BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,<br><br>Complainant,<br><br>v.<br><br>PUGET SOUND ENERGY, INC.,<br><br>Respondent. | DOCKET NOS. UG-040640 and UE-040641 (consolidated) |
|---|---|

**INITIAL BRIEF OF PUBLIC COUNSEL**

**WASHINGTON STATE ATTORNEY GENERAL'S OFFICE**

**JANUARY 18, 2005**

## I. SUMMARY OF ARGUMENT

1. Public Counsel has devoted the bulk of its resources in this case to cost of capital and to rate spread/rate design. Since the latter issue has been resolved by settlement, this brief focuses primarily on capital structure and cost of capital. Public Counsel recommends that the Commission adopt a return on equity of 9.75 % on Puget Sound Energy's (PSE) actual equity ratio of 40 %. These are the levels that are reasonably supported by a careful application of the financial formulas, a review of the Company's data, the objective corroborating information, and economic conditions.

2. PSE's equity ratio is based on a hypothetical capital structure, not on the way PSE has actually chosen to finance its operations. PSE's cost of capital witness has produced an excessive cost of equity recommendation based on a flawed and unorthodox Discounted Cash Flow (DCF) analysis and other methodologies which yield such volatile results as to fall outside any boundaries of credibility. His testimony in this docket also reflects significant inconsistencies with prior testimony.

3. Public Counsel has also identified issues of concern in connection with monetization of PSE's short term debt through Rainier Receivables.

4. In addition, Public Counsel recommends that the Commission deny PSE full recovery of its excessive rate case expenses, and that the Commission retain the 40-year rolling average method for hydro normalization.

## II. INTRODUCTION/GENERAL ARGUMENT

### A. PSE Ratepayers Have Made Significant Contributions To The Company's Financial Well-Being In The Past Three Years.

5. PSE CEO Steve Reynolds testified in his rebuttal testimony that he was "disappointed" in the responsive testimony of opposing parties in the case, including that of Public Counsel. Ex. 53, p. 2, l. 5. (Reynolds) Mr. Reynolds goes on to argue that ratepayers must "step up to the plate" and "contribute," Ex. 53, p. 7, ll. 2-3, in recognition of their "shared responsibility." Ex. 53, p. 7, ll. 8-9.

6. It is important to keep this rate request in context. Recent PSE history reflects major contributions by PSE ratepayers to Company financial health. Any suggestion, intended or not, that PSE ratepayers have not been paying their fair share is inaccurate and should play no part in the rate determination here. If anything, the rate pressures already at work on customers should generate even more careful scrutiny of this GRC filing.

7. A brief review of recent history helps to keep this in perspective.

- In March 2002, the Commission approved an increase in electricity rates of $25 million for a three month period (approximately 8.3%), pursuant to a settlement of the interim phase of PSE's 2001 general rate case.[1]
- In June 2002, the Commission approved a permanent $58.3 million electric rate increase (overall 4.6%), pursuant to the comprehensive settlement of PSE's 2001 general rate case (electric and common issues).[2]

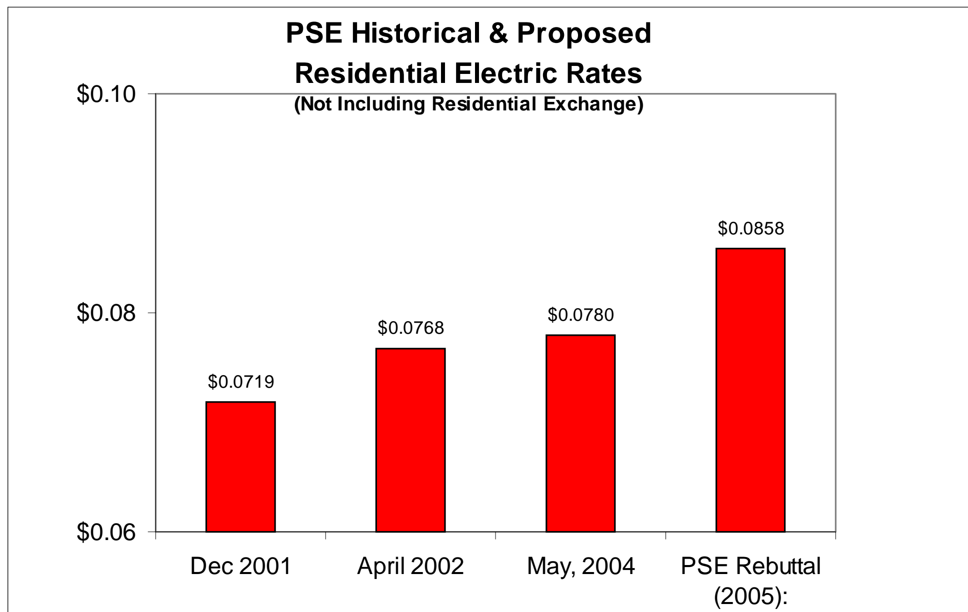
[1] *WUTC v. PSE*, Docket Nos. UE-011570, UG-011571, Ninth Supplemental Order.
[2] *WUTC v. PSE*, Docket Nos. UE-011570, UG-011571, Twelfth Supplemental Order.

- The settlement of the 2002 general rate case also included adoption of a Power Cost Adjustment (PCA) mechanism that will "result in a sharing of costs and benefits between PSE and its customers if power costs deviate significantly from those embedded in PSE's rates"[3] and permit recovery of excessive costs through "single issue" rate surcharges.[4] The PCA also provided for a Power Cost Only Rate Review (nka "PCORC") to add new resources and change rates without a full rate case review (see below).[5]
- In August 2002, the Commission approved a permanent gas rate increase $35.6 million (5.77% overall), pursuant to the settlement of the natural gas issues in the PSE 2001 general rate case.[6]
- In May 2004, in its first PCORC order, the Commission approved a PSE electric rate increase of $44.1 million (approximately 3.2%).[7]
- Gas rate changes resulting from Purchased Gas Adjustments since 2002 are shown on Exhibit 58 and graphically displayed below. The most recent of these, in Docket Nos. UG-041565 and 041566 had the combined effect of increasing residential rates by 16.7%.[8]

8. In Record Requisition No. 1, Public Counsel asked PSE to catalog these rate changes. The summary results prepared by PSE were included in Ex. 58. The graph below, derived entirely from data in Ex. 58 and Ex. 293 (Heidell, p. 1) show the trajectory of Puget's electric rates absent the effect of the residential exchange credit:

---

[3] Id., ¶ 22.
[4] Id., ¶¶ 23-24.
[5] Id., ¶¶ 25-30.
[6] *WUTC v. PSE*, Docket Nos. UE-011570, UG-011571, Thirteenth Supplemental Order.
[7] *WUTC v. PSE*, UE-031725, Order No. 14.
[8] PSE Advice No. 2004-18 (PGA), August 31, 2004, p. 1.




9. Puget's rates have risen over the past three years, and are expected to continue to rise, creating problems for family (and business) budgets throughout its service territory.

10. The Company's data presentation in Ex. 58 appears designed to show its residential electricity prices have declined. It primarily achieves this by melding the effect of rising costs on Puget's systems with the restructuring of the Bonneville Power Administration (BPA) residential exchange credit. The Commission has consistently held that the BPA credit should always be treated separately from the underlying rates that are approved by this Commission, reflecting Puget's own costs.

11. The residential exchange issue is relatively simple, but very important. As a result of deferring some residential exchange benefits to which Puget was entitled in the last 1990's and into 2001, the Company is now receiving larger exchange credits. This was done to help BPA deal with the power cost crisis it faced. All major regional utilities were expected to help with

this problem, the Commission was heavily involved in the negotiations, and these exchange credit changes were the result.

12. On the gas side, it should be recalled that the starting point for the natural gas rate history occurs during the power crisis period so the full surge in recent gas prices is not reflected. Puget's natural gas rates are at an all-time high, and poised to go up further as a result of this proceeding. Much of this is due to the soaring wholesale cost of natural gas, and Puget's failure to enter into long-term gas supply contracts when prices were more reasonable. A portion of the increase is due to increased management and distribution costs on Puget's own system, the subject of this proceeding.

13. The graph below, derived entirely from Ex. 58 and Ex. 294 , p.1, show what has happened to Puget's natural gas prices in the past three years. After sharply subsiding in 2002-03 from the peak of the 2001 crisis, these rates have soared again.

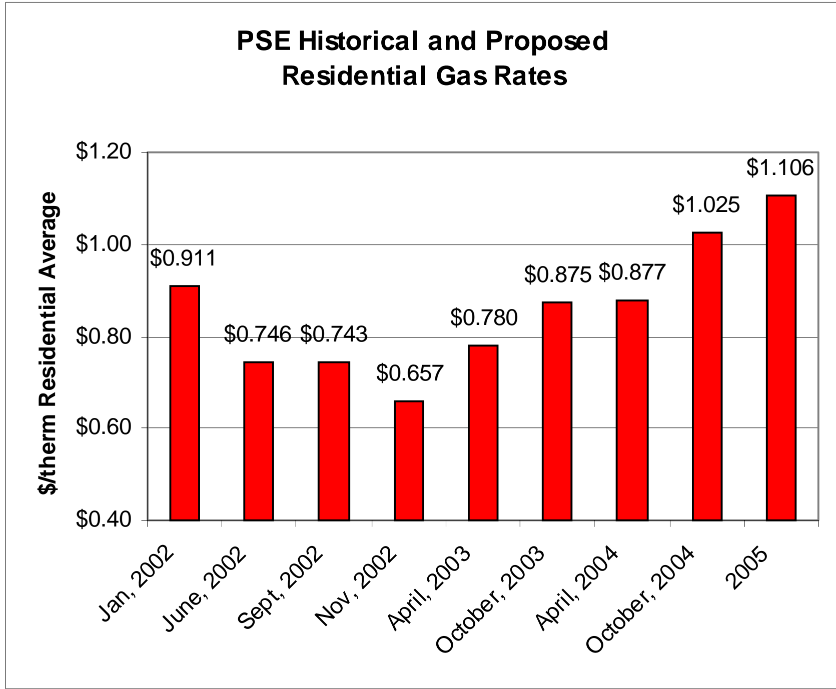
/ / /

/ / / /

/ / / / /

/ / / / / /

/ / / / / / /




14. Ratepayers are paying for past PSE problems in several ways today. First, Puget's cost of debt issued during the 1990's was higher than it should have been, as we have discussed in the section of this brief on cost of capital. Some of that debt is still on the books today. Second, ratepayers have been paying for an artificially-inflated level of common equity under the equity tracking mechanism of the previous rate case.

**B. Written Comment and Witnesses at Public Hearings Opposed the Rate Request.**

15. Exhibit 10 consists of letters, e-mails and other written materials submitted by the public to provide comment on the Puget Sound Energy general rate case. These letters and materials were submitted to the Commission and to the office of Public Counsel. The WUTC received 194 e-mails and letters opposing the rate increase proposals of the Company. Public Counsel received two letters. The Citizens Utility Alliance (CUA) received 79 postcards opposing the rate increase proposals which are included in the exhibit. An additional 105 postcards in the

same format were received by CUA, but not in time for inclusion in the exhibit. Written materials were submitted at the public hearings in Olympia and Bellevue.

