

**EXHIBIT NO. ___(RCS-1T)
DOCKET NO. UE-090704/UG-090705
2009 PSE GENERAL RATE CASE
WITNESS: RALPH C. SMITH**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-090704
Docket No. UG-090705**

**PREFILED
DIRECT TESTIMONY (REDACTED) OF
RALPH C. SMITH
ON BEHALF OF
THE NAVY UTILITY RATE AND STUDIES OFFICE
AND FEDERAL EXECUTIVE AGENCIES**

NOVEMBER 17, 2009

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PUGET SOUND ENERGY, INC.

**PREFILED DIRECT TESTIMONY (REDACTED)
OF
RALPH C. SMITH**

I. INTRODUCTION

Q. Please state your name and business address.

A. Ralph C. Smith, 15728 Farmington Road, Livonia, Michigan 48154.

Q. What is your occupation?

A. I am a certified public accountant and a senior regulatory utility consultant with the firm Larkin & Associates, PLLC, certified public accountants and regulatory consultants.

Q. What is your educational background and professional experience?

A. These are presented in Exhibit No. ____ (RCS-2). This exhibit also summarizes some of my regulatory experience and qualifications.

Q. On whose behalf are you appearing?

1 A. My firm is under contract with the Navy Utility Rates and Studies Office
2 (URASO) to perform utility revenue requirement studies on behalf of the
3 consumer interests of the Navy and all other Federal Executive Agencies (FEA).
4

5 **Q. Please describe the tasks that you performed related to your testimony in this**
6 **case.**

7 A. We reviewed the Company's testimony, exhibits, and workpapers, issued
8 information requests, and analyzed PSE's responses to them. We reviewed and
9 analyzed data (1) to obtain an understanding of the Puget Sound Energy's ("PSE,"
10 "Puget" or "Company") rate filing package as it relates to the selected issues in
11 the Company's proposed rate increase and (2) to formulate an opinion concerning
12 the reasonableness of the Company's proposals on those selected issues.
13

14 **Q. What issues will you be addressing in your testimony?**

15 A. My direct testimony discusses Puget's ratemaking proposals concerning the
16 following areas:

17 1) Wild Horse Expansion Project

18 a. PSE's inadvertent omission of a test year amount for plant held for
19 future use in computing its proposed pro forma adjustment.

1 **II. WILD HORSE EXPANSION PROJECT**

2 **Q. What is Puget’s Wild Horse Expansion Project?**

3 A. The Company’s Wild Horse Expansion Project is a 44 MW expansion of the
4 existing 228.6 MW Wild Horse Wind Generating Facility located in Kittitas
5 County, WA. The expansion will install an additional 22 Vestas V80, 2.0 MW
6 wind turbines. PSE expects the project to be completed in December 2009 and
7 has included the extra wind capacity in its application.¹

8
9 **A. PSE Adjustment Error Correction**

10 **Q. Did your review of PSE’s adjustment calculations reveal an error in the**
11 **Company’s adjustment calculations?**

12 A. Yes. FEA data request 1.10 asked PSE to identify, by amount and account, all
13 recorded costs in the test year for the Wild Horse expansion project, including but
14 not limited to all rate base, operating expense, depreciation and property tax
15 amounts. PSE’s response to FEA data request 1.10 indicated that the test year
16 recorded costs on an average of monthly averages (“AMA”) basis included
17 \$3,727,373 in Account 107, Construction Work in Progress, and \$1,345,461, in
18 Account 105, Electric Plant Held for Future Use. Moreover, PSE’s response to
19 FEA data request 1.10 concedes that:

¹ See, e.g., PSE Exhibit No. ____ (JHS-1T), Prefiled Direct Testimony of John H. Story, pages 19-20

1 “This test year amount was inadvertently omitted from the Wild Horse
2 expansion project adjustment, found on Page 4.07 of the Third Exhibit to
3 the Prefiled Direct Testimony of John H. Story, Exhibit No. __ (JHS-4).
4 This omission will be corrected in PSE’s rebuttal filing in this proceeding.
5 The impact on electric revenue requirement deficiency would be a
6 decrease of \$155,384.”

