**EXHIBIT NO. \_\_\_(DAD-1T)
DOCKET NO. UE-121373
DOCKET NO. UE-121697/UG-121705
DOCKET NO. UE-130137/130138
WITNESS:  DANIEL A. DOYLE**

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

|  |  |
| --- | --- |
| In the Matter of the Petition of PUGET SOUND ENERGY, INC.For Approval of a Power Purchase Agreement for Acquisition of Coal Transition Power, as Defined in RCW 80.80.010, and the Recovery of Related Acquisition Costs | DOCKET NO. 121373 |
| In the Matter of the Petition of PUGET SOUND ENERGY, INC. and NW ENERGY COALITION For an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms | DOCKET NOS. UE-121697 and UG-121705 (Consolidated) |
| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant,v.PUGET SOUND ENERGY, INC.,  Respondent. | DOCKET NOS. UE-130137 and UG-130138 (Consolidated) |

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF**

**DANIEL A. DOYLE
ON BEHALF OF PUGET SOUND ENERGY, INC.**

*In Support of the Multiparty Settlement*

*Re: Coal Transition PPA and other Pending Dockets*

**MAY 8, 2013**

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY
(NONCONFIDENTIAL) OF** **DANIEL A. DOYLE**

**CONTENTS**

[I. INTRODUCTION 1](#_Toc355779792)

[II. THE DETERMINATION OF PSE’S AUTHORIZED COST OF CAPITAL IS OUTSIDE THE SCOPE OF THIS PROCEEDING 2](#_Toc355779793)

[A. The Determination of PSE’s Authorized Return on Equity for PSE is Outside the Scope of This Proceeding 2](#_Toc355779794)

[B. The Determination of PSE’s Authorized Cost of Debt for PSE is Outside the Scope of This Proceeding 7](#_Toc355779795)

[C. Public Counsel Incorrectly Assumes that Decoupling Requires a Lower Allowed Return on Equity 9](#_Toc355779796)

[III. THE DETERMINATION OF PSE’S AUTHORIZED CAPITAL STRUCTURE IS OUTSIDE THE SCOPE OF THIS PROCEEDING 12](#_Toc355779797)

[A. Public Counsel’s Proposal to Adjust PSE’s Capital Structure is Misplaced 12](#_Toc355779798)

[B. PSE’s Capital Structure for the Twelve Months Ending December 31, 2012, Contained 48.65 Percent Equity and Not 46.6 Percent Equity as Suggested by ICNU 14](#_Toc355779799)

[IV. ICNU MISINTERPRETS CERTAIN INFORMATION REGARDING PUGET ENERGY AND PSE 17](#_Toc355779800)

[A. ICNU Incorrectly Asserts that PSE’s Operating Return on Equity in Calendar Year 2012 Was 10.75 Percent 17](#_Toc355779801)

[B. ICNU’s Concern Regarding the Dividend Payout Ratio of PSE is Misplaced 20](#_Toc355779802)

[C. ICNU Erroneously Suggests that PSE’s Pension Expense is Not Indicative of Current Contribution Levels 24](#_Toc355779803)

[V. CONCLUSION 26](#_Toc355779804)

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF DANIEL A. DOYLE**

# I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Daniel A. Doyle. I am employed as Senior Vice President and Chief Financial Officer for Puget Sound Energy, Inc. (“PSE”). My business address is 10885 NE Fourth Street, Bellevue, WA 98009-9734.

Q. Have you prepared an exhibit describing your education, relevant employment experience and other professional qualifications?

A. Yes, I have. It is Exhibit No. \_\_\_(DAD-2).

Q. What is the purpose of your rebuttal testimony?

A. This prefiled rebuttal testimony also responds to arguments made in the following testimonies:

(i) the Prefiled Response Testimony of Mr. Stephen G. Hill, Exhibit No. \_\_\_(SGH-1T), on behalf of the Public Counsel Section of the Washington Attorney General’s Office (“Public Counsel”);

(ii) the Prefiled Response Testimony of Mr. Michael P. Gorman, Exhibit No. \_\_\_(MPG-1T), on behalf of the Industrial Customers of Northwest Utilities (“ICNU”); and

(iii) the Prefiled Response Testimony of Mr. Kevin G. Higgins, Exhibit No. \_\_\_(KGH-1T), on behalf of The Kroger Co. (“Kroger”) on behalf of its Fred Meyer Stores and Quality Food Centers divisions.

# II. THE DETERMINATION OF PSE’S AUTHORIZEDCOST OF CAPITAL IS OUTSIDE THESCOPE OF THIS PROCEEDING

## A. The Determination of PSE’s Authorized Return on Equity for PSE is Outside the Scope of This Proceeding

Q. How do you respond to testimony from Public Counsel and ICNU proposing reductions in PSE’s authorized return on equity in this proceeding?

A. As discussed in more detail below, the determination of PSE’s authorized return on equity is outside the scope of this proceeding. The Commission made a determination on PSE’s return on equity one year ago in PSE’s general rate case. Further, the recommended reductions to PSE return on equity proposed by Public Counsel and ICNU are not supported by evidence, and the witnesses proposing such adjustments admit their proposals are not based on complete capital studies or analyses.

Q. Has Public Counsel advocated for a reduction in PSE’s authorized return on equity in this proceeding?

A. Yes. Although Public Counsel does not expressly identify a recommended reduction in PSE’s authorized return on equity, the testimony suggests that Public Counsel is advocating for a thirty basis point reduction in PSE’s authorized return on equity—from 9.80 percent to 9.50 percent —due to alleged changes in capital markets, without any formal justification.

Q. How does PSE calculate Public Counsel’s suggested reduction in authorized return on equity due to alleged changes in capital markets?

A. Because Public Counsel does not expressly state what its suggested reduction in authorized return on equity is, Public Counsel’s suggested reduction must be deduced from other statements in the testimony.

First, Public Counsel advocates that the Commission reduce PSE’s authorized return on equity by fifty basis points if the Commission were to adopt PSE’s decoupling proposal. Hill, Exh. No. \_\_\_(SGH-1T), at page 12, lines 3-5. If adopted, this proposed reduction would reduce PSE’s authorized return on equity from 9.8 percent to 9.3 percent.

Public Counsel then suggests that

[t]aking those factors into account as well as my own recent estimate of the cost of equity capital for BBB-rated electric utilities, an equity return of 9.0 percent would be reasonable for [PSE] under a decoupling ratemaking scenario.

Hill, Exh. No. \_\_\_(SGH-1T), at page 12, lines 8-10. This suggests a reduction from the suggested authorized return on equity from 9.3 percent to 9.0 percent —or a thirty basis point reduction—due to alleged changes in capital markets.

Q. Has Public Counsel presented a return on equity study in this proceeding?

A. No. Public Counsel admits that it has not undertaken a return on equity study in this proceeding that would support the proposed 30 basis point reduction in PSE’s authorized return on equity. Hill, Exh. No. \_\_\_(SGH-1T), at page 10, lines 15-16.

Public Counsel points to declines in corporate bond yields and suggests that capital costs are now lower than when the Commission adopted PSE’s authorized return on equity of 9.80 percent. Hill, Exh. No. \_\_\_(SGH-1T), at page 8, line 13, through page 9, line 14. Public Counsel fails to provide any evidence, however, of any positive or negative correlation between corporate bond yields and authorized utility returns on equity or how the spread between the two changes over time.

Public Counsel also suggests that cost of capital testimony in a rate proceeding involving Southwestern Electric Power Company before the Public Utilities Commission of Texas is instructive. Hill, Exh. No. \_\_\_(SGH-1T), at page 10, line 16, through page 11, line 11. In that proceeding, witness for Public Counsel suggests that an appropriate range of authorized returns on equity for BBB-rated electric utilities would be within a range from 8.50 percent to 9.50 percent. The Public Utilities Commission of Texas, however, has yet to issue an order in the Southwestern Electric Power Company rate proceeding. Moreover, Public Counsel fails to disclose that other evidence presented in Southwestern Electric Power Company would support an authorized return on equity within a range of 10.5 percent and 11.5 percent.

More fundamentally, Public Counsel’s references regarding Southwestern Electric Power Company rate proceeding are irrelevant. Public Counsel neither presents evidence that Southwestern Electric Power Company has a risk profile similar to PSE nor provides detail regarding Southwestern Electric Power Company’s customer base and service territory. Moreover, the use of a single utility as a reference significantly departs from the appropriateness, and time-honored tradition, of considering peer groups when assessing cost of capital.

Q. Has ICNU advocated for a reduction in PSE’s authorized return on equity in this proceeding?

A. Yes. ICNU is advocating for a fifty basis point reduction in PSE’s authorized return on equity, from 9.80 percent to 9.30 percent. ICNU suggests that “the decline in utility bond yields suggests that PSE’s current capital cost should be much lower today than it was at the time the final order in the last rate case was issued.” Gorman, Exh. No. \_\_\_(MPG-1T), at page 12, lines 12-13. ICNU fails to provide any evidence, however, of any positive or negative correlation between utility bond yields and authorized utility returns on equity.

