EXHIBIT NO. ___(KJH-1T)
DOCKET NO. UE-06___/UG-06___
2006 PSE GENERAL RATE CASE
WITNESS: KIMBERLY J. HARRIS

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-06____** **Docket No. UG-06____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF
KIMBERLY J. HARRIS
ON BEHALF OF PUGET SOUND ENERGY, INC.

FEBRUARY 15, 2006

PUGET SOUND ENERGY, INC.

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Please state your name, business address, and position with Puget Sound Energy, Inc.

A. My name is Kimberly J. Harris. My business address is 10885 N.E. Fourth Street Bellevue, WA 98004. I am the Senior Vice President Regulatory Policy and Energy Efficiency for Puget Sound Energy, Inc. ("PSE" or "the Company").

Q. Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?

A. Yes, I have. It is Exhibit No. ___(KJH-2).

Q. What are your duties as Senior Vice President Regulatory Policy and Energy Efficiency for PSE?

A. I am responsible for the Company's policy strategy and relationships with regulatory commissions and departments. My duties include participation and negotiations in regional discussions related to energy matters, including issues involving the Bonneville Power Administration and regional transmission organizations. I am also responsible for the Company's strategy and development of Energy Efficiency initiatives and programs.

Q. What is the purpose of your testimony?

A. My testimony provides a high level overview of the Company's general rate case filing including the relief that is being requested by the Company and the reasons for these requests. I also introduce the Company's other witnesses in the case and describe the topics that each witness addresses in his or her prefiled direct testimony.

Q. Please summarize your testimony.

A. The Company is asking for an increase in electric and natural gas rates through this general rate case filing because the costs of providing service to the Company's customers have increased above levels that existed or were projected at the time rates were last set. The Company has taken steps to control these cost increases, to the extent possible. But even after doing what it can to improve efficiencies in its operations, the Company's costs to provide service to its customers have increased beyond the revenues it collects in its current rates.

Power costs account for a majority of the Company's request for an increase in electric rates. Higher wholesale natural gas prices are driving up the costs of generating power as well as the cost of power the Company purchases in wholesale energy markets. The Company's costs of purchasing power in wholesale energy markets are expected to decrease from what they otherwise would have been during the time rates set in this case go into effect and over the next twenty years because of PSE's acquisition of the Wild Horse Project -- a wind powered electric generation facility located near Ellensburg, Washington that is being presented for approval in this case. However, the up-front costs of building the facility are also driving power costs higher in the short term.

As in prior rate cases, the Company will be updating its power cost projections during the course of this case. If wholesale market forward natural gas prices return to lower levels, the Company's requested electric rate increase may well be significantly lower than is requested in this initial filing.

The Company's costs to provide natural gas service have increased primarily due to the need to keep up with increasing demand for gas service in the Company's service territory. These costs include the capital investment and operations costs required to expand PSE's gas distribution system to serve a growing gas customer base and to maintain or replace aging pipelines and related equipment.

The Company is also seeking a rate increase because it has already exceeded the target it had set for itself at the time of the 2004 general rate case of achieving a capital structure with 43% equity by early 2006. The Company's approved equity percentage, as well as its authorized return on this equity, now need to be raised to higher levels in order to support the Company's ability to meet the long-term interests of its customers by investing in new power plants and other infrastructure. Improving the financial health of the Company, including its credit rating, will also better support the Company's efforts to engage in hedging activities that help protect customers from wholesale energy market volatility and price spikes.

In support of these goals, the Company is advancing several proposals in this case to improve its opportunity to actually collect the revenues that this Commission has approved in the Company's rate cases and to encourage increased electric and gas energy efficiency investment by the Company and more efficient use of electricity by the Company's customers.

Finally, recognizing the especially difficult burden that rate increases place on the Company's low income customers, the Company is proposing to increase the funding for its low income program to assist low income customers in paying their gas and electric bills.

II. REQUESTED RELIEF

Q. Would you please specify in more detail what proposals for rate relief the Company is filing in this case?

A. This rate case seeks Commission approval of the following key proposals:

a) additional revenue in rates to pay for increases in costs the Company incurs to serve its customers, including approval of the costs and prudence of the new electric and gas resources acquired by the Company that are presented in the filing;

b) a fair and reasonable rate of return on equity of 11.25%, a level commensurate with the returns expected by investors if they are to provide the funds required for the Company's extensive investments in the resources and systems needed to serve its customers;

c) a capital structure comprised of 45% equity, a structure the Company will need to improve its corporate credit rating to BBB+, to improve the Company's ability to access capital markets on reasonable terms and to improve the Company's ability to engage in hedging activities to reduce the cost volatility in its energy portfolio;

d) revisions to the sharing bands of the Company's current Power Cost Adjustment ("PCA") Mechanism in order to align the potential upside and downside of power cost volatility between the Company's shareholders and customers;

e) authority to pass through the PCA Mechanism and Purchased Gas Adjustment ("PGA") Mechanism the costs of a new credit line to be established to support the Company's wholesale market hedging efforts;

f) a new Depreciation Tracker in order to support the Company's extensive and growing investments in the electric and natural gas delivery infrastructure required to safely and reliably serve customers;

