Exhibit No. __ T (DPK-1T)
Dockets UE-072300-
UG-072301-UE-080064
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET UE-072300 DOCKET UG-072301 *(Consolidated)* DOCKET UG-080064

TESTIMONY OF

DANNY P. KERMODE

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Working Capital and Storm Damage Amortization

May 30, 2008

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Danny P. Kermode. My business address is The Richard Hemstad Building, 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504. My email address is dkermode@utc.wa.gov.

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

A. I am employed by the Washington Utilities and Transportation Commission ("UTC") as a Regulatory Analyst.

Q. How long have you been employed by the UTC?

A. I have been employed by the UTC since 1996.

Q. Please describe your educational background.

A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a Bachelor of Science in Accounting. Later that same year, I attended San Carlos University in the Philippines for postgraduate studies in economic analysis and quantitative business analysis. I am licensed in Washington as a Certified Public Accountant ("CPA").

In 1992 and 1993, I was a member of the faculty at the National Association of Regulatory Utility Commissioners ("NARUC") Annual Regulatory Studies Program held at Michigan State University in East Lansing, Michigan. I taught

classes in Financial and Regulatory Accounting Standards and in Deferred Tax Accounting. This year I taught classes in income taxes and the regulatory income statement for the NARUC Western Rate School in San Diego, California.

I published an article in the Journal of the American Water Works Association titled *Contributions in Aid of Construction: IRS Final Regulations* (2002). I later published an article in the National Regulatory Research Institute's Journal of Applied Regulation titled *Regulatory Provision of Income Taxes for S Corporations and Other Nontaxable Business Forms* (2004).

Q. Please describe your professional background.

A. I am a financial professional with a CPA and 20 plus years experience in private practice, industry and government. I spent ten years (1983-93) as a CPA in private practice in Phoenix, Arizona, where I was an expert witness in a number of utility cases before the Arizona Corporation Commission, the state's public utility regulatory body. From 1994 to 1996, I was the controller for the Rocky Mountain Institute, a large internationally-recognized non-profit organization that conducts research and performs services in the energy field.

During my employment at the UTC, I have testified in numerous cases including the last three PacifiCorp general rate cases, Docket UE-032065, Docket UE-050684 and UE-061546. In addition, I testified to the results of operations in the last Avista Corporation general rate case, Docket UE-070804. I testified on accounting and income tax issues in a 2001 rate case involving Olympic Pipeline Company, Docket TO-011472. I also filed testimony in four water company general

rate cases, American Water Resources, Docket UW-980258; Rainier View Water Co., Inc, Docket UW-010877; Marbello Water Company, Docket UW-041181; and Iliad Water Service, Inc. UW-060343. I filed testimony regarding income taxes in the Verizon Northwest, Inc. general rate case, Docket UT-040788.

II. SCOPE OF TESTIMONY

Q. What is the scope of your testimony in this general rate case of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. The purpose of my testimony is threefold. First, I list the electric and natural gas operations adjustments within my area of responsibility that are uncontested as between Staff and PSE. This includes adjustments the Company revised in its Supplemental Testimony and Exhibits filed April 14, 2008.

Second, I present Staff's analysis of investor supplied working capital. I also calculate the impact on working capital of Mr. Schooley's adjustment to unbilled revenue.

Third, I present Staff's recommendation regarding the recovery of deferred storm damage expense. I accept the Company's proposal with one modification. I propose to extend the amortization of catastrophic storm expenses, excluding expenses related to the December 2006 windstorm, from 3 years, as proposed by PSE, to 4 years.

All of the adjustments I address in my testimony are reflected in Staff witness Mr. Weinman's Exhibit No. __ (WHW-2) and Exhibit No. __ (WHW-5).

Q. Have you prepared any exhibits in support of your testimony?

A. Yes. I have prepared the following exhibits:

Exhibit No. ___(DPK-2), Schedule of Investor Supplied Working Capital

Exhibit No. ___(DPK-3), Amortization of Catastrophic Storms.

Q. Please list the electric operations adjustments that you reviewed that are uncontested as between Staff and the Company?

