EXHIBIT NO. ___(KRK-11CT)
DOCKET NO. UE-060266/UG-060267
2006 PSE GENERAL RATE CASE
WITNESS: KARL R. KARZMAR

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF
KARL R. KARZMAR
ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED
VERSION

AUGUST 23, 2006

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF KARL R. KARZMAR

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Are you the same Karl R. Karzmar who submitted prefiled direct testimony in this proceeding on February 15, 2006, and supplemental prefiled direct testimony in this proceeding on July 10, 2006, each on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes.

Q. Please summarize the purpose of your rebuttal testimony.

A. My rebuttal testimony will discuss the various gas proforma and restating adjustments and adjustments that are common between the electric and gas service that the Company is proposing in rebuttal. First, I will discuss the adjustments proposed by Commission Staff and other parties that the Company agrees with and has incorporated in its updated gas revenue requirement determination presented with my prefiled rebuttal testimony. Second, I will discuss adjustments that the Company, Commission Staff and other parties are in agreement with as to methodology, but which have changed since parties filed their response as the result of updated information. These changes have also been incorporated in the Company's updated gas revenue requirement determination and are not expected to be contentious. Third, I will discuss adjustments proposed by Commission Staff and other parties with which the Company disagrees.

Based on the proforma and restating adjustments proposed by the Company and presented in Exhibit No. ___(KRK-12), there is a revenue deficiency of $39,008,416 for natural gas service which includes an allocation of $804,230 to water heater rental customers. This would represent an average 4.06% overall rate increase.

II. COMPARISON BETWEEN THE COMPANY'S SUPPLEMENTAL FILING REVENUE DEFICIENCY AND COMMISSION STAFF REVENUE DEFICIENCY

Q. Have you prepared a reconciliation between the revenue deficiency filed by the Company in its July 2006 supplemental filing and that filed by Commission Staff?

A. Yes. The following table highlights the differences between the Company's and the Commission Staff's gas revenue deficiency.

PSE Supplemental Filing Revenue Deficiency	**$39,211,573**
12.01 Revenues and Expenses	(333,180)
12.09 Rate Case Expenses	(208,530)
12.12 Wage Increase	107,681
12.13 Investment Plan	4,998
12.20 Director and Officer Insurance	19,526
12.21 Everett Delta	206,348

PSE Rebuttal Filing Revenue Deficiency	**$39,008,416**
Staff Adjustments:	
Actual Results of Operation	(17,279,917)
12.01 Revenues and Expenses	32,531
12.03 Tax Benefit of Pro forma Interest	(808,305)
12.09 Rate Case Expense	(163,682)
12.12 Wage Increase	(107,681)
12.13 Investment Plan	(4,998)
12.15 Incentive Pay	(344,412)
12.20 Director and Officer Insurance	(356,088)
12.21 Everett Delta	168,480
Spirit Ridge	(795,470)
Commission Staff Revenue Deficiency	**$19,348,874**

Q. What is the major difference between the Company's revenue deficiency and the Commission Staff's revenue deficiency?

A. The Commission Staff's proposal is in essence a cost of capital adjustment. The $19.3 million increase recommended by Commission Staff is $19.9 million less than the Company's supplemental proposal. Of this $19.9 million reduction, $17.3 million is the result of their proposed adjustment to the Return on Equity and the Company's capital structure.

III. THE COMPANY AGREES THAT THE FOLLOWING ADJUSTMENTS SHOULD BE MADE TO ITS SUPPLEMENTAL FILED REVENUE REQUIREMENT

Q. Have you prepared an exhibit which details the updated restating and pro forma adjustments that the Company is proposing?

A. Yes. Exhibit No. ___(KRK-12) summarizes the Company's gas restating and pro forma adjustments. This exhibit is presented in the same format as my Exhibit No. ___(KRK-4), Exhibit No. ___(KRK-9) and Mr. Russell's Exhibit No. ___(JMR-4).

Complete List of Uncontested Adjustments

Q. Please list the adjustments where the Company is in agreement with Commission Staff.

A. The adjustments and their impact on net operation income (NOI) or rate base are:

Adjustment	NOI	Rate Base
12.02 Federal Income Tax	$490,787	
12.04 Conservation	$2,426,926	
12.05 Bad Debts	($236,343)	
12.06 Miscellaneous Operating Expense	($978,686)	$2,857,353
12.07 Property Tax	$469,425	
12.08 Excise Tax and Filing Fee	$389,325	
12.10 Property & Liability Insurance	$123,942	
12.11 Pension Plan	($1,603,511)	
12.14 Employee Insurance	($418,486)	
12.16 Interest on Customer Deposits	($131,750)	
12.17 Property Sales	$456,881	
12.18 General Office Relocation	($914,888)	($1,746,177)
12.19 Other Amortization Expense	$1,361,790	
12.22 Depreciation	$0	

Q. Is this list of uncontested adjustments different than the list of uncontested adjustments that Mr. Russell presents in his prefiled response testimony?

A. Yes. There are two adjustments that Mr. Russell lists as uncontested that the Company has updated for changes in estimates or actual amounts. Although these adjustments are still done in the same manner, the amount of the adjustment has changed as a result of the updates. I will explain the difference in the two adjustments categorized as uncontested that are common to both electric and natural gas.

Q. Would you please specify the adjustments that are on Mr. Russell's uncontested adjustments where you will discuss the differences between the Company's adjustment and Commission Staff's adjustment?

A. Yes. These adjustments are listed below:

Adjustment	NOI	Rate Base
12.12 Wage Increase	($1,460,754)	
12.13 Investment Plan	($62,124)	

Q. Would you please describe the difference between the Company and Commission Staff on these adjustments?

A. Yes.

<u>Wage Increase electric adjustment 20.20 and gas adjustment 12.12</u>

Q. Please explain the differences with respect to the adjustment for wage increases?

A. Since the Company originally filed its case, the Human Resources Department examined wages for all of the various union positions across the bargaining unit and evaluated the Company's ability to attract and retain qualified employees. As Ms. McLain describes, the marketplace has changed dramatically in the last few years with respect to the Company's ability to attract and retain Service Linemen and qualified Substation and Relay Wiremen. As a result, on July 20, 2006, the Company signed a letter agreement with International Brotherhood of Electrical Workers ("IBEW") Union Local #77, dated July 17, 2006, providing for a journeyman wage adjustment effective August 28, 2006 in certain classifications. This adjustment put PSE in a competitive position in the market for the critical classifications that were affected. This journeyman wage adjustment was provided to Staff in the Company's Supplemental Response to WUTC Staff Data Request No. 243, but not in time to be incorporated into any of Staff's response adjustments. Accordingly, the Company has updated its wage adjustment for these union step increases.

This change in the wage adjustment resulted in an additional decrease in net operating income of $304,040 and $66,934 for PSE's electric and gas operations respectively, and in turn a total decrease in net operating income of $2,512,047 and $1,460,754. This adjustment properly affected both of the Company's electric and gas operations because of common work elements and consequent allocation methods.

<u>Investment Plan electric adjustment 20.21 and gas adjustment 12.13</u>

Q. Please explain the differences with respect to the adjustment for the investment plan?

A. The investment plan difference and adjustment merely reflects the impact on the investment plan associated with the wage adjustment discussed above. This change in the investