Exhibit T-___ (MRL- 2T)
Docket No. UE-011570
Witness: Merton R. Lott

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission, **Petitioners,** **v.** **Puget Sound Energy Inc.,** **Respondents.**	**DOCKET NOS. UE-011570 and UG-011571 (Consolidated)**

TESTIMONY OF

MERTON R. LOTT

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

REVENUE REQUIREMENT, RATE SPREAD AND RATE DESIGN, POWER COST ADJUSTMENT, TIME OF USE, LINE EXTENSION AND BACKUP DISTRIBUTION SERVICE

June 7, 2002

Q. Please state your name and business address.

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

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

A. I am employed by the Washington Utilities and Transportation Commission as the Energy Coordinator.

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

A. Since May 1974.

Q Have you previously testified in this proceeding?

A Yes, in the interim portion of this case I sponsored Exhibit 451T.

Q. What is the purpose of your testimony?

A. I am the general policy witness for Staff in support of the Settlement Stipulation filed with the Commission on June 6, 2002. My testimony also addresses the following settlement terms:

1. Electric Revenue Requirement
2. Electric Rate Spread
3. Electric Rate Design
4. Time of Use (TOU)

5. Backup Distribution Service for Schedules 448 and 449

6. Power Cost Adjustment (PCA)

7. Electric Line Extensions

Q. Does Staff provide testimony supporting the other specific settlement terms?

A. Yes. Ms. Joelle Steward supports the conservation, low income, and service quality index (SQI) agreements. Ms. Graciela Etchardt supports the agreement on relocation and underground conversions.

Q. Are you presenting any exhibits?

A. Yes. Exhibit ___(MRL-3) supports the agreed revenue requirement of $58.8 million.

Q. Please briefly discuss the Staff's analysis of PSE's general rate case filing up to this point.

A Yes. There has been a team of seven staff members, including myself, analyzing different aspects of PSE's filed case. Most of my time has been spent discussing issues in the various collaboratives that were established by the Commission's Order approving the March Interim Settlement. In addition, I have focused my review on rate spread and rate design, including TOU, along with analysis of power supply with regards to the PCA and the revenue adjustments in the revenue requirement calculation. Staff members Mr. Russell, Mr. Parvinen, and Mr. Hua focused on auditing PSE's results of operations during the test period and were assigned various adjustments by broad topical area. Mr.

McIntosh was responsible for the variable power supply issues. He also participated in development of the proposed PCA, and worked on various rate design and avoided costs issues, most specifically the Backup Distribution Service for Schedule 448 and 449 customers. Further, Mr. McIntosh and I worked together in evaluating the King County agreement. Ms. Steward was responsible for issues related to conservation, low-income, TOU rate design, and service quality. Ms. Etchart reviewed PSE's goals and achievements during the rate plan period, the Company's performance relative to its peers, and she worked on the collaborative with the cities related to underground conversions. In addition, Staff consulted with Dr. Randall Woolridge to analyze cost of money issues. Dr. Woolridge is a Professor of Finance, the Goldman, Sachs & Co. and Frank P. Smeal Endowed Faculty Fellow in Business Administration, and Director of the Smeal College Trading Room in the College of Business Administration of the Pennsylvania State University. Dr. Woolridge has testified on numerous occasions before state utility commissions.

REVENUE REQUIRMENT

Q. Turning to revenue requirement issues, do you have any introductory comments on the Revenue Requirement Settlement Terms?

A. Yes. In the March Interim Settlement, agreements were made concerning revenue requirement for both gas and electric operations. The maximum electric increase was agreed to be $89.7 million. The maximum increase for gas service was agreed to be $56.2 million.

In addition, the parties agreed to collaborate on initiatives, such as conservation and low income, that could increase revenue requirement above the maximum increase identified in the interim settlement. The Revenue Requirement Settlement Terms now presented deal only with the portion of revenue requirement that is included within the cap.

In addition to the revenue requirement settlement, other agreements affect the total revenue to be collected by PSE. Both the Low Income Settlement Terms and the Conservation Settlement Terms increase the total revenue and rates to be collected from each customer class. Further, certain TOU costs incurred by the Company will be recovered directly from those customers participating in the program.

Finally, as part of the revenue requirement settlement, an agreement was made which increases the cap on electric revenue requirement to $99,441,756, while decreasing the cap on revenue requirement in the gas portion of the case to $46,529,746. Settlement Terms for Revenue Requirement, ¶ 3. The electric cap increased because of the four-factor common cost allocator and a correction to the allocation of Personal Energy Management (PEM) costs.