Q. Has ICNU presented a return on equity study in this proceeding?

A. Yes. ICNU presented a return on equity study as Exhibit No. \_\_\_(MPG-3). In that study, ICNU relied upon a constant growth discounted cash flow (“DCF”) model, a sustainable growth DCF, a multi-stage growth DCF, risk premium, and capital asset pricing model. The results of ICNU’s return on equity study are provided in Table 1 below.

**Table 1. ICNU Return on Equity Results**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Model** | **Low** | **High** | **Mean** | **Median** | **Source** |
| Constant Growth DCF | 5.70% | 11.37% | 9.10% | 9.29% | Exh. No. \_\_\_(MPG-10) |
| Sustainable Growth DCF | 7.21% | 9.69% | 8.42% | 8.38% | Exh. No. \_\_\_(MPG-13) |
| Multi-Stage Growth DCF | 7.55% | 10.18% | 9.01% | 9.03% | Exh. No. \_\_\_(MPG-15) |
| Risk Premium | 9.09% | 9.44% | N/A | N/A | Exh. No. \_\_\_(MPG-1T) |
| CAPM | N/A | N/A | 8.40% | N/A | Exh. No. \_\_\_(MPG-22) |

Q. Is PSE presenting a return on equity study in this proceeding?

A. No. The scope of this proceeding is to consider whether a proposed global settlement of five dockets is consistent with the public interest, and the determination of the cost of capital, including the authorized return on equity for PSE, is outside the scope of this proceeding. Additionally, even if PSE’s authorized return on equity were properly within the scope of this proceeding—which it is not—PSE had only seven business days to prepare this rebuttal testimony. PSE simply could not analyze ICNU’s return on equity study within the time allowed and prepare a study responding to ICNU’s study. Therefore, PSE is not presenting a return on equity study in this proceeding.

Q. Does PSE have any comments regarding ICNU’s return on equity study?

A. Yes. ICNU’s recommended return on equity in this proceeding (9.30 percent) does not materially differ from ICNU’s recommended return on equity in PSE’s 2011 general rate proceeding (9.50 percent), in which this Commission authorized a return on equity of 9.80 percent. Given the similarities in ICNU’s suggested returns on equity in the two proceedings, no compelling evidence exists to warrant a reduction in PSE’s authorized return on equity.

Moreover, the ICNU testimony fails to provide a complete picture because ICNU has failed to provide evidence regarding the authorized returns on equity and capital structure of those operating utilities contained within the holding companies presented in ICNU’s proposed proxy group. PSE researched those authorized returns on equity and capital structures using the SNL Energy databases. According to the SNL Energy database, the average authorized return on equity for the operating utilities within ICNU’s proposed proxy group is 10.08%, and the average capital structure for the operating utilities within ICNU’s proposed proxy group contains 48.80% equity. Please see Exhibit No. \_\_\_(DAD-3) for a copy of the results of the research. Thus, each of the average authorized return on equity and the average authorized capital structure of the operating utilities in ICNU’s proposed proxy group is substantially higher than that advocated for PSE in this proceeding.

Finally, the cost of capital reductions proposed by Public Counsel and ICNU ignore that fact that we are in unprecedented economic times where, in efforts to improve economic growth, the Federal Reserve has engaged in expansionary policies that have reduced interest rates to historic lows. The three or four-year term of the proposed settlement and the pre-established K-factors protect customers from the impacts of the inevitable increase in interest rates and capital costs that will ultimately come when the Federal Reserve relaxes these expansionary policies.

## B. The Determination of PSE’s Authorized Cost of Debt for PSE is Outside the Scope of This Proceeding

Q. Has Public Counsel made a recommendation with respect to PSE’s cost of debt?

A. Yes. Public Counsel suggests that PSE’s embedded debt cost is likely to decline in the near-term. Hill, Exh. No. \_\_\_(SGH-1T), at page 14, line 8, through page 16, line 10. Public Counsel acknowledges, however, that projections in future interest rates are inherently subjective and that “it is certainly possible that the U.S. economy could heat up and interest rates could rise as rapidly as [PSE] currently projects . . . .” Hill, Exh. No. \_\_\_(SGH-1T), at page 16, lines 1-2. Thus, Public Counsel highlights the speculative nature in making prospective adjustments to costs of debt capital and equity returns.

Q. Does Public Counsel suggest what PSE’s cost of debt should be?

A. No. Public Counsel fails to provide any suggested reduction in PSE’s authorized cost of debt. Perplexingly, Public Counsel suggests that its opinion that costs of debt are likely to continue to decline “provides further justification for the Commission by reduce PSE’s allowed ROE to 9.0 percent . . . .” Hill, Exh. No. \_\_\_(SGH-1T) at page 16, lines 6-10. Public Counsel fails to provide any evidence or rationale that would support a reduction in an authorized return on equity due to alleged projections of reductions in cost of debt.