16. The following are excerpts from the exhibit:

> Send a strong message that this is inappropriate and must stop. Please deny the proposed rate increase. Please help the consumer. We've already paid too much for too long. Let PSE pay now.
>
> Linda Donaldson, Olympia. Ex. 10, p. 2

> Never mind in order for me to stay warm and have lights (electricity) I have to not eat very much dress up like I'm in the North Pole in the house to make ends meet. Do any of you have common sense and consider the fact that old people have pills to buy, food other expenses to get to the store, house insurance other utilities to pay?
>
> Lois Carter, Renton. Ex. 10, p. 3

> I'm not sure what profit rate you allow the utilities? I do know the State credit unions give a person 1 to 2 % on its' members savings; that must be what the credit unions feel is a fair return. Larger accounts get 3%. Maybe it's time Puget Sound Energy's top management and stock holders are required to settle for less pay and profit?
>
> Eugene Bremner, Kent. Ex. 10, p. 6

17. Comments at the public comment hearings included the following:

> Unless the rate of return is in serious trouble for Puget Sound Energy, I think the rate increase is out of line, and it will create a severe hardship on those who can least afford it. I guess I probably I watch the stock market. When you're retired and have not much else to do you watch the stock market. And I see Puget Sound Energy Stock continuing to go up, so the investor's aren't concerned about their rate of return, and that seems to be what kind of keeps the stock edging upwards.
>
> Jack Doyle, Olympia,
> December 16, Tr. 1029

> Likewise energy affordability is a constant concern for consumers, especially those living on fixed and low incomes. The constant monthly increases and the total cost of energy due to power cost adjustment mechanisms, rate cases, and other means can especially be devastating for those older consumers[.]

* * *

I'm a member of the Olympia Kiwanis Club and we operate a wood bank to low income citizens that are referred to us from other organizations. As an example this morning I delivered a load of wood to an elderly retired widow whose sole income is Social Security. She cannot afford to turn her electric heat on, therefore she only heats with the wood that we can supply her, and that is a limited amount.

Gene Forrester, AARP, Olympia
December 16, Tr. 1033, 1034

And so when you're talking about basic needs for families and you're already paying --- at this point paying over, you know, nine percent [of annual income] for your energy, that next increment of – whether its six percent or seven percent or whatever the rate increase would be, has a dramatic impact on these families. They're making the decisions between transportation, school clothes for the kids, food, medical, all those kinds of things [.]

David Finet, Opportunity Council (Bellingham)
Bellevue, November 10, Tr. 79

First, I would like to commend Steve Reynolds and Puget Sound Energy for all they have recently done in conservation and energy assistance. The Puget Sound Energy Help program, in particular, has had positive impact on our ability to assist our clients with their energy bills. However, the proposed increases will significantly diminish the impact the established programs can have and will create and even greater need than we can meet.

Tony Orange, Central Area Motivation Program
Bellevue, November 10, Tr. 92.

## III. CAPITAL STRUCTURE AND COST OF CAPITAL

### Introduction

18. The overall rate of return and cost of equity requested by the Company in this proceeding are unjustified given the evidence of record. Public Counsel's recommended rate of return and cost of capital are adequate to provide the Company with a return that will meet investor

requirements and maintain the Company's credit and its ability to attract capital, thereby protecting the public interest.

19. The Company claims in this proceeding that it needs a higher equity return than it was awarded in the past even though interest rates and other indicators of capital costs are much, much lower than they have been in the past. The Company claims that it needs to base rates on common equity capital it does not actually have in order to avoid a bond rating downgrade and possibly improve its bond rating to save money. However, there is no guarantee that the use of the hypothetical common equity ratio the Company requests will result in any change in the bond rating or save even $1 of debt costs. It is certain, on the other hand, that a 5% increase in the common equity ratio, from the current 40% to 45%, will cost Washington ratepayers approximately $15 Million every year rates set in this case are in effect. Ex. 351, p. 23 (Hill). The Commission should adopt the recommendations of the Public Counsel as to rate of return and cost of capital, explained in detail below.

## A. Debt

### 1. Long-term Debt

20. The cost rate of long-term debt in this proceeding is not at issue. All parties have used the Company’s requested cost rate of long-term debt, 6.88%. The percentage amount of long-term debt contained in each of the parties’ recommended ratemaking capital structure differs for the timing reasons cited.

### 2. Short-term Debt



ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

21. With regard to short-term debt, the amounts and cost rates recommended by the parties all differ. Again the amount and cost rate of short-term debt recommended by the Staff and Company are functions of the nature of their projections. The Company is using rate-year end data while Staff is using average rate-year data. Public Counsel recommends a level of short-term debt that is representative of the actual amount of short-term debt available to the Company. Public Counsel used a slightly lower short-term debt cost rate than estimated due to discrepancies in the Company's method of calculating short-term debt costs that were never fully explained by the Company. Ex 351, p. 29 (Hill).

22. While the differences in the weighted cost of short-term debt in this proceeding are relatively small, Public Counsel believes there are issues related to the Company's use of short-term debt about which this Commission should be concerned. First, Public Counsel is concerned that there is no way for the Commission to tell by examining Puget's books of account how much short-term debt the Company is actually using. Although the Company projects that about 3% of its total capital will be comprised of short-term debt during the rate-year, it could actually be using more. Because short-term debt is considerably less expensive than any other form of capital, Puget could "game" the regulatory process, by using more short-term debt than allowed in the ratemaking capital structure, drive down its overall capital costs and leverage up its common equity return above what is allowed in this proceeding.

23. The reason that the Commission cannot tell how much short-term debt Puget is actually using is that the Company has created a wholly-owned special entity called Rainier Receivables. Puget transfers the rights to its receivables (the monies it expects to receive from ratepayers paying their bills) and Rainier Receivables then uses those receivables as collateral to obtain

short-term debt loans from a consortium of banks. Ex. 351, p. 26 (Hill). The short-term debt issued by Rainier Receivables does not appear on the books of Puget Sound Energy, even though that short-term debt is being secured by Puget's receivables. Therefore, it is not possible to tell whether or not the 3% level of short-term debt that Puget projects to appear on its books in February 2006 is all of the short-term debt that will be available to the Company at that time.

24. As Public Counsel witness Hill demonstrated, Puget's books indicated that over the most recent five quarters, the Company's short-term debt balances averaged $10.5 million. Ex. 357, p.1 (Hill). However, over that same time period the debt appearing on the books of Rainier Receivables averaged $184 Million. Although Company witness Gaines (a corporate officer in both companies) was reluctant to admit it, there is clearly not an arms-length relationship between Puget and Rainier Receivables. Tr. 427, ll. 2-21. Tr. 454, l.12- Tr. 455, l. 13 (Gaines). The debt of Rainier Receivables, secured by monies to be paid by ratepayers to Puget, should be considered as Puget's short-term debt. However, a review of Puget's books will not show that debt.

25. Second, Public Counsel is concerned that the arrangement with Rainier Receivables may be distorting the cost rate of short-term debt. As shown in the testimony of Public Counsel witness Hill, applying all of the costs associated with the total available amounts of the Rainier Receivables loan agreements caused Puget's short-term debt cost rate to balloon to over 8% in mid-year 2004—a time during which commercial paper rates were in the 2% to 3% range. Ex. 357, p. 61 (Hill). The Company touts its creation of Rainier Receivables and the sale of receivables as a means to attain lower-cost short-term debt, but applying all of Rainier's costs to

a small amount of short-term debt appearing on Puget's books has pushed short-term debt costs far in excess of long-term cost rates.

26. Third, there are unresolved questions as to the manner in which Puget calculates its short-term debt costs. From data request responses provided by the Company, it appears that Puget calculates its short-term debt costs for internal purposes in one manner and for regulatory purposes in another manner that produces a higher cost rate. In response to Public Counsel Data Request No. 3, Ex. 188, the Company supplied its short-term debt costs. However, as was discussed with Company witness Gaines on the witness stand, Tr. 443, l.1-Tr. 449, l. 4, Puget calculated its short-term debt costs in one manner internally and in another manner for regulatory reporting purposes. In the internal calculation Puget applied the Facility Fee and Securitization Fee (associated with the Rainier Receivables debt) to the total amount of the entire borrowing capacity available under those borrowing agreements, including the unused amounts. As a result, the calculated cost of short-term debt was only very slightly higher than the actual cost of short-term debt. In calculating the cost of debt reported to the Commission, Puget applies all of the Facility and Securitization Fees to only the short-term debt outstanding on Puget's books. As noted above, Rainier Receivables short-term debt does not appear on Puget's books of account. Therefore, the short-term debt cost reported to the Commission is substantially greater than the cost Puget calculates internally.

27. For example, if the short-term debt cost calculation on page 31 of Ex. 188 had been completed, the calculated embedded cost of short-term debt would be 2.4% for the year ending June 30, 2003. However, as shown on page 23 of Ex. 188, the "regulatory" version of the cost of short-term debt calculation posts a cost rate of 5.3%.



ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

28. Moreover, as pointed out in cross-examination of Mr. Gaines, that internal calculation of short-term debt costs changed over time, with portions of the calculation simply being left out or, apparently, electronically altered. Tr. 446, l. 23-Tr. 449, l. 4. When asked about those methodological changes in Public Counsel Data Request No. 62, Ex. 193, the Company denied the existence of any such changes. On the witness stand, when presented with the same information, Mr. Gaines was unable to provide any rationale as to the reasons for the different calculations or why those internal short-term debt cost calculations had been changed over time. Tr. 447, ll. 8-15, Tr. 449, ll. 6-13.

29. Fourth, there are other issues related to Puget's effective sale of its accounts receivable to Rainier Receivables that Public Counsel has not been able to investigate thoroughly, but which could have a significant impact on revenue requirements and deserve scrutiny. For example, instead of waiting to receive payments due from ratepayers, Puget has awarded those assets to Rainier Receivables and that firm then monetizes those assets by using them as security to issue debt. Therefore, the cash working capital balances available to Puget are affected by that transaction and the normal revenue lag that arises from waiting for customers to pay their bills is certainly drastically reduced if not eliminated entirely. Yet, the Company has made no adjustment to its cash working capital balances. Tr. 451, ll. 6-15 (Gaines). In addition, if the Company cedes its rights to its accounts receivable but retains its allowance for bad debts, it may be over-recovering its costs there as well.

30. Also, Rainier Receivables operates at a loss, creating negative income taxes or tax credits. To Public Counsel's knowledge, those tax credits have not been considered in this proceeding. Certainly Puget would not set up a subsidiary that generates tax credits absent the

intent to use those credits and if the regulated entity is not using them, then it is reasonable to believe that benefit is being passed on to the parent Company, Puget Energy. However, the genesis of that negative tax expense is the accounts receivable of the regulated entity and, to the extent there are tax savings, those savings should be passed on to ratepayers.