Q. Excluding the low income, conservation and TOU additions to the revenue requirement, will PSE's revenue increase by $58.8 million as a result of the Revenue Requirement Settlement Terms?

A. No. Included in the pro forma adjustments was an adjustment embedded in the Company's filing to reduce Washington jurisdictional revenues for Schedules 448 and

449 to a distribution cost-of-service based rate. A portion of this adjustment is directly related to transmission rates under federal jurisdiction. While the parties did not agree upon the exact level of rate changes for Schedules 448 and 449, it is certain that Washington jurisdictional revenues for these customers will decrease substantially. To resolve this issue, the parties agreed to present revenue requirement and rate spread based on restating these revenues to a cost-based distribution rate. However, in the rate design settlement, an agreement to phase-in the rate reduction is included. This agreement involves the $3 million surcharge to Schedule 448 and 449 customers through Schedule 126 for the period July 1, 2002 through June 30, 2003, and the corresponding credit to all other customers of $3 million through Schedule 127. Rate Design Settlement Terms, ¶7, last bullet.

Q. Please describe Staff's work on the case prior to reaching settlement on revenue requirement.

A. Staff began its audit of PSE's books soon after PSE made its filing in this case in November 2001. Staff began by reviewing the Company's filed case and work papers in detail. Staff reviewed several years of actual results of operations and detailed budget data for comparative purposes. Then, Staff performed a detailed audit of the test period. Staff reviewed PSE's response to nearly 500 data requests and made numerous field visits to review internal records and interview Company personnel.

Q. Please briefly describe Exhibit ___ (MRL-3).

A. Yes. Page 1 of Exhibit MRL-___ (MRL-3) is an illustration of PSE's actual and adjusted results of operations for the test period ended June 30, 2001, and depicts the settled revenue requirement of $58.8 million (column (f), line 6). Pages 2 through 5 show the revenue, expense, and/or rate base impacts of each adjustment, the total of which is brought forward to page 1, column (d). Pages 6 through 32 are the detail of each of the adjustments amounts shown on pages 2 through 5. Page 33 is the calculation of the conversion factor. The shaded areas on pages 6 through 33 indicate changes from the Company's original filed case. Exhibit ___ (MRL-3) is in the same format as Company witness Mr. Karzmar's Exhibit ___ (KRK-E3), for comparative purposes.

Q. As well as proposing revisions to PSE adjustments in its direct case, did Staff and other parties propose additional adjustments during the collaborative process?

A. Yes, as a result of the audits of PSE's books and reviews of Company work papers and data requests, the parties proposed many additional adjustments during the collaborative process. The proposed additional adjustments are shown in the "Miscellaneous Operating Expense" adjustment, on page 15, adjustment 2.10. The proposed operating expense adjustments are shown on lines 19 through 22 and the rate base adjustments are shown on lines 38 through 40.

RATE SPREAD and RATE DESIGN

Q. Please explain what interests Staff believes are achieved by the settlement rate spread in this case.

A. The rate spread was developed to achieve various sound ratemaking principles. First, the Commission has often stated that cost of service is one tool it will use in setting rates. The rate spread Staff agreed upon considers the various cost studies prepared by the Company in its original testimony and in several data request responses by the Company. No one cost study is accepted by all parties, but the general result of all cost studies indicates that Schedules 25 and 26 and Schedules 448 and 449 were paying above their respective cost of service. This is true for Schedules 448 and 449 even after moving to the cost of service distribution rates as discussed earlier in my testimony.

Q. Please continue.

A. Staff considered significant the current rate differential between Schedules 26 (secondary) and 31 (primary). These schedules are generally related to customers of similar loads, but the current differential creates an incentive for a Schedule 26 customer to move to Schedule 31, even though the change is not cost effective on a total system basis. The settled rate design removes the differential between these schedules over time. Another principle applied in the settled rate spread is gradualism. This principle is reflected in the proposal to move rates closer to cost, and in the proposal to phase-in over 3 years the elimination of the rate differential between Schedules 26 and 31.

Q. Does the resulting rate spread result in class revenue requirements that are just and reasonable?

A. Yes. The proposed rates are closer to each class' cost of service, and the major rate inequities in rate schedules 26 and 31, and 448 and 449 are resolved over a two to three year period.

