Exhibit No. ___T (JRS-9T)
Docket UE-060266 and UG-060267
Witness: Joelle Steward

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NO. UE-060266 DOCKET NO. UG-060267

CROSS-ANSWERING TESTIMONY OF

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STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Electric Conservation Incentive Mechanism and Natural Gas Decoupling

August 23, 2006

I. INTRODUCTION

Q. Please state your name and business address.

A. I am Joelle Steward. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504.

Q. Have you previously offered testimony in this proceeding?

A. Yes, I filed testimony on behalf of Commission Staff on natural gas decoupling, electric conservation incentives, and electric demand response pilots. In separate joint testimonies, I also support:1) a joint proposal with Public Counsel and the Northwest Industrial Gas Users on natural gas rate spread, rate design and low income energy assistance; and 2) the Partial Settlement Agreement Re: Electric Rate Spread, Rate Design and Low Income Energy Assistance.

Q. What is the purpose of your cross-answering testimony?

A. I respond to the testimony of Nancy Glaser (NW Energy Coalition), Elizabeth Klumpp (Public Counsel) and James Selecky (Federal Executive Agencies) on electric conservation incentives. I also respond to Steven Weiss (NW Energy Coalition) and Michael Brosch (Public Counsel) on the decoupling mechanism.

II. ELECTRIC CONSERVATION INCENTIVE MECHANISM

Q. Staff, NW Energy Coalition (NWEC) and Public Counsel have all proposed electric conservation incentive mechanisms in response to PSE's own filing. What are the similarities in the proposals of Staff, NWEC and Public Counsel?

A. Staff, NWEC and Public Counsel have very similar proposals. We have all rejected the Company's proposal for an incentive tied to expenditures. Our three alternative mechanisms are all comprised of a fixed dollar per MWh incentive and a shared savings incentive. Additionally, we have agreed upon a set of criteria for implementing the mechanism.

Q. What are differences in the proposals of Staff, NWEC and Public Counsel?

A. There are three primary differences between our proposals: 1) where the incentives start in relation to the target; 2) the calculation and level of incentives for exceeding the target; and 3) what the baseline target should be for 2007, the first year the mechanism would be in effect.

Staff's proposed mechanism is the most balanced and reasonable approach. It is designed to guard against unintended consequences and minimize any temptation by the Company to "game" the mechanism. Minimizing any such temptation will make it easier for Staff to oversee the process and administer the mechanism.

Q. First, what are the parties' differences on where the incentives start in relation to the target?

A. Staff's proposal is that the Company would receive an incentive if it achieves 100 percent of the target. Under the NWEC proposal, the Company would receive an incentive if it achieves 105 percent of the target.[1] Under Public Counsel's proposal, incentives start at 90 percent of the target.[2]

Q. Why is Staff's proposal the most reasonable?

A. The simplest, most straightforward message to convey to the Company is that it should achieve its conservation savings target. The target should be honest, aggressive and achievable. That message is blurred and the process of setting a target may be compromised when the incentives start somewhere above or below the target.

The targets are developed using the conservation potential assessments and supply curves prepared in the resource planning process, as well as the Company's on-the-ground experience with its programs and its customers. Currently, the Company identifies a savings target and vets it through its advisory group before filing it with the Commission. The Company has considerable influence over setting the target because it controls most of the information used in setting the target.

If the incentives start above the target, then there may be a temptation for the Company to seek a target lower than it could actually achieve into order to receive an incentive. If the incentives start below the target, then the target is undermined to the extent that the Company does not have to achieve the target in order to receive incentives.