31. In sum, there are many questions unanswered regarding Puget's short-term debt arrangements. As a start in addressing these problems, Public Counsel suggests that the Commission utilize the larger amount of short-term debt and the lower cost rate of short-term debt in setting rates for the Company. Also, Public Counsel recommends that the Commission require the Company to report Rainier Receivables short-term debt balances along with its own as part of its normal reporting to the Commission and that, for ratemaking purposes in the future, short-term debt balances be based on utilization of short-term debt at Puget and at Rainier Receivables. Further, Public Counsel recommends that the Commission analyze the impact of the early receipt of monies from accounts receivable on Puget's cash working capital accounts as well as the ultimate impact of any tax savings associated with the creation of Rainier Receivables.

### B. Trust Preferred Stock

32. The cost rate of trust preferred stock is not at issue in this proceeding. The percentage levels of that form of capital are somewhat different due to the timing assumptions of the parties described above. It is important to understand that trust preferred stock is effectively debt because the payments of the preferred stock dividends are provided by debt payments to a special purpose trust created for the purpose of issuing the preferred stock. This type of financing instrument avoids the tax responsibilities of standard preferred stock.

### C. Preferred Stock

33. The cost rate of preferred stock is not at issue in this proceeding. The percentage levels of that form of capital are somewhat different due to the timing assumptions of the parties described above.

### D. Common Equity

#### 1. The Evidence Developed In The Record In This Proceeding Does Not Support An Equity Return Award Above 10%.

34. The 11.75% return on common equity requested by the Company significantly overstates the cost rate of common equity for Puget Sound Energy. This is particularly true in the light of the fact that the Company's own DCF analysis, when updated to be contemporaneous with that of Public Counsel, supports the reasonableness of an equity cost estimate well below 10%. The appropriate cost rate of common equity for fully-integrated electric utility operations similar in risk to Puget ranges from 9.0% to 9.75% (the Commission Staff and Public Counsel recommendations respectively). The equity return requested by the Company is substantially above even the highest end of that range of equity capital costs.[9]

35. The Commission has other objective evidence in this proceeding that the investor-required return is below 10% for Puget. In response to PC Data Request No. 169, Ex.160, Mr. Valdman supplied investor analysts' reports for the ten firms that he testified provide equity research on Puget Energy. The reports uniformly indicate that Puget is a stock that investors should "hold" or "buy;" there are no "sell" recommendations for the Company. The reports also confirm that the 9% to 9.75% cost of equity recommendations of Staff and Public Counsel are

---

[9] The Company request is also significantly higher than Mr. Hill's overall range of 9%-10%. Ex. 351, p. 41 (Hill).

actually within the range of the returns investors currently expect. For example, D.A. Davidson advises its clients to expect a long-term growth for Puget of 5.0%, which, combined with the 4.4% dividend yield indicates a total return expectation of 9.4%. Ex. 160, p. 3, Tr. 199-200 (Valdman).[10] Lehman Brothers projects a long-term growth of 4% and a dividend yield of 4.43%, producing an expected return to investors of 8.43%. Ex. 160, p. 9.

36. Merrill Lynch refers to Puget's 4.3% dividend yield as "attractive." Ex. 160, p. 17 (Valdman). Ragen MacKenzie notes Puget's 4.6% dividend yield and 5% growth rate, implying a 9.6% total return to investors. Ex. 160, p. 20. Citigrop/Smith Barney pegs Puget's growth rate at 4%, indicating a total return in the 8% to 9% range, assuming a dividend yield comparable to that used by the other analysts cited. Ex. 160, p. 28. Finally, UBS Investment Research provides the highest total return estimate for Puget with a forecast dividend yield of 4.4% and a price appreciation projection of 5.6%, which would yield a total return of 10%. Ex. 160, p. 52.

37. Another indication of the reasonableness of Public Counsel's equity return recommendation in this proceeding is the change in measurable capital costs since the Company's last rate proceeding before this Commission. In 2002, in Docket Nos. UE-011570/UG-011571, the Company accepted a return on common equity capital of 11%, based on a hypothetical capital structure containing 40% common equity (the Company's actual common equity ratio was in the low 30% range).[11] At that time, PSE was in worse financial condition than it is currently.[12] Moreover, as the Company's financial position has improved, capital costs have dramatically declined. In mid-year 2002, the time when the settlement in Docket Nos. UE-

[10] The DCF methodology calls for the determination of the dividend yield and the expected growth rate (see discussion below).

[11] Ninth Supplemental Order (May 28, 2002), Appendix A (Settlement Stipulation), ¶¶ 13-18.

011570/UG-011571 was finalized, A-rated utility bonds were yielding about 7.5%. Ex. 356, p.1 (Hill). Currently A-rated utility bonds are yielding 5.92%. Ex. 351, p. 8 (SGH-1T). This represents a more than 150 basis point decline in utility bond yields since the Company accepted an 11% return on common equity, further objective evidence that the allowed return on equity in this proceeding should be consistent with the recommendations of Staff (9.0%) and Public Counsel (9.75%). An 11% equity return less 150 basis points results is a 9.5% return – a reasonable return for Puget.

38. The Company's claim that a bond rating downgrade will result if the Commission adopts any other recommendation is alarmist. Company witness Valdman admitted during cross-examination that, over the past five years, when the Company was in worse financial condition than it is currently, PSE maintained its current bond rating. Tr. 180, l. 1-Tr. 184, l. 3; Ex. 164, p.3 (Valdman). Mr. Valdman also informs the Commission that the Company's borrowing capacity has recently improved. Ex. 154, p. 4, ll. 7-8; Tr. 191, ll. 11-14 (Valdman) and Mr. Gaines provides the information on the stand that recently Standard & Poor's (S&P) bond rating agency has lowered Puget Sound Energy's business position ranking from 5 to 4, indicating declining business risk for the Company. Tr. 478, l.1-11. In sum, the Company is in much better financial condition now that it has been over the past five years and that condition is improving.

[12] Ninth Supplemental Order, ¶ 18 ("PSE's financial condition is precarious[.]").

Rates based on the Company's actual capital structure, as recommended by Public Counsel, will act to maintain, not harm, Puget's financial position.

39. Company witness Valdman's testimony also confirms that the equity return award in this proceeding should be substantially lower than the 11% used in the Company's most recent rate case. Mr. Valdman indicated in his Rebuttal Testimony, Ex. 154, p. 24, that an increase in a utility's dividend yield corresponded to an increase in that utility's cost of equity capital, and confirmed this at the hearing. Tr. 201, ll. 2-16 (Valdman). On the witness stand, when presented with the evidence that Puget's dividend yield had fallen from 7.9% in 2001 to 4.3% currently and asked if those data show that Puget's cost of equity had fallen 3.6% since 2001, Mr. Valdman agreed with that proposition. Tr. 201, l. 17-Tr. 202, l. 9.

40. These data as well as the decline in debt costs discussed above show that the Company's 11.75% equity return request lacks credibility from a technical perspective. Indeed, this request – seeking an increased return for a less risky Company in a lower interest rate environment— fails even the common sense test.

### 2. The Recommendations Of Public Counsel Comply With The Applicable Legal Standards.

41. A public utility with facilities and assets used and useful in public service is entitled to a reasonable opportunity to earn a fair rate of return on its investment. The United States Supreme Court established the standard with which to evaluate whether a rate of return is fair in *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) (*Bluefield*), stating:

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical

> management. . .to raise the money necessary for the proper discharge of public duties.

*Bluefield*, 262 U.S. at 693. The Court also said that allowed rates of return should reflect the following:

> [A] return on the value of the [utility's] property which it employs for the convenience of the public equal to that. . .being made at the same time… on investments in other business undertakings which are attended by corresponding risks and uncertainties.

*Bluefield*, 262 U.S. at 692. Twenty-one years later, the Court reviewed the issue of fair rate of return in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*). In *Hope*, the Court held that a fair rate of return "should be commensurate with returns on investments in other enterprises having corresponding risks" while being sufficient "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Hope*, 320 U.S. at 603. The Court noted that "[t]he rate-making process under the Act, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and consumer interests . . . and does not insure that the business shall produce revenues." *Id.* More recently, the Court stated that consumers are obliged to rely upon regulatory commissions to protect them from excessive rates and charges. *See Permian Basin Area Rate Cases*, 390 U.S. 747, 794-95 (1968) (*citing Atlantic Refining Co. v. Public Service Comm'n*, 360 U.S. 378, 388 (1959).

42. Finally, in *Duquesne Light Co. v. Barasch*, the Court stated "whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting, and on the amount of capital upon which the investors are entitled to earn on that return." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989), *aff'g Barasch v. Pa. P.U.C.*, 516 Pa. 142, 532 A.2d 325 (1987).

43. These standards are applied in Washington. *See, e.g., WUTC v. Puget Sound Power & Light Company*, UE-921262 et al., Eleventh Supplemental Order, p. 25.

44. Public Counsel's recommended 9.75% cost of equity capital and 8.01% overall rate of return not only assures adequate service to the public at the most reasonable cost, but also serves the interests of Puget and its investors, providing those investors the return they require, and supporting the Company's ability to attract capital.

45. As Public Counsel witness Stephen Hill[13] noted in his testimony:

> [The Public Counsel's 8.02%] overall return, is based on the Company's actual capital structure and affords Puget an opportunity to achieve a pre-tax interest coverage of 2.46 times. Over the past three years, during which time the Company has maintained its current bond rating, its average pre-tax interest coverage was 1.99 times. Therefore, the equity return I recommend is sufficient to support or improve the Company's current bond rating and fulfills the requirement of providing the Company the opportunity to earn a return which is commensurate with the risk of the operation and serves to support and maintain the Company's ability to attract capital. Exhibit 351, pp. 3-4, (SGH-1T).

Therefore, Public Counsel's overall return recommendation in this proceeding fulfills the legal requirements of *Hope* and *Bluefield* by providing the Company an opportunity to earn a return commensurate with the returns investors require for similar-risk firms and will support the Company's financial position and its ability to continue to attract capital.

### 3. PSE's Actual Capital Structure Should Be Used to Set Rates.

46. The capital structure recommendations of the parties in this proceeding are set out in the table below.

---

[13] Stephen G. Hill is a financial consultant and principal of Hill Associates, a consulting firm specializing in financial and economic issues of regulated utilities. Mr. Hill has testified previously before this Commission and has testified on cost of capital, corporate finance, and capital market issues in more than 220 regulatory proceedings before other state regulatory bodies. Ex. 352 of Mr. Hill's Direct Testimony provides a more detailed description of his education and experience.

| Type of Capital | Company[14] | Staff[15] | Pub. Counsel[16] |
|---|---|---|---|
| Common Equity | 45.00% | 41.84% | 40.00% |
| Preferred Stock | 0.40% | 0.40% | 0.50% |
| Trust Pref. Stock | 6.28% | 6.32% | 6.74% |
| Long-term Debt | 45.59% | 48.58% | 48.86% |
| Short-term Debt | 3.09% | 3.21% | 4.36% |

47. The primary difference in the capital structures recommended in this proceeding is the percentage of common equity. Because common equity capital, on a rate-making basis, is twice as costly as debt capital. Ex 351, p. 20 (Hill), the use of more common equity means that the capital structure requested by the Company—no matter what the decision regarding the cost of equity capital—will be the most expensive of the three for Puget's Washington ratepayers.