Q. Has ICNU made a recommendation with respect to PSE’s cost of debt?

A. Yes. ICNU has identified five PSE debt issuances that will mature and be refinanced during the maximum four-years of the rate case stay-out period and recommends that the Commission

request [PSE] to present supporting documentation on how it intends to replace the maturing debt issuances and update its embedded cost of long-term debt. In addition, the Commission should direct the Company to update its cost of short-term debt.

Gorman, Exh. No. \_\_\_(MPG-1T), at page 11, lines 17-20.

Q. How does PSE respond to the recommendations of Public Counsel and ICNU?

A. As stated above, the scope of this proceeding is to consider whether a proposed global settlement of five dockets is consistent with the public interest, and the determination of the cost of capital, including the cost of long-term and short-term debt for PSE, is outside the scope of this proceeding. Additionally, it is impossible for PSE—or any party to this proceeding—to project likely changes in interest rates during the four-year period. The proposals by these parties do not comport with the rigorous studies and analyses upon which this Commission has historically relied when making cost of capital determinations. Therefore, any adjustment to the cost of either the long-term or short-term debt of PSE would be speculative and inappropriate.

## C. Public Counsel Incorrectly Assumes that Decoupling Requires a Lower Allowed Return on Equity

Q. Do parties in this proceeding suggest that the Commission reduce PSE’s authorized return on equity if the decoupling mechanism proposal?

A. Yes, although as I discuss below, there is no evidence supporting their suggested adjustments. Public Counsel asserts that, if the Commission were to adopt the decoupling mechanism proposal, the Commission should reduce PSE’s authorized return on equity by 50 basis points. Hill, Exh. No. \_\_\_(SGH-1T), at page 11, lines 16-18. Witness for Public Counsel asserts that this 50 basis point reduction is supported by testimony on behalf of another party in a proceeding that occurred seven years ago. Hill Exh. No. \_\_\_(SGH-1T), at page 11, lines 14-18. Public Counsel fails to provide similar testimony in this proceeding.

ICNU also asserts that, if the Commission were to adopt PSE’s decoupling mechanism proposal, the Commission should reduce PSE’s authorized return on equity. Gorman, Exh. No. \_\_\_(MPG-1T), at page 27, lines 3-5. ICNU recommends a 25 basis point reduction. Gorman, Exh. No. \_\_\_(MPG-1T), at page 28, lines 13-14. Like Public Counsel, ICNU fails to provide analysis in this proceeding that such a reduction is warranted and instead relies on previous testimony of its witness from other proceedings. Gorman, Exh. No. \_\_\_(MPG-1T), at page 28, lines 13-15.

Finally, Kroger asserts that, if the Commission were to adopt PSE’s decoupling mechanism proposal, the Commission should reduce PSE’s authorized return on equity by 25 basis points. Higgins, Exh. No. \_\_\_(KCH-1T), at page 20, lines 12-14.

Q. Have other jurisdictions implemented reductions in authorized returns on equity in connection with the adoption of proposed decoupling mechanism?

A. Although a few jurisdictions have implemented reductions in authorized returns on equity in connection with the adoption of proposed decoupling mechanism, a comprehensive survey of jurisdictions conducted by Pamela Lesh Morgan, shows that the vast majority of jurisdictions have not reduced authorized returns on equity due to the implementation of a proposed decoupling mechanism. Table 2 below provides the results of the comprehensive analysis conducted by Ms. Morgan.

**Table 2. Commission Decisions on Authorized Returns on Equity
in Light of Implementation of Decoupling Mechanisms**

|  |  |  |
| --- | --- | --- |
| **Reduction in Return on Equity** | **Number of Decisions** | **Result of Settlement** |
| None | 56 | 28 |
| 10 basis points | 9 | 4 |
| 25 basis points | 3 | 1 |
| 50 basis points | 4 | 0 |
| Total | 72 | 33 |

Pamela Lesh Morgan, “A Decade of Decoupling for US Energy Utilities: Rate Impacts, Designs, and Observations,” at page 15 (2012) (available at <http://switchboard.nrdc.org/blogs/rcavanagh/decouplingreportMorganfinal.pdf>).

As demonstrated by Table 2 above, the large majority (80 percent) of decisions adopting decoupling make no reduction to the authorized returns on equity. Among those decisions that did include a reduction in the authorized return on equity, the majority have reductions (10 basis points) that are smaller than the 25 basis point reduction advocated by ICNU and Kroger and significantly smaller than the 50 basis point reduction advocated by Public Counsel.

Q. Have Public Counsel, ICNU, or Kroger provided evidence that the proposed decoupling mechanism will reduce PSE’s business risk?