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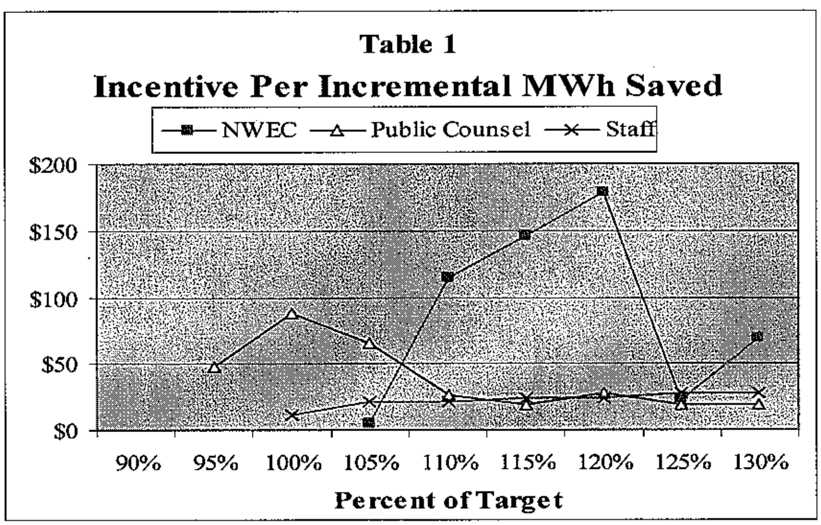
[1] Exhibit No. __ (NLG-1T) at 6:13-15.
[2] Exhibit No. __ (ECK-1T) at 9:10.

If the incentives start anywhere other than 100 percent of the target, it may have unintended consequences and muddle the message of Commission expectation for program performance.

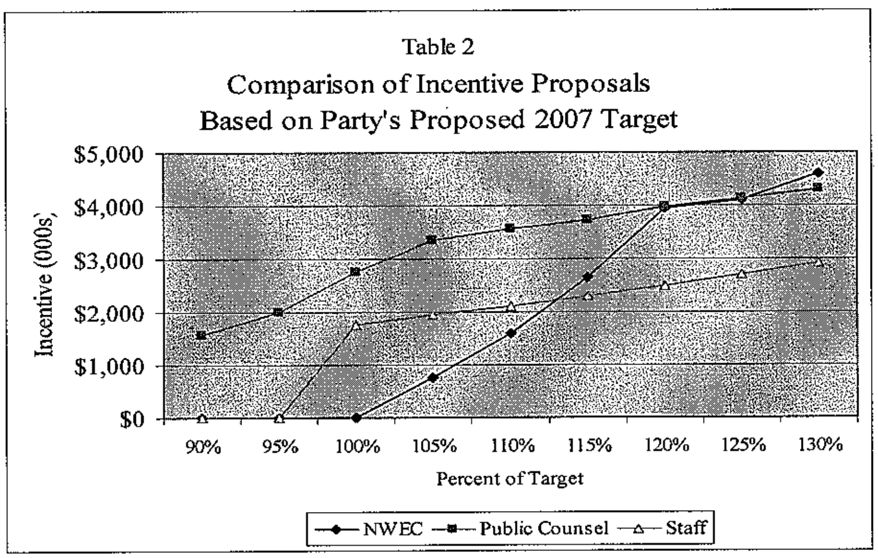
Q. The second area of disagreement between the three alternative proposals is how the incentive is calculated and the overall level of incentive. Please explain these differences.

A. In Staff's proposed mechanism, the incentives for savings achieved above 100 percent of the target apply to only the incremental savings within reach range. This produces a steady increase in the incentive for achieving the next megawatt-hour (MWh) saved. In contrast, in both NWEC's and Public Counsel's proposals, the incentives apply to all MWh savings. The result is discontinuity in the incentive ratepayers pay for the Company to pursue the next MWh of savings. Table 1 compares the incentive per incremental MWh for the three alternative proposals, relative to each party's target.



This table shows, for instance, that the incentive per MWh that customers pay at 110 percent of Public Counsel's target, is less than what they pay per MWh at 100 percent of the target. NWEC's mechanism produces a similar result at the higher end of the scale. The incentive per MWh increases at a more constant rate as the savings exceed the baseline in Staff's proposed mechanism, so customers are paying more for each additional MWh achieved.[3]

Additionally, the NWEC and Public Counsel proposals provide significantly higher incentives as the Company exceeds the baseline target. Table 2 below illustrates this difference in the proposals, relative to the proposed target each party has identified for 2007.



