Xcel Energy



1225 17th Street, Suite 900
Denver, Colorado 80202

September 17, 2009

Doug Dean, Director
Colorado Public Utilities Commission
1560 Broadway, Suite 250
Denver, CO 80202

Re: Proposed Formal Complaint of the Commission Staff with Respect to Alleged Over-earnings of Public Service's Gas Department for 2007 and 2008

Dear Mr. Dean:

Public Service Company of Colorado has received your letter of August 4, 2009, and the proposed formal complaint drafted by the Commission Staff relating to alleged earnings in excess of the authorized rate of return for natural gas service by Public Service ("Proposed Complaint"). You indicated that the letter is to serve as the notice of Proposed Complaint required by Rule 1302(h) of the Commission's Rules of Practice and Procedure, 4 CCR 723-1-1302(h).

On September 3, 2009, we sent you a letter requesting an extension of time of two weeks in which to respond to the Proposed Complaint. In that letter, we also notified you of an error that we discovered in the 2007 and 2008 Appendix A reports during our investigation into the allegations of the Proposed Complaint. Specifically, the Company had allocated certain Permanent Tax Differences between its Gas Department and Electric Department, when in fact this item should have been assigned entirely to the Electric Department. We advised that the 2007 and 2008 Appendix A reports, which had been relied on extensively by the Commission Staff in the Proposed Complaint, would need to be corrected and re-filed. Public Service is today filing the corrected 2007 and 2008 Appendix A reports, as well as a corrected 2006 Appendix A report. The corrections result in the reduction to the Gas Department earnings indicated in the Appendix A report of about $2 million for 2007 and a corresponding reduction of $3.9 million for 2008.

The Company regrets the inconvenience caused by the above-noted error, and provides a detailed explanation below. Nevertheless, we believe that the correction of this error in the 2007 and 2008 Appendix A reports, as well as the correction of a smaller error in the reporting of property taxes for 2008 (also described below), goes a long way towards responding to the Proposed Complaint. Public Service now reports that it earned $723,000 less than its authorized return on equity in 2007. The corrected earned return on equity in 2008 is 11.37 percent, which is about 112 basis points or $7.3 million above its authorized return on equity. The major reasons for the increased revenues and decreased costs for the Gas Department in 2008, as detailed more fully below, are unlikely to result in over-earnings going forward. In fact, Public Service's near-term projections indicate that our Gas Department will earn below its authorized return for the twelve months ending December 31, 2010, and that we will be required to file to increase its gas service rates in 2010 to address the shortfall.

## *I.* ***Introduction***

As we understand the Proposed Complaint, the Commission Staff is alleging that Public Service's gas service rates are no longer just and reasonable in violation of C.R.S. § 40-3-101 and that the Commission should set a hearing pursuant to C.R.S. § 40-3-111 to initiate a rate case proceeding to establish new just and reasonable rates. We further understand that, under the formal complaint procedures, the Staff, as the proponent of the rate change, would have the burden of proof and the burden of going forward in such a proceeding to establish that Company's gas service rates are not just and reasonable. To support its allegations in the Proposed Complaint that Public Service's gas service rates are not just and reasonable, Staff has relied exclusively on the results reflected in the Appendix A reports filed by Public Service for calendar years 2007 and 2008. Based on the normal fluctuations of results reflected in Appendix A reports and the assumptions incorporated into the Appendix A calculations, we believe that a simple presentation of the Appendix A results is insufficient to warrant the initiation of a rate case complaint proceeding under C.R.S. § 40-6-108. Based on the information presented in this response, Public Service believes the Proposed Complaint does not establish a sufficient basis to warrant the Commission's initiation of a formal complaint proceeding into Public Service's gas service rates. As such, the Commission should not issue the complaint.

In addition, Public Service has legal and policy concerns with the proposed remedial actions set forth in the Complaint, which the Company would request be modified in the event the Commission elects to issue the complaint. Based on the limitations on the Commission's remedial authority in a rate proceeding initiated pursuant to C.R.S. § 40-6-108, Public Service believes that subparagraphs e and f of proposed Ordering Paragraph 3 of the Proposed Complaint should be eliminated in their entirety. Our discussion of the legal and policy implications of these potential remedial actions, and why they would be inappropriate in a complaint proceeding initiated on the Commission's own motion, is set forth in this response.