A. No. Neither Public Counsel, ICNU, nor Kroger has provided evidence that the proposed decoupling mechanism will reduce PSE’s business risk. Indeed, no empirical evidence exists that quantifies how, if at all, decoupling changes a utility’s business risk. Indeed, an empirical study conducted by The Brattle Group found that decoupling may actually *increase* a utility’s overall business risk to some extent. Joseph B. Wharton, *et al*., “The Impact of Decoupling on the Cost of Capital – An Empirical Investigation” (Mar. 2011) (available at <http://www.brattle.com/_documents/UploadLibrary/Upload922.pdf>). Given the dearth of empirical evidence regarding the effect of decoupling mechanisms on business risk, the reductions proposed by Public Counsel, ICNU, and Kroger are arbitrary and wholly without support.

# III. THE DETERMINATION OF PSE’S AUTHORIZEDCAPITAL STRUCTURE IS OUTSIDE THESCOPE OF THIS PROCEEDING

## A. Public Counsel’s Proposal to Adjust PSE’s Capital Structure is Misplaced

Q. Does Public Counsel make a proposal to adjust PSE’s authorized capital structure?

A. Yes. Public Counsel suggests that the Commission adjust PSE’s authorized capital structure as a purported “alternative means to address the lower risk imparted by decoupling . . . .” Hill, Exh. No. \_\_\_(SGH-1T), at page 17, lines 9-10; *see also* Hill, Exh. No. \_\_\_(SGH-1T), at page 16, line 11, through page 18, line 11.

Q. Does Public Counsel provide a rationale to support the proposed adjustment PSE’s authorized capital structure?

A, No. Public Counsel’s proposed adjustment to PSE’s authorized capital structure is a results-driven adjustment offered in lieu of Public Counsel’s proposed reduction in PSE’s authorized return on equity. In other words, Public Counsel offers the proposal as a means by which the Commission could adopt Public Counsel’s proposal but keep PSE’s authorized return on equity at 9.8 percent by adjusting PSE’s authorized capital structure to include 37.5 percent common equity and 62.5 percent debt. Mathematically, this achieves the same result as reducing PSE’s authorized return on equity to 9.0 percent but keeping PSE’s authorized capital structure at 48.0 percent common equity and 52.0 percent debt ratio.

In other words, Public Counsel’s suggested adjustment to PSE’s authorized capital structure is no different than Public Counsel’s suggested adjustment to PSE’s authorized return on equity, which, as discussed above, is without support. Moreover, this proposed adjustment is entirely results-driven and fails to acknowledge how the adjustment (i) reflects the actual capital structure supporting regulated activities or (ii) satisfies the balance of safety and economy required by Commission orders. A capital structure with 37.5 percent equity would (i) be inconsistent with the direction taken by the Commission for more than a decade, encouraging the PSE to increase its equity level; (ii) contain significantly less equity than the 44 percent minimum contained within the merger commitments approved by this Commission; and (iii) likely affect the risk and credit profile of PSE significantly.

## B. PSE’s Capital Structure for the Twelve Months Ending December 31, 2012, Contained 48.65 Percent Equity and Not 46.6 Percent Equity as Suggested by ICNU

Q. How do you respond to ICNU’s assertion that PSE’s actual common equity ratio has been approximately 46 percent for the last two years?

A. ICNU’s calculation fails to adjust for the impact of unrealized non-cash mark-to-market accounting gains or losses on PSE’s capitalization. If ICNU were to make this adjustment alone, then the result would be a capital structure with an equity component of 48.65 percent for the twelve months ending December 31, 2011.

Q. Please explain how ICNU calculates PSE’s capital structure.

A. ICNU calculates a capital structure based on information “recorded on [PSE’s] FERC Form 1 over the period March 31, 2011 through December 31, 2012.” Gorman, Exh. No. \_\_\_(MPG-1T), at page 8, lines 9-10. From this information, ICNU concludes that “[d]uring this time period, PSE increased its common equity ratio from 45.7 percent at year-end 2011, up to 46.07 percent at year-end 2012.” Gorman, Exh. No. \_\_\_(MPG-1T), at page 8, lines 10-11.

Q. Why is it appropriate to adjust for the impact of unrealized non-cash mark-to-market accounting gains or losses on PSE’s capitalization?

A. It is necessary to adjust for the impact of unrealized non-cash mark-to-market accounting gains or losses on PSE’s capitalization as well as adjustments for non-regulated subsidiary retained earnings and pension accounting for the same reasons discussed below as to why it is necessary to adjust returns on equity to calculate an operating return on equity.