7
8 PSE’s response also states that there were no test year recorded costs for
9 operating expenses, depreciation, or property taxes related to the Wild Horse
10 expansion project.

11
12 **Q. What adjustment are you recommending?**

13 A. PSE’s rate base adjustment for the Wild Horse expansion project should be
14 reduced by \$1,345,461 to account for the test year amount that PSE inadvertently
15 had failed to account for in its proposed pro forma adjustment.

16
17 **B. 2009 Bonus Tax Depreciation – Impact on Accumulated Deferred**
18 **Income Taxes**

19 **Q. How did PSE compute tax depreciation for the Wild Horse expansion**
20 **project?**

21 A. PSE witness Story’s PDT indicates that the Company computed tax depreciation
22 on its pro forma plant additions, including the Wild Horse expansion project, as
23 follows: “Deferred taxes associated with the tax depreciation of the plant were

1 calculated in the manner prescribed by Internal Revenue Code Regulations,
2 Section 1.167(l)-1(h).”

3
4 **Q. Did you inquire whether any of PSE’s pro forma plant additions were**
5 **expected to qualify for 2009 bonus tax depreciation?**

6 A. Yes. FEA data request 1.44 asked PSE about this.

7
8 **Q. Is the Wild Horse expansion project expected to qualify for 2009 bonus tax**
9 **depreciation?**

10 A. Yes. As stated in the PSE’s response to FEA data request 1.44: “PSE’s
11 expectation is that the expansion will be completed in time to place the project in
12 service by 12/31/09. If the in-service date slips to 2010, bonus depreciation may
13 not be available.”

14
15 **Q. Has PSE estimated the impact on ADIT from 2009 bonus tax depreciation**
16 **generated by the Wild Horse expansion project?**

17 A. Yes. PSE’s response to FEA data request 1.44(d) indicates an expected impact of
18 bonus depreciation on Deferred Tax of \$10,803,909.

1 **Q. Did PSE take the 2009 bonus tax depreciation for the Wild Horse expansion**
2 **project into account in computing its requested revenue requirement?**

3 A. It does not appear so, although PSE's responses to FEA data request 1.44 is
4 somewhat ambiguous and seemingly contradictory concerning this.

5 PSE's response to FEA data request 1.44(b), for example, indicates that
6 PSE did take bonus depreciation for the Wild Horse expansion project into
7 account in its determination of Deferred Taxes, and references a confidential pro
8 forma adjustment calculation contained in PSE witness Elsea's workpapers.

9 However, PSE's response to FEA data request 1.44(d), references PSE
10 witness Story's pro forma adjustment at Exhibit No. ___ (JHS-4), page 4.07, and
11 states as follows:

12 "Bonus depreciation increases the deferred taxes. Bonus depreciation was
13 **not** included in the Wild Horse Expansion adjustment 4.07E. **Should the**
14 **commercial operation date fall in 2009, bonus depreciation will be**
15 **included in the revenue requirement in PSE's rebuttal filing.**"

16
17
18 Based on these responses, it appears that PSE did not take into account the
19 2009 bonus tax depreciation related to the Wild Horse expansion project when
20 making its proposed ratemaking adjustment that was described in PSE witness
21 Story's testimony and in the response to FEA data request 1.44(d).

22
23 **Q. What do you recommend?**

1 A. If the Wild Horse expansion project becomes commercially operational in 2009,
2 PSE's rate base should be reduced for approximately \$10.804 million of
3 Accumulated Deferred Income Taxes ("ADIT") related to 2009 bonus tax
4 depreciation that is expected to be generated by the Wild Horse expansion project.

5
6 **Q. What if this project is not in-service in 2009?**

7 A. Because obtaining this bonus depreciation is a significant tax benefit, it should
8 strongly motivate PSE management to assure that the project is commercially
9 operational in 2009. If the in-service date slips beyond 2009, PSE must be
10 required to explain in detail to the Commission what caused the slippage.
11 Depending upon PSE's explanation, it may be appropriate to impose a rate base
12 reduction of some form.

