'Connell, Exh. No. ECO-6 (Highly Confidential PSE response to Staff Data Request 59, Attachment A).

1 A. Generally speaking, PSE's proposed leasing program involves three types of risks:
2 operational risk, financial risk, and risks related generally to [REDACTED]

3 **Q. How does PSE intend to address these risks?**

4 A. It appears PSE expects customers to share program risks with the Company. While
5 the tariff may act to mitigate certain risks, it assigns other risks directly to the
6 customer.

7
8 **Q. What are the operational risks you refer to above?**

9 Operational risks are directly associated with operation of the appliance. According
10 to PSE, the customer is responsible for activities like: inspecting the appliance no
11 less than twice each calendar year;⁵² cleaning or replacing air filters no less than four
12 times each calendar year;⁵³ and maintaining operation of any plumbing and systems
13 supplying fuel and/or electricity to the appliance and ducts.⁵⁴

14
15 **Q. Please describe the leasing program's financial risks.**

16 A. I have already described the risks associated with estimated appliance and service
17 costs, and the risk of cross-subsidization of costs. I turn now to other financial risks
18 associated with the leasing program. Here, the financial risks I refer to are a
19 customer's failure to pay (or bad debt) and risk of loss.

⁵²[Proposed] Schedule 75, Sheet 75-O, Clause 7.b.

⁵³*Id.*

⁵⁴*Id.* at Sheet 75-I. Clause 4e and 4f.

1 PSE would mitigate the risk of failure to pay through the establishment of a
2 credit rating acceptable to the Company prior to providing service.⁵⁵ [REDACTED]

3 [REDACTED]⁵⁶

4 As to risk of loss or damages to the appliance, PSE again assigns these risks
5 to the participating customers. To protect the Company, it added the following
6 provision in Schedule 75:

7 [Commercial Customers] must pay and keep the equipment insured
8 against all risks of loss or damage from every cause whatsoever for
9 not less than the full replacement value thereof, and shall carry
10 general liability and property damage insurance covering the
11 Equipment and its use in amounts customary for such Equipment, and
12 name PSE as an additional insured under Customer's general liability
13 insurance policy.⁵⁷

14 The Company provides itself even more protections by giving it the power to bill a
15 customer for any excess maintenance and repair that results from events not under
16 PSE's control (such as fires, explosions, earthquakes, drought, tidal waves or floods).
17 Staff understands the tariff to require customers self-insure or otherwise acquire an
18 insurance policy that covers all these contingencies.

⁵⁵ *Id.* at Sheet 75 (first page) (comparatively, there is no provision for a minimum credit rating assessed for new customers that wish to receive traditional electric or gas services).

⁵⁶ O'Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: line 76).

⁵⁷ [Proposed] Schedule 75, Sheet 75-K, Clause 5d.

1 **Q. Please describe the platform risks.**

2 A. [REDACTED] 58 [REDACTED]

3 [REDACTED]

4 [REDACTED]

5 [REDACTED] 59 [REDACTED]

6 [REDACTED]

7

8 **Q. What is the relevance of PSE's extensive risk mitigation by transferring the**
9 **risks to the lease program customers?**

10 A. Although PSE has transferred many risks to the customer, it expects to receive its
11 authorized rate of return on the leased appliance rate base. It may be difficult to
12 quantify each type of risk, but PSE takes very little responsibility for its ownership of
13 the rate base located in a customer's home or business. However, in the context of
14 the traditional utility service provided by PSE, these risks are borne by the Company
15 and it has the responsibility to protect the items from damage and to protect the
16 public from possible harm by the infrastructure. PSE's extensive attempt to
17 exonerate itself from these risks is one more example of how the leasing program
18 does not fit within the structure of utility regulation.

⁵⁸ See O'Connell, Exh. No. ECO-13 (Highly Confidential PSE response to Public Counsel Request 19, Attachment A 04, Page 39).

⁵⁹ *Id.* at 40.