Q. Does the proposed rate design meet the public interest test and send appropriate price signals to customers?

A. In general, I believe it does. While there is substantial disagreement between some parties on what costs should be included in each portion of the rates for each class, the proposed rates achieve cost recovery for PSE through the customer charges that is similar to other electric company customer charges regulated by the Commission. In his rate design testimony, Mr. Lazar discusses the costs the Commission has included in a customer charge and what costs should be included in a customer charge. Staff does not disagree with Public Counsel's position on this issue.

Q. Please continue.

A. The proposed rates also move closer to recovering all demand-related costs for large customers (Schedules 25 and above) through their demand charge. This includes the movement in Schedule 25 of the demand charges included within the first energy block.

In general, the proposal moves heavily away from direct seasonal rates, however, as described by Mr. Lazar, the proposed residential rates still result in winter high use customers paying higher rates due to the further increase in the tail block rate.

Q. Please describe the purpose of the new Schedules 126 and 127.

A. As discussed earlier in my testimony, these schedules are created to phase in the decrease in Schedules 448 and 449 to the new distribution cost-based rates included in the pro forma revenue adjustment. This item could have been treated through the revenue requirement and rate spread portions of the case, but we agreed to accept PSE's pro forma adjustment and deal with the phase-in in the rate design portion of the settlement.

TIME OF USE

Q. Please describe Staff's position on Time of Use.

A. In Cause No. U-78-05 implementing PURPA, the Commission concluded that, if cost effective, TOU billing may be implemented. Staff's position is based on this principle.

In this case, however, there has been no reliable analysis which indicates that the benefits of mandatory TOU would offset the costs of the program. The most extensive analysis presented by PSE to the TOU Collaborative relied upon costs savings for capacity costs of distribution and possible double counting of capacity costs related to power supply. Correcting only for the collaborative's agreement on capacity avoided costs, the study results show increased system costs due to the implementation of TOU. This correction still assumes distribution capacity benefits associated with shifted load that may not materialize. In addition to the errors in the measurement of capacity savings, Public Counsel states that the Company under-measures the cost of the program, specifically with respect to environmental impacts. While I understand Public Counsel's position, I am not convinced that there is reliable evidence at the current time to support or refute this position.

Q. What does Staff believe needs to be studied further by the TOU Collaborative to determine whether TOU is cost effective?

A. In addition to the review of the environmental impacts of load shifting in the Northwest, Staff is concerned that the evaluation of the program during the last year is incomplete and the design for the control group may not fairly capture the actual level of load shifted. Further, the level of conservation strictly attributable to this program and not paid for through other sources such as the conservation rider needs to be determined, including an analysis of the persistence of conservation. In addition, a better analysis of which costs can actually be saved should be performed. Both the distribution and transmission savings have been measured on an accounting approach rather than through an economic analysis. Further, PSE's consultants identified the potential of utilizing TOU metering during extreme peak periods which may be a useful alternative to TOU rates for the collaborative to examine. Their analysis indicated that substantial benefits may be possible from the implementation of such a program.

Q. The TOU Settlement Terms call for customers who participate in the TOU program to pay $1 per month to participate in the program. Why is that appropriate?

A. As indicated earlier in my testimony, the cost effectiveness of a mandatory program has not been demonstrated. As the majority of the benefits associated with the program relate to the reduced power costs between the peak and off-peak periods, and the customers who participate in the program receive these benefits though lower energy charges, it is appropriate that those customers who choose to participate in TOU bear the majority of the incremental cost of providing this service.

BACKUP DISTRIBUTION SERVICE

Q. What are Schedules 458 and 459?

A. Schedules 458 and 459 are back-up distribution tariffs for self-generators served under Schedules 448 and 449 service.

Q. Why is it necessary to revise Schedules 458 and 459?

A. Current Schedules 458 and 459 resulted from the *Air Liquide* settlement in Docket No. UE-001952. The schedules allow a credit based only on the number of generators at a site with no requirement that the generators are operable or even scheduled for operation. This resulted in billing disputes because some customers interpreted the schedules to apply the credit based on the number of generators operating in fact, while other customers interpreted the credit to apply to the number of equipment whether or not the equipment was operating. The proposed Schedules 458 and 459 correct this unintended consequence of the *Air Liquide* case. If the revisions are approved, customers will be billed for their total load served by PSE distribution resources.