13
14 **III. AMERICAN RECOVERY AND REINVESTMENT ACT**

15 **Q. Is an income tax deduction available for Domestic Production Activities?**

16 A. Yes. The American Jobs Creation Act of 2004 enacted §199 of the Internal
17 Revenue Code, to provide for a new tax deduction, phased in through 2009,
18 related to income attributable to Domestic Production Activities. The Code
19 phases in the §199 deduction over six years through increases in the applicable
20 percentage of Qualified Production Activities Income ("QPAI"), or taxable
21 income if less, that is eligible for the §199 deduction. The applicable percentage

1 is 3% in taxable years beginning in 2005 and 2006, increases to 6% for taxable
2 years beginning in 2007 through 2009, and finally phases in fully at 9% for
3 taxable years beginning in 2010.² The §199 deduction is an “add on” deduction,
4 as it does not require additional economic expenditures or outlays by the taxpayer,
5 therefore, has the effect of a tax credit or tax reduction.³ Because of this feature,
6 the §199 deduction is sometimes referred to as the Production Tax Credit.
7

8 **Q. Has PSE availed itself of the §199 deduction for Domestic Production**
9 **Activities?**

10 A. Yes. PSE has availed itself of this tax benefit, which PSE refers to as Production
11 Tax Credits (“PTC”).
12

13 **Q. How has PSE reflected PTC associated with the wind turbines that are being**
14 **constructed at its Wild Horse expansion project?**

15 A. PSE recognizes that the Wild Horse expansion project is expected to produce
16 PTCs. However, PSE has not reflected such PTCs in computing its retail electric

² §199(a)(1), (a)(2)

³ For accounting purposes, the benefit of the §199 deduction will be presented in financial statements as a special charge, similar to the treatment of a tax credit. *See, e.g.*, FASB Staff Position No. FAS 109-1.

1 revenue requirement deficiency of \$148.148 million.⁴ PSE’s response to FEA
2 data request 1.34(e) states that: “PTCs are passed through to customers under
3 Schedule 95A and are not included in general rate case filings.”
4

5 **Q. How does the American Recovery and Reinvestment Act (“ARRA”) affect**
6 **the income tax analysis?**

7 A. The ARRA has introduced other tax options that may be more beneficial to some
8 taxpayers than the Production Tax Credits. In response to FEA data request
9 1.34(e) and (f), PSE has indicated that the ARRA introduced additional benefits
10 that may be claimed in lieu of the PTC, namely, the possibility to elect investment
11 tax credit (“ITC”) or cash grants from the U.S. Treasury. PSE has indicated that it
12 is updating its Wild Horse expansion project analysis to identify which option
13 (PTC, ITC or cash grants) is most beneficial to ratepayers. PSE’s response to FEA
14 data request 1.34(f) indicates, however: “That review has not been completed at
15 this time. PSE will identify the option that appears most favorable in its update to
16 power costs later in this proceeding.”
17

18 **Q. What do you recommend?**

⁴ Per PDT of John Story at page 2: “This increase does not reflect an additional production tax credit (“PTC”) associated with the wind turbines being constructed at the Wild Horse Wind Project.”

1 A. The various options for tax benefits under the ARRA should be reviewed from the
2 perspective of minimizing the cost of the Wild Horse expansion project to
3 ratepayers. This should include a review of PSE's analysis of such tax benefits,
4 as described in the Company's response to FEA data request 1.34(f).
5

6 **IV. MAJOR TAX ACCOUNTING CHANGE**

7 **Q. During the 2008 test year, did PSE apply for a major tax accounting change?**

8 A. Yes. As described in the response to FEA data request 2.03(a), [**BEGIN
9 CONFIDENTIAL**]

10 . [**END

11 CONFIDENTIAL**]

12
13 **Q. Was the tax accounting change requested by PSE approved by the Internal
14 Revenue Service?**

15 A. Yes. As described in PSE's response to FEA data request 2.03(d), [**BEGIN
16 CONFIDENTIAL**]

17

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[**END

20 CONFIDENTIAL**]

21

1 **Q. Has PSE provided a copy of its application for a change in tax accounting**
2 **method?**

3 A. Yes. In response to FEA data request 2.03(c), PSE provided a copy of Form
4 3115, Application for Change in Accounting Method, and a copy of the executed
5 Consent Agreement dated August 20, 2009.

6
7 **Q. What impact on PSE's rate base is this tax accounting change expected to**
8 **have?**

9 A. In general terms, this change is expected to significantly increase ADIT and
10 should therefore reduce PSE rate base for the rate year. As stated in PSE's
11 response to FEA data request 2.03(d):

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Q. Have you seen this issue arise in other recent electric utility rate cases?

A. Yes. I am aware of this issue, involving a major change to a utility's tax accounting method, being raised in two recent electric utility rate cases (beyond the current PSE rate case).

Q. What impact did it have in those other recent electric utility rate cases?

A. It had the impact of significantly reducing the utility's rate base. ADIT, which is an offset to utility rate base, was significantly increased as a result of the tax accounting change. As a result of reflecting the impact of the change in tax accounting, an adjustment was made to increase ADIT and significantly reduce rate base.

Q. What do you recommend in the current PSE rate case?

A. The Commission should order PSE to provide a detailed analysis of the impact of this major tax accounting change on PSE's rate year ADIT balance. The expectation that the ADIT balance reflected by PSE in its rate increase application should be substantially increased to reflect the impact of this tax accounting change is supported by the information provided by PSE in response to FEA data request 2.03.

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V. PENSION EXPENSE – QUALIFIED PLAN

Q. What is PSE proposing for an expense allowance for its qualified pension plans?

A. PSE recommends a pension expense of approximately \$3.7 million for electric and 2.0 million for gas. This does not include PSE’s requested expense for its Supplemental Executive Retirement Plan, which I address separately, below.

Q. What is the basis for PSE’s request for pension expense?

A. PSE witness Story states at pages 41-42 of his PDT that the Company’s adjustment restates the test year to reflect cash contributions to the Company’s qualified retirement fund. He indicates that, in previous general rate cases, the Commission has used the average of four years of contributions to determine the amount that is to be included in operating expense. PSE’s request is based upon an average of four years ending September 2009, including estimates which PSE indicates will be adjusted to actual during the course of the proceeding. PSE has allocated its pension contribution to O&M based on wage distributions and then allocated between electric and gas based on its labor benefit assessment distribution allocation.

Q. What amounts has PSE contributed to its qualified pension plan in recent years?

1 A. PSE's response to FEA data request 1.16 listed the following amounts for such
2 contributions: zero in each year, 2005, 2006, and 2007, and \$24.5 million in
3 2008.
4

5 **Q. Why didn't PSE contribute to its qualified pension plan in years 2005-2007?**

6 A. PSE's response to Public Counsel ("PC") data request No. 010 indicates that
7 PSE's pension plan was well funded and no contributions were needed in the
8 years 2004 through 2007.
9

10 **Q. How did PSE determine its 2008 contribution amount?**

11 A. This was apparently based upon a management decision after PSE's pension plan
12 became underfunded in 2008 due to investment market declines. PSE's response
13 to PC data request No. 010 states that, for 2008, PSE considered options for
14 contributing to the plan to improve its status.

15 One of the confidential attachments to the response to PC data request No.
16 010 was a [****BEGIN CONFIDENTIAL****]
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[**END CONFIDENTIAL**]

Q. What reports and options did PSE evaluate ?

A. PSE's response to Public Counsel data request No. 010 states that PSE requested reports from its actuary, Milliman Inc. PSE did not request studies on pensions or funding from outside individuals or firms other than Milliman Inc.