48. The capital structure requested by the Company in this proceeding is projected at the end of the rate-effective period—February 2006. The end of the rate-effective period corresponds with the time at which Puget indicates it may issue common equity capital[17]. The capital structure recommended by the Staff is also based on Puget's current capital budget projections. It is a year-average capital structure, however, not a year-end capital structure as utilized by the Company. The capital structure recommended by Public Counsel is based on the manner in which the Company has actually capitalized its operations recently, not on how it might capitalize its operations sometime in the future.

---

[14] Ex. 181C (Gaines)

[15] Ex. 490 (Wilson)

[16] Ex. 368 (Hill).

[17] Mr. Reynolds indicated that PSE does not want to be tied to any date certain for issuing common equity by regulatory targets. Tr. 165, l. 17- Tr. 166, l. 14. This implies that the time of the stock issuance, if any, is uncertain.

49. There are several important reasons why Public Counsel's recommended capital structure is appropriate for rate-setting purposes in this case.

- The Company's requested capital structure is not an actual, known-and-measurable, booked capital structure. Ex. 351 p. 18 (Hill).
- The Company's requested capital structure contains far more common equity and less debt capital than actually employed by the Company, on average, over the past five quarters. Ex. 351. pp. 18.
- The manner in which the Company has actually capitalized its operations over the most recent five quarters is: 39.97% common equity, 1.02% preferred stock, 7.09% trust preferred, 52.39% total debt. Exhibit 357, p. 1 (Hill).
- The Company's requested capital structure is more equity-rich than that of its riskier parent company, Puget Energy; and setting rates for Puget Sound Energy using a capital structure similar to its riskier parent would require the Company's Washington ratepayers to provide an inappropriate financial cross-subsidy to the parent Company's unregulated operations. Exhibit 351, pp. 19-20.
- The Company's requested capital structure contains substantially more common equity and less debt capital than exists, on average, for similar-risk companies in the electric utility industry. Exhibit 351, pp. 20, 21, Exhibit 357, p.3.
- The Company's requested capital structure would be economically inefficient, requiring Washington ratepayers to provide approximately $15 Million annually of capital costs in excess of those necessary for a firm in its risk-class. Ex. 357, p. 4.

50. Finally, as part of the settlement of Puget's 2002 rate proceeding, Docket No. UE-11570/UG-011571, PSE's Washington ratepayers agreed to provide a return on common equity capital the Company did not have, in the context of an incentive mechanism. This was done (and Public Counsel supported that action) in order to restore the Company's financial well-being. It is very important to understand, however, that that action (i.e., setting rates on equity capital the Company did not have) was undertaken as an extraordinary measure to provide assistance to the Company to reach an acceptable capital structure. The goal of that action was a 40% common equity ratio and that goal has been reached.

51. In this case, unfortunately, the Company now seeks to institutionalize this special remedy, urging that ratepayers should now accept this as the norm and "stay the course" by continuing to pay on hypothetical equity as long as requested by PSE. Tr. 162, ll. 22-24 (Reynolds).

52. Public Counsel and other parties, however, did not agree to pay on hypothetical equity indefinitely until the Company reached a 45% ratio. The agreed target has been reached and Washington ratepayers have done their part in restoring the Company to a normal, industry-average capital structure. Rates should be based on that cost-effective actual capital structure, not something else.

53. Steve Reynolds made an important point at the hearing: "We are going to be back in front of this Commission on a very regular basis year in and year out for the next – for the long term foreseeable future. There is every opportunity to continue to revisit this issue over time." Tr. 163, ll. 1-5. These cases will provide an opportunity for the Company to request inclusion of common equity in rates at the appropriate time, as it is actually issued. Until that time, asking

ratepayers to again provide a common equity return on debt capital for this Company, this time involuntarily, would be improper and unfair.

### 4. Public Counsel Witness Hill's Cost of Equity Estimation Methods.

#### a. Overview.

54. The 11.75% equity return requested by the Company in this proceeding is too high in relation to current economic conditions and trends, including a forty year low in interest rates and a reduction in the federal dividend tax rate. Moreover, interest rates are likely "to remain at relatively low levels for some time to come." Ex. 351, p. 12 (Hill) In addition, as witness Hill notes, investor advisory services are indicating that investors should buy and hold energy utility stocks with the expectation of average expected market-based returns of 8.45%. Ex. 351, p. 7. Also, the relationship between utility market prices, book value and expected equity returns indicates that the cost of common equity capital is most likely well below the 11% return requested by Puget. Ex.351, pp. 13-17.

55. Public Counsel witness Hill pointed out on the stand, in response to Chairwoman Showalter's questions, that the majority of energy utility equity return awards over the past year, as reported in the November 2004 Public Utility Fortnightly, have fallen between 10% and 10.5%. Tr. 507, ll. 14-18; Tr. 508, ll. 21-25, and that the cost of capital has continued down since those awards were made. Tr. 509, ll. 1-20. In his Direct Testimony, Mr. Hill also notes there have been many instances in which regulatory bodies have awarded utilities equity returns below 10%, consistent with Mr. Hill's recommendations in this proceeding[18].

---

[18] Ex. 351, p. 5, ll. 1-10, n. 1 (Hill).



ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

56. In order to determine a fair rate of return on equity, Public Counsel witness Hill performed a Discounted Cash Flow (DCF) analysis, corroborated by a Capital Asset Pricing Model (CAPM) analysis, a Modified Earnings-Price Ratio (MEPR) analysis, and a Market-to-Book Ratio (MTB) analysis, to develop a range of current equity capital costs for electric utilities similar in risk to Puget of 9.00% to 10.00%.

57. The table below summarizes Mr. Hill's results.[19]

| **Method** | **Equity Cost** (%) |
|---|---|
| DCF | 9.32 |
| CAPM | 8.94 – 10.15 |
| MEPR | 8.55 – 8.82 |
| MTB | 9.26 – 9.01 |

58. In assessing the results of his analyses, Mr. Hill stated:

> Averaging the lowest and the highest results of the corroborative analyses (CAPM, MEPR, and MTB) produces an equity cost rate range of 8.83% to 9.41%—a range that encompasses the DCF result. The other corroborative analyses indicate that my DCF results provide an accurate estimate of the cost of common equity of electric and gas utilities.
>
> Given the results shown above, it would be reasonable to construct a current range of equity capital costs with the DCF result at the mid-point of that range. However, over the next year or two capital may increase to some degree if the U.S. economy continues to advance. Therefore, weighing all the evidence presented herein, I believe it is reasonable to construct a current cost of equity range around the DCF estimate, and my best estimate of the cost of equity capital for a [sic] firms similar in risk to Puget Sound Energy is 9.00% to 10.00%. The mid-point of that range is 9.50%. Ex.351, pp. 40- 41 (Hill).

Mr. Hill concluded that Puget's equity return should be 9.75%, in the upper half of this range due to financial risk differences between Puget and his sample group of companies.[20] In addition, it

is important to note that in constructing an appropriate range of common equity cost rates, Mr. Hill explicitly took into account the fact that, if the economy continues to expand, interest rates are likely to increase slowly over the next few years.

**b. The DCF result proposed by the Public Counsel accurately and adequately considers current low capital cost rates.**

*59.* Mr. Hill's DCF evaluation is 9.32% for electric utilities with generally similar in risk to Puget. The DCF methodology relies on the equivalence of the market price of stock with the present values of the cash flows investors expect from stock and calls for a determination of the dividend yield and the expected growth rate. To develop an accurate DCF result, Public Counsel witness Hill used a dividend yield and an expected growth rate that mirror current economic conditions. The following is a detailed discussion of those inputs.

*60.* While the dividend yield of a publicly traded stock is easily measured, it is necessary to use proxy companies for measuring the dividend yield for Puget Sound Energy because Puget has no such publicly traded stock. Mr. Hill's proxy group consisted of thirteen publicly held fully-integrated electric and gas combination utility companies. Mr. Hill selected these electric companies for his barometer group from Value Line, which provides projected information important in gauging investors' expectations.[21] These combination electric and gas companies have a continuous financial history with at least 50% of operating revenues generated by electric utility operations. Mr. Hill did not include companies that were in the process of merging or of being acquired and that had realized an upward stock price shift due to the merge or acquisition. The companies in Mr. Hill's sample group also have bond ratings from at least one major rating

[19] Ex. 351, p. 40 (Hill).

agency ranging from "BBB-" to "BBB+", a stable book value, and no recent reductions in dividends.

*61.* Mr. Hill further checked his sample of companies to ensure that they have similar or greater risk than Puget, using Standard & Poor's business profile rankings. Ex. 351, p. 33 (Hill), Ex. 345 (Lazar). As Mr. Hill noted in his Direct Testimony, the average business risk position of his sample companies is 5.75. Ex. 351, p. 33. By that measure, Mr. Hill's sample companies have greater business risk than Puget. At the time of his analysis, Puget also had a higher price/earnings ratio that his sample group—indicating that investors value a dollar of Puget earnings more highly than the sample group. Also, Puget has a better ranking with regard to buy and sell recommendations of analysts.

62. As the Commission learned from Company witness Donald Gaines, just prior to the rate hearing, PSE received an improved business profile score of 4 on the Standard & Poor's scale, moving from its prior position of 5. Tr 475, ll. 19-22; Tr. 477, l.22 -478, l.11. Mr. Gaines testified that this was "not a lowering of risk." Tr. 478, l.14. This is a curious statement, given that Standard & Poor's describes its profiles as designed to "reflect the relative business risk among companies in the [utility] sector." Ex. 345, p. 1 (Lazar). S&P concluded that among the benefits of its new 2004 rankings was the fact that "[f]uller utilization of the 10-point scale provides a *superior relative ranking of qualitative business risk.*" Id. (emphasis added). Company witness Dr. Valdman, testifying earlier in the hearing regarding Ex. 345, concurred that the profiles rank utility business risk on a scale of 1 (low risk) to 10 (high risk). Tr. 171,

[20] Ex. 351, pp. 43-46 (Hill).
[21] Ex. 351, p. 32 (Hill).

l.18-Tr. 172, l.1. Perhaps Mr. Gaines was unwilling to concede the significance of the change because it runs contrary to PSE assertions in this case about the Company's financial position.

63. To determine the dividend yield for his selected proxy companies, Mr. Hill first estimated, and then annualized the next quarterly dividend payment of each firm in the proxy groups.[22] Mr. Hill adjusted the quarterly dividend amounts for a few companies in the proxy groups based on information that these companies would raise their dividends in the future. Mr. Hill identified the average monthly dividend yield for the companies in his sample group as 4.66%.