A. I reviewed and agree with the following adjustments:

11.02, General Revenues
11.04, Federal Income Tax
11.05, Pro Forma Tax Benefit
11.15, Property Taxes
11.18, Montana Electric Energy Tax
11.20, SFAS 133
11.24, Pension Plan
11.29, Montana Corp Licenses Tax

Q. **Please list the natural gas operations adjustments that you reviewed that are uncontested as between Staff and the Company?**

A. I reviewed and agree with the following adjustments:

9.02, Revenue & Purchased Gas
9.04, Federal Income Tax
9.05, Pro Forma Debt Tax Benefit
9.07, Pass Through Rev & Exp
9.10, Property Taxes
9.17, Pension Plan

III. INVESTOR SUPPLIED WORKING CAPITAL

Q. Does the Company provide for working capital in its filing?

A. Yes. PSE included working capital in its electric-operations rate base in the amount of $95.5 million, as shown in Mr. Story's Exhibit No. __ (JHS-10), Page10.03, line 51. For its natural gas operations, rate base includes $37.1 million for working capital, as shown in Mr. Karzmar's Exhibit No. __ (KRK-8), Page 8.03-1, line 13.

Q. Please briefly discuss working capital and its significance in rate making.

A. The traditional concept of working capital is a measure of financial liquidity reflecting a company's ability to meet its day-to-day operational requirements inherent in the business cycle. The business cycle is made up of three basic stages – production, sales and collection of revenue from customers. The costs of production and sales are incurred prior to collection. Working capital is customarily defined as the funds needed by a company to pay its current obligations while waiting for payment from its customers.

From the regulatory perspective, working capital is measured to quantify the amount of investment associated with working capital, which is then included in rate base in order to provide a return on the related investment.

Q. What methodology did PSE use to compute its proposed working capital amounts?

A. The Company used the balance-sheet approach, more commonly known as the Investor Supplied Working Capital ("ISWC") approach, for both its electric and natural gas operations.

Q. Please explain the basic concept of the ISWC method.

A. Broadly speaking, the ISWC measures the difference between the capital invested in a business and the investments in the business. ISWC is the amount of invested capital that was provided by investors and available for the Company's use, over and above the Company's investments in operating plant, non-operating plant, and other specific items of investment. If there is an excess of invested capital over investments, that amount represents investor-supplied working capital.

Q. Is the ISWC methodology used currently by PSE consistent with the method it used in its prior general rate case?

A. Yes, except for a new technique used by the Company to allocate total ISWC to its regulated and non-regulated operations. In contrast to prior filings, the allocation of ISWC to the different segments is computed on a single schedule used by both regulated operations, although Mr. Story and Mr. Karzmar each testify for their respective operations. Mr. Karzmar describes this change in technique in Exhibit No. __ (KRK-1T) at pages 8 to 11.

Q. Did you review the Company's filed ISWC?

A. Yes.

Q. Please describe the Company's filed ISWC computation.

A. PSE filed a single combined computation for both its natural gas operations and its electric operations, although the schedule is filed as separate exhibits in each witness' testimony. (Exhibit No. __ (JHS-10), Page 10.04 and Exhibit No. __ (KRK-8), Page 8.03-3a to 3b). As I stated earlier, the use of a single combined computation is in contrast with the Company's prior practice of presenting separately-computed ISWC computations for each operating segment. Although the filed computation continues to follow the established ISWC methodology, total investor supplied working capital is computed using distinct classifications for each segment (natural gas, electric and non-operating investments) on a single schedule.

Q. Please describe your evaluation of the Company's filed ISWC computation.

A. ISWC is a computation involving balance sheet accounts. In order to confirm the Company's numbers, Staff started with the balance sheet accounts of PSE's trial balance and compiled each grouping of accounts directly from that data. This allowed Staff not only to confirm the groupings provided by the PSE in its working capital computation, but it also provided the same titles and account numbers as used by the Company's witnesses, allowing comparability.

Q. Did you prepare an exhibit that shows your evaluation of PSE's working capital on an investor-supplied basis?

A. Yes. Exhibit No. __ (DPK-2) shows my analysis.

Q. Please describe your exhibit.

A. Exhibit No. __ (DPK-2) is a two-page exhibit that is based upon the Company's average-of-monthly averages ("AMA") of its balance sheet accounts for the test year ended September 30, 2007. Page 1, column (a) of the schedule provides the summary account titles. Column (b), labeled "Company", shows PSE's April 14th revised AMA amounts. The next column, column (c), is labeled "Adjustment" and reflects the cumulative amount of Staff's adjustment to that line item. Column (d), labeled "Staff", is the Staff adjusted amount and is the sum of columns (b) and (c). The schedule follows the basic format used by the Company in its case.