The Company has proposed, and Staff, Public Counsel and NWEC have agreed, that the target will be set each year. The targets, therefore, should be

[3] In Table 1, the line representing Staff's proposal is consistent with the table on page 27 of Ms. Steward's direct testimony, Exhibit No. __T (JRS-1T).

relatively more precise since they would incorporate the current program experience and economic climate. Having incentives that scale upwards significantly may create another temptation for the Company to seek a lower target than it could actually achieve in order to maximize the incentive payment.

I am concerned about making the target setting process more contentious if the mechanism includes temptations, or perverse incentives, such as these.

Q. The third primary difference between the proposals of NWEC, Public Counsel and Staff is what target should be set for 2007. Please explain this difference.

A. Table 3 below displays each party's proposed 2007 target and the point at which incentives and penalties start in relation to the target.

Table 3

Party	2007 Target	Incentives start at...% of Target	Penalties start at...% of Target
PSE	16.5 aMW	100% (16.5 aMW)	80% (13.2 aMW)
Staff	18.3 aMW	100% (18.3 aMW)	90% (16.5 aMW)
Public Counsel	20 aMW	90% (18.0 aMW)	80% (15.8 aMW)
NWEC	16.5 aMW	105% (17.3 aMW)	95% (15.7 aMW)

Setting the target for 2007 is complicated by the fact that the Company currently has a target in place for the 2006-2007 period. However, the design of the mechanism should be focused on the features that endure, not on the first year aberration of setting a target when a penalty-related target and stretch goal already exist. My proposal attempts to look beyond 2007, to what unintended consequences could occur as a result of the mechanism's design, while reflecting the penalty mechanism associated with the current target to ensure that the status quo is not weakened.

Public Counsel is correct that the Company has a stretch goal of 20 aMW for 2007. Currently, however, there are no consequences for achieving this target and the budget is not fixed. If PSE does not spend what it has budgeted for this stretch goal, then the unspent funds are factored into the tariff rider in the following year. I am concerned that using this stretch goal for 2007 as the basis for establishing a enduring target in which the Company can receive incentives if it achieves at least 90 percent of the target, creates an unclear message and will complicate the target-setting process in the future.

Under both PSE's and NWEC's proposed targets, the Company's risk of incurring penalties is less than the status quo, since currently, penalties start at 16.5 aMW. Therefore, their proposed targets should be rejected.

Q. Please summarize the position of the Federal Executive Agencies (FEA) on PSE's proposed electric conservation incentive mechanism.

A. FEA witness James Selecky opposes incentives for energy efficiency because, he argues, the Company's efficiency programs are a part of its obligation to serve customers at the least cost. Energy efficiency costs, he argues, should be treated in the same fashion as supply-side costs; therefore, customers should only pay the prudently-incurred costs of efficiency programs.[4]

[4] Exhibit No. __ (JTS-1T) at 14:6-15 (Selecky).

Q. How do you respond to Mr. Selecky's arguments?

A. I agree with Mr. Selecky that energy efficiency is a resource that the Company should pursue in its obligation to serve customers at the least cost. Creating an incentive mechanism, however, provides a strong policy signal that the Commission values and places a priority on capturing cost-effective energy efficiency. Incorporating energy efficiency as a resource has pressing appeal as the industry and customers face higher fuel costs, more system constraints due to growing demand, and an increasing awareness and concern over greenhouse gas emissions and their climatic consequences.

The Company does not earn a return on its efficiency investments as it does with supply-side investments. Although, I do not recommend that the Commission return to treating efficiency as a regulatory asset since this places too much emphasis on expenditures. Incentives are a way to better balance the differences between supply-side and demand-side in regulatory policy. Moreover, the incentives in my proposed mechanism are relatively modest. My goal is to balance the current penalty structure and to encourage the Company to take advantage of any opportunities for additional efficiency that may arise in a program year. It is intended to reflect a policy goal, not produce a windfall to shareholders.

Q. Does this conclude your cross-answering testimony on the electric conservation incentive mechanism?

A. Yes.

III. DECOUPLING MECHANISM

Q. Please summarize Mr. Weiss's testimony on behalf of NWEC on decoupling.

A. Mr. Weiss recommends that the Commission approve a decoupling mechanism that: 1) includes weather effects; 2) applies to only residential Schedule 23; 3) collects a different margin revenue for new customers; 4) ties recovery of any deferral to achievement of conservation exceeding the current target; and 5) caps annual rate adjustments to 3 percent.