Regardless of whether the Commission decides to issue the complaint, Public Service commits to cooperate with Staff in its investigation into the causes of any past Gas Department over-earnings that may have been realized, as well as projections of future earnings. The Company would further commit to file a Gas Department revenue requirements rate case in 2010.

## *II. Corrections to Public Service's Appendix A Reports for Calendar Years 2006, 2007 and 2008.*

As mentioned above, Public Service is filing revised Appendix A reports for 2006, 2007 and 2008 to reflect a correction in the allocation of Permanent Tax Differences, which capture expenses and revenues that are not recognized in the derivation of income taxes. As the nature and impact of this error is quite complex, Public Service offers the following explanation to facilitate the Commission's understanding.

The Company records income tax expense in accordance with generally accepted accounting principles, which are used for SEC and Regulatory reporting. Four primary income statement tax accounts are used: Current Federal Income Tax Expense, Current State Income Tax Expense, Deferred Income Taxes and Investment Tax Credits. Additionally, income tax expense must be allocated between "above the line" utility income tax expense and "below the line" income tax expense. The utility income tax expense must also be allocated among Electric, Gas and Thermal Department expenses. Any items that are identified as Common must ultimately be allocated among Electric, Gas and Thermal.

The Company's general ledger system, JD Edwards (JDE), has been designed to systematically capture and report this information, as required for internal and external financial reporting purposes. For regulatory accounting and reporting purposes, the Company uses information from its JDE regulatory ledger (accounting information by FERC account) to prepare its FERC Form 1 and other required state and federal financial reports. In preparing the Company's Annual Appendix A Questionnaire Report, the Company makes certain manual adjustments to its Electric, Gas and Thermal information to derive the required Colorado jurisdictional financial information and to allocate certain below the line accounts, including equity Allowance for Funds Used During Construction (equity AFUDC).

In the process of investigating the Gas Department earnings information, as filed in the Appendix A Report for the year ending December 31, 2008, the Company identified an error in the manual adjustment to the permanent differences in calculating State and Federal

Income Tax Expense for the Electric, Gas and Thermal Departments. Specifically, the Company used an erroneous income tax report to identify the permanent income tax differences and create the manual pro forma adjustment related to equity AFUDC. The error in the income tax report resulted from the use of a default allocation to common plant for projects that are still under construction at the end of a tax year. The report allocated too much equity AFUDC for purposes of the income tax calculation to the Gas Department and too little equity AFUDC to the Electric Department. There was a similar error in 2007, as well as in 2005 and 2006.

For 2008 the Plant Related Permanent & Flow-through difference on Line 40 of Attachment 1(b), page 10 of 17, was reported as ($10,430,020), but should have been $356,909. In addition, the Company discovered that it understated its Gas Department property taxes in its 2008 Appendix A by about $224,000. This error occurred because the Company inadvertently added an expense that it should have subtracted. Both errors affected the calculation of the State and Federal Income Tax amount for the Gas Department on Line Nos. 3 and 7 of Attachment 1(b), page 11 of 17. The reported amounts of the State and Federal Income Tax Expenses were $660,999 and $4,765,406, respectively. The correct amounts of State and Federal Income Tax Expense are $1,170,554 and $8,438,984, respectively. These corrections reduce the Gas Department earnings for calendar 2008 from $11.2 million to $7.3 million.

Similarly, the 2007 earnings were overstated by about $2 million due to the error in reporting Permanent Tax Differences described above. As a result of this correction, the Company's actual 2007 earnings were about $723,000 less than our authorized rate of return.

The schedule attached to this response shows the previously reported and corrected amounts for the plant-related Permanent Tax Difference for all utility departments for calendar years 2008, 2007, 2006 and 2005. The 2005 difference does not affect the earned returns reported in the 2005 Appendix A.

While the use of a default allocation approach for 2005 and 2006 did not result in significant errors, the CWIP related to the construction of Comanche 3 and other electric department projects have resulted in large differences for 2007 and 2008. The information from this specific report was used as support for a manual adjustment by the Rates and Regulatory Affairs Group in preparing the Appendix A Report. In hindsight, the Company should have questioned the magnitude of this adjustment as it relates to the Gas Department, given that equity AFUDC related to Gas Department construction work in process has historically been small.