As discussed below, the Commission’s established practice for the recovery of commodity costs is to reflect in rates the actual commodity costs PSE has, or expects, to incur. Therefore, unrealized non-cash mark-to-market accounting gains or losses from marking derivatives to market as required by generally accepted accounting principles are not, and should not, be reflected in rates.

Q. What was PSE’s capital structure for the twelve months ending December 31, 2011?

A. As shown below in Table 3 below, PSE’s capital structure for the twelve months ending December 31, 2011, contained an equity component of 48.65 percent. This equity component contained in this capital structure slightly exceeds the equity component of 48 percent authorized in PSE’s last rate proceeding.

**Table 3. PSE Capital Structure
(for the twelve months ending December 31, 2011)**

|  |  |  |
| --- | --- | --- |
| **Description** | **Amounta** | **Ratio** |
| Short-Term Debt | $159,106,118 | 4.39% |
| Long-Term Debt | $3,509,682,195 | 49.12% |
| Common Stock | $3,476,036,691 | 48.65% |
| Total | $7,144,825,004 | 100.00% |
| aAverage of Month-End Balances |

This is the same capital structure presented in Exhibit No. \_\_\_(KJB-7) at page 3.

Q. What was PSE’s capital structure for the twelve months ending December 31, 2012?

A. As shown below in Table 4 below, PSE’s capital structure for the twelve months ending December 31, 2012, contained an equity component of 48.65 percent.

**Table 4. PSE Capital Structure
(for the twelve months ending December 31, 2012)**

|  |  |  |
| --- | --- | --- |
| **Description** | **Amounta** | **Ratio** |
| Short-Term Debt | $94,047,784 | 1.26% |
| Long-Term Debt | $3,773,845,605 | 50.44% |
| Common Stock | $3,613,954,006 | 48.30% |
| Total | $7,481,847,395 | 100.00% |
| aAverage of Month-End Balances |

This equity component contained in this capital structure slightly exceeds the equity component of 48 percent authorized in PSE’s last rate proceeding.

Q. Is there a “mismatch” between the common equity presented on page 3 of Exhibit No. \_\_\_(KJB-7) and the common equity presented on page 8 of the same exhibit, as ICNU claims?

A. The common equity presented on page 3 of Exhibit No. \_\_\_(KJB-7) is different from the common equity presented on page 8 of the same exhibit. Specifically, the common equity presented on page 3 of Exhibit No. \_\_\_(KJB-7) is $3,476 million of common equity at year-end 2011, and the common equity presented on page 8 of Exhibit No. \_\_\_(KJB-7) is $3,220 million of common equity at year-end 2011.

The differences between these two common equity amounts, however, explicitly illustrate the importance of the adjustments made by PSE—and accepted by this Commission—in calculating the appropriate capital structure for ratemaking purposes. The amounts presented on page 3 of Exhibit No. \_\_\_(KJB-7) have been adjusted to reflect the appropriate capital structure for ratemaking purposes, whereas the amounts presented on page 8 of Exhibit No. \_\_\_(KJB-7) are in FERC accounts and have not been so adjusted. As pointed out by ICNU, the difference between these two amounts ($255.8 million) is material and largely accounts for the differences between the capital structures presented by PSE and ICNU.

# IV. ICNU MISINTERPRETS CERTAIN INFORMATION REGARDING PUGET ENERGY AND PSE

## A. ICNU Incorrectly Asserts that PSE’s Operating Return on Equity in Calendar Year 2012 Was 10.75 Percent

Q. How do you respond to ICNU’s claim that PSE’s return on equity in calendar year 2012 was 10.75 percent?

A. PSE disagrees with ICNU’s calculation of the return on equity. ICNU’s calculation fails to make the following adjustments to the calculated return on equity necessary to reflect the regulated nature of PSE’s operations:

* ICNU’s calculation fails to exclude unrealized non-cash mark-to-market accounting gains and losses on derivative instruments, after tax, from earnings.
* ICNU’s calculation fails to remove the impacts of accumulated other comprehensive income (“OCI”), subsidiary retained earnings, pension accounting and retained earnings of derivative instruments.
* ICNU's calculation fails to remove the accumulated retained earnings from unregulated activities, such as Puget Western ("PWI").
* ICNU’s calculation fails to adjust average common equity for the impact of the average of monthly averages.

If ICNU were to make these three adjustments, then the result would be a return on equity of 7.7 percent in calendar year 2012.

Q. How does ICNU calculate the 10.75 percent return on equity?

A. ICNU calculated a return on equity of 10.75 percent, based on earnings of $356,170,000, and an average common equity of $3,313,180,000. Gorman, Exh. No. \_\_\_(MPG-1T), at page 4, Table 1. ICNU’s calculation is similar to the return on equity of 10.8 percent calculated in accordance with U.S. Generally Accepted Accounting Principles (“GAAP”) which is different from established regulatory methodology.