1 **VII. ACCOUNTING TREATMENT OF THE LEASING TRANSACTION**

2
3 **Q. Which guidance does PSE intend to use to record the transaction pertaining to**
4 **PSE's leasing program?**

5 A. The Company intends to follow the guidance provided in General Instructions ("GI")
6 19 "Criteria for classifying leases" and GI 20 "Accounting for Leases" of the FERC
7 prescribed Uniform System of Accounts (USoA) in Title 18, Chapter I, Subchapter
8 F, Parts 101 and 201 in the Code of Federal Regulations for regulatory reporting.⁶⁰

9
10 **Q. Is this an appropriate guidance for the transactions under Schedule 75?**

11 A. No, because the guidance offered by GI 19 and GI 20 is *not* intended to record
12 transactions with the utility as a lessor, only as a lessee. The accounting approach
13 further supports why these appliances should not be treated as rate base. In the
14 current scenario PSE acting as a lessor requires the recognition of the value of the
15 asset in PSE's accounting records in a receivable account not in an electric or gas
16 plant account. Furthermore, the appliances themselves do not fit in any description
17 of utility property in electric or gas plant-in-service according to the USoA as I will
18 explain later in my testimony.

19
20 **Q. What is the proper accounting structure for the leasing program?**

21 A. Absent guidance from the FERC, Staff relies on the Accounting Standard
22 Codification Update on Leases Topic 842 (ASC Update) promulgated in February

⁶⁰ O'Connell, Exh. No. ECO-14 (PSE response to Staff Data Request 46).

1 2016 by the Financial Accounting Standards Board (FASB). Staff considers the ASC
2 Update to be the most-appropriate accounting method in this case. The application of
3 the ASC Update reveals the true economic result of the agreement proposed in
4 Schedule 75: it is a sales-type lease—effectively a direct sale of the appliance to the
5 customer through financing by PSE.

6
7 **A. Definition of Lease.**

8
9 **Q. Do the applicable accounting standards define a lease?**

10 A. Yes, a lease is defined⁶¹ as:

11 [A] contract, or part of a contract, that conveys the right to control the
12 use of identified property, plant, or equipment (an identified asset) for
13 a period of time in exchange for consideration. Control over the use of
14 the identified asset means that the customer has both (1) the right to
15 obtain substantially all of the economic benefits from the use of the
16 asset and (2) the right to direct the use of the asset.⁶²

17 The transaction between PSE and customer meets this broad definition of lease.
18 Schedule 75 provides customers the right to have exclusive use of the appliance. For
19 example, Customers can direct the use of the leased appliance by setting the
20 temperature for the hot water or hot air from furnaces and heat pumps, thus dictating
21 when the hot air is delivered into the house. For control of this appliance, the

⁶¹ The USoA does not specifically identify the elements of a lease, so Staff refers to the most current definition of leases according to the ASC Update to obtain a clearer definition of what constitutes a lease. The amendments in this update are effective for fiscal years beginning after December 15, 2018. However early application of the amendments in the ASC Update is permitted for all entities. These guidelines are the appropriate reference because of PSE's intent to operate and expand the leasing program for the long-term.

⁶² O'Connell, Exh. No. ECO-15 (ASC Update. Definition of Lease).

1 customer will pay PSE a monthly lease payment, i.e. “consideration.” In some cases,
2 the customer’s right to decide how and for what purpose the appliance will be used
3 becomes more relevant, as it can change the economic benefits resulting from the use
4 of the “asset.”⁶³ Decision making rights include the following: type of output that is
5 produced by the “asset,” when the output is produced, where the output is produced,
6 whether the output is produced, and the quantity of output.⁶⁴ In this case, there’s
7 only two types of output (hot water or heated air) that can be produced by the
8 appliance and the customer will be able to control when the appliance produces it
9 and in what quantities.⁶⁵

10
11 **Q. Please identify the roles agreed to by the customer and PSE in the contractual**
12 **relationship established by Schedule 75.**

13 A. Considering that the transaction constitutes a lease, customers will “obtain the right
14 to use an underlying asset⁶⁶ for a period of time in exchange for consideration”⁶⁷; so
15 they will act as the lessee. PSE on the other hand will “provide the right to use an
16 underlying asset for a period of time in exchange for consideration”⁶⁸ so they will act
17 as the lessor.

18

⁶³ O’Connell, Exh. No. ECO-16 (ASC Update, 842-10-15-24).

⁶⁴ *Id.* at 842-10-15-25.