g) an incentive mechanism to encourage the Company to invest in even more cost-effective electric energy efficiency measures than the Company is undertaking under its existing energy efficiency program, which currently provides only for penalties;

h) a set of new electric demand side management pilot programs, as well as expansion of an existing program, so that the Company can determine whether voluntary customer efforts to reduce their energy usage during peak weather or price events holds promise for reducing overall system and power supply costs;

i) a revised electric and natural gas rate design that better ensures that the Company will recover the fixed costs it incurs for serving its customers that have been approved by this Commission in a rate case even when individual customers subsequently use less electricity or natural gas than was projected in a rate case;

j) a new natural gas decoupling mechanism, known as the Gas Revenue Normalization Adjustment ("GRNA"), to better assure that the Company recovers the amount of revenues from its gas customers that this Commission approves in rate cases even when the amount of gas used by individual customers subsequently declines or when the weather is warmer or colder than normal; and

k) an increase in the benefits the Company provides to support the ability of its low income customers to pay their electric and natural gas bills.

Q. What level of rate increase is the Company requesting in this case?

A. This filing requests an annual increase in electric revenues of approximately $148.8 million and in gas revenue of approximately $51.3 million. This is an average 9.21% increase for electric customers and an average 5.34% increase for natural gas customers.

The requested increase described above includes the impact of the new Depreciation Tracker mechanism that the Company is proposing in this case. The additional revenue requirement associated with the Depreciation Tracker mechanism is approximately $7.9 million, or 0.49%, for electric and $10.9 million, or 1.13%, for natural gas.

The requested electric increase does not include the impact of an additional Production Tax Credit associated with the new Wild Horse Project, which is expected to provide a credit to electric customers' bills during the rate year of $18.7 million.

Q. Would approval of the relief the Company is requesting serve the interests of its customers?

A. Yes. Commission approval of this filing would improve the Company's recovery of costs incurred to serve customers and help to improve the Company's financial condition. This will better enable the Company to invest in the energy resources and infrastructure needed to provide reliable, cost-effective service to our customers, and to engage in hedging activities that help protect customers from volatile wholesale energy markets. We believe that over the long term, this will lower the customers' ultimate energy costs.

III. COST PRESSURES FACING THE COMPANY AND ITS EFFORTS TO CONTROL THEM

A. <u>Electric and Gas System Infrastructure Costs</u>

Q. Why are the Company's costs related to its electric and gas systems increasing?

A. The Company's aging gas and electric systems require substantial investment to maintain current levels of reliability and safety and to meet increasingly stringent reliability, safety and environmental standards. Growth is also a significant factor driving the increases to the Company's cost of service: growth in the number of customers served and growth in the distribution systems required to meet their needs. Ms. Susan McLain describes these delivery operations issues in her prefiled direct testimony, Exhibit No. ___(SML-1CT). A failure to fund these required investments in the interest of avoiding rate increases in the short term could lead to much higher long-term costs for customers.

Q. Has the Company attempted to control its costs before coming in for a rate increase?

A. Yes. As detailed in Ms. McLain's testimony, PSE has implemented a wide variety of process and performance improvements that have resulted in cost efficiencies as well as the provision of high quality service. The Company also has tools and methodologies in place to allocate its resources efficiently as between the gas and electric systems and between capital investments and operations and maintenance expenses.

Looking at all non-production/generation operations and maintenance expenses on a cost-per-customer basis, PSE is one of the lowest cost providers among investor owned utilities in the United States. At the same time, the Company has consistently met or exceeded the service quality standards ("SQIs") that were established in the Company's 2001 general rate case.

In short, the Company has done all it reasonably can to make its revenues go farther through operational efficiencies. Without rate relief, the Company will be unable to continue to provide the high quality service its customers expect and still be able to raise the significant amounts of capital required to provide low cost, reliable energy in the future.

B. Power Costs

Q. How do the Company's projected power costs in this case compare to the 2005 Power Cost Only Rate Case ("PCORC")?

A. PSE's projected rate year net power costs for this case are approximately $90.5 million – or 10.3% – higher than what is presently reflected in PSE's PCA Power Cost Baseline Rate as established in the 2005 PCORC, Docket No. UE-050870.

Q. Why are the Company's power costs increasing?

A. Generally, higher natural gas and oil prices are driving higher costs for generation from gas- and oil-fired resources. In turn, these higher gas prices result in higher wholesale power market prices, which increase the Company's power costs because it is a net purchaser of wholesale market power.

In addition, the projected power costs for this case reflect more market purchases due to increases in PSE's load. The need to purchase more power in the wholesale markets is partially offset by increased generation from the Wild Horse Project as well as from other Company generating resources.

Other factors affecting power costs include increased transmission costs and escalation in the costs of PSE's existing long-term power purchase agreements.

Q. How would rate year projected power costs for this case change if the Wild Horse Project were not included as a resource?

A. Without the forecasted generation from the Wild Horse Project, PSE's anticipated rate year power costs would increase by approximately $27.5 million.

Q. Does that mean that the Wild Horse Project results in a lower rate increase than PSE would otherwise have requested in this case?