Q. Why is it appropriate to make the four adjustments listed above to the return on equity?

A. These four adjustments are necessary to calculate PSE’s operating return on equity, which is an annualized non-GAAP financial measure. PSE uses the operating return on equity because it is a better indicator of the utility’s operating performance and PSE’s earnings from regulated operations.

The Commission’s established practice for the recovery of commodity costs is to reflect in rates the actual commodity costs PSE has, or expects, to incur. These costs are recovered through the Purchased Gas Adjustment (“PGA”) and Power Cost Adjustment (“PCA”) mechanisms, with general rates set to reflect the expected level of electric energy costs in a base rate. Unrealized non-cash mark-to-market accounting gains or losses from marking derivatives to market (as required by GAAP) are not, and should not, be reflected in rates. As a result, the impact of these unrealized non-cash mark-to-market accounting gains or losses on PSE’s capitalization, generally reflected in OCI, must also be removed for ratemaking purposes. Additionally, it is appropriate to remove the accumulated retained earnings of PWI from PSE's consolidated capital structure because those accumulated retained earnings were generated from unregulated activities. This treatment is consistent with PSE's past practices in general rate proceedings and is consistent with capital structures included in Commission Basis Reports. Failure to adjust for these items would result in an inconsistency between (i) the balance sheet impacts of these items and (ii) the cost recovery of these items.

Q. What was PSE’s return on equity in calendar year 2012?

A. As shown below in Table 5 below, PSE’s operating return on equity in calendar year 2012 was 7.7 percent. This operating return on equity is 210 basis points lower than the 9.80 percent return on equity authorized in PSE’s last rate proceeding.

**Table 5. PSE Earned Return on Equity (Thousands)**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Earnings** | **AverageCommonEquity** | **Return onEquity** |
| Return on Equity -- GAAP | $356,170 | $3,313,183 | 10.8% |
| Less/Plus: Unrealized gains and losses on derivative instruments, after-tax | (77,428) | — | \* |
| Other Equity Adjustments | — | 268,610 | \* |
| Impact of Average of Monthly Averages (AMA) | — | 32,131 | \* |
| AMA Regulated Return on Equity | $278,742 | $3,613,924 | 7.7% |

## B. ICNU’s Concern Regarding the Dividend Payout Ratio of PSE is Misplaced

Q. Is ICNU’s expressed concern regarding the dividend payout ratio of PSE misplaced?

A. Yes. ICNU expresses concern that “PSE was paying out approximately 80% of its earnings” and that “its payout ratio to its holding company was . . . relatively high.” Gorman, Exh. No. \_\_\_(MPG-1T), at page 8, lines 19-23. PSE makes these distributions to Puget Energy, Inc. (“Puget Energy”) in large part to service debt obligations at the Puget Energy level. Puget Energy has used these funds to finance, reduce and refinance its debt obligations. It would be improper to suggest that this payout ratio yielded an extraordinary benefit to Puget Energy shareholders. Indeed, average dividends paid from Puget Energy to shareholders over the past three years are lower than average dividends to Puget Energy shareholders over the past decade. In other words, the equity investors today are receiving less in dividends than were shareholders prior to the merger.

Q. Please describe the credit facilities at Puget Energy?

A. At the time of the merger in February 2009, Puget Energy entered into a $1.225 billion five-year term-loan and a $1.0 billion five-year capital expenditure credit facility for funding capital expenditures. On February 10, 2012, Puget Energy entered into a $1 billion five-year revolving[[1]](#footnote-1) senior secured credit facility. Puget Energy used initial borrowings under this five-year revolving facility to repay debt outstanding under the term loan and capital expenditure credit facility, and Puget Energy terminated those agreements.

On June 15, 2012, Puget Energy issued $450 million of senior secured notes, which mature on July 15, 2022, and have an interest rate of 5.625 percent. Puget Energy used net proceeds from this note offering to pay down $425 million of the $859 million balance outstanding on the five-year revolving facility.

As of December 31, 2012, Puget Energy had a $434 million balance outstanding on the five-year revolving facility. In February 2013, Puget Energy reduced the size of five-year revolving facility from $1 billion to $800 million. (The five-year revolving facility also has an accordion feature that, upon the banks’ approval, would increase the size of the facility to $1.3 billion.) These refinancings were made in line with the merger commitments approved by this Commission that required PSE to refinance the term loan with intermediate or long-term debt.