⁶⁵ [Proposed] Schedule 75, Sheet 75-J, Clause 5a.

⁶⁶ Underlying asset is an asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset. *See* O’Connell, Exh. No. ECO-17 (ASC Update, Underlying Asset definition).

⁶⁷ O’Connell, Exh. No. ECO-18 (ASC Update, Lessee definition).

⁶⁸ *Id.*

1 **Q. Please describe the guidance from USoA regarding leasing transactions.**

2 A. According to GI 20 in the USoA, “all leases shall be classified as operating or
3 capital leases.”⁶⁹

4

5 **B. Types of Lease.**

6

7 **Q. What are the criteria for classification of leases according to USoA?**

8 A. The USoA speaks only to the situation where the utility is the lessee. Yet PSE
9 claims it “will follow General Instruction 19 ‘Criteria for classifying leases’”. I
10 follow that path for the purpose of classifying the leases in the leasing program. GI
11 19 defines a capital lease as a lease of property used in utility or nonutility
12 operations, which meets one or more of the criteria:

- 13 1) The lease transfers ownership of the property to the lessee by the end of
14 the lease term;
- 15 2) The lease contains a bargain purchase option;
- 16 3) The lease term is equal to 75 percent or more of the estimated economic
17 life of the leased property; and
- 18 4) The present value at the beginning of the lease term of the minimum lease
19 payments, excluding that portion of the payments representing executory
20 costs such as insurance, maintenance, and taxes to be paid by the lessor,
21 including any profit thereon, equals or exceeds 90 percent of the excess of the
22 fair value of the leased property to the lessor at the inception of the lease over

⁶⁹ O’Connell, Exh. No. ECO-19 (Accounting For leases, General Instructions 20).

1 any related investment tax credit retained by the lessor and expected to be
2 realized by the lessor.⁷⁰

3
4 **Q. Would the contract under Schedule 75 be classified as a capital lease?**

5 A. Yes, because it meets at least two of the criteria:⁷¹ criteria (3) and (4) above. The
6 lease term is equal to 75 percent or more of the estimated economic life; therefore, it
7 meets criteria 3.⁷² The contract contains a purchase option,⁷³ but it does not qualify
8 as a bargain purchase option.⁷⁴

9
10 **Q. Does the lease arrangement meet criterion 4?**

11 A. Yes. PSE states that fair value is not specifically defined in GI 19 and GI 20, but that
12 the value of the assets assumed in determining the rates was derived from individual
13 bidder responses. These bid responses were used to establish average costs for each
14 product, then bundled based on aligned characteristics.⁷⁵ For the purposes of lease
15 classification, Staff uses these averages as fair value in this context, exclusively and
16 only for the purpose of comparing them to the present value at the beginning of the

⁷⁰ O'Connell, Exh. No. ECO-24 (Accounting for leases, General Instructions 19).

⁷¹ This exercise is only done with the purpose of classifying the contract as a capital lease not to recognize the assets in Schedule 75 as utility or non-utility.

⁷² O'Connell, Exh. No. ECO-20 (PSE response to Staff Data Request 47).

⁷³ [Proposed] Schedule 75, Sheet 75-R, Clause 5.9.

⁷⁴ In this context the fair value of the property would be the undepreciated portion of the total capital cost at the date of exercising the option to purchase established in Schedule 75. The bargain purchase option is a provision allowing the lessee, at her option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.

⁷⁵ O'Connell, Exh. No. ECO-21 (PSE response to Staff Data Request 43).

1 lease term of the minimum lease payments.⁷⁶ Using the heat pump as an example,
2 the present value of the minimum lease payments is [REDACTED],⁷⁷ which is in
3 excess of 90 percent of the fair value of [REDACTED].⁷⁸ Therefore, Staff finds the leases
4 also meet criterion 4 for capital leases.