Q. Did PSE provide a copy of the Milliman pension funding study?

A. In response to Public Counsel data request No. 010, PSE provided a Milliman presentation entitled [**BEGIN CONFIDENTIAL**]

[**END CONFIDENTIAL**]

Q. What are the parameters that typically determine the range of pension funding?

1 A. Typically, parameters such as the minimum required contribution and the
2 maximum tax-deductible contribution determine the range of pension funding
3 contributions that are considered by management.
4

5 **Q. Has PSE provided its maximum tax deductible contribution amounts?**

6 A. Yes. In one of the confidential attachments to its response to PC data request No.
7 010, PSE listed its maximum tax-deductible employer contributions for 1998
8 through 2008. **[**BEGIN CONFIDENTIAL**]**

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[END CONFIDENTIAL**]**

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In that response, PSE **[**BEGIN CONFIDENTIAL**]**

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[END CONFIDENTIAL**]**

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24

Q. Does PSE project additional funding contributions in 2009?

1 A. Yes. Page 41 of the PDT of PSE witness Story states that: “In 2009 the
2 Company made a cash contribution of \$6 million and is expected to make further
3 contributions of \$12.4 million by December 2009.”
4

5 **Q. What concerns are raised by the large pension expense increase that PSE is**
6 **requesting?**

7 A. As indicated by such information, the range of contributions in any given year can
8 be very broad. Consequently, basing a ratemaking allowance for qualified
9 pension expense on actual contributions presents a risk of having the amounts be
10 dependent upon management discretion, and subject to significant manipulation
11 for purposes of deriving an expense allowance in a rate case. This was not as
12 much of a concern when PSE’s qualified pension plan was over-funded and no
13 contributions into the plan were being made.
14

15 **Q. Might it be time for PSE to re-evaluate whether it should continue to provide**
16 **a defined benefit pension plan?**

17 A. Yes. The recent experience with poor investment performance has highlighted
18 the cost and the upward cost exposure of providing a defined benefit pension plan
19 benefit. It may therefore be a good time for a re-evaluation of the cost of this
20 benefit program and consideration of alternatives such as a defined contribution
21 plan, where the employer’s cost for the year is known and is not subject to radical
22 increases based on investment performance, which can be variable. Other

1 companies have discontinued their defined benefit pension plans, in favor of other
2 alternatives. Factors such as worker mobility, the regulatory burden, and the
3 increased costs of defined benefit pension plans have hastened their decline, and
4 there is a discernible trend away from such plans. Basing a ratemaking allowance
5 for pension costs on plan funding contributions, which are up to utility
6 management and in any year can span a range as wide as \$60 million or more
7 could deter the Company from making reforms to its pension plans that would
8 reduce cost, as many companies are currently doing.

9
10 **Q. Do defined benefit pension plans have some characteristics similar to other**
11 **postretirement benefits?**

12 A. Yes. Defined benefit pension plans have a number of characteristics similar to
13 other postretirement benefits. Common characteristics include that they can be a
14 very costly benefit to provide. Benefits can be funded via tax-advantage trusts.
15 Additionally, both types of postretirement benefits are also subject to accrual
16 accounting for financial reporting purposes. Other postretirement benefits are
17 subject to accrual account pursuant to the guidance of FAS 106, among other
18 provisions. Defined benefit pension plans are subject to accrual account pursuant
19 to the guidance of FAS 87, among other provisions, such as FAS 88, for plan
20 curtailments, etc. Both defined benefit pension plans and other postretirement
21 benefits are now also subject to the accounting guidance provided in FAS 158,
22 and changes in the valuation of plan assets versus obligations can now result in

1 charges or credits to Other Comprehensive Income (“OCI”). Generally, the OCI-
2 related accruals affecting pensions and other postretirement benefits are not
3 reflected for utility ratemaking purposes.
4

5 **Q. Has PSE described how its ratemaking allowance for Other Postretirement**
6 **Benefits is determined?**