64. To determine the growth rate of the dividends for the proxy groups, Mr. Hill used both historic and projected growth rates with an emphasis on recent trends. Mr. Hill evaluated five-year sustainable growth rates, including retention ratios, equity returns, book values per share, and the number of shares outstanding. Regarding forward-looking growth rates, Mr. Hill considered Value Line's three- to five-year projected growth in earnings, dividends, and book value, as well as sustainable growth.[23]

65. The result of Mr. Hill's DCF growth rate analysis was an average investor-expected growth rate of 4.66%. When compared to published growth rates available to investors, Mr. Hill's growth rate estimate is on the high side. The average of Value Line's 3- to 5-year projected earnings, dividends and book value growth for the companies in Mr. Hill's sample group is 3.35%—more than 100 basis points below Mr. Hill's long-term growth estimate. Also, the average earnings growth projection of investment analysts from First Call (IBES) is 4.07%, also

---

[22] Ex. 351, pp. 38, 39 (Hill).
[23] Ex. 351, pp. 34-38 (Hill).

considerably lower than Mr. Hill's DCF growth rate estimate[24]. Mr. Hill's DCF result for his combination electric and gas utility sample group is 9.32%.[25]

**c. Mr. Hill's corroborative equity cost estimation methods (Capital Asset Pricing Model, Modified Earnings-Price Ratio, and Market-to-Book Ratio) support a cost of equity below 9.75.**

66. Mr. Hill explains the CAPM analysis as follows:

> The CAPM states that the expected rate of return on a security is determined by a risk-free rate of return plus a risk premium which is proportional to the non-diversifiable (systematic) risk of a security. * * * As the CAPM is designed, the risk-free rate is that short-term rate of return investors can realize with certainty.[26]

To perform the analysis, Mr. Hill derives a risk-free rate of return, market risk premiums, and a beta coefficient. First, Mr. Hill chooses both the T-Bill and long-term Treasury bond yields for his risk-free rate.[27] Second, Mr. Hill uses arithmetic (6.6%) and geometric (5.0%) averages of market risk premiums related to long-term Treasury yields for his market risk premiums.[28] Third, Mr. Hill uses the Value Line beta coefficient, the average of which for electric and gas proxy group is 0.76.[29]

67. In performing the CAPM calculation, Mr. Hill takes the overall arithmetic average market risk premium of 6.6% times the beta coefficient of 0.76 to determine the sample group risk premium of 5.00%.[30] This represents the electric and gas utility risk premium that is added to the risk-free T-Bond rate of 5.15%, which yields a common equity cost estimate of 10.15%.[31]

---

[24] Ex. 360, p. 2 (Hill).
[25] Ex. 351, p. 39, (Hill).
[26] Ex.355, pp. 1, 5 (Hill).
[27] Id., p. 4.
[28] Id. p. 5.
[29] Id.; Ex. 363 (Hill).
[30] Ex. 355, p. ; Ex. 363 (Hill).
[31] Id.

Also considering geometric market risk premiums, which are published by the same source as arithmetic risk premiums and, thus, are equally available to investors, Mr. Hill concludes that the use of the long-term Treasury bond yields, which indicate a range of equity capital costs of 8.94% to 10.15%, is reasonable in light of the current economic conditions.

68. Mr. Hill also performs a Modified Earnings-Price Ratio (MEPR) analysis. According to Mr. Hill:

> The earnings-price ratio is calculated simply as the expected earnings per share divided by the current market price. In cost of capital analysis, the earning-price ratio (which is one portion of the analysis) can be useful in corroborative sense, since it can be a good indicator of the proper range of equity costs when the market price of stock is near its book value.[32]

69. However, when the market price of stock is above the book value, as is the case in this proceeding, the earnings-price ratio understates the cost of capital.[33] Also, in that situation where utility market prices are above book value, the projected equity return overstates the cost of equity.[34] Mr. Hill modified his analysis by finding the midpoint between future, expected book equity returns and current earnings-price ratios, a modification in line with the Federal Energy Regulatory Commission's equity cost estimation models.[35]

70. Mr. Hill calculated the 7.57% average earnings-price ratio for his electric and gas sample group, which understates the cost of equity because market value is above book value.[36] He next determined that the 2004 and 2007-2009 expected book equity returns were 9.54% and 10.08%,

---

[32] Ex. 355, p. 6. (Hill).
[33] Id.
[34] Id.
[35] Id. , p. 7.
[36] Id., p. 7.

according to Value Line.[37] The midpoint of the earnings-price ratio and the current equity return, another indication of the current cost of common equity capital, ranges from 8.55% to 8.82%. [38]

71. Finally, Mr. Hill performs a Market-to-Book ratio (MTB) analysis, which is a method derived from the DCF model that attempts to address the inequalities that exist in the market-to-book ratios.[39] Mr. Hill explained the MTB analysis:

> The MTB seeks to determine the cost of equity using market-determined parameters in a format different from that employed in the DCF analysis. In the DCF analysis, the available data is "smoothed" to identify investors' long-term sustainable expectations. The MTB analysis, while based on the DCF theory, relies instead on point-in-time data projected one year and five years into the future and, thus, offers a practical corroborative check on the traditional DCF.[40]

Mr. Hill determined the market-to-book cost of equity for the sample of electric and gas combination utility firms to be 9.26% for the current year and 9.01% with the projected three to five year data.[41]

72. Averaging the lowest and the highest results of Mr. Hill's corroborative cost of equity estimation analyses (CAPM, MEPR and MTB) produces a range of equity cost estimates from 8.83% to 9.41%[42]. That range of additional equity cost estimates brackets the results of Mr. Hill's DCF analysis—9.32%—indicating that Mr. Hill's DCF is an accurate representation of current equity capital costs. However, as Mr. Hill noted, in establishing a range of common equity costs for ratemaking purposes, it is reasonable to recognize the fact that investors expect

---

[37] Id.
[38] Id.
[39] Id., pp. 8-9.
[40] Id. , p. 9.
[41] Id., p. 10, Ex. 366 (Hill).



ATTORNEY GENERAL OF WASHINGTON
Public Counsel
900 4th Ave., Suite 2000
Seattle, WA 98164-1012

interest rates to increase somewhat over the next few years. For that reason, Mr. Hill estimated an appropriate range of equity capital cost rates for electric utilities that are similar in risk to Puget ranges from 9.0% to 10.0%. the mid-point of that range, 9.5%, is similar to but higher than Mr. Hill's DCF result of 9.32%.

**5. Puget witness Cicchetti's equity cost estimates do not provide support for the equity return requested by the Company.**

**(a) Overview**

73. Dr. Cicchetti's DCF analysis is fatally flawed by his reliance solely upon stock price changes to establish the long-term sustainable growth called for in the DCF model. His election to use only stock price growth is unorthodox and causes his DCF results to be extremely volatile. That extreme volatility is evident in several ways.

74. First, it is apparent in his own DCF results. Dr. Cicchetti's DCF analysis for Puget Energy is shown at Table 5 of Page 34 of his Direct Testimony. Ex. 201, p. 34. That analysis, while concluding that the overall DCF result is an expected 12.2 % ROE, shows a DCF for Puget Energy of 5% in August 2003 and 21.9% in January 2004, a dramatic variance within the 12 month period.

75. Second, when Mr. Hill replicated Dr. Cicchetti's analysis, simply updating by four months,[43] the average DCF result was 8.6%—fully 3.6% lower than Dr. Cicchetti's 12.2 %. Ex. 351, Table 2, p. 52 (Hill). While Dr. Cicchetti admitted Mr. Hill's math was correct, he complained that the additional months included at time period where Puget's stock price fell. Ex. 206C, p. 72, l.15-p. 73, l.10 (Cicchetti); Ex. 255 (Cicchetti). However, that is *precisely* the

[42] Ex. 351, pp. 40-41 (Hill).

reason why the use of stock price changes to set the growth rate in a DCF analysis is unorthodox and leads to such extremely volatile results. That is also *precisely* the reason this Commission should give Dr. Cicchetti's DCF analyses no weight in determining the Company's cost of common equity.

76. Third, Dr. Cicchetti's analysis of "comparable" utilities mirrors the extreme volatility seen in his DCF analysis for Puget because he relies on the same flawed growth rate—stock prices changes. In Table 6 in his Direct Testimony, Dr. Cicchetti offers this Commission the following DCF equity costs for "comparable utilities:" Avista (+35.8%); Sierra Pacific Resources ( -22.8%); Great Plains Energy ( +50.6%), TECO Energy (-6.0%). Ex. 201, p. 35 (CJC-1T). Nowhere does Dr. Cicchetti explain what it means to have a negative 22.8% cost of equity, or whether investors would realistically expect or ratepayers pay for a return on investment of over 50%. These results, on their face, are simply not credible.

77. Statistical analysis casts even more doubt on Dr. Cicchetti's numbers. For example, a typical two standard deviation analysis around his average DCF for combination utilities (15.5%) results in the conclusion that the Commission can be 95% confident that Puget's ROE lies somewhere between -26% and + 51%. Ex. 351, p. Table 1, p. 50 (Hill). This conclusion could have been reached with no DCF analysis at all. It is an understatement to say that analytical volatility of this magnitude is not useful to this Commission in setting the allowed return for the Company in this proceeding.[44] It is essentially meaningless.

---

[43] Dr. Cicchetti used the period March 03-March 04. Mr. Hill used the Dr. Cicchetti's method for the period July 03-July 04.

[44] Mr. Hill notes that in more than twenty years of testifying on the issue of cost of equity capital he had never encountered a DCF based solely on stock price growth. Ex. 351, p. 48.

**(b) Dr. Cicchetti's DCF analysis in this proceeding conflicts with DCF methods used in prior testimony.**

78. As noted above, Dr. Cicchetti's DCF analysis relies on a stock price growth rate estimation technique that is untenable. Dr. Cicchetti's DCF growth rate analysis in this case is problematic for another reason as well—he has selected a different DCF growth rate methodology in this proceeding than that which he has used in prior cost of capital testimony. In his cost of capital testimony in Docket No. 01-WSRE-436-RTS before the Kansas Corporation Commission in 2001, Dr. Cicchetti's DCF was based on Value Line projected earnings growth rates for his sample group. No mention was made in that Kansas testimony regarding the use of stock price growth as a possible DCF growth rate methodology. Ex. 351, p. 52 (Hill).

79. When Dr. Cicchetti's Kansas DCF methodology (Value Line's projected earnings as a DCF growth rate) is used for Dr. Cicchetti's sample companies in this proceeding, the average DCF result is 7.56% and the median DCF result is 9.25%. Ex. 351, Table 3, p. 53 (Hill). In his Rebuttal Testimony, Dr. Cicchetti indicates that Public Counsel "should have recreated my analysis for the combination gas and electric companies for which I derived the 15.5% ROE." Ex. 206C, p. 73. Unfortunately for Dr. Cicchetti, that is exactly what Mr. Hill did do—the companies in Mr. Hill's Table 3, Ex. 351, p. 53, are identical to those in Dr. Cicchetti's Table 6. Ex. 201, p. 35 (Cicchetti). Again, when using a DCF method Dr. Cicchetti himself testified to as reasonable in another jurisdiction, the median result for his combination gas and electric companies, in jurisdictions *that have no restructuring* is 9.25%.