In order to prevent a similar error from occurring in the future, the Company has instituted control checks to validate the permanent income tax differences with the Company's other financial records as part of preparing the manual adjustments to the Appendix A.

Specifically, the Company plans to use other available detailed plant reports for this information, which allocates all permanent AFUDC differences to the proper function plant classifications without the use of a default allocation. In addition, the Company plans to implement a more robust review process of all adjustment within the Appendix A report.

We have determined that these errors were limited to the Company's Annual Appendix A and related historical cost of service calculations. The Company's 2009 and 2010 forecast test-year cost-of-service calculations were not impacted by this error. Also, we have determined that our financial regulatory reporting for our other operating utilities was not impacted.

## *III. <u>A Public Utility Is Allowed to Earn in Excess of Its Authorized Return on Equity; Over Earnings Do Not Constitute Any Violation of Law.</u>*

Before addressing the details of our preliminary findings regarding the factors contributing to the 2008 Appendix A results showing that the Gas Department earned in excess of its authorized return on equity, we would like to address certain overarching policy implications of the Proposed Complaint. In particular, we are troubled by the implication in the Proposed Complaint that a public utility should not be allowed to earn in excess of the authorized rate of return approved by the Commission in its last rate case, and that to do so somehow constitutes a violation of law. The use of the terms "over-earnings" and "over-earned" throughout the Proposed Complaint mistakenly suggests that there is some legal restriction or cap on the ability of a public utility to achieve successful financial results. Public Service at all times has charged its customers the Commission-approved rates in effect and set forth in its tariff for natural gas services, and there is no suggestion in the Proposed Complaint to the contrary.

Any "over-earnings" indicated by an Appendix A report do not mean that the Company's rates are no longer just and reasonable. Contrary to what appears to be suggested in the Proposed Complaint, a Commission-authorized return does not mandate a particular future financial result. When the Commission approves a return on equity, as well as any other element of cost, for inclusion in the Company's test year cost of service, the Commission is merely providing the utility an opportunity to earn its authorized return. The costs and revenues associated with providing utility service are constantly changing. Just as it is not unlawful for a utility to earn less than its authorized rate of return, it is not unlawful for a utility to earn in excess of its authorized rate of return. Over time, and based on the normal course of events, it is expected that a utility's established rates and charges will generate revenues that result in either over-earnings or under-earnings.

The scheme of public utility regulation in Colorado provides for the prospective adjustment of rates by the Commission if a public utility's current rates are determined to be excessive (i.e., generate over-earnings) or deficient (i.e., generate under-earnings). If the utility believes that its rates are insufficient to recover its cost of service, the utility has the right to file to revise its rates by tendering revised tariff sheets on not less than 30-days notice in accordance with C.R.S. § 40-3-104. When any other person, governmental body or the Commission Staff believes that the utility's rates are generating revenues greater that those necessary to recover the utility's cost of service, they have the right to file to a complaint to revise the utility's rates pursuant to C.R.S. § 40-6-108.

The issues described by the Commission Staff in subparagraphs 13.a. and 13. b., and the parallel issues set forth in ordering paragraphs 3.a and 3.b., appear to be inconsistent with these well-established principles. Subparagraph 13.a. and ordering paragraph 3.a. identify, as an issue to be determined in this potential formal complaint action, whether and in what amount Public Service has earned, for the period from August 2007 to the present, in excess of its authorized rate of return on equity of 10.25% approved in Decision No. C07-0568 in Docket No. 06S-656G. In a rate case proceeding, whether initiated by the Company's filing revised tariffs in accordance with C.R.S. § 40-3-104 or a complaint action brought under C.R.S. § 40-6-108, the appropriate determination for the Commission is to establish the utility's just and reasonable rates, including an appropriate rate of return on equity based on evidence of the appropriate cost of capital for the utility. C.R.S. § 40-3-111(1) grants the Commission considerable flexibility in what it may consider in establishing just and reasonable rates:

> In making such determination, the commission may consider current, future, or past test periods or any reasonable combination thereof and any other factors which may affect the sufficiency or insufficiency of such rates, fares, tolls, rentals, charges, or classifications during the period the same may be in effect, and may consider any factors which influence an adequate supply of energy, encourage energy conservation, or encourage renewable energy development.