5
6 **Q. What is the criteria for classification of leases according to the ASC Update?**

7 A. According to ASC Update for Leases (Topic 842) the criteria for classifying leases
8 are:

9 A lessee shall classify a lease as a finance lease and a lessor shall
10 classify a lease as a sales-type lease when the lease meets any of the
11 following criteria at lease commencement⁷⁹:

- 12
13 a. The lease transfers ownership of the underlying asset to the
14 lessee by the end of the lease term.
15 b. The lease grants the lessee an option to purchase the underlying
16 asset that the lessee is reasonably certain to exercise.
17 c. The lease term is for the major part of the remaining economic
18 life⁸⁰ of the underlying asset. However, if the commencement
19 date falls at or near the end of the economic life of the
20 underlying asset, this criterion shall not be used for purposes of
21 classifying the lease.
22 d. The present value of the sum of the lease payments and any
23 residual value guaranteed by the lessee that is not already
24 reflected in the lease payments in accordance with paragraph
25 842-10-30-5(f) equals or exceeds substantially all of the fair
26 value of the underlying asset.

⁷⁶ O'Connell, Exh. No. ECO-22 (PSE response to Staff Data Request 48).

⁷⁷ O'Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tab 34, cell C86)

⁷⁸ *Id.* at Tab 34, Cell C16.

⁷⁹ Commencement date of the lease is the date on which a lessor makes an underlying asset available for use by a lessee.

⁸⁰ Economic life is either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

1 e. The underlying asset is of such a specialized nature that it is
2 expected to have no alternative use to the lessor at the end of the
3 lease term.”⁸¹
4
5

6 **Q. Would the contract under Schedule 75 be classified as a sales-type lease?**

7 A. Yes, because it meets criteria b, c, and d. The lease term is for the major part of the
8 economic life of the asset⁸² and the present value of the sum of the lease payments
9 exceeds the fair value of the underlying asset as demonstrated above. Also, it is
10 rational to expect that some customers (lessee) would have an incentive to exercise
11 the purchase option at the beginning of the lease if they were given complete
12 information regarding the purchase price⁸³ and the information of total lease payment
13 over lease term.⁸⁴ For example, at the start of year one customers that enter a contract
14 to install a heat pump would have the option to pay ██████████⁸⁵ to purchase the asset
15 from PSE (the customer would also assume the costs and risks of future maintenance
16 and repairs) or to pay \$25,056⁸⁶ over a period of 18 years. Moreover, PSE can be
17 reasonably certain that the purchase option at the end of the lease will be exercised
18 because even though some customers will not have the financial capacity to purchase
19 the appliance at the beginning of the lease, most of the customers will have a superior
20 motivation to exercise the purchase option right before the end of the lease term after

⁸¹ O’Connell, Exh. No. ECO-23 (ASC Update. 842-10-25-2).

⁸² O’Connell, Exh. No. ECO-20 (PSE response to Staff Data Request 47).

⁸³ The purchase price changes each year based on completed years. *See* O’Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: cell E128).

⁸⁴ O’Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet, Tabs 32, 33, 34, 35, 36, 38, 39, 40, 41, 42, 44, 45: cell C90)

⁸⁵ O’Connell, Exh. No. ECO-5 (Highly Confidential PSE Pricing Worksheet cell E128 of Tab 34).

⁸⁶ [Proposed] Schedule 75, Sheet 75-B (This is the monthly lease charge for Efficient Air Source Electric Heat pump, multiplied by 216 monthly payments for 18 years of the lease term.).

1 the appliance has depreciated. That is, before the appliance is removed from
2 customer's premises by PSE, which would leave lessees without the appliance that
3 provides them with hot water or space heating.

4
5 **C. Recording of Leasing Transactions.**

6
7 **Q. Please describe the importance of recording for leasing transactions under**
8 **Schedule 75.**

9 A. The recording of leasing transactions highlights the role of PSE as a lessor and the
10 accounts that should be used to recognize the fundamental economic impact of the
11 agreement. PSE's proposal raises the potential to double count the assets. PSE
12 expects to book these leased assets to the same FERC account (account 386 "Other
13 property on customers' premises") it uses for the natural gas assets for the existing
14 rental program. Likewise, the Company plans to use account 372 for the electric
15 leased assets. Also the Company plans to use "Customer accounts receivable" to
16 recognize accounts receivable from Schedule 75.⁸⁷ If PSE records assets and
17 receivables without following proper accounting standards and guidance, there is the
18 potential for double counting. It is also important to clarify which types of assets
19 should be included in the accounts previously mentioned and if those accounts are
20 suitable for the leasing program appliances.