7 A. Yes. PSE’s response to FEA data request 3.04 and Public Counsel data request
8 No. 082 describes PSE’s funding and accounting for other postretirement benefits
9 under FAS 106. PSE’s response explains that PSE’s actuary firm Milliman
10 determines the FAS 106 accounting expense amounts each year. PSE pays out of
11 general corporate assets an amount annually at least equal to the FAS 106
12 “ratemaking” accounting expense, which is charged above the line and partially
13 allocated to construction for accounting purposes. Any postretirement medical
14 costs and life insurance plan costs incurred above the FAS 106 “ratemaking”
15 accounting expense are paid by the benefit plan funding trusts. PSE has a
16 Voluntary Employee Benefit Association (“VEBA”) and a Section 401(H) trust.
17 PSE also has the Aetna X-Fund for retiree life insurance. If there is no
18 “ratemaking” expense in a year, the retiree medical costs should be paid by the
19 trusts rather than from PSE corporate assets. PSE’s response explains further
20 that:

21 “Net Periodic Benefit Cost (“NPBC”) for the Post-Retirement Plan
22 consists of two components: Ratemaking and Disallowed.

1 Ratemaking NPBC is included in the labor benefit overhead rate and
2 allocated, based on labor charges, to various FERC accounts which
3 include capital, O&M and non-utility accounts, with an offset to the FAS
4 106 liability in Account 228.3. The O&M labor benefits component is
5 then reallocated to FERC 926 for Ratemaking.

6 The disallowed NPBC is charged directly to Other Deduction account
7 426.5.

8 The FAS 106 Benefit Plan Liability is recorded to 228.3. This account
9 reports the Funded Status of the Plan, which is defined as: Plan Assets
10 less Plan Accumulated Projected Benefit Obligation.

11 The unrecognized expense is recorded in OCI which is reported in account
12 219 and is not included for Ratemaking. Amortization of OCI is offset to
13 228.3 throughout the year.”

14
15 **Q. How has the Commission previously addressed reasonableness concerns**
16 **regarding PSE’s retirement benefits costs?**

17 A. PSE attached an excerpt from the Commission’s decision in Docket Nos. UE-
18 920433, UE-920499 and UE-921262 to its response to Public Counsel data
19 request No. 082. That part of the decision addresses concerns that arose when
20 FAS 106 was first adopted for ratemaking purposes for postretirement benefits.
21 Interestingly, at pages 56-57, the decision describes concerns that had been raised
22 by Staff as follows:

23 “Commission Staff witness Thomas Schooley ... argued that the company
24 imprudently incurred pension expense prior to 1992 because the company
25 had never evaluated the cost of these programs. He cited testimony and
26 exhibits which indicated that the company, in its own evaluation of these
27 plans, eventually realized that they were too costly to be continued, and
28 that the use of cash basis accounting only made them appear to be
29 affordable. The company subsequently limited its exposure to these costs,
30 based on an actuarial analysis of its liability. Employees retiring after
31 January 1, 1992, will receive a defined dollar plan rather than the
32 previously-effective defined benefit plan. Mr. Schooley recommended
33 treating benefits greater than the revised policy as imprudent. He

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recommended basing the level of expense for ratemaking purposes on the defined dollar plan.”

With respect to the reasonableness of the benefits, page 58 of that decision states as follows:

“The Commission has never previously been asked to consider the appropriateness of these costs. The company nonetheless should have regularly and routinely evaluated the costs of providing these benefits. ...

The Commission accepts the Commission Staff position that the company should have identified these costs earlier and acted to limit its exposure to prudent levels. Since the company apparently did not do so, the Commission Staff’s proposal to base the expenses, for ratemaking purposes, for all employees and retirees on the level of the defined dollar plan should be accepted. ...

... The determination made here is for ratemaking purposes only. Puget may determine that all plans should continue unchanged. It may decide to change payments under the plans. Those determinations will be made by management, not by the Commission.”

Q. How is that relevant to PSE’s request for pension costs in the current PSE rate case?

A. It is relevant for a number of reasons. First, the cash basis of accounting for postretirement benefits had made them appear affordable. PSE has used a cash basis (average of cash contributions) for pensions for ratemaking purposes, which in the past has made the cost of that benefit appear affordable. PSE’s pension plan in the past had also been fully funded, which also had the impact of making the accounting costs, under FAS 87, appear affordable. Indeed, in some of the prior years, PSE had recorded pension income under FAS 87.