A. No, the power costs savings projected because of Wild Horse Project generation are just one aspect of the Project's impact on rates. The Company is incurring approximately $383 million in capital costs for acquiring and constructing the Project that have to be recovered over time, as described in the testimonies of Mr. Eric Markell, Exhibit No. ___(EMM-1HT) and Mr. Roger Garratt, Exhibit No. ___(RG-1HCT). After taking into account recovery of such fixed costs and power cost savings provided by the Project, plus the Production Tax Credits associated with the new wind generation, the net impact of adding the Wild Horse Project to the Company's electric portfolio is an increased revenue requirement of $18.1 million in this case. These calculations are provided in the testimonies of Mr. John Story, Exhibit No. ___(JHS-1T).

Q. If the Wild Horse Project increases the Company's revenue requirement, why did it purchase the resource?

A. The above discussion relates only to the rate year in this case, which is the first year of operation for the Wild Horse Project. The Project is a long-term resource that, over its service life, is expected to reduce costs compared to what they would have been if the Company had not acquired the Project. The Company projected during its evaluation process that acquisition of the Wild Horse Project would provide a net present value benefit to PSE's electric portfolio of greater than $50 million over the next twenty years, as explained in the testimony of Mr. W. James Elsea, Exhibit No. ___(WJE-1HCT).

Q. Has the Company taken other steps to control its power costs?

A. Yes, the Company continuously works to reduce energy costs associated with its wholesale market purchases of power and natural gas. As described in Mr. Mills' testimony, the Company actively manages the power and gas cost risks faced by its customers and shareholders through robust and sophisticated organizational structures, tools and strategies that guide its portfolio management and hedging activities.

The Company has also continued to seek out and acquire new sources of power for its electric portfolio that will reduce the Company's dependence on wholesale power markets. Three such acquisitions in addition to the Wild Horse Project are presented for the Commission's prudence determination in this case. The

Company anticipates that these new resources will provide benefits to its electric customers for decades to come by reducing the costs that would otherwise have been incurred to provide electric service.

Q. For what resources is the Company seeking a prudence determination from the Commission in this case?

A. PSE is seeking a prudence determination in this proceeding with respect to the following electric portfolio resource acquisitions, along with their associated capital and operating costs:

1. acquisition of the Wild Horse Project;
2. execution of a new purchased power agreement with OrSumas, LLC for the output of the Northwest Pipeline recovered heat generation resource at Sumas developed by ORMAT ("ORMAT PPA");
3. execution of a new purchased power agreement and related transmission agreement with Public Utility District No. 1 of Chelan County, Washington for the output from the Rock Island and Rocky Reach Hydroelectric Projects ("Chelan Contract"); and
4. relicensing of the Company's Baker River Hydroelectric Project.

The Company is also seeking a prudence determination from the Commission with respect to the Company's acquisition of additional long-term gas pipeline transportation capacity from Duke Energy Trading and Marketing for PSE's gas portfolio.

Q. What is your understanding of the Commission's prudence standard?

A. In the Company's 2003 PCORC proceeding, Docket No. UE-031725, the Commission reaffirmed the standard it applies in reviewing the prudence of power generation asset acquisitions as follows:

> The test the Commission applies to measure prudence is what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made a decision. This test applies both to the question of need and the appropriateness of the expenditures. The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made. (Order No. 12, Docket No. UE-031725, at ¶ 19)

In addition to this generic reasonableness standard, the Commission has cited several specific factors that are relevant to the question whether a utility's decision to acquire a new resource was prudent. These factors include the following:

- First, the utility must determine whether new resources are necessary.[1]
- Once a need has been identified, the utility must determine how to fill that need in a cost-effective manner. When a utility is considering the purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself.[2] The utility must analyze the resource alternatives using current information that adjusts for such factors

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[1] *See, e.g., WUTC v. Puget Sound Power & Light Co.,* Docket No. UE-921262, *et al.,* Nineteenth Supplemental Order (September 27, 1994) ("*Prudence Order*") at 11.

[2] *Id.*

as end effects, capital costs, impact on the utility’s credit quality, dispatchability, transmission costs, and whatever other factors need specific analysis at the time of a purchase decision.[3]

- The utility should inform its board of directors about the purchase decision and its costs. The utility should also involve the board in the decision process.[4]
- The utility must keep adequate contemporaneous records that will allow the Commission to evaluate its actions with respect to the decision process. The Commission should be able to follow the utility’s decision process; understand the elements that the utility used; and determine the manner in which the utility valued these elements.[5]

Q. Did the Company’s resource acquisitions meet this standard?

A. Yes. As described in the testimonies and exhibits in this case of Mr. Markell and five members of his Energy Resources department, the Company had a clear, documented need for power as well as for gas transportation capacity. The Company’s decision to acquire the electric projects occurred as a result of, or in the context of, formal requests for proposals issued pursuant to the Commission’s competitive bidding rules, WAC Chapter 480-107, shortly after completion of the Company’s 2003 Least Cost Plan (the “2004 RFP Process”). The Company then conducted an extensive process through which it evaluated the relative costs and risks of many potential alternative resource opportunities, and repeatedly updated the information and assumptions it considered in this process. The evaluation

[3] *Id.* at 2, 33-37, 46-47.