80. There are other inter-jurisdictional inconsistencies in Dr. Cicchetti's testimony in this proceeding, which undermine the credibility of his testimony. Dr. Cicchetti states that "[h]igh debt ratios also work against retail customers by increasing the risk of both debt and equity,

thereby increasing their respective costs." Ex. 201, p. 25 (Cicchetti). However, in the 2001 Kansas rate proceeding for Western Resources cited above, Dr. Cicchetti's testimony relied on a theory that "capital structure does not matter," terming the theory a "central concept" for the proceeding. Ex. 227, p. 21 (Cicchetti).[45] While the Western Resource rate case in which Dr. Cicchetti appeared was pending, Western Resources was preparing to spin off its unregulated operations and leave its regulated utility operations with essentially no common equity capital. Tr. 289, ll. 3 -8.. In the rate case, Dr. Cicchetti , on behalf of the utility (Western Resources), made the case that the planned spin-off of utility assets "does not affect the fundamental value of the utility[,] [n]or should affect a reasonable regulatory determination of a 'just and reasonable' rate of return and revenue requirement." Ex. 227, p. 20 (Cicchetti). Opposing theories he called "foolish and incorrect." Id., p. 21.

81. Dr. Cicchetti also testified for Western Resources in the Kansas proceeding regarding the spin-off. At the hearing in this case, Dr. Cicchetti, appeared to be uncomfortable acknowledging his role in supporting the Western Resources proposals:

> Q: [ffitch] Did you ever testify before the Kansas Commission that the spin off was reasonable?
>
> A: I don't believe I did.

Tr. 289, ll. 18-20.

82. Dr. Cicchetti was then shown a copy of his testimony in the Kansas spin-off case, and read an excerpt from the section stating his conclusions:

> A: The first three sentences are: I have reviewed the documents that define the rates offering, the split off, and the transaction with PNM, that stands for Public

[45] Company witness Valdman, on the other hand, testified in this case that capital structure is a "fundamental" element in rate setting. Tr. 178. l. 22.

Service New Mexico, I am convinced that these agreements are not by any means extraordinary. These agreements offer the best solution to resolving WR's current financial situation and ensuring superior continued utilities service in Kansas.

Tr. 293, ll. 8-20. After being presented with this passage, Dr. Cicchetti, after some lengthy explanation, appeared ultimately to concede that he supported the "package" as beneficial to consumers. Tr. 295, ll. 9-12. Surprisingly, he did not recall that the Kansas Commission rejected the proposal as harmful to the electric utility and contrary to the public interest. [46] Tr. 295, ll. 15-19. He was aware, however, that the CEO of Western Resources is currently under indictment for criminal activity stemming from his activities at Western Resources. Tr. 295, l. 20- Tr. 296, l. 8.

83. In the instant proceeding, Dr. Cicchetti now advocates the position that Puget must have a 45% common equity ratio because too much debt is too risky and expensive. Theoretical inconsistency on this scale cannot be overlooked. It is also troubling, from a credibility perspective, that Dr. Cicchetti appeared to equivocate to such an extent regarding his positions in the Kansas proceedings where his views on capital structure differed so markedly.

**(c) Dr. Cicchetti's Capital Asset Pricing Model (CAPM) contains fundamental errors.**

84. Dr. Cicchetti also performed a CAPM analysis. That analysis suffers from the same fundamental problem that plagues his DCF analysis—his exclusive reliance on stock price growth to estimate long-term growth. There are three elements in the CAPM: the risk-free rate, beta, and the market risk premium (investors' expectations regarding the return on the market

[46] *In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Public Utility Business from its Unregulated Business*, Kansas Corporation Commission, Docket No. 01-WSRE-949-GIE (July 20, 2001), Order, p.1 *See also, In the Matter of Western Resources, Inc. For Approval to Make Certain Changes in its Charges for Electric Service*, Kansas Corporation Commission, Docket No. 01-WSRE-436-RTS, Order on Rate Applications (July 25, 2001), (the rate case referenced above).

portfolio above that of the risk-free rate). It is in constructing the market risk premium that Dr. Cicchetti errs, in two fundamental ways.

85. First, Dr. Cicchetti measures the market risk premium as the difference between the DCF cost of equity of the broad stock market less the average Treasury Bond yield. As with his primary DCF analysis, Dr. Cicchetti uses stock price growth as "g" in the DCF. As noted above this is an unorthodox growth rate measure which can be very volatile. Moreover, Dr. Cicchetti has "cherry picked" historical periods to study in which stock market prices were rising, e.g., March 2003- March 2004, and January 2003-December 2003. As Public Counsel witness Hill noted, if Dr. Cicchetti had chosen different time periods his results for both the DCF on the market and his market risk premium for the CAPM would have been drastically different. Ex. 351, p. 55 (Hill).

86. The normal analytical approach in determining risk premiums is to use a very long time period in order to eliminate the short-term volatility that Dr. Cicchetti apparently seeks to emphasize. As Ibbotson Associates (the most widely referenced source of historical return data) note, by selecting shorter time periods "the analyst can justify any number he or she wants." Id.

87. Second, Dr. Cicchetti's market risk premium, 12.91%, Ex.201, p. 40 (Cicchetti) substantially overstates the 5% to 6.6% market risk premium that has existed over the past 77 years, as reported by Ibbotson Associates in 2004. Ex. 363, (Hill). Furthermore, recent research in the field of financial economics indicates that even that long-term market risk premium overstates investors' current risk premium expectations. As Mr. Hill notes, current research indicates that the market risk premium is more on the order of 2% to 4%, rather than the 5% to

6% that has occurred since the mid-1920s. These data show how very far out of touch with the current thinking in financial economics Dr. Cicchetti's 12.9% market risk premium really is.

88. As Ibbotson Associates report, the stock market, on average, has earned a 12.4% return over the long-term, since the mid-1920s. That figure overstates investors' current expectations by 3% or 4%, according to current research, and yet, Dr. Cicchetti informs this Commission that investors currently expect a return on the stock market of 17.8%. Dr. Cicchetti's market risk premium estimate is *double* the highest independently-determined long-term market risk premium available. Ex. 351, p. 56 (Hill). Simply substituting that highest available market risk premium (Ibbotson's 6.6% arithmetic mean market risk premium) into Dr. Cicchetti's CAPM for Puget Energy on page 40 of his Direct, produces an equity cost estimate of 9.04%.

89. Finally, Dr. Cicchetti's inter-jurisdictional inconsistency appears in this aspect of his testimony as well. In prior regulatory testimony, Dr. Cicchetti has rejected the CAPM, indicating that "a different CAPM answer could be formed by selecting different time periods," and "CAPM is fraught with differences in experts' opinions that often yield wide variation." Ex. 351, pp. 57-58 (Hill). Those are the very flaws that cause his CAPM in this proceeding to be substantially overstated.

90. The above cites are from Dr. Cicchetti's 2001 Kansas testimony, previously referenced. Yet, when presented with his past positions on the CAPM, Dr. Cicchetti responded in rebuttal, by providing rationale supposedly related to a different rate proceeding in 1996. Ex. 206C, p. 70, l. 19-p.71, l. 6. Subsequently, when reminded by Public Counsel in PC Data Request 208, Ex. 224, that he had referenced the wrong case in his Rebuttal, Dr. Cicchetti acknowledged the error. He nevertheless failed to amend the rationale provided in his Rebuttal, and noted that he

did use a CAPM in Kansas in 1996. In summary, Dr. Cicchetti never explained why the CAPM is appropriate now but wasn't appropriate in the 2001 proceeding. Moreover, his only "response" is to confirm another instance of his methodological flip-flopping. He used CAPM in the 1996 Kansas rate case, but not in 2001, and then uses it again in this case. Dr. Cicchetti's testimony on this issue provides an additional rationale for this Commission to question the credibility of his testimony in this proceeding.

#### (d) Dr. Cicchetti's Risk Premium analysis is not based on utility company data and repeats flawed assumptions regarding stock price growth.

91. The Risk Premium methodology holds that the higher risk of stocks over bonds requires a higher return for those stocks to compensate investors for assuming a higher risk. The Commission should not consider Dr. Cicchetti's Risk Premium results because they are based on DCF analyses over short-term historical periods. In addition, as Public Counsel witness Hill explains, Dr. Cicchetti has analyzed the wrong set of companies:

> The studies on which Dr. Cicchetti relies for his risk premium analysis are based on the cost of equity capital of a broad market measure (the S&P 500), not on the cost of capital of utility operations. Therefore, the 12% cost of capital estimates he provides (even if we assume his "updating" of the risk premiums is accurate) is that of unregulated, industrial operations not the cost of capital of a combination electric/gas utility operation. Utility operations are significantly less risky than the S&P 500, and Dr. Cicchetti's Risk Premium results, which are based on the cost of equity of the latter, should not be considered a reliable estimate of the cost of equity of the former. Ex. 351, p. 59 (Hill)

92. Finally, if Dr. Cicchetti's Risk Premium is adjusted so that it provides an equity cost estimate for utilities rather than the unregulated industrial firms in the S&P 500 Index, that analysis provides a cost of equity indication for Puget of 9.38%. Ex. 351, p. 60 (Hill).

**6. Dr. Cicchetti's attempt to draw distinctions between jurisdictions based on restructuring is not supported by the facts in the record.**

93. One of the themes of Dr. Cicchetti's cost of equity presentation in this proceeding is that equity return awards are different in regulatory jurisdictions that have undergone restructuring and those that have not done so. For example, Dr. Cicchetti provides examples in both his Direct, Ex. 201, Table 1, p. 29, and Rebuttal, Ex. 206C, p. 81, of very high equity return awards provided in a few jurisdictions in which restructuring has not occurred. However, the high equity returns he cites are a function of some sort of "rate plan" or special regulatory arrangement such as PBR. Ex. 201, p. 28. For example the Georgia Power plan he cited was based on an Accounting Order that set an acceptable range of equity returns from 10% to 12.95%. *In the Matter of Georgia Power Co.,* Docket No. 14000-U, Order in Re 2001 Rate Case p. 4 (December 20, 2001). Dr. Cicchetti elected to report only the highest number.

94. Dr. Cicchetti fails to mention other regulatory jurisdictions that have not restructured and have awarded equity returns that are much, much lower: Arkansas – 9.9%, Tennessee - 9.9%, Wyoming – 9.21%, Colorado – 9.5% and West Virginia – 7.0%. Ex. 351, p. 5, n. 1. In addition, the equity return awards from jurisdictions that have embraced restructuring are not uniformly lower, as Dr. Cicchetti's thesis would imply. In his Table 3 of his Direct Testimony, Dr. Cicchetti lists some equity return awards in some restructured states. Ex. 201, p. 31. One of those states, New York awarded a high rate of return to one of its electric utility operations. This indicates that there are many factors that influence allowed returns in the process of ratemaking, not just the type of jurisdictional regulatory process, as witness Cicchetti theorizes.[47]

[47] As noted above, Mr. Hill testified at the hearing that Public Utilities Fortnightly's most recent compilation of equity return awards for energy utilities shows that the vast majority of equity return awards over the last year fell in the 10% to 10.5% range. Tr. 507, ll. 14-18; Tr. 508, ll. 21-25.