21

⁸⁷ O'Connell, Exh. No. ECO-25 (PSE response to Staff Data Request 49).

1 **Q. Does the USoA guidance apply in this situation?**

2 A. No. Although General Instruction 20 “Accounting for leases” provides a step-by-step
3 process to use for the recording of capital and operating leases, these instructions
4 refer to *the utility as a lessee*. This is inadequate in this case because PSE is acting
5 as a lessor. USoA Title 18 does not provide any general accounting instructions for
6 instances when the utility is the lessor.

7
8 **Q. What is the guidance to account for leases according to ASC Update?**

9 A. Subtopic 842-30-25-1 of ASC update addresses the methodology that lessors should
10 use to recognize sales-type leases:

11 At the commencement date, a lessor shall recognize each of the
12 following and derecognize the underlying asset in accordance with
13 paragraph 842-30-40-1:

- 14 a. A net investment in the lease, measured in accordance with
15 paragraph 842-30-30-1
16 b. Selling profit or selling loss arising from the lease
17 c. Initial direct costs as an expense if, at the commencement date,
18 the fair value of the underlying asset is different from its
19 carrying amount. If the fair value of the underlying asset equals
20 its carrying amount, initial direct costs (see paragraphs 842-10-
21 30-9 through 30-10) are deferred at the commencement date and
22 included in the measurement of the net investment in the lease.
23 The rate implicit in the lease is defined in such a way that those
24 initial direct costs eligible for deferral are included”
25

26 It is important to point out that the lessor shall not derecognize the underlying asset if
27 collectability of the lease payments—plus any amount necessary to satisfy a residual
28 value guarantee provided by the lessee—is not probable at the commencement date.

29 Given that PSE will assess the creditworthiness of customers before they enter the
30 lease agreement, the collectability of the lease payments should be considered

1 probable. Therefore, the underlying asset must be derecognized. There is no residual
2 value estimated for these appliances at the end of the lease.⁸⁸

3
4 **Q. How is the net investment measured?**

5 A. Subtopic 842-30-30-1 of the ASC update addresses the methodology that lessors
6 should use to measure the net investment in the lease:

7 A lessor shall measure the net investment in the lease to include both
8 of the following:

- 9 A. The lease receivable, which is measured at the present value
10 discounted using the rate implicit in the lease, of:
- 11 1. The lease payments (as described in paragraph 842-10-30-5)
12 not yet received by the lessor.
 - 13 2. The amount the lessor expects to derive from the underlying
14 asset following the end of the lease term that is guaranteed
15 by the lessee or any other third party unrelated to the lessor
- 16 B. The unguaranteed residual asset at the present value of the
17 amount the lessor expects to derive from the underlying asset
18 following the end of the lease term that is not guaranteed by the
19 lessee or any other third party unrelated to the lessor, discounted
20 using the rate implicit in the lease.

21
22 This means that the Company should recognize a lease receivable at the beginning of
23 the lease and derecognize the underlying leased asset. In other words, now the
24 Company would record a receivable and no longer a fixed asset, or “plant-in-service”
25 in utility-speak.

26
27 **Q. Would the equipment under Schedule 75 be recorded in an asset account**
28 **according to the previously stated lease guidelines?**

⁸⁸ O’Connell, Exh. No. ECO-20 (PSE response to Staff Data Request 47).

1 A. No. Staff recommends the Company should follow the guidelines of the ASC
2 Update. PSE should derecognize the underlying asset at the commencement date and
3 recognize a net investment in the lease, selling profit or loss and the initial indirect
4 costs as expense. Derecognition means that all underlying leased assets are removed
5 from the asset accounts. The consequence of derecognition is that the Company
6 would not have any assets recorded in plant accounts but rather a lease receivable.
7 Recognizing both appliances as an asset and as a receivables simultaneously would
8 be double accounting.