[4] *Id.* at 37, 46.

[5] *Id.* at 2, 37, 46.

process also included significant modeling that can be replicated. Consistent with the Commission's prior orders, the Company kept detailed records in connection with this evaluation process and the management decisions that resulted from that process. Extensive analyses were also undertaken for the resource acquisitions presented in this case that arose outside the 2004 RFP Process. The gas transportation capacity acquisition for the gas sales portfolio was acquired consistent with analyses in PSE's 2005 Least Cost Plan and additional evaluation undertaken by the Company.

The Company's efforts clearly meet the "adequate study" and "reasonable data and methods" standards applied by the Commission in determining whether an acquisition was prudent. In addition, through acquiring these resources, the Company obtained new electric and natural gas resources at a reasonable cost compared to other potential resource options.

IV. IMPROVING THE COMPANY'S FINANCIAL STRENGTH WILL ALSO HELP CONTROL COSTS IN THE LONG RUN

Q. Is the Company's financial strength an issue in this case?

A. Yes. Although the Company's financial strength has continued to improve since the 2001 and 2004 rate cases, it is still not where it needs to be to support the huge investments that must be made in PSE's gas and electric systems and in new resources for PSE's customers. Over the three year period of 2005-2007 alone, the Company projects the need to invest in the range of $2 billion, with continued substantial investments thereafter. As explained by Mr. Bertrand Valdman, Exhibit No. ___(BAV-1CT), it is particularly important for the Company to maintain a high level of credit and capital market access in order to make these needed investments. The Company must improve its corporate credit rating and be able to realize its full earnings power to better enable it to raise the capital that will be required for these investments in external financial markets at the lowest cost to customers.

In addition, while the Company has continued to improve its risk management systems and tools to help reduce the risks and volatility of energy costs associated with its electric and gas portfolio, the Company's financial position limits its ability to make use of hedging products.

Q. What is the issue with the Company's credit rating?

A. The Company's corporate credit rating is the lowest rating in the investment grade category (Standard & Poor's "BBB-"). This places the Company in a weak position relative to the counterparties with which it does business, makes debt more expensive, interferes with the extent to which the Company can enter into transactions to hedge against wholesale energy market risks, and places the Company and its customers at risk of serious financial consequences if the occurrence of an event impacting the Company or the industry were to trigger a downgrade by the credit rating agencies.

Q. What do you mean that the Company must "be able to realize its full earnings power"?

A. Investors have expressed a concern regarding the Company's inability over the past several years to actually earn the returns on equity that have been allowed by this Commission. Viewed from an investor's perspective, PSE's actual return on equity has consistently and significantly trailed its authorized return on equity. This concern is heightened because of the Company's large capital investment projections over the next several years. Although investors are aware that capital expenditures of this type are generally approved and ultimately included in ratebase, there has been concern expressed as to the delay in actually getting these costs included in rates. The impact of this delay is seen as a further barrier to the Company having the opportunity to earn its allowed return on equity. These matters are discussed by Mr. Valdman and Dr. Roger Morin, Exhibit No. ___(RAM-1T).

Q. How does the Company's case address these issues?

A. The Company's proposed higher equity ratio and return on equity would position it to improve its corporate credit rating toward the "BBB+" level, to attract the capital that is needed to fund the Company's resource acquisition program, and to continue, and expand upon, its risk management efforts.

Several of the Company's other proposals in this case are also intended to address the concern about the delay between the time investments are made and the time the Company begins to recover the investment in rates – which is sometimes called "regulatory lag" – as well as the concern about the Company's ability to actually earn the return that the Commission has authorized.

The proposed Depreciation Tracker will help capture and recover depreciation expense as increasing investments are made in the Company's electric and gas transmission and distribution systems. The proposed natural gas decoupling mechanism addresses the Company's under-recovery of its fixed costs of providing natural gas service due to decreasing usage per customer and weather variability. The proposed revisions to the PCA Mechanism sharing bands will result in a more consistent recovery of the commodity costs the Company incurs to serve its electric customers, while also providing customers a greater opportunity to share the benefits of future power cost savings.

Q. Has the Company attempted to improve its financial condition prior to seeking rate relief from this Commission?

A. Yes. In addition to the efforts to control operations and power costs described above, the Company improved its equity ratio from a level of 30% in 2001 to the 44% level we achieved by year-end 2005. The Company accomplished this through: (i) the issuance of 25.4 million additional common shares that generated net proceeds of nearly $527 million, and (ii) by increasing its retention of earnings by lowering its dividend. The Company has also worked actively to lower its cost of debt, where possible, as described by Mr. Don Gaines, Exhibit No. ___(DEG-1CT).

Despite these efforts, the Company has not yet achieved the financial strength, stability and flexibility needed to support its energy supply and infrastructure requirements. This situation is expensive for both the Company's customers and shareholders and should be corrected. This rate case is another important step in that direction.