Q. What has Puget Energy’s dividend to shareholders been since the merger?

A. As shown below in Table 6 below, Puget Energy’s annual average dividends to shareholders since the merger has been $98.334 million per year:

**Table 6. Puget Energy Dividend**

**(since merger in 2009)
(Thousands)**

|  |  |
| --- | --- |
| **Year** | **Dividend** |
| 2009 (post-merger)\* | $82,991 |
| 2010 | $104,311 |
| 2011 | $117,441 |
| 2012 | $88,594 |
| Average | $98,334 |

\* February 6, 2009, through December 31, 2009

This average annual dividend to shareholders is less than the ten-year average annual Puget Energy dividend of $108.773 million to shareholders, as shown in Table 7 below.

**Table 7. Puget Energy Dividend
(Calendar Years 2003-2012)
(Thousands)**

|  |  |
| --- | --- |
| **Year** | **Dividend** |
| 2003 | $93,965 |
| 2004 | $99,386 |
| 2005 | $100,172 |
| 2006 | $116,094 |
| 2007 | $116,914 |
| 2008 | $129,677 |
| 2009 (pre-merger)\* | $38,188 |
| 2009 (post-merger)\*\* | $82,991 |
| 2010 | $104,311 |
| 2011 | $117,441 |
| 2012 | $88,594 |
| Average | $108,773 |

\* January 1, 2009, through February 5, 2009

\*\* February 6, 2009, through December 31, 2009

Given the relative reduction in annual average Puget Energy dividends to shareholders since the merger and considering the growth of PSE over this period, any potential implication that Puget Energy is paying extraordinary dividends to shareholders is patently false. Indeed, the Puget Energy dividends in calendar year 2012 were the smallest dividends in over a decade.

## C. ICNU Erroneously Suggests that PSE’s Pension Expense is Not Indicative of Current Contribution Levels

Q. Is ICNU correct that the recovery of PSE’s pension contributions in rates is not indicative of current contribution levels?

A. No. ICNU incorrectly asserts that PSE’s pension recovery is not indicative of current contribution levels. Specifically, ICNU suggests as follows:

the 2009 and 2010 contribution levels are significantly higher than the 2011 and 2012 amounts. The four-year average amount during the 2009 through 2012 period of $17.8 million is over 50% higher than the current 2012 level. As a result, the amount proposed by PSE is overstated and is not indicative of the current contribution levels.

Gorman, Exh. No. \_\_\_(MPG-1T), at page 14, lines 10-14.

Q. What time period does ICNU reference in testimony regarding pension contributions?

A. ICNU uses 12-month periods ending June 30, 2009 – 2012, consistent with the ERF test period, to analyze pension contributions. This is an important distinction because pension contributions in 2011 were low and as a result, skew the numbers for the last two periods.

Q. What is PSE’s projected pension contributions for test year ending June 2013?

A. PSE's total pension contribution from July 1, 2012 to June 30, 2103 is projected to be $21.6 million, which is based on (i) the additional $11.4 million contributed in the second half of calendar year 2012; (ii) the pension contribution of $5.1 million made in the first quarter of 2013; and (iii) the pension contribution of $5.1 million scheduled for the second quarter of 2013. This additional test year illustrates that PSE's pension contributions are in line with the historical average. Similarly, PSE’s pension contributions in calendar year 2012 was $22.8 million, which is also in line with the average annual pension contributions since July 1, 2008, as shown in Table 8 below.

**Table 8. PSE Pension Contributions
(Thousands)**

|  |  |
| --- | --- |
| **Year** | **Pension Contributions** |
| 7/1/2008 - 6/30/2009 | $30,500 |
| 7/1/2009 - 6/30/2010 | $24,400 |
| 7/1/2010 - 6/30/2011 | $5,000 |
| 7/1/2011 - 6/30/2012 | $11,400 |
| 7/1/2012 - 6/30/2013\* | $21,600 |
| Average | $18,580 |
| \* PSE’s pension contributions for the period July 1, 2012, through March 31, 2013, were $16,500,000, and PSE has a pension contribution of $5,100,000 scheduled for June 2013. |

Q. Is the 4-year average contribution used in the ERF proceeding representative of current of pension contributions?

A. Yes. As presented above, the average is representative of the pension contributions made in 2012. As discussed in the Prefiled Direct Testimony of Katherine J. Barnard, Exhibit No. \_\_\_(KJB-11T), the use of the 4-year average is consistent with the methodology adopted in recent general rate cases, including PSE's 2011 general rate case. Therefore, ICNU's adjustment should be rejected.

# V. CONCLUSION

Q. Does this conclude your prefiled rebuttal testimony?

A. Yes.

1. As a revolving facility, amounts borrowed may be repaid without a reduction in the size of the facility. [↑](#footnote-ref-1)