1 Second, the Commission made an adjustment to expense to reflect that
2 PSE should have made a change to its benefit program at an earlier date, in
3 response to concerns of escalating costs for such benefits and to limit exposure to
4 such escalating costs.

5 Third, the Commission ultimately decided to use an accrual method for
6 other postretirement benefits for ratemaking purposes, rather than recognizing
7 such costs on a cash basis. PSE in the current rate case seeks rate recovery of its
8 pension costs on a cash basis, based on an average of four years of cash
9 contributions into the pension trust fund through September 2009. Continuing to
10 utilize a cash basis for the ratemaking recognition of the cost of providing a
11 qualified defined benefit pension plan would cause this cost to be significantly
12 higher in the current PSE rate case than it has been in recent years.

13
14 **Q. How did the Commission adopt accrual accounting recognition of PSE's**
15 **other postretirement benefits?**

16 A. As described in the Commission's decision in Docket Nos. UE-920433, UE-
17 920499, and UE-921262, accrual accounting under FAS 106 for postretirement
18 benefits was adopted, subject to an initial phase-in.

19
20 **Q. What do you recommend?**

21 A. I recommend that the allowance for pension expense in the current PSE rate case
22 be limited to the average annual net periodic pension costs determined pursuant to

1 Statement of Financial Accounting Standards No. 87 (“FAS 87”) for the four year
2 period ending December 31, 2008, as allocated to expense, and between PSE’s
3 electric and gas operations.
4

5 **Q. Why should a four-year average be used?**

6 A. A four-year average should be used because the use of such an average appears to
7 be consistent with Commission practice, and it helps smooth out or “normalize”
8 the expense allowance for ratemaking purposes.
9

10 **Q. Why did you cut-off the average with 2008?**

11 A. I used an average for the four-year period ending with 2008 because reliable FAS
12 87 accrual basis information for calendar 2009 did not appear to be available. If
13 PSE is able to produce reliable FAS 87 accruals for calendar 2009, such as net
14 periodic pension costs supported by an actuarial report, I would not be opposed to
15 considering that information in an updated average.
16

17 **Q. What adjustment to PSE’s requested pension expense do you recommend?**

18 A. As shown on Exhibit ___(RCS-3), I recommend that PSE’s requested amount of
19 expense for its qualified pension plan be reduced by \$3.607 million for electric
20 and \$1.9 million for gas, respectively. This increases PSE’s net operating income
21 for electric and gas by approximately \$2.345 million and \$1.266 million,
22 respectively.

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V. SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN

Q. What expense has PSE requested for its Supplemental Excess Benefit Retirement Plan?

A. PSE has requested approximately \$2.1 million and \$1.2 million for expense for the Supplemental Excess Benefit Retirement Plan (“SERP”) for its electric and gas operations, respectively. PSE based this on an average of four years of expense through September 2009.

Q. Does PSE have funding contributions to its SERP?

A. No. PSE’s response to PC data request No. 010 indicates that PSE does not have contributions to its SERP like it does for its qualified pension plan. PSE makes accrual entries to expense and to a liability account, pursuant to financial accounting standards. When SERP benefits are paid to retirees, PSE reduces its accrued liability.

Q. Please explain your adjustment to remove the expense for SERP.

A. This adjustment removes PSE’s requested expense for the SERP. The SERP provides supplemental retirement benefits for select executives. Generally, SERPs are implemented for executives to provide retirement benefits that exceed limitations in qualified plans set by the Internal Revenue Service (“IRS”). Companies usually maintain that providing such supplemental retirement benefits

1 to executives is necessary in order to ensure attraction and retention of qualified
2 employees. Typically, SERPs provide for retirement benefits in excess of the
3 limits placed by IRS regulations on pension plan calculations for salaries in
4 excess of specified amounts.