V. THE COMPANY'S ADDITIONAL PROPOSALS IN THIS CASE

A. <u>Proposed Revisions to the Company's PCA Mechanism</u>

Q. How does the Company's current PCA Mechanism work?

A. The PCA Mechanism provides for some level of sharing between PSE's shareholders and its customers of excess power costs (power costs higher than the "Power Cost Baseline Rate" set in rates) and of power cost savings (power costs lower than the Power Cost Baseline Rate). Whether there is any sharing of costs or benefits and if so, how much, depends on how the costs or benefits fall in a given year within four "bands" of power cost variances.

Currently, the Company must absorb the first $20 million of excess power costs and also keeps all the benefits of the first $20 million in power cost savings each year. This first +/- $20 million is called the "dead band." The next +/-

$20 million is shared 50/50, the next +/- $40 to 120 million is shared 90% by customers and 10% by the Company, and costs or benefits over $120 million are shared 95% by customers and 5% by the Company.

In addition, when the PCA Mechanism was established, it set a +/- $40 million cumulative cap on the Company's potential exposure over a 4-year period ending June 30, 2006. On power cost variances over the $40 million cap, the PCA sharing mechanism allocated 99% of costs or benefits to customers and the remaining 1% of costs or benefits to the Company.

Q. Why is the Company proposing changes to the PCA Mechanism?

A. As experience has shown, it is difficult to set a Power Cost Baseline Rate so that future power costs can be recovered within a reasonable margin of error. The fact is simply that actual power costs are likely to vary substantially from year to year above or below the power cost baseline that is embedded in rates based on projections of future conditions that cannot be known at the time rates are set. Factors such as streamflow and weather uncertainty make it very difficult to predict the amount of power PSE's resources will produce and that PSE's electric customers will use. In addition, many of these factors are beyond the Company's ability to control.

The Company's sophistication in modeling these power cost risks has also increased since the PCA Mechanism was first established. As Mr. Salman Aladin describes in his testimony, Exhibit No. ___(SA-1CT), the Company has performed extensive modeling work in order to better understand the magnitude of potential variations in power costs above or below a baseline power cost rate that is projected at the time of a rate case and embedded in PSE's electric rates.

Based on this modeling work and the financial considerations described in Mr. Valdman's testimony, the Company is proposing in this case to revise the sharing bands and percentages of the PCA Mechanism to better align shareholder and customer interests.

Q. What is the Company's proposal?

A. The Company is proposing in this case that the annual sharing bands be revised to the following:

Power Costs ($ in millions) (over or under the PCA baseline)	Customers' Share	Shareholders' Share
$0 - $25 +/-	50%	50%
$25 - $120 +/-	90%	10%
> $120 +/-	95%	5%

Q. Why is the Company proposing these revised sharing bands?

A. It is the Company's hope that elimination of a dead band and a 50/50 sharing of the first $25 million of power costs or benefits will align all parties to seek to set the Power Cost Baseline Rate as close as possible to the level of power costs that are actually likely to prevail in future PCA years. By sharing this first band 50/50, shareholders and customers will also typically share equally in the upside of good hydro years and the downside of bad hydro years -- outcomes which are inherently unpredictable.

The second band, from $25 million to $120 million, is meant to capture a significant range of power cost risks reflected in PSE's electric portfolio. By retaining 10% of the upside or downside of this second band, the Company will continue to have significant incentive to manage power costs and achieve power cost savings.

The final sharing band, for costs or savings plus or minus $120 million, with 95% customer sharing and 5% shareholder sharing, is meant to continue to provide protection to the Company in the current PCA Mechanism sharing bands from extreme negative departures from the power costs that are embedded in rates, as well as to continue to provide a small upside incentive in the event such significant power cost savings could be achieved.

B. <u>A New Credit Line to Support Hedging</u>

Q. Please briefly describe the Company's proposal regarding a new credit line to support hedging.

A. As Mr. Mills explains in his testimony, parties to wholesale energy market transactions are concerned about each others' ability to actually perform contracts that are entered into to purchase or sell energy or natural gas at some time in the future. They control this risk by limiting the amount of exposure they have to any one party unless the other party is willing to back transactions beyond this limit by posting collateral. The limited amount of credit one party is willing to give another without collateral is called "open credit."

The Company's current hedging strategies have virtually exhausted the open credit that is available to the Company from wholesale energy market counterparties. However, the Company's current credit facilities are also needed to support its operations other than hedging activities. PSE is therefore proposing in this case to establish a separate credit line dedicated to supporting its wholesale energy market transactions and to pass the costs of such credit facility through to PSE's customers in the same manner as other power and gas commodity costs, via the PCA and PGA Mechanisms.

C. <u>A New Depreciation Tracker</u>

Q. What are the concerns that led the Company to propose a Depreciation Tracker?

A. As described above and in Ms. McLain's testimony, the Company is facing very high levels of capital investment in its electric and gas system infrastructure to address customer growth, replacement and maintenance of PSE's aging system, and increased reliability and safety regulations or requirements. As soon as this new plant is placed in service, the Company must start depreciating the new plant, meaning that the Company is generating depreciation expense. However, the

Company does not begin to recover the cost of the new plant or a return on that investment in rates until the next rate case after it makes the investment. This has a negative impact on PSE's earnings, particularly because the new plant is typically far more costly to install than the cost of similar plant that was embedded in rates decades earlier.