Although historical costs and past financial performance may be important factors, the Commission must consider changed circumstances and how they affect the utility's anticipated costs and revenues for the period in which the new rates will be in effect. Consequently, in contrast to the limited historical view provided in subparagraph 13.a. and Ordering Paragraph 3.a. of the Proposed Complaint, the basic issue for determination by the Commission is what are the utility's just and reasonable rates going forward.

Similarly, subparagraph 13.b. and ordering paragraph 3.b. of the Proposed Complaint misstate the relevant inquiry in this potential formal complaint proceeding as being whether the alleged "over earnings" in 2007 and 2008 "constitute unjust or unreasonable charges made demanded, or received in violation of § 40-3-101, C.R.S." C.R.S. § 40-3-101 pertains to rates, not to earnings. Since Public Service at all times has charged the Commission-approved rates for its gas services, it cannot be found to have charged rates in violation of C.R.S. § 40-3-101. The Commission-approved rates and charges are *per se* just and reasonable until the Commission determines that they are no longer just and reasonable, after a hearing, pursuant to C.R.S. § 40-3-111. Until then, a public utility is required by law to charge its Commission-approved rates and charges, and those rates cannot be considered unjust or reasonable in violation of C.R.S. § 40-3-101. Once the Commission determines that a utility's rates are no longer just and reasonable, it is required to establish just and reasonable rates on a prospective basis. Accordingly, Public Service's past earnings cannot, as a matter of law, constitute a violation of C.R.S. § 40-3-101, as stated in subparagraph 13.b. and ordering paragraph 3.b. of the Proposed Complaint.[1]

Accordingly, Public Service does not believe that a simple presentation of the results of Appendix A reports is sufficient to support a conclusion that Public Service's gas service rates and charges are likely to generate revenues currently or in the future that are in excess of its cost of service. The 2007 and 2008 Appendix A reports relied upon by Staff reflect only a limited view of past performance, and are not reliable predictors of whether the Company's rates are just and reasonable currently and going forward. Even if these Appendix A reports indicated past "over earnings," clearly some further inquiry is required to determine the factors driving those over-earnings, whether the same factors will continue to influence the Company's earnings, and whether and to what extent the Company's earnings will be offset by other countervailing factors.

The Appendix A reports filed with the Commission employ a preset accounting convention that incorporates many assumptions and regulatory principles followed in prior rate cases, some of which reflect compromise positions contained in settlements that are subject to being raised and litigated in the next rate case. For example, while Public Service's gas

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1 Public Service also disagrees with the characterization in subparagraph 13.d of the Proposed Complaint, suggesting that the Commission consider "corrective measure ... to rectify the excess earnings established by the evidence." Setting just and reasonable rates to be effective on a prospective basis is not equivalent to rectifying past over-earnings. The Commission's authority to establish a utility's rates and charges is limited to prospective application only. As clearly provided under C.R.S. § 40-3-111(1), once the Commission has held a hearing to determine a utility's rates and charges, it may issue an order prescribing the just and reasonable rates for the utility's services "to be thereafter observed." While the Commission certainly has authority to order a negative GRSA rider that is intended to implement just and reasonable rates going forward, the Commission cannot order a negative GRSA rider that is intended to disgorge the utility of its alleged over-earnings from prior years. Such an order would constitute retroactive ratemaking that is prohibited by Colorado law. Because the Commission's ratemaking authority is considered a legislative function, any order attempting to undo the past effects of previously-established rates and charges would be precluded by the Colorado constitution's prohibition against retroactive legislation. Just as the Commission may not authorize a public utility to recover past losses incurred as a result of its previously-established rates, the Commission may not order a negative GRSA that is intended to flow back to customers any past over-earnings resulting from previously-established rates.

service rates were developed for nearly 20 years using a year-end rate base, the Appendix A convention currently incorporates the settled average rate base method adopted in recent rate case settlements. The Appendix A also does not take into account known and measurable changes to sales and revenues that occur outside of the calendar year. For instance, as well-documented in the complaint proceeding in Docket No. 08F-033G, Public Service will lose approximately $4 million of annual revenue contributions from its largest customer, Atmos Energy Corporation, as a result of the construction in late 2008 of a bypass pipeline. The Company did not make an adjustment to the 2008 Appendix A for the loss of the Atmos Energy load. Obviously, an inquiry into whether a utility's rates and charges generate excessive revenues, currently or into the near future, can be quite complex and, at the very least, requires additional investigation beyond the past results reflected in an Appendix A report.