**7. Puget's response to Public Counsel witness Hill does not effectively rebut issues raised in his testimony.**

95. Dr. Cicchetti's Rebuttal Testimony in this proceeding does not contain a current update of his equity cost estimation methodologies. The cost of equity analysis contained in his Direct Testimony, Ex. 201, p. 35, was based on data from the third quarter of 2003. That result is clearly outdated as pointed out by Public Counsel witness Hill, and in rebuttal, the Company witness elected to update that analysis, but only through the second quarter of 2004. Ex. 206C, p. 74. Dr. Cicchetti used data through the second quarter, even though his Rebuttal Testimony was filed in November, when third quarter data was certainly available. Nevertheless his "updated" results confirm the unreliability of Dr. Cicchetti's DCF analysis. Shown below are a few of the cost of equity capital estimates for Dr. Cicchetti's companies, taken from his Direct and Rebuttal Testimony.

| | Direct [48] | Rebuttal[49] |
|---|---|---|
| Great Plains Energy | 50.60% | 8.40% |
| Empire District | 32.00% | -1.50% |
| Sierra Pacific | -22.80% | 25.90% |
| MDU Resources | 40.60% | -30.10% |

As noted above the Company witness' DCF results are simply non realistic and are far too variable to provide any useable information to this Commission regarding Puget's actual cost of common equity capital.

96. Dr. Cicchetti suggests that Public Counsel and Staff could have used a multi-stage DCF analysis, Ex. 206C, p. 48, even though Dr. Cicchetti did not use a multi-stage DCF and, instead used the same constant-growth DCF used by witnesses Hill and Wilson. His suggestion is

[48] Ex. 201, Table 6, p. 35 (Cicchetti).

apparently based, not on theoretical grounds, but rather on the notion that Public Counsel and Staff's equity returns are too low and should be made higher by some means.

97. Similarly Dr. Cicchetti offers three different growth rates that Mr. Hill could have used in order to increase his DCF results. Ex. 206C, p. 52. When asked in PC Data Request 203, Ex. 221 (Cicchetti), Dr. Cicchetti was unable to provide any support from the financial literature for either the origin of or the relevance of those growth rates. Also, the growth rates that Dr. Cicchetti suggests Mr. Hill could use has never been included in any cost of capital analysis presented by Dr. Cicchetti. Ex. 221. Again, in his Rebuttal Testimony Dr. Cicchetti is providing unorthodox, theoretically unsupported "gimmicks" that an analyst could use to increase the cost of equity results. He hasn't used them, but he recommends that Public Counsel or Staff ought to because their numbers are just too low, in his opinion. This does not constitute credible rebuttal.

98. Dr. Cicchetti also presents mathematical formulas that are purportedly intended to quantify a leverage adjustment to be applied to the cost of capital results of Public Counsel witness Hill. Ex. 206C, pp. 58, 64 (Cicchetti). There are many problems with Dr. Cicchetti's testimony on this point.

99. First, Dr. Cicchetti is replicating an analysis Mr. Hill has already made, and doing it incorrectly. Mr. Hill's testimony provides an analysis of the financial risk (leverage) differences between Puget and Mr. Hill's sample group of companies. Exhibit 367 (Hill). That analysis shows that Mr. Hill's companies have an average common equity ratio of 43.8% and indicates that, using market data from those companies as a basis, the relative cost of equity to Puget should be 12 to 16 basis points higher because of that financial risk difference. Dr. Cicchetti's

[49] Ex. 206C, Table 6 (Revised), p. 74 (Cicchetti).

leverage analysis purports to do the same thing, but he incorrectly assumes that the sample group has a common equity ratio of 50% to compare to Puget's 40% common equity. As a result, he derives an equity cost increment that is too high.

100. Second, in performing that analysis Dr. Cicchetti incorrectly used book value capital structures when the theory supporting the analysis calls for market-value capital structures. *See* Ex. 351, pp. 44-47 (Hill). He was asked at the hearing if he had in fact used book value rather than market value and responded: "I have no idea, because I made those numbers up." Tr. 279, l.9. Dr. Cicchetti went on to concede that market value capital structures are required. Tr. 279. ll. 17-18. Dr. Cicchetti's adjustment is overstated for that reason also.

101. Third, although the leverage analysis presented on page 58 and on page 64 of Dr. Cicchetti's Rebuttal is intended to make the same adjustment (i.e., adjusting the equity cost of Puget with a 40% equity ratio to that of a sample group with a 50% common equity ratio), the formulas presented Dr. Cicchetti on each of the pages are different, which he concedes. Tr. 280, ll. 19-22. Then, after a request from the Administrative Law Judge, corrected formulas were provided. The conclusions of Dr. Cicchetti's incorrect formulas, however, were not changed. It appears that for Dr. Cicchetti, the result must be the same, regardless of the methodology employed.

102. If Dr. Cicchetti's Rebuttal Testimony is conclusive of anything it is that logical rational, and consistent application of supportable economic theory are not the foundation of that testimony. The end result—a <u>higher</u> cost of common equity capital recommendation for Puget—is.

### 8. Dr. Cicchetti's fees are excessive.

103. The fees paid to Dr. Cicchetti and Pacific Economics Group for the cost of capital testimony in this case are excessive by any measure. Ex. 249C. For this unreasonable fee, moreover, PSE has received testimony with significant technical flaws, and of questionable credibility. These factors should be taken into account when determining the reasonableness of this expense.

### E. Total Capital.

104. Based on the above analysis of Public Counsel witness Hill, the Commission should adopt an overall rate of return of 8.01% with a return on equity of 9.75% for Puget. The overall capital structure, cost rates, and rate of return is stated in the table in Appendix A.

## IV. REVENUE REQUIREMENT

### A. Contested Adjustments – Electric.

#### 1. Adjustment 2.03 – Power Costs

##### d. Hydro Normalization

105. Public Counsel supports the position of ICNU in favor of retaining the use of the 40-year rolling average for hydro normalization. Ex. 371, p. 9 (Schoenbeck) PSE has not carried its burden to show why there should be a change of policy on this issue.

i. The Commission previously resolved this issue decisively in favor of the 40 year rolling average for PSE rate making.

106. The Commission has required the use of a 40-year rolling average for hydro normalization purposes at least since Puget's 1989 rate case. In that case the Commission rejected Puget's contention that hydro conditions should be determined using 50 years of water

(at that time 1929 to 1978), at the time described by Puget as all available data. This issue was deemed important and relevant on a statewide basis. The other major electric IOUs in the state and other interested parties were invited to evaluate the best method to use in the entire state. PSE convened such a group. [50]

107. In 1992, in its next rate case, Puget attempted to have the Commission revisit its decision, again proposing the use of water years for a 50 year period (1929-1978), again assertedly all the available data. Puget was supported by intervenors Washington Water Power and Pacific Power & Light, both of whom presented expert testimony. Commission Staff advocated continued use of the 40-year rolling average. Witness Donald Schoenbeck, appearing for WICFUR[51] advocated use of all available data from an extended 110 year data base. Public Counsel witness Glenn Blackmon recommended use of 30 years. [52]

108. The Commission gave careful and extensive consideration to this issue and sought, in quite emphatic terms, to put the issue to rest for purposes of future cases, stating:

> The Commission accepts the Commission Staff position, and directs the Company to continue to use a 40-year rolling average. The Commission believes that the parties spent far too much time revisiting this issue. They repeated arguments and evidence they have presented in previous rate cases. [Staff witness] Mr. Winterfield's presentation in Docket No. U-89-2688-T demonstrated convincingly that the cumulative error would be less under a 40-year rolling average than under the Company's proposal. While a rolling average may not be the most precise estimate, errors tend to offset one another as the method is applied over time. The evidence presented in this proceeding does not persuade the Commission that hydro availability is subject to cycles or trends. *The Company is put on notice that this will*

---

[50] *WUTC v. Puget Power & Light Co* , UE-921262, Eleventh Supplemental Order, pp. 41; *WUTC v. Puget Power &Light Co*., U-89-2688-T, Fifth Supplemental Order on Reconsideration, p. 8.

[51] Washington Industrial Customers for Fair Utility Rates, a predecessor industrial intervenor to ICNU.

[52] *WUTC v. Puget Power & Light Co.*, UE-921262, Eleventh Supplemental Order, pp. 41-44. In a 1984 Washington Water Power Case, Public Counsel advocated use of a 105-year study of the Columbia River drainage at The Dalles. The recommendation was not adopted by the Commission. *WUTC v. Washington Water Power Company*, U-84-28, Second Supplemental Order, p. 14.

*remain the Commission's position on this issue unless and until a clear and convincing argument supports a superior alternative.* (emphasis added).[53]

This is strong and clear language, intended not merely to make a finding in the individual case, but to establish a standard for the future and to put debate to rest. This was appropriate because the Commission had previously ruled on the issue, and had then invited the other investor-owned utilities and stakeholders to participate in a collaborative resolution of the issue. This is the type of language which the Commission reserves for making absolutely clear to parties what it expects, to avoid any misunderstanding about Commission intent.

109. Despite this history, in this proceeding, for the third time in 15 years, PSE has brought back to the Commission the same twice-rejected theory – use of "all available" water years, which PSE now interprets as 1929-1988.

110. The first problem with PSE's case on this issue is that it disregards the importance of the Commission's 1992 order. While there is passing reference to earlier Commission action on the issue in Dr. Dubin's testimony, nowhere does he acknowledge that (1) PSE was "on notice" that the 40-year rolling average standard would be used; (2) that the Company was specifically "directed" to continue to use that standard; and (3) that the standard would "remain" until unless there was "clear and convincing" evidence to support a "superior alternative."

111. Not only does Dr. Dubin ignore these clear Commission directives in his testimony, he either misunderstands or was misinformed regarding the nature of the 1992 case. In his testimony on the stand he characterized the 1992 decision as adopting Public Counsel's position, Tr. 640, l. 24- Tr. 641, l.2, when in fact the Commission makes clear in its order that it was adopting Staff's position.

[53] Id., p. 43.

ii. The PSE and Staff positions on this issue are flawed.

112. While Dr. Dubin has presented a substantial piece of testimony, he does not appear to have specifically analyzed the basis of the Commission's prior decision, or the testimony of Staff witness Winterfield on the issue of rolling versus cumulative average, which he did not address in his testimony. Tr. 629, ll. 2-8. Dr. Dubin also was confused or unaware of the availability of more data than the 60 years he proposes using, stating that "such data doesn't exist." Tr. 661, l.19; Tr. 684, ll. 11-12 ("no measurements that go back before 1928"). Even in the prior PSE rate cases where the issue was litigated, it was known that streamflow data was available for at least 105 years.[54] As Mr. Schoenbeck testified in this case, that data set has now expanded to 120 years. Tr. 986, l. 1. Dr. Dubin appeared unaware of the data available, and dismissive of its importance.

113. Neither Dr. Dubin nor Dr. Mariam argue that there has been some dramatic change in hydro normalization since 1992 that warrants a change in policy. Dr. Dubin merely replicated work done in the 1992 proceeding and has offered no new theory. Tr. 987, ll. 2-11 (Schoenbeck).

114. Neither Dr. Dubin nor Dr. Mariam have explained away the fact that essentially all other normalization in the case is based on the use of multi-year rolling averages. This is true for storm damage. Tr. 791, l. 14-Tr. 792, l. 6 (Story). It is true for weather normalization for electric loads, Tr. 710, l. 16-Tr. 711, l.5 (Mariam), and is true for weather normalization for natural gas loads. Tr. 711, l. 6-Tr. 712, l. 10 (Mariam). Given this fact, it's difficult for Drs.