Q. Please describe the Company's proposed Depreciation Tracker.

A. The Company is proposing that the increased expense associated with growth in depreciation for electric and natural gas transmission and distribution plant investments be recovered using a tracker mechanism. A tracker mechanism is a surcharge to the Company's existing tariff schedules that can be changed or trued up in between rate cases. The Depreciation Tracker surcharge would be based on the incremental depreciation expense of natural gas and electric transmission and distribution investment over and above the depreciation expense reflected in existing rates. The mechanism would not apply to depreciation on generation investments, which can be addressed in a PCORC. Additional details regarding the proposed Depreciation Tracker are described in Mr. John Story's testimony, Exhibit No. ___(JHS-1T).

Q. Would this solve the "regulatory lag" issue associated with the Company's increasing infrastructure investments?

A. No, the Depreciation Tracker is only a partial step. It offsets the negative pressure caused by increased depreciation expense but does not address the lack of recovery *of* or *on* the new plant from the time it is placed into service until the plant is included in the Company's next general rate case. However, the Company is proposing the Depreciation Tracker at this time because it is a relatively simple, transparent mechanism that can be estimated in advance, trued up to actuals after the fact, and will go part of the way toward addressing the financial pressures the Company is experiencing related to its increasing infrastructure investments.

D. <u>Electric Energy Efficiency Proposals</u>

Q. Why is PSE requesting that the Commission approve an electric energy efficiency incentive mechanism?

A. Under the Company's current energy efficiency program, which was established in its 2001 general rate case, the Company must achieve minimum threshold energy savings goals in order to avoid incurring a financial penalty, but there is no reward for meeting or exceeding those goals. Thus, the Company has no incentive to aggressively pursue energy efficiency beyond the threshold goals. In fact, there is a built-in disincentive since reductions in the volume of energy sales due to energy efficiency programs result in lost revenue to the Company.

Despite these disincentives, the Company has undertaken aggressive energy efficiency efforts and would like to explore whether additional investments in cost-effective energy efficiency measures are feasible.

PSE seeks support for its goal of further expanding cost-effective energy efficiency through its proposal to offset the disincentives described above by proposing a mechanism that encourages continued outstanding performance of its electric energy efficiency programs over the long term. A performance-based incentive mechanism for energy efficiency would provide positive reinforcement for the Company to continue to aggressively pursue low cost, clean alternatives to traditional fossil fuel generation. It would also encourage innovation to develop and deliver new energy efficiency measures as they emerge. The Company's proposal is detailed in the testimony of Mr. Calvin E. Shirley, Exhibit No. ___(CES-1T).

Q. Why isn't the Company proposing to apply the incentive mechanism to natural gas energy efficiency?

A. The Company is proposing a decoupling mechanism in this case as the most appropriate method to address the disincentives to natural gas energy efficiency, as described below.

Q. Is the Company proposing any other electric energy efficiency initiatives?

A. Yes. The Company has submitted with this rate case filing proposed revisions to existing electric tariff Schedule 93 and several new voluntary pilot programs that are designed to offer customers a "menu" of demand-response options specifically targeted toward reducing winter peak electric demand.

Q. Why is the Company proposing to pilot these types of programs?

A. The proposed voluntary pilot programs are part of the Company's effort to develop resources to meet its peak resource needs. Reducing demand during a relatively small number of peak hours can help reduce rates by reducing utility power costs during those hours, when costs may be much higher than the rest of the year. Reduction of peak demand can also help the Company delay or avoid making expensive investments that would be required to meet peak demand but that would otherwise generally not be needed during the rest of the year.

The Company's proposed pilot programs are intended to test a variety of demand response strategies in order to gain implementation experience and information that is necessary in order to determine the feasibility and cost-effectiveness of expanding these programs in the future.

E. <u>Proposals to Better Recover PSE's Revenue Requirement and the Fixed Costs of Serving Customers</u>

Q. How does the Company's current rate design impact its recovery of the costs of serving customers?

A. PSE's current rate schedules rely heavily on volumetric rates to recover fixed delivery costs. That is, if customers pay only the basic charge to PSE, PSE will not recover the fixed costs required just to have the customers hooked up to its electric grid or gas system. Instead, a portion of these fixed costs are recovered in the portion of the customers' bill that varies depending on how much electricity or natural gas the customers use (i.e., the volumetric portion of the rate).

Under this rate design, in order to recover the revenue requirement that is assigned to the rate schedules of each customer class in a rate case, PSE's customers must use at least as much electricity or natural gas as they were projected to use during the rate year at the time rates were set. However, the electricity and natural gas usage of PSE's residential customers has been decreasing over time due to a number of factors including conservation, fuel switching, and changes in the housing mix in PSE's service territory. Because of this declining use per customer, PSE is under recovering the costs of providing service to its customers.

Q. How is the Company proposing to address this issue?

A. The Company is proposing to increase the basic or customer charges for its electric and natural gas customers to recover more of its fixed costs in that basic charge. Even after the proposed increases, PSE's residential basic charges will continue to be considerably below the Company's cost of service.