Q. Do you have concerns about Mr. Weiss' testimony regarding decoupling?

A. Yes. I disagree with: 1) his contention that including weather effects in decoupling decreases the customer's bill volatility; and 2) his proposal tying recovery of margin to efficiency achievement exceeding the savings target.

Q. First, please discuss your concern with Mr. Weiss's contention that including the effects of weather in his proposed decoupling mechanism decreases bill volatility.

A. In his testimony, Exhibit No. __ (SDW-1T), on page 4, lines 12 through 15 and on page 7, lines 15 through 18, Mr. Weiss implies that including weather effects in his decoupling proposal stabilizes customer's bills on a real-time basis. In fact, he states, "From a customers' point of view, decoupling works best in countering weather volatility. Rebates can provide relief after especially cold weather, and surcharges are needed only after mild weather."[5]

His proposal, however, actually increases the likelihood of customer bill volatility because it involves the use of deferred accounting. Mr. Weiss's proposal, like PSE's, addresses weather and associated earnings volatility through an accounting means—a deferral mechanism. The customer is still billed the basic charge and commodity charges based on actual metered volumes (actual weather). PSE then makes a two-sided accounting entry on its books to reflect revenues as if weather was normal. The customer's bill is unchanged, but only for now.

As an example, in a warm year PSE would book additional revenue to reflect normal weather with an offsetting entry to its balance sheet to reflect a receivable (deferral account) from customers to pay back the next year. Now, assume the next year is colder than normal and a surcharge is put in place to collect last year's under-collection. Not only is the customer's bill higher because of colder weather, but he is also paying an additional surcharge (on increased volumes) to make up for last year's underpayment.[6]

Q. Please give a sense of the magnitude of the deferrals if you include weather and the potential rate of return benefits.

A. My Exhibit No. ___ (JRS-3) calculates examples of the deferral amounts for decoupling with and without weather, based on the three-year simulation presented

[5] Exhibit No. __ (SDW-1T) at 7:16-18.
[6] Mr. Weiss does cap the recovery of any surcharge to 3 percent, but this still increases the customer's bill volatility and is magnified when the recovery year is colder than normal.

by PSE. Under these examples, which are based on the actual weather experienced in the three years prior to the test year, weather increases the deferrals by $11.0 million, $16.8 million, and $10.9 million, respectively, for the years shown. In contrast, Staff witness Mr. Hill recommends a 12.5 basis point reduction in the cost of equity if weather is included in the decoupling mechanism. This cost of equity reduction translates into only $930,000 in annual savings for customers.

Q. Are you opposed to any weather stabilization mechanism?

A. No, not if benefits to both customers and PSE can be realized. I believe Mr. Weiss's contention that stabilizing both the customer's bill and PSE's earnings could be a win-win situation. However, PSE's and Mr. Weiss's revenue deferral proposals do not achieve both objectives.

Q. Are there ways to achieve both objectives?

A. Yes. Rate designs that reflect actual fixed and variable costs would achieve both objectives. Weather normalized billing could also achieve both objectives (although there are many implementation issues).

Q. How would a rate design that better reflects fixed and variable costs achieve these goals?

A. More fixed costs would be collected through monthly basic charges and less through the variable energy charges. I discuss this type of rate design in my direct testimony on pages 10-11. This rate design would stabilize both the Company's earnings and reduce the customer's bill volatility.

Q. How might weather normalized billing achieve both goals?

A. Basic and energy rates could remain as is, however the current energy charge could be broken down between true fixed and variable costs components. The true variable costs, i.e., gas commodity costs, could be billed on metered volumes and the fixed cost energy component billed on weather normalized volumes. Both of these methods eliminate the need for multi-million dollar deferrals, and stabilize both the Company's earnings and customer bills.