Starting at the top of page 1, the schedule shows the summary computation of Average Invested Capital (Average Capital). Following the total Average Investment computation starting on line 15, the computation of Average Operating Investments for Electric and the Average Operating Investments for Gas is shown. At the bottom of page 1 is the computation of total Non-operating Investments. Line 70 reflects the total investor-supplied working capital before allocation.

Q. What is the Company's proposed total Investor-Supplied Working Capital?

A. The total Company working capital proposed by PSE is $144.7 million (Column (b), line 70).

Q. What are the adjustments you propose to PSE's computation of total ISWC?

A. My exhibit reflects three adjustments. The first adjustment reclassifies the additional paid in capital related to a PSE subsidiary, Rainier Receivable, from non-operating investments to average invested capital. The net effect on total working capital is zero, however, the adjustment correctly increases non-operating investments which effects the later allocation of the total working capital amount between the segments. I reclassified the amount because additional paid in capital is simply not an operating investment. It is a form of capital. This adjustment appears on page 1 of Exhibit No. __ (DPK-2), column c, line 3.

Q. Please describe your second adjustment to PSE's computation of total ISWC.

A. My second adjustment removes from non-operating investments the accounts payables and miscellaneous liabilities associated with fines and penalties. Rate payers should not pay a return on costs associated with these types of liabilities. Shareholders must absorb the cost of any lost return. The combined effect of the reclassification and the removal of these liabilities is the $2.5 million decrease in total investor-supplied working capital, as shown on Exhibit No. __ (DPK-2) page 1, line 55, column (c).

Q. Please describe your third adjustment to PSE's computation of total ISWC.

A. My third adjustment is to unbilled revenues to reflect the impact of metering and related billing problems. Mr. Schooley is responsible for the rationale behind the

adjustment. The effect of the unbilled revenue adjustment decreases working capital by $139 million before allocation.

The total effect of all three adjustments reduces working capital by $141 million, resulting in a total working capital amount of $2.89 million before allocation, as shown on Exhibit No. __ (DPK-2), page 1, line 70, column (d).

Q. Did you compute the amount of total investor-supplied working capital to be allocated to the Company's operating and non-operating segments?

A. Yes. On page 2 of my Exhibit No. __ (DPK-2) is a schedule titled "Allocation of Total Investor-Supplied Working Capital." The schedule is divided between the different segments of PSE's corporation, *i.e.*, Electric, Natural Gas and Non-Operating. The three sections of the schedule show the computation of the investor-supplied working capital for each segment. Column (b) reflects the Company's April 14th revised amounts, whereas column (d) reflects Staff's proposed working capital amount.

Line 33 of the schedule reflects the total amount of the ISWC allocated. The amount shown on line 33 corresponds to the amount shown on page 1, line 70.

Q. Briefly describe how working capital, once computed, is allocated to the different segments.

A. One of the basic assumptions of ISWC is that the relationship of total working capital to total average investment is the same relationship as working capital to operating and non-operating investment. In other words, if working capital is equal

to 2 percent of total average investment, then working capital will be 2 percent of the electric segment's average investment. This relationship is called the *Working Capital Ratio*.

For example, as shown on line 23 of page 2 of Exhibit No. __ (DPK-2), the natural gas working capital ratio in column (b) is 2.8319%.[1] When this ratio is applied to the segment's average investment, it effectively allocates working capital using the same working capital ratio relationship to natural gas.

Q. Are there any other Company adjustments that effect the allocation of working capital?

A. Yes. PSE has used additional adjustments to total average investment for its electric operations, which reduces the average investment by the amount of electric Construction Work in Progress ("CWIP").

Q. What is the effect of this adjustment on the allocation of working capital?

A. The adjustment, by reducing the total average investment, increases the electric working capital ratio which, in turn, increases the amount of working capital allocated to electric operations.

[1] 2.8319% = $144,668,849/$5,108,499,862 or WCR= tWC / tAI, Where: WCR= Working Capital Ratio, tWC = Total Working Capital, and tAI = Total Average Investment.

Q. Do you agree with this adjustment?

A. No. PSE's adjustment is based on a Staff adjustment proposed in 1984. The Company's support for the adjustment (other than that it is consistent with prior electric filings since 1984) is to ensure that non-operating working capital is "not distorted by the exclusion of CWIP from being treated as part of electric operating investment for allocation purposes." Exhibit No. __ (KRK-1T), page 11:17 to 18:2.