9
10 **Q. Which accounts does PSE anticipates to use to record the transactions**
11 **associated with net plant?**

12 A. PSE anticipated the use of the FERC account 386 "Other property on customers'
13 premises" for natural gas assets and account 372 "Leased property on Customers'
14 premises" for electric assets offered under offered under Schedule 75.⁸⁹ Each of
15 these subsidiary-level FERC accounts belong to FERC 101 "Electric plant in
16 service".⁹⁰ Accounts receivable from Schedule 75 customers would be recognized in
17 FERC account "Customer accounts receivable."⁹¹

18 Accounts 386 and 372 are classified as Distribution Plant. Distribution Plant
19 means:

20 [A]ll land, structures, conversion equipment, lines, line transformers,
21 and other facilities employed between the primary source of supply

⁸⁹ O'Connell, Exh. No. ECO-25 (PSE response to Staff Data Request 49).

⁹⁰ *Id.*

⁹¹ *Id.*

1 (i.e., generating station, or point of receipt in the case of purchased
2 power) and of delivery to customers, which are not includible in
3 transmission system, as defined in paragraph A, whether or not such
4 land, structures, and facilities are operated as part of a transmission
5 system or as part of a distribution system.⁹²

6 This means that a facility will be included in the distribution plant, regardless of the
7 nature of the operation of the facility (used for either transmission or distribution
8 system), if the equipment is employed between the primary source of supply and of
9 delivery to customers and can't be included in the transmission system.

10
11 **Q. Are the assets in Schedule 75 consistent with the definition of FERC**
12 **distribution plant?**

13 A. No, because the equipment is not used for transmission or distribution operations.
14 The Company's capability to deliver electricity and gas to customers is independent
15 of the existence of water heaters and HVAC systems in customer's premises.

16
17 **Q. Are electric account 372, Leased property on Customers' premises, and gas**
18 **account 386, Other property on customers' premises, the appropriate accounts**
19 **for PSE to use?**

20 A. No. Account 372 states:

21 This account shall include the cost of electric motors, transformers,
22 and other equipment on customers' premises (including municipal
23 corporations), leased or loaned to customers, but not including
24 property held for sale.

25
26 Furthermore, Note B of account 372 states:

⁹² Electric Plant Instructions on Defining Transmission and Distribution Plant, 18 C.F.R. Chapter 1, Subchapter C, Part 101, page 416, number 14 (April 1, 2015).

1 Do not include in this account any costs incurred in connection with
2 merchandising, jobbing, or contract work activities.

3 PSE's lease program, for all intents and purposes, is a merchandising program.
4

5 **VIII. ASYMMETRY OF INFORMATION**
6

7 **Q. What information related to the leasing program do customers have access to?**

8 A. The Company's leasing program involves a considerable amount of uncertainty for
9 the lessee. The tariff does not explicitly provide important data for decision making,
10 such as the make and model of the appliances, unit costs, installation costs, and the
11 discount rate used to calculate minimum lease payments. PSE will know exactly
12 which brands and models of appliances will be available for installation and how
13 much they will cost and how much it will cost to install them, but customers will not.
14 This is called asymmetric information.⁹³

15 In order to make a balanced decision, customers need access to relevant
16 information, and it should be presented to them in a manner that is clear and
17 understandable. Customers will be unable to compare and fairly assess PSE's leasing
18 option with other alternatives available in the unregulated markets without such
19 information.
20

⁹³ Asymmetric information occurs when an agent on one side of a transaction has information that the agent on the other side of the transaction does not have.

1 **Q. Will PSE give sufficient information for customer's decision making purposes?**

2 A. PSE states that the lease program will provide customers with a clear understanding
3 of the full costs of the service, and that it will be up to customers to assess whether
4 the service provides value and is appropriate for their needs.⁹⁴ The Company,
5 however, recognizes that "customers look to PSE as a trusted energy partner to
6 provide them with safe, dependable and efficient energy management options"⁹⁵ and
7 that the customer values the Commission's regulatory process to lease services
8 because it supports "fair pricing."⁹⁶ For these reasons, if the leasing program is given
9 regulatory treatment, customer's incentives to research and compare PSE's offer to
10 other service providers in unregulated markets would considerably diminish.

11

12 **Q. What would a customer need to compare PSE's rates to unregulated rates?**

13 A. Customers should know exactly what they are paying for and how much they are
14 paying for it. PSE does not intend to provide customers with sufficient, detailed
15 information for customers to make a comparison to other alternatives in the market.
16 PSE testifies that it will disclose to its customers four elements: (1) the lease term,
17 (2) its total cost, (3) an equipment maintenance schedule, and (4) the warranty.⁹⁷
18 Thus, a customer would know she would pay \$116 a month for an Efficient Air
19 Source Heat Pump for a period of 18 years, or a total of \$25,056 over the life of the
20 lease, which includes all standard maintenance and servicing. That heat pump,

⁹⁴ McCulloch, Exh. No. MBM-IT at 13:17-19.