The Company is also proposing to address this issue by implementing a new natural gas decoupling mechanism, called the Gas Revenue Normalization Adjustment ("GRNA"). The GRNA will permit the Company to recover the overall amount of revenues from its gas customers that this Commission approves in rate cases even when the amount of gas used by individual customers subsequently declines or when the weather is warmer than normal. The GRNA will also remove the disincentive that currently exists for the Company to invest in more gas energy efficiency measures. The Company's proposed GRNA is described in the testimony of Mr. Ron Amen, Exhibit No. ___(RJA-1T).

Q. Why is the Company proposing to include weather in its GRNA?

A. Rates are set based on "normal" or average weather conditions. If actual temperatures are colder than normal after rates are set, PSE's natural gas customers would typically use more gas, pay more for utility service, and potentially overpay their share of fixed costs. This would also typically generate higher revenues for the Company than the level of fixed costs established for ratemaking purposes. But in warmer than normal weather, the reverse situation will occur. Customers' gas usage would decrease with warmer temperatures, thus generating lower revenues than required to recover the Company's total fixed costs that do not decrease due to warm weather.

The Company's GRNA, consistent with many other natural gas decoupling measures across the country, proposes to adjust for these weather impacts in order to better match the revenues it receives from customers with the amount of revenues the Commission has approved for recovery in rates.

F. Expanded Benefits for Low Income Customers

Q. Why is the Company proposing to increase the benefits that are available to qualifying low income customers?

A. The Company's approved level of funding for the low income bill assistance program has not been revised since it was originally established in PSE's 2001 general rate case, Docket Nos. UE-011570 et al. Since that time, both electric and natural rates have increased. For an average residential customer, their electric bill has increased by about 9.5% since 2002. For an average residential natural gas customer, their base rates increased by about 5% in the 2004 general rate case. Gas customers have also had higher bills since that time due to higher wholesale market gas prices, which have been passed through to customers in accordance with the Company's PGA Mechanism.

Q. Please describe the Company's proposal.

A. The Company proposes to increase the existing overall funding cap by $1 million, from the current $8.5 million to $9.5 million. This represents an overall increase of 11.8% for funds available for program costs and bill assistance. These funds would be allocated between the low income assistance programs for gas and for electric customers consistent with the Company's allocation methods in this case.

For the electric program, Electric Schedule 129, the annual program cap would increase from $5.7 million to $6.1 million, or 7.0%. For the gas program, natural gas Schedule 129, the annual program cap would increase from $2.8 million to $3.4 million, or 21.4%.

Q. When would the increased caps in cost recovery go into effect?

A. The changes to the caps in Schedules 129 would go into effect upon the approval of the Commission, but the money available to match those new caps would not be available until the next full low income bill assistance Program Year. The Program Year starts on October 1 and ends on September 30. The Company would also file new rates in Schedule 129 to collect the funds necessary for cost recovery, as it has done in the past.

VI. OVERVIEW OF OTHER WITNESSES

Q. Please summarize the testimony of the other witnesses who appear for PSE.

A. The following additional witnesses present direct testimony on PSE's behalf:

> **Ms. Susan McLain**, the Company's Senior Vice President Operations, discusses the Company's work to control costs related to its electric and natural gas systems while providing high quality service and reliability. She also describes the cost increases the Company is facing to replace and maintain its aging infrastructure and to expand that infrastructure to serve new customers.
>
> **Mr. Eric Markell**, Senior Vice President Energy Resources, describes the magnitude of the Company's need to acquire new electric resources for its customers. He then presents an executive summary of the Company's electric and gas supply portfolios and the new acquisitions for these portfolios for which the Company is seeking the Commission's approval in this case. Mr. Markell's executive summary of these matters is supported by five members of his Energy Resources team, whose testimonies are described next.
>
> **Mr. Roger Garratt**, Director of Resource Acquisition, describes in greater detail than Mr. Markell's executive summary the due diligence, negotiations and evaluation that the Company undertook prior to acquiring the Wild Horse Project and the ORMAT PPA. He presents additional detail regarding the costs and construction schedule for the Wild Horse Project as well as an update of the status and costs of the Hopkins Ridge Project that the Commission approved in the 2005 PCORC.
>
> **Mr. Joel L. Molander**, Manager Hydro Contracts, provides additional detail regarding the Chelan Contract.
>
> **Mr. Kris Olin**, Manager Hydro Assets, presents additional detail regarding the Baker River Hydroelectric Project relicensing process and related costs.
>
> **Mr. W. James Elsea**, Financial Analysis Manager of Energy Resources, describes the modeling updates and additional analyses that were completed after the Hopkins Ridge acquisition and were utilized to further evaluate the costs and benefits of the Wild Horse

Project and ORMAT PPA. He also describes how the Company's modeling tools, analyses and additional information were utilized to evaluate the costs and benefits of the Chelan Contract.