However, CWIP is properly included in non-operating investments for the computation of total working capital and should continue to be included in non-operating investments for allocation purposes. This is consistent with the exclusion of CWIP from electric operating investment and correctly mirrors CWIP's exclusion from rate base. It is also consistent with the Company's inclusion of CWIP in its allocation of its gas operations. Simply stated, the inclusion of CWIP in non-operating investment does not distort the allocation of working capital.

Q. Do you believe that CWIP has a working capital requirement?

A. No. CWIP does not require or provide working capital. Working capital was defined in a recent UTC order as ". . . [capital provided] to bridge the gap between the time expenditures are required to provide service and the time collections are received for that service." *WUTC v. PacifiCorp*, Docket UE-061546, Order 08, Glossary (June 21, 2007). CWIP does not fit that description.

Q. In Staff's analysis, was CWIP, or similar deferral accounts, used to reduce total average investment?

A. No. Reducing total average investment prior to the computation of the working capital ratio merely distorts the allocation factor, resulting in an over-allocation to the Company's electric operations.

Q. Please describe the results of your analysis related to the allocation of total investor-supplied working capital for PSE's electric operations?

A. My analysis indicates that PSE has total investor-supplied working capital for its electric operations of $1.68 million, in contrast to the Company's revised investor-supplied working capital amount of $95.4 million. Staff's proposed amount reflects an overall reduction of $93.8 million. The overall impact of my analysis for the Company's electric operations is shown in Adjustment 11.39 in Mr. Weinman's Exhibit No. __ (WHW-2).

Q. What accounts for the majority of the difference between the Staff and Company proposals for the electric operations?

A. The majority of the difference relates to the Staff adjustment to reduce working capital by $139 million for unbilled revenue related to PSE's electric and natural gas operations.

Q. What accounts for the majority of the increase Staff proposes for the working capital needs of the electric operations?

A. The majority of the increase relates to the deferral of $61.4 million (net of tax effect) in storm damage that is included in working capital.

Q. Please describe the results of your analysis related to the allocation of total investor-supplied working capital for PSE's natural gas operations?

A. My analysis indicates that PSE has total investor-supplied working capital for its natural gas operations of $0.69 million. The Company's proposed revised investor-supplied working capital amount is $37.1 million. Staff's amount reflects an overall reduction of $36.4 million. The overall impact of my analysis for the Company's gas operations is shown in Adjustment 9.23 in Mr. Weinman's Exhibit No. __ (WHW-5).

IV. STORM DAMAGE AMORTIZATION

Q. Please explain the Company's storm damage amortization proposal?

A. PSE proposes in Exhibit No. __ (JHS-11) Page 11.31, a three-prong approach to the recovery of prior storm damage costs. In the category of "Normal Storms" the Company averages the cost of the storms over a six-year period resulting in a normalized expense of $8.0 million. The resulting average is then used as the normalized expense, replacing the test-year storm damage of $11.0 million. Staff is not opposed to PSE's adjustment reducing expense by $3.0 million.

Starting on line 19 of Exhibit No. __ (JHS-11) Page 11.31, the Company addresses the impact of unrecovered costs associated with recent catastrophic storms. The costs of those storms, excluding the December 2006 wind storm, are divided by three years to allow for a three-year recovery period. Costs associated with the

December 2006 wind storm were divided by six years. The six-year amortization period mitigates the rate impact of the of that storm's extraordinary cost.

Q. Do you accept the Company's approach for catastrophic storms?

A. Yes, with one modification. For the amortization of the catastrophic storms, other than the December 2006 storm, I propose a four-year amortization rather than the three-year amortization proposed by PSE. In its last three general rate cases, the average time between filings is two years. A four-year period would mitigate the rate impact of the catastrophic storms, while allowing recovery over a two-year rate case cycle. The use of a three-year recovery could result in a mis-match of recovery to rate filings.

Q. Did you prepare an exhibit for your proposed adjustment?

A. Yes. I prepared Exhibit No. __ (DPK-3). My exhibit shows the computation of my change to the Company's proposed catastrophic storms amortization expense when the amortization period is extended from three to four years.

Q. What is the change to net income of your proposal to lengthen the amortization period?

A. The change in amortization increases net income after taxes by $1.5 million. My recommendation appears in Adjustment 11.31 in Mr. Weinman's Exhibit No. __ (WHW-2)

Q. Does this conclude your testimony?

A. Yes.