Q. Do you recommend that the Commission adopt either one of these methods at this time?

A. No. I believe the joint position on natural gas rate spread and rate design, along with my recommendation on gas decoupling, is an appropriate move in the direction to help resolve both objectives outlined above. Staff's response case attempted to resolve the goal of eliminating the disincentive by the Company to promote conservation and to minimize any customer bill impacts by eliminating weather from the deferral. My goal with the partial decoupling mechanism is to remove the disincentive for conservation and allow PSE recovery of fixed costs from the test year regardless of changes in customer usage. These goals can be accomplished without including weather effects in the mechanism.

Q. Next, please discuss your concern with Mr. Weiss's proposal to tie recovery of deferrals to conservation achievement beyond the target.

A. Mr. Weiss proposes a tier structure that ties recovery of margin to the achievement gas savings exceeding the current gas conservation target. Staff's goal with the partial decoupling mechanism is to remove the Company's disincentive to pursue conservation by restoring lost margins. The Company would be indifferent to any programmatic or customer-pursued efficiency efforts. Creating a high threshold for recovery of margin deferral may be counter-productive to the goal of removing the disincentive for conservation because the value of higher revenue from increased usage that still exists may exceed the incremental value of partial margin recovery through his mechanism.

Making the Company indifferent to conservation, which is what my proposed mechanism does, is not the same as creating an incentive to pursue more conservation, but with the current target-setting process and penalty mechanism in place, it is sufficient. Creating incentives can lead to unintended consequences with an added burden to verify savings.

Q: What kind of unintended consequences could result?

A: NWEC's proposal includes no provision for cost-effectiveness or for the budget required to achieve the savings exceeding the "stretch" goal. These costs are passed on to ratepayers. We need to look at the savings and costs to achieve these savings together, which is what was done in setting the current target. To put forth an "incentive" to achieve 150 percent of the target without any consideration of the costs or some cost-containment provision, is reckless. Additionally, setting the target may become more contentious by creating a temptation for the Company to set the target below what it expects to achieve, as I discussed in regards to the electric incentive mechanism. Moreover, as with any type of incentive mechanism, there is an added burden to verify the savings. The timing of the mechanism may not allow adequate time to do this.

Q. Do you disagree with setting a saving threshold higher than the current target for the conservation achievement?

A. Yes. Mr. Weiss argues that PSE's conservation target is not ambitious enough, given PSE's achievements in the prior years and the Company's 2005 Least Cost Plan (LCP). However, a couple of things should be noted about both PSE's past achievement and the potential identified in the LCP. For one, in 2005, 40 percent of PSE's gas program savings were attributable to one measure that the Company pursued aggressively – the low-flow dishwasher sprayhead. PSE pursued this measure aggressively in order to achieve its target, which it was otherwise in danger of not meeting. As a result of PSE's efforts and the fact that there is now an efficiency standard for this measure in the state, the potential for this program is essentially tapped out in PSE's service area. The Company has added new programs and has increased its budget and incentives for the next program year, but still projects fewer savings because the easiest and cheapest savings are not as readily available. This does not mean that we should expect savings to decline each year, but year to year comparisons can be problematic as the Company's programs evolve to accommodate changing standards and increasing penetration of measures.

Second, it is problematic to mechanically apply the results of the analyses from the Least Cost Plan because they are highly dependent on assumptions. The Company noted in its plan that "given the theoretical nature of the optimal portfolio, specific resource acquisitions must be backed up and supported by specific resource acquisition analysis."[7] Efficiency resource assessment is a balancing act between trying to cast a wide enough net to capture the possibilities, and incorporating current reality and past experience. The Commission recognized this problem in its acknowledgment letter for PSE's 2005 LCP, stating:

> However, a weakness with PSE's assessment of efficiency savings is that the plan incrementally increases the capacity of DSM programs. In reality, economics of scale dictate that efficiency programs be more "lumpy." In its next plan, PSE should better reflect "real-world" DSM conditions.[8]

PSE discussed this discrepancy between the LCP and the Company's program experience with its Conservation Resource Advisory Group (CRAG) prior to filing the 2006-2007 targets with the Commission.[9] No member of the CRAG, which includes NWEC, filed objections to the Company's targets. The LCPs are critical guides for setting targets and planning resource strategies, but they undergo a constant evolution to fine-tune inputs and processes, and therefore their detailed results need to be considered in this light.