⁹⁵ O'Connell, Exh. No. ECO-2 (UE-151871 Cover letter 9-18-15).

⁹⁶ O'Connell, Exh. No. ECO-26 (PSE response to Staff Data Request 38. Attachment A) at 3.

⁹⁷ Englert, Exh. No. EEE-1T at 10:1-18.

1 however, will have: a capacity ranging from 2 ton to 3 ton; a Heating Season
2 Performance Factor of ≥ 9.0 ; and a Seasonal Energy Efficiency Ratio of 16. The
3 customer can turn to the unregulated markets and compare to other retailers of the
4 same appliance, but won't know exactly what PSE is offering in terms of brand,
5 capacity, energy efficiency, unit costs, installation costs, maintenance costs or
6 servicing costs.

7 For comparison purposes, I make the assumption that the customer knows
8 how much installation and unit costs are [REDACTED] and finds a similar offer in the
9 unregulated markets. Once the customer identifies that she is getting the same model
10 as PSE at the same price, she will need to determine how much the finance charges
11 will be to make a decision.

12 Many financial institutions provide financing for these particular appliances,
13 but for this exercise I will use the Energy-Smart Loans provided by Puget Sound
14 Cooperative Credit Union (PSCCU). PSCCU offers financing throughout the State of
15 Washington for equipment used for everything from heating and cooling, hot water
16 tanks, gas conversions—to windows and renewable energy like solar.⁹⁸ It offers
17 Annual Percentage Rate (APR) ranging from 4.25% to 8.74%. PSCCU charges a
18 filing fee of \$180, which is the cost of placing a lien on the fixture installed in
19 residential premises and a \$5 dollar membership fee. In order to compare the
20 alternatives I subtracted all PSE's O&M costs after the first year of the lease,

⁹⁸ <https://www.pscu.org/Borrow/Energy-Smart-Loans.aspx>

1 including maintenance and servicing, to obtain the value of how much the customer
 2 would pay for financing only the appliance through PSE:

Efficient Air Source Electric Heat pump	PSCCU Lowest Annual Percentage Rate	PSCCU Highest Annual Percentage Rate	PSE Model
APR. (Implicit rate for PSE.)	4.25%	8.74%	12.77%
Capital costs	██████	██████	██████
Washington State Sales and Use Tax (6.5%) at the beginning of the contract	██████	██████	██████
PSCCU filing fee	\$180.00	\$180.00	\$0.00
PSCCU membership fee	\$5.00	\$5.00	\$0.00
Total	██████	██████	██████
Term in years	15	15	18
Term in months	180	180	216
Monthly payments (Includes Monthly payment of Washington State sales tax for PSE)	██████	██████	██████
Total Lease payments over lease term using PSCCU	██████	██████	██████
Difference between PSE and PSCCU	██████	██████	
No Local City/County Sales and Use Tax or State and/or City Utility Tax were included in the calculation. PSE's Implicit APR includes the Company's approved rate of return.			

3
 4
 5 **Q. Do customers have payment options within PSE tariffed rates?**
 6 A. No. The customer is locked into the tariffed rate in effect at the time the contract is
 7 signed. If the tariff is updated at a later time, that new rate is only available
 8 prospectively. The customer's only options are to pay the fixed price for the fixed
 9 term or to exercise the purchase option and forego the remainder of the maintenance
 10 and repair service.

1 **Q. Does the open market offer more options for financing than PSE's tariff?**

2 A. Yes. The customer will find that there are financing alternatives that charge
3 significantly lower interest rates than the ones proposed by PSE, making the
4 Company's alternative more expensive in comparison to unregulated markets.
5 However, PSE is regulated as a utility company, not a financial institution. Staff
6 recommends that the Commission should deny PSE's equipment leasing service for
7 the many reasons discussed above.

8

9 **Q. Does this conclude your testimony?**

10 A. Yes.