Mr. William (Bill) F. Donahue, Manager Gas Resource Planning and Analysis, provides more detail regarding the Company's Gas Supply Portfolio and its acquisition of pipeline capacity from DETM. He also describes how the Company plans for and acquires gas transportation capacity needed to serve its natural gas customers and provides a recommendation as to the allocation of certain pipeline capacity costs in the Company's gas cost of service study.

Mr. Salman Aladin, the Company's Director of Structuring, Asset Optimization and Analytics, describes the volatility and risk inherent in the Company's electric portfolio and the modeling work the Company has performed regarding the magnitude of potential variations in power costs. He also presents the Company's proposed revisions to the sharing bands in its existing PCA Mechanism and explains why PSE's proposal is fair and will result in risk sharing that better aligns the interests of the Company's customers and shareholders.

Mr. David E. Mills, Director Power and Gas Supply Operations, presents the Company's projection of power costs for this case and compares them to those the Commission approved in the 2005 PCORC. Mr. Mills also describes the structures and policies the Company has in place to manage the volatility in its electric and natural gas portfolios, the manner in which such policies are implemented, and the limitations that credit concerns are placing on the Company's ability to engage in further hedging activities.

Mr. Bertrand Valdman, the Company's Senior Vice President Finance and Chief Financial Officer, describes the importance of PSE's financial condition to its shareholders and customers. He provides an assessment of PSE's financial condition and explains why improving the Company's financial condition beyond existing levels is essential to managing the business and financial risks associated with providing electric and natural gas service to PSE's customers.

Mr. Donald Gaines, Vice President Finance and Treasurer, discusses the steps taken by the Company to strengthen its financial condition since its last general rate case, the Company's current credit ratings, and the Company's requested capital structure, cost of capital calculations and overall rate of return.

Dr. Roger Morin, Professor of Finance at the College of Business, Georgia State University, Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University, and principal in Utility Research International, presents his appraisal of the just, fair, reasonable and sufficient rate of return on the Company's combined gas and electric utility operations, with particular emphasis on the fair return on the Company's common equity capital committed to that business.

Mr. Calvin E. Shirley, the Company's Vice President Energy Efficiency Services, presents the incentive mechanism that PSE is proposing in this case to better align the interests of the Company's customers and its shareholders with respect to the Company's efforts to promote electric energy efficiency. He also describes the electric demand response measures that PSE is proposing in this case to reduce power costs and transmission and distribution system costs by reducing customers' use of electricity at key times of the day or on especially cold days when the demand for energy is at its highest.

Mr. John Story, Director of Cost and Regulation, presents the electric results of operations and revenue requirement, as well as the allocation of common expenditures between electric and natural gas. Mr. Story also presents details regarding the proposed revised PCA Mechanism and Depreciation Tracker.

Mr. Karl Karzmar, Director of Regulatory Relations, presents the gas results of operations and revenue requirement. He also describes the change to the Company's PGA Mechanism required to implement PSE's proposal to pass through costs related to the new credit line to support the Company's hedging efforts.

Mr. James Heidell, of PA Consulting Group, Inc., presents the Company's electric cost of service study and its proposed rate spread, rate design, and revised electric tariff schedules.

Mr. Ronald J. Amen, of Navigant Consulting, Inc. ("NCI"), describes the NCI Cost of Service Model used by PSE in the Company's electric and gas cost of service studies, as well as the results of the Company's gas cost of service study. He also presents PSE's proposed natural gas decoupling mechanism.

Ms. Janet K. Phelps, the Company's Senior Regulatory Analyst in Pricing and Cost of Service, presents PSE's pro forma revenue from gas operations, gas cost of service study, proposed rate spread and rate design for gas service, and revised gas tariff schedules.

Dr. Jeffrey A. Dubin, of Pacific Economics Group L.L.C. and tenured Professor of Economics at the California Institute of Technology (Caltech), describes his review of the Company's weather normalization methodology, including consideration of comments and suggestions made by Commission Staff in the weather normalization methodology collaborative. He also describes the recommendations he made for changes to PSE's existing weather normalization models and presents the final weather normalization models that the Company used to develop its temperature adjustments for this case.

Mr. Thomas (Tom) Hunt, Director Compensation and Benefits, describes PSE's compensation and benefits programs and how they are competitive and benefit the Company's customers.

VII. CONCLUSION

Q. Do you have any concluding remarks?

A. Yes. The Company understands that our customers would prefer not to see their rates increase. We know that such increases can be particularly difficult for low income customers and for customers on fixed incomes such as seniors. The Company is working hard to control the costs and risks that it can in order to avoid having to come back to customers for rate increases.

Nevertheless, the Company is struggling, like many others in the economy, with the recent increases in the costs of natural gas and energy in wholesale markets that are beyond the Company's control. The Company must also take a long-term view of the best interests of its customers. We need to make sure that we have generating resources and long-term power contracts in place to provide the power our customers will need into the future as this region continues to grow. We also need to invest in the electric and natural gas systems that are critical to providing safe, reliable service to our customers. The additional revenues we are asking our customers to pay in this case will be put to good use to meet these long-term objectives. We believe the changes suggested here will only marginally affect short-term customer rates and represent an excellent investment in the future for our customers.

Q. Does this conclude your testimony?

A. Yes it does.

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