[7] PSE 2005 Least Cost Plan, Chapter XIV, page 14.
[8] WUTC Acknowledgment Letter For PSE's 2005 Least Cost Plan, Docket No. UE-050644 (Aug. 29, 2005).
[9] Docket No. UG-051781.

Q. Please summarize Mr. Brosch's testimony on behalf of Public Counsel on decoupling.

A. Mr. Brosch recommends that the Commission not approve PSE's proposed decoupling mechanism, the Gas Revenue Normalization Adjustment (GRNA), because it constitutes piecemeal ratemaking that is not warranted by extraordinary circumstances. More specifically he argues that the mechanism: 1) does not account for increasing margin revenues associated with adding new customers; 2) departs from the traditional "holistic test year" approach for establishing just and reasonable rates; 3) discourages the regulatory lag incentive for the utility to pursue productivity gains to optimize earnings between rate cases; and 4) would create a significant burden on Staff and other concerned parties to administer.

Q. Are these concerns you share with Mr. Brosch?

A. In part, yes, and that is why I have proposed an alternative partial decoupling mechanism that is more constrained than PSE's proposed GRNA. My proposal addresses some of Mr. Brosch's concerns by making an adjustment for new customers to reflect their actual revenue, which then mirrors traditional regulation for new customers, and by limiting the mechanism's implementation to three years in order to minimize the potential mismatch of revenues and costs over time. However, I would disagree that the mechanism I propose presents a significant departure from the traditional test year approach or removes the Company's "incentive" to pursue productivity gains. It is also not a significant burden to administer for Staff.

Q. Please explain why your partial decoupling mechanism is not a significant departure from the traditional approach of taking a balanced review of all ratemaking elements at a common point in time to determine a revenue requirement.

A. Decoupling does rely on a balanced review in a rate case of the cost to serve and revenues at a point in time, i.e., the test year. The Commission determines a revenue requirement in a rate case. How that revenue requirement is recovered is a product of pricing. The Commission's pricing policy has placed most of the fixed cost recovery (e.g., margin) on volumetric rates. This was intended to provide a price signal to customers that would encourage and reward conservation. The flip-side of this policy is that for the Company to ensure that it is going to recover the revenue requirement the Commission sets in the rate case (i.e., its costs to serve), the Company must maintain or increase customer usage. This creates a disincentive to encourage conservation. Decoupling allows us to align the Company's recovery of the costs that were authorized in a rate case to the same regulatory goal to encourage conservation by customers through pricing.

Q. Do you think there are compelling circumstances in the industry right now to support decoupling?

A. Yes. The unprecedented rise in gas costs is sufficient reason for the Commission to re-evaluate its regulatory framework. Since the fall of 2003, PSE's customers have seen gas costs go up 42 percent.[10] There is no indication that these commodity costs will decline any time soon. There is a compelling public interest to do all we can to help customers combat these rising costs and possibly mitigate on-going gas price volatility. Removing the Company's disincentive to encourage sales is one step.

Q. How does your partial decoupling mechanism retain the Company's incentive to pursue productivity gains?

A. The more the Company can reduce its operating costs below the authorized revenue requirement the Commission sets in a rate case, which is the baseline for calculating authorized revenue in Staff's partial decoupling mechanism, the more it can maximize its earnings. This incentive is the same with or without decoupling. Moreover, since my proposed mechanism uses the actual revenue for new customers, there is no change in the status quo in regards to the incentive the Company faces for new customers.

Q. Lastly, will your partial decoupling mechanism be a significant administrative burden for Staff?

A. No. Staff has a lot of experience in handling deferred accounting. Annual review of the mechanism is expected to take somewhere between 15 to 30 hours of an analyst's time.

[10] The Purchased Gas Adjustments for the last three year were: 9.8 percent in October 2003 (Docket No. UG-31485), 17.6 percent in October 2004 (Docket No. UG-014565) and 14.7 percent in October 2005 (Docket No. UG-051297).

Q. Does this conclude your response to NWEC and Public Counsel on decoupling?

A. Yes.

Q. Does this conclude your cross-answering testimony?

A. Yes.