---

[54] *WUTC v. Washington Water Power,* U-84-28, Second Supplemental Order, p. 14.

Mariam and Dubin to credibly argue that use of a rolling average is by its very nature methodogically flawed.

115. Like Dr. Dubin, Dr. Mariam attempts to reinvent the wheel and revisit the rolling average issue, without acknowledging the history of the issue. Nowhere in his testimony does he carefully review or analyze the findings in the prior cases, or explain why Staff was wrong in those cases. In essence what Drs. Mariam and Dubin have done here is to address this issue as if they were writing on a clean slate. They seek to reopen an issue already thoroughly analyzed, litigated and resolved. The impact on revenue requirement, if Dr. Dubin's recommendation is approved is $11 million. Tr. 693, ll. 5-12, (Dubin).

116. Another important factor arguing against a departure from the current standard is the absence of other IOU stakeholders from this proceeding. In the 1989-92 period, the industry worked together on this issue at the Commission's request. In the 1992 case, the second and third largest electric IOUs intervened and offered expert testimony. In essence, the case was a "generic case" for these purposes. There has been no such industry participation in the issue here. This is still another piece of the record of this issue ignored by PSE. The Company seeks to unravel progress made, and return to a piecemeal approach. If it wanted this issue to be revisited, it could have convened a collaborative as was done in 1989-92, or at least sought intervention by other IOUs in this docket for an explicit effort to find a "superior alternative."

iii. PSE fails to show by clear and convincing evidence that the 40-year rolling average standard should be abandoned.

117. In its 1992 order the Commission established that the 40-year rolling average would be used unless it was persuaded of a superior alternative by clear and convincing evidence.[55] The "clear and convincing" standard is a stricter evidentiary standard than the preponderance of the evidence standard.[56] The Commission's specific use of that language in the 1992 order reflects an express intent to employ the higher standard should the issue again come before it. This is the first case since the 1992 order where PSE has sought to revisit the 40-year rolling average. It is not enough for PSE to simply present an expert in support of the same (limited) "all years" proposal and argue that it has carried its burden by a preponderance of the evidence – 50% plus one. Instead, it must show that the proposal is clearly and convincingly a "superior alternative" to the standard that has been in use for at least 15 years. PSE fails to meet that standard.

118. PSE's proposal should again be rejected. The 40-year rolling average previously found to be indicative of lower cumulative error, and now in use for 15 years, should be retained. PSE should be directed, if it desires to revisit this issue again, to convene a collaborative or petition for a generic case so that proposed changes in the use of a rolling average for hydro normalization can be fully and fairly explored.

### 7. Adjustment 2.18—Rate Case Expense

119. Public Counsel concurs in the position of ICNU with respect to rate case expense. Ex. 371, pp. 28-29 (Schoenbeck) While there is no dispute that rate case expense is recoverable as a general proposition, Public Counsel finds both the total amount of expenditure, and the amounts spent for experts on individual issues such as cost of capital to be shocking. Public Counsel has

[55] *WUTC v. Puget Sound Energy*, Docket UE-921262, Eleventh Supplemental Order, p. 43.

two major concerns with the PSE expenses in this case. First, the expenses are of such a magnitude as to raise questions about the ultimate fairness of the process. With such a dramatic imbalance of resources it is a fair question whether interests other than those of the Company can truly be adequately represented. Responding to the Company witnesses and testimony and trying to present the Commission with sufficient analysis and evidence on the range of issues in the case quickly becomes lop-sided battle. This applies not only to intervenors, but even to the Commission Staff itself.

120. Second, the magnitude of the expenses incurred by the Company here raises the question of at what point expenses become so high as exceed the reasonable and prudent level that ratepayers should be required to bear. If PSE wishes to spend $3 million on this rate case it may choose to do so, but all costs above a reasonable and prudent level of expense should be borne by shareholders, not customers. Expenditures at such an elevated level belie Company claims of financial need. Asking ratepayers who are struggling in difficult economic times to underwrite such levels of compensation, to ask the Company in making their energy bills ever higher is indefensible.

121. These arguments apply as well to Adjustment 2.10 – Gas Rate Case Expense.

## VI. RATE SPREAD AND RATE DESIGN SETTLEMENT

122. Public Counsel has executed the Partial Settlement Agreement on rate spread and rate design. Ex. 1. Public Counsel's support for the settlement is set forth by Public Counsel/Energy Project/A.W.I.S.H. witness Jim Lazar in the Joint Testimony filed herein and marked as Ex. 2.

---

[56] 29 Am. Jut. 2d Evidence § 157 (clear and convincing : "highly probable" or establishing "firm belief" as to truth of assertion; preponderance: "more likely than not"); *In re Discipline of Sanders,* 135 Wn. 2d 175, 181, 955 P. 2d 369 (1998)("evidence which is weightier and more convincing that a preponderance of the evidence").

## VII. PCORC COSTS

123. Public Counsel concurs with the position of ICNU with respect to recovery of PSE's PCORC costs. Public Counsel reiterates the concerns discussed above in Section IV.A.7.

## IX. COMMISSION AUTHORITY TO APPROVE REVENUES ABOVE AMOUNTS PRODUCED BY THE TARIFF SHEETS FILED ON APRIL 5, 2004

124. Public Counsel concurs with the Commission Staff position that the Commission does not have the authority to approve revenues above amounts contained in the tariffs filed by PSE on April 5.

## X. CONCLUSION

125. For the reasons set forth above Public Counsel respectfully urges the Commission to adopt Public Counsel's recommendations with respect to capital structure, cost of capital, hydro normalization, rate case expense, and the other issues addressed in this brief,

DATED this 18th day of January, 2005.

ROB McKENNA
Attorney General

Simon J. ffitch
Assistant Attorney General
Public Counsel

TABLE OF CONTENTS

I. SUMMARY OF ARGUMENT....1

II. INTRODUCTION/GENERAL ARGUMENT ....2

A. PSE Ratepayers Have Made Significant Contributions To The Company's Financial Well-Being In The Past Three Years. ....2

B. Written Comment and Witnesses at Public Hearings Opposed the Rate Request....6

III. CAPITAL STRUCTURE AND COST OF CAPITAL....8

A. Debt....9

1. Long-term Debt ....9

2. Short-term Debt....9

B. Trust Preferred Stock ....14

C. Preferred Stock....15

D. Common Equity ....15

1. The Evidence Developed In The Record In This Proceeding Does Not Support An Equity Return Award Above 10%. ....15

2. The Recommendations Of Public Counsel Comply With The Applicable Legal Standards. ....18

3. PSE's Actual Capital Structure Should Be Used to Set Rates. ....20

4. Public Counsel Witness Hill's Cost of Equity Estimation Methods....24

a. Overview. ....24

b. The DCF result proposed by the Public Counsel accurately and adequately considers current low capital cost rates. ....26

c. Mr. Hill's corroborative equity cost estimation methods (Capital Asset Pricing Model, Modified Earnings-Price Ratio, and Market-to-Book Ratio) support a cost of equity below 9.75. ....29

5. Puget witness Cicchetti's equity cost estimates do not provide support for the equity return requested by the Company. ....32

(a) Overview ....................32

(b) Dr. Cicchetti's DCF analysis in this proceeding conflicts with DCF methods used in prior testimony....................34

(c) Dr. Cicchetti's Capital Asset Pricing Model (CAPM) contains fundamental errors. ....................36

(d) Dr. Cicchetti's Risk Premium analysis is not based on utility company data and repeats flawed assumptions regarding stock price growth. ....................39

6. Dr. Cicchetti's attempt to draw distinctions between jurisdictions based on restructuring is not supported by the facts in the record. ....................40

7. Puget's response to Public Counsel witness Hill does not effectively rebut issues raised in his testimony. ....................41

8. Dr. Cicchetti's fees are excessive. ....................44

E. Total Capital....................44

IV. REVENUE REQUIREMENT ....................44

A. Contested Adjustments – Electric. ....................44

1. Adjustment 2.03 – Power Costs ....................44

d. Hydro Normalization ....................44

7. Adjustment 2.18—Rate Case Expense....................49

VI. RATE SPREAD AND RATE DESIGN SETTLEMENT....................50

VII. PCORC COSTS ....................51

IX. COMMISSION AUTHORITY TO APPROVE REVENUES ABOVE AMOUNTS PRODUCED BY THE TARIFF SHEETS FILED ON APRIL 5, 2004 ....................51

X. CONCLUSION ....................51

XI. APPENDICES....................See Appendix A

a. Relief Requested Re Capital Structure and Cost of Capital....................See Appendix A

TABLE OF AUTHORITIES

**Cases**

*Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia,*
262 U.S. 679 (1923)……………………………………………………………………18,19,20

*Duquesne Light Co. v. Barasch,*
488 U.S. 299, 310 (1989) , *aff'g Barasch v. Pa. P.U.C.,* 142, 532 A.2d 325 (1987)……….…..19

*Federal Power Commission v. Hope Natural Gas Co.,*
320 U.S. 591 (1944)………………………………………………………………….……..19

*In Re Discipline of Sanders,*
135 Wn.2d 175, 181, 955 P.2d 369 (1998)…………………………………………..………..50

*Permian Basin Area Rate Cases,*
390 U.S. 747, 794-95 (1968) (citing Atlantic *Refining Co. v. Public Service Comm'n,*
360 U.S. 378, 388 (1959)………………………………………………………………….…..19

**Treatises**

*29 Am. Jut. 2d Evidence § 157*……………………………………………………………….... 50

**State Regulatory Commission Orders**

*In the Matter of Georgia Power Co.,* Docket No. 14000-U,
Order in Re 2001 Rate Case p. 4 (December 20, 2001) ........................................................ 40

*In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Public Utility Business from its Unregulated Business*, Kansas Corporation Commission,
Docket No. 01-WSRE-949-GIE (July 20, 2001 ...................................................................... 36

*In the Matter of Western Resources, Inc. For Approval to Make Certain Changes in its Charges for Electric Service*, Kansas Corporation Commission,
Docket No. 01-WSRE-436-RTS, Order on Rate Applications (July 25, 2001) ....................... 36

*WUTC v. PSE*,
Docket Nos. UE-011570, UG-011571, Ninth Supplemental Order .............................. 2, 16, 17

*WUTC v. PSE*,
Docket Nos. UE-011570, UG-011571, Thirteenth Supplemental Order.................................. 3

*WUTC v. PSE*,
UE-031725, Order No. 14 .......... 3

*WUTC v. PSE*,
Docket Nos. UE-011570, UG-011571, Twelfth Supplemental Order .......... 2

*WUTC v. Puget Power &Light Co*.,
U-89-2688-T, Fifth Supplemental Order on Reconsideration .......... 45

*WUTC v. Puget Sound Power & Light Company*, UE-921262 et al.,
Eleventh Supplemental Order .......... 20, 45, 49

*WUTC v. Washington Water Power,*
U-84-28, Second Supplemental Order, p. 14 .......... 45, 47