For Public Service's Gas Department, financial results indicating an over-earnings situation have been the exception, rather than the rule, over the past two decades. Following the economic recession of the late 1980's, the Colorado Front Range and other areas of Colorado embarked on an era of unprecedented economic and population growth. As the gas utility providing service to the majority of the population centers in Colorado, Public Service carried out an aggressive construction campaign requiring large investments to expand the gas pipeline infrastructure, and was required to constantly expand its pipeline system. Consequently, our rate base grew rapidly, along with related O&M and other costs, contributing to many years of sustained earnings attrition within the Gas Department. To combat this earnings attrition, Public Service filed rate cases with the Commission to increase its gas service rates in 1993, 1996, 1998, 2000, 2002, 2005 and 2006. Despite these attempts to bring the Company's earnings in line with its Commission-authorized return on equity, the Appendix A results confirm that the Company has actually earned less than its authorized return far more frequently than it has earned more than is authorized return.

The below table lists the Appendix A results for the Company's Gas Department for every year from 1991 through 2008.

PSCo Gas Department Earnings
Per Appendix A
Authorized vs. "Actual" Returns

| Year | Authorized | "Actual" |
|---|---|---|
| 1991 | 14.40 | 6.38 |
| 1992 | 14.40 | (3.25) |
| 1993 | 11.00 | 5.49 |
| 1994 | 11.00 | 6.34 |
| 1995 | 11.00 | 6.16 |
| 1996 | 11.00 | 8.59 |
| 1997 | 11.25 | 9.07 |
| 1998 | 11.25 | 6.74 |
| 1999 | 11.25 | 8.42 |
| 2000 | 11.25 | 11.06 |
| 2001 | 11.25 | 10.60 |
| 2002 | 11.25 | 11.94 |
| 2003 | 11.25 | 12.22 |
| 2004 | 11.25 | 8.76 |
| 2005 | 11.25 | 7.00 |
| 2006 | 10.50 | 7.79 (Corrected) |
| 2007 | 10.25 | 10.14 (Corrected) |
| 2008 | 10.25 | 11.37 (Corrected) |

The above results include the effect of revised rates implemented effective December 1, 1993, pursuant to the rate case in Docket No. 93S-001EG; effective May 15, 1997, pursuant to Docket No. 96S-290G; effective July 1, 1999, pursuant to Docket No. 98S-518G; effective March 16, 2001, pursuant to Docket No. 00S-422G; effective July 1, 2003, pursuant to Docket No. 02S-315EG; effective February 6, 2006, pursuant to Docket No. 05S-264G; and effective July 30, 2007, pursuant to Docket No. 06S-656G.

Despite the corrections that one would have expected to result from the Commission's establishing just and reasonable rates on seven different occasions during the period shown in the above table, these results (based as they are on the Appendix A convention) confirm that many other factors play a role in whether there will be over-earnings or under-earnings going forward.

## *IV. Key Factors That Have Influenced Public Service's Gas Department Earnings Since Its Last Phase I Rate Case in Docket No. 06S-656G and Will Continue to Affect Its Gas Department Earnings Into the Near Future.*

In addition to the discovery and correction of the above-described errors reflected in the 2007 and 2008 Appendix A reports, the Company has conducted a preliminary analysis of the reasons for the remaining "over-earnings" reflected in the corrected Appendix A report for 2008. In the Proposed Complaint, Staff relied on the Company's originally-filed Appendix A report for 2007 to support its allegation that Public Service realized earnings in 2007 of $1,433,817, or 20 basis points, in excess of its authorized return on equity of 10.25 percent approved by the Commission in Docket No. 06S-656G. The corrected Appendix A report for 2007 no longer supports an allegation of over earnings, but instead indicates that Public Service earned less than its last-approved return on equity of 10.25 percent.