POWER COST ADJUSTMENT

Q. Please identify Staff's interest in the creation of a Power Cost Adjustment (PCA).

A. Staff's interests derive from the long running dialogue between electric utilities and this Commission concerning power cost recovery. This dialogue started in the early 1980's with the Energy Cost Adjustment Clause (ECAC), and continued through the Commission's rejection of Washington Water Power's request in Cause No. U-88-2363, the ultimate elimination of ECAC, the creation and elimination of the Periodic Rate Adjustment Mechanism for Puget Sound Power and Light, and the Commission's rejection of Avista's request for a PCA in Docket No. UE-991606.

The principles the Commission established from this dialogue are the interests Staff brought to the collaborative: (1) rate payers should receive the benefits of a cost-of-capital reduction related to the transfer of risk; (2) the costs to be recovered through a PCA should be weather related; (3) the procedure should be a short-run accounting procedure that reflects short run costs and long-term resources acquisitions which increase costs should be excluded from the mechanism; and (4) rate payers should not be faced with constant frequent changes in power costs and changes in power costs should be easily explainable to the public.

Q. Does the proposed PCA meet all of these interests?

A. Yes.

Q. Please describe how the PCA Settlement Terms meet Staff's interests.

A. With respect to the cost of capital, the March Interim Settlement included an 11% equity return and a 40% equity ratio. The parties agreed to propose a PCA that would be consistent with these capital cost elements. From Staff's viewpoint, these capital costs reflected consideration of a PCA mechanism which eliminated the risk of extreme impacts of variable power supply, rather than an elimination of all variable power supply risk. The PCA the parties propose leaves PSE at risk for a substantial portion of variable power supply risks, while protecting the Company from extreme events such as occurred during the last year. Further, PSE remains partially at risk in all situations for at least a portion of increased power supply costs.

With respect to the relationship of the PCA to weather, the testimony of Mr. Lazar fully covers this issue and Staff concurs with his comments. It is possible that events other than weather may impact market prices and therefore impact this PCA mechanism. Staff believes that such factors, like weather, will most likely be out of the control of PSE and understandable to the public.

The proposed mechanism is limited to short-run power cost changes and has specific measures to deal with new resources not currently included in general rates. However, in the collaborative PSE expressed the need to deal with increased costs associated with adding new resources for growth or replacing old low-cost resources.

Thus, new resources will not be recovered directly through the PCA, but the Company may periodically update its general rates to reflect increased power supply costs associated with new resources or increased costs of existing resources. These Power Cost Only rate proceedings are an exception to the general rule that a company should not be allowed to file single issue rate cases. For that reason, these single issue rate cases are limited and under certain events will trigger a general rate case to true-up all costs. Further, these single issue rate cases will look at all costs included within the PCA mechanism. And, the Company will be required to support these rate proposals in the same detail it must support power supply costs in a general rate proceeding.

Finally, the PCA has two mechanisms to limit the number of rate changes the Company actually files. First, the dead band is designed to cover approximately one standard deviation of the cost variability associated with stream flow. This means that about two thirds of the time cost fluctuation attributable to hydro conditions alone will not trigger any deferrals. (Note, other cost changes may well make these events happen more often.) The second element is that the Company will not file rate changes unless the deferrals reach a $30 million trigger or appear that they will in the near future. If hydro were the only cost fluctuation, there would be few if any filings in a 40 year period. Of course, as can be seen from last couple of years, events tend to compound each other.

Q. Do you have any closing comments on the PCA proposal?

A. Yes. At page 2 of his testimony, Mr. William Gaines provides a number of policy justifications for establishing a PCA. I agree generally with his testimony and believe that the PCA proposal the parties are presenting meets those policies.

ELECTRIC LINE EXTENSIONS

Q. Please describe the Line Extension Settlement Terms and the goals it accomplishes.

A. The proposed line extension policy achieves the goals described in Mr. Lazar's testimony, which I will not repeat here, while at the same time giving consideration to the costs currently included in rates. In addition, the proposed line extension policy for residential customers has been updated to the current costs being experienced by PSE. For new residential customers, this represents the biggest change in the policy. In Staff's viewpoint, updating these costs is long over due. The Company should consider modifying these cost more regularly to avoid increased rate impacts of adding new customers. The policy also treats commercial line extension development similar to the residential plat development by requiring up-front payment of the extension subject to refund if service is actually taken.

Q. Does this conclude your testimony?

A. Yes.