5
6 **Q. Has utility SERP expense been disallowed in other recent rate cases of which**
7 **you have direct knowledge?**

8 A. Yes. In Arizona Corporation Commission Decision 69663, June 28, 2007, in a
9 rate case involving Arizona Public Service Company (“APS”), the Arizona
10 Commission adopted a recommendation to remove SERP expense. In reaching its
11 conclusion regarding SERP, the Commission, in referencing a recent Southwest
12 Gas Corporation rate case in which SERP was disallowed, stated on page 27 of
13 Order 69663 that:

14 “APS has not demonstrated any reason to treat the SERP expense
15 for its SERP eligible employees any differently than our
16 determination of SERP expenses associated with SWG employees.
17 Accordingly, we find that the SERP expense should not be
18 recovered from APS ratepayers...”
19

20 In Decision No. 68487, February 23, 2006, in a Southwest Gas Corporation rate
21 case, the Commission adopted a recommendation by RUCO to remove SERP
22 expense. In reaching its conclusion regarding SERP, the Commission stated on
23 page 19 of Order 68487 that:

24 “Although we rejected RUCO’s arguments on this issue in the
25 Company’s last rate proceeding, we believe that the record in this
26 case supports a finding that the provision of additional

1 compensation to Southwest Gas' highest paid employees to
2 remedy a perceived deficiency in retirement benefits relative to the
3 Company's other employees is not a reasonable expense that
4 should be recovered in rates. Without the SERP, the Company's
5 officers still enjoy the same retirement benefits available to any
6 other Southwest Gas employee and the attempt to make these
7 executives 'whole' in the sense of allowing a greater percentage of
8 retirement benefits does not meet the test of reasonableness. If the
9 Company wishes to provide additional retirement benefits above
10 the level permitted by IRS regulations applicable to all other
11 employees it may do so at the expense of its shareholders.
12 However, it is not reasonable to place this additional burden on
13 ratepayers."
14

15 SERP expense was also disallowed in the Arizona Commission's recent decisions
16 in the rate cases involving UNS Gas, Inc. and UNS Electric, Inc.

17 Notably, at page 28 of Decision No. 70011, the Arizona Commission,
18 citing Decision No. 69663, stated:

19 "...the issue is not whether UNS may provide compensation to
20 select executives in excess of retirement limits allowed by the IRS,
21 but whether ratepayers should be saddled with costs of executive
22 benefits that exceed the treatment allowed for all other employees.
23 If the Company chooses to do so, shareholders rather than
24 ratepayers should be responsible for the retirement benefits
25 afforded only to those executives. We see no reason to depart
26 from the rationale on this issue in the most recent Southwest Gas
27 rate case [See also Arizona Public Service Co., Decision No.
28 69663, at 27 (June 28, 2007), wherein SERP costs were excluded
29 in their entirety.], and we therefore adopt the recommendations of
30 Staff and RUCO and disallow the requested SERP costs."
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32 In addition, in the recent UNS Electric, Inc. rate case, in Decision No. 70360 at
33 page 22, referencing the above captioned quote, the Arizona Commission stated:
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“We see no reason to depart from the rationale on this issue in the most recent UNS Gas rate case, and we therefore adopt the recommendations of Staff and RUCO and disallow the requested SERP costs.”

Additionally, in a Southwest Gas rate case, Docket No. G-01551A-07-0504, Decision 70665 stated as follows on pages 17-18:

“We agree with Staff and RUCO that the SERP expenses sought by Southwest Gas should once again be disallowed. We do not believe any material factual difference exists in this case that would require a result that differs from the Company’s prior case.”

Q. What adjustment related to APS’ SERP expense do you recommend?

A. I recommend the adjustment to remove PSE’s expense for the SERP, which is shown on FEA Exhibit (RCS-4). This adjustment reduces O&M expense by approximately \$2.139 million for electric and \$1.155 million for gas, respectively. This adjustment increases PSE’s net operating income for electric and gas operations by approximately \$1.390 million and \$751,000, respectively.

Q. Does that conclude your testimony?

A. Yes, it does.