Staff also relied on the Company's originally-filed Appendix A report for 2008 to support its allegation in the Proposed Complaint that Public Service realized earnings in 2008 of $11,870,541, or 174 basis points, in excess of our authorized return on equity of 10.25 percent approved in Docket No. 06S-656G. The corrected Appendix A report for 2008 indicates a significantly reduced level of "over-earnings"; Public Service's earned return on equity was 11.37 percent, or only 112 basis points above our last-approved return on equity of 10.25 percent. Our analysis below focuses on the main drivers contributing to this corrected level of so-called "over earnings" for 2008. In addition, we will attempt to analyze how some of these same drivers will continue to influence the Company's Gas Department earnings in the prospective period that should be the focus of any determination of whether the Company's current rates are excessive.

To identify the drivers of the 2008 over-earnings, the Company compared the levels of expenses and revenues for the test year ending June 30, 2006, which were used to derive our current rates as approved in Docket No. 06S-656G, with the comparable levels in 2008. Based on this comparison, we have identified the following significant drivers:

RATE BASE

Gas Storage Inventory Balance: The Gas Department rate base includes the Company's average investment in gas stored underground during the test year. The inventory accounting method is weighted average cost. The average test year investment is determined using the 13-month average. The average 13-month gas storage inventory balance decreased from about $157 million in the test year ending June 2006 to about $133 million in 2008. This decline was due primarily to lower gas prices, which lowered our cost of service by roughly $3 million.

Accumulated Deferred Income Taxes: Accumulated Deferred Income Taxes is a reduction to the Company's rate base. Accumulated Deferred Income Taxes grew significantly between the year ending June 2006 and 2008. The main drivers of this increase were the additions of long-lived assets (up to 65 years) that have much shorter tax lives (typically 15 or 20 years) and the impact of bonus depreciation provided under the federal Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009. Accumulated Deferred Income Taxes increased from about $168 million in the test year ending June 2006 to about $214 million in 2008. This increase reduced the cost of service by almost $6 million from the year ending June 2006 to 2008.

Distribution Capital Costs: Between the test year ending June 2006 and 2008, net distribution plant increased by about $63 million, due to customer growth and other factors. The direct net increase in costs related to distribution plant (depreciation expense, return on investment and O&M expense) was over $8 million.

O&M COSTS

Incentive Accrual: The Company's test year ending June 2006 included about $1.1 million in incentive compensation. In 2008, the Company accrued no incentive awards, and actually booked about ($200,000) as a true-up to accruals booked in previous years. The resulting decrease in our cost of service was about $1.3 million.

REVENUE

Base Rate Revenue: Between the test year ending June 2006 and 2008, the Company's base rate revenues increased by about $21 million. Roughly $5 million of this increase was attributable to use per customer. The Company believes this increase in use per customer is in large part attributable to lower gas prices in 2008, and represents a temporary reversal of the long-term trend of declining average use -- particularly for residential and commercial sales customers. Interruptible transportation volumes per customer also increased significantly, due to lower gas prices and other factors. The remaining $16 million of additional revenue is attributable to customer growth and other factors.

Late Payment Revenue: Late payment revenue increased by about $1.7 million from the test year ending June 2006 to 2008.

Product Extraction Revenue: Product extraction revenue increased by almost $1.2 million between the test year ending June 2006 and 2008.

Obviously, there were many other cost changes between the 12-months ending June 2006 and 2008 – both increases and decreases. For example, total O&M increased by over $16 million, or at an annual rate of about 5 percent. The analysis summarized above is intended to capture only some of the most significant changes – not cost or revenue changes that fall within a reasonable range of expected percentage changes.

The Company also evaluated whether the changes that occurred between the test year ending June 2006 and 2008 were likely to continue into 2010. The Company chose 2010 because that is the period for which a prospective change in rates would be most applicable. (As explained below, the Company does not believe that any relief ordered by the Commission should retroactively adjust earnings during a period when the Company charged its authorized rates.)

The Company's preliminary analysis suggests that several of the cost and revenue trends identified between the year ending June 2006 and 2008 will continue into 2010, as explained in more detail below:

- Accumulated deferred income taxes will continue to rise from 2008 levels, thereby reducing the cost of service.
- Gas storage inventory balances will continue to decline from 2008 to 2010, thereby reducing the cost of service.
- The growth in O&M expense between 2008 and 2010 will be similar to the growth between the year ending June 2006 and 2008.
- Rate base is expected to stay relatively flat (but will not decline as it did between the year ending June 2006 and 2008).
- Late payment and product extraction revenues will continue to grow, such that 2010 revenues will be higher than they were in 2008.

But the Company expects that several cost and revenue trends between the year ending June 2006 and 2008 will reverse in 2010, as explained below:

- Incentive compensation costs are expected to increase in 2010, since no incentive was accrued for 2008.
- Use per customer is expected to decline between 2008 and 2010, and customer growth is expected to be flat. In fact, the Company actually projects that its base revenues will decline from 2008 to 2010.

The upshot is that, between 2008 and 2010, capital costs will change little, O&M expenses will continue to grow, and total revenues (base and other revenues) will remain flat or decline. These trends suggest that the over-earnings in 2008 will not only be reversed in 2010, but that the Company will face a revenue deficiency absent an increase in our base rates.

## V. ***Certain Claims for Relief Requested by Staff Are Inappropriate From a Legal and Policy Perspective.***

Public Service has legal concerns regarding the potential remedial action set forth in subparagraph e of Ordering Paragraph 3 of the Proposed Complaint and both legal and policy concerns regarding the potential remedial action set forth in subparagraph f of Ordering Paragraph 3 of the Proposed Complaint. These two subparagraphs indicate that the Commission should consider ordering Public Service to file a revenue requirement rate case at a date certain and to establish an earnings test. As explained below, the Commission lacks authority to grant these two remedies. Accordingly, if the Commission elects to issue the complaint, those potential remedies should be excised from the Proposed Complaint.

Staff's proposed remedial action provided in subparagraph e of ordering paragraph 3 of the Proposed Complaint suggests that the Commission should order Public Service to file a "revenue requirement rate case" in the proceeding that Staff is requesting be initiated here. As explained below, the Commission is without authority to order a public utility, without its prior consent, to file a rate case to change its effective and established rates and charges. Nonetheless, the Company is willing to voluntarily commit to filing a revenue requirements rate case before the end of 2010.

For similar reasons, the Commission is without authority to grant Staff's proposed remedial action in subparagraph f of ordering paragraph 3 of the Proposed Complaint, which suggests that the Commission should establish "an earnings test to mitigate the negative impact on retail customers related to over earnings." Because an earnings test mechanism would automatically require a public utility to file to revise its gas service rates at specific times in the future, it would effectively deprive the utility of its inherent right under the Public Utilities Law to determine whether and when to file to change its rates. As such, an earnings test mechanism cannot be imposed on a public utility by the Commission without the utility's first agreeing to waive that right. In addition, the one-sided earnings test described in subparagraph f is a poor public-policy option, as such a mechanism essentially converts the authorized return on equity approved by the Commission in the Company's last rate case into an earnings cap. A one-sided earnings test that caps earnings at the authorized rate of return would allow Public Service only to under-earn (as compared to its authorized return), with no opportunity ever to earn more than its authorized return. Such an asymmetrical earnings test is essentially a de facto reduction to the authorized return. Accordingly, any complaint issued by the Commission should not include these two proposed remedial actions.

Moreover, the Commission lacks the authority to require Public Service to make a future filing to change its existing rates and services. Under the scheme of regulation established under the Colorado Public Utilities Law, it is the public utility's sole prerogative whether and when to file to change its rates or services. As described by the Colorado Supreme Court:

> Colorado has a "file and suspend" system of public utility ratemaking. The procedure is initiated by the utility's filing of tariffs with the Commission setting forth the proposed new rates. If the Commission does not suspend the rates, they go into effect automatically in thirty days, or in a lesser time if the Commission so orders. Section 40-6-111(2), C.R.S. 1973. See Public Utilities Commission v. District Court, 186 Colo. 278, 527 P.2d 233 (1974). The Commission may, however, order a hearing and suspend the tariffs for two periods not exceeding an aggregate of 210 days. If a hearing is ordered, all parties are "entitled to be heard, examine and cross-examine witnesses, and introduce evidence." Section 40-6-109(1), C.R.S. 1973.

*Office of Consumer Counsel v. Pub. Utils. Comm'n*, 752 P.2d 1049, 1053 (Colo. 1988) (quoting *Pub. Serv. Co. v. Pub. Utils. Comm'n*, 653 P.2d 1117, 1121 (Colo. 1982)) (citations and emphasis omitted).

Once the Commission establishes just and reasonable rates or services, such rates and services are subject to change only by the public utility's filing a subsequent change thereto or through the exercise of the Commission's powers under C.R.S. §§ 40-3-111(1). Under this authority, the Commission may only change a public utility's rates and charges "after a hearing upon its own motion or upon complaint" in which it determines that such rates and charges are "unjust, unreasonable, discriminatory, or preferential, or in any way violate any provision of law, or … are insufficient."

The protections and safeguards accorded to public utilities and the consuming public under the Colorado Public Utilities Law cannot be circumvented by the Commission's appropriating for itself authority to designate when a public utility shall be required to file to initiate a rate case to change its rates and charges. The Commission cannot do indirectly through the purported exercise of its authority to provide relief from a utility's excessive or burdensome rates and charges what it is precluded from doing directly under its authority to regulate rates and services. Any interpretation of the Colorado Public Utilities Law as granting to the Commission authority to provide such relief under a complaint initiated under C.R.S. § 40-6-108 would significantly erode the role and function of C.R.S. §§ 40-3-111 and 40-6-111, as consistently interpreted and applied by the Colorado courts. Under any reasonable reading of the statutes, such an interpretation could not withstand judicial scrutiny.

## *VI.* ***<u>Summary and Conclusion</u>***

Public Service's corrections to the 2007 and 2008 Appendix A reports significantly reduce the alleged "over-earnings" that formed the basis of Staff's Proposed Complaint. As detailed above, Public Service has determined that the remaining over-earnings indicated by its corrected 2008 Appendix A Report are unlikely to continue. In fact, Public Service's current financial projections suggest that we will need to file a gas rate case to increase rates before the end of 2010. In fact, Public Service is willing to commit to the Commission, through this letter response, that it will file a gas base rate case before the end of 2010, unless it is required to change its rates through a formal proceeding before that time. Accordingly, the initiation of a rate proceeding by the Commission at this time on its own motion is premature and unwarranted. Public Service, therefore, urges the Commission to decline to issue the complaint.

If the Commission declines to issue the compliant and instead directs Staff to perform an investigation into Public Service's 2007 and 2008 Appendix A results for its Gas Department, Public Service pledges to cooperate fully with Staff in such an investigation. We would also cooperate with any Staff analysis of likely earnings in future years.

If the Commission elects to issue the complaint, the Commission should eliminate subparagraphs e and f of Ordering Paragraph 3 in their entirety for the legal and policy reasons described above.

Sincerely,

Karen T. Hyde
Vice President

**PSCo**
**Permanent Income Tax Differences: Plant related items, including AFUDC**

| | | Total | Electric | Gas | Thermal | Other |
|---|---|---|---|---|---|---|
| **2008** | As reported on Appendix A | (30,595,584) | (20,033,124) | (10,430,020) | (35,233) | (97,207) |
| | Revised | (5,289,463) | (5,639,271) | 356,909 | (7,128) | 27 |
| | Difference | **(25,306,121)** | **(14,393,853)** | **(10,786,929)** | **(28,105)** | **(97,234)** |
| **2007** | As reported on Appendix A | (6,178,130) | (1,137,474) | (4,929,613) | (10,740) | (100,303) |
| | Revised | 2,295,761 | 1,868,943 | 471,890 | 6,709 | (51,781) |
| | Difference | **(8,473,891)** | **(3,006,417)** | **(5,401,503)** | **(17,449)** | **(48,522)** |
| **2006** | As reported on Appendix A | 3,226,214 | 2,790,334 | 474,508 | 12,204 | (50,831) |
| | Revised | 3,226,214 | 2,345,710 | 911,189 | 14,155 | (44,841) |
| | Difference | **0** | **444,624** | **(436,682)** | **(1,950)** | **(5,991)** |
| **2005** | As reported on Appendix A | 4,343,584 | 3,665,468 | 819,135 | (31,310) | (109,709) |
| | Revised | 4,343,585 | 3,789,842 | 665,155 | 716 | (112,129) |
| | Difference | **0** | **(124,375)** | **153,980** | **(32,026)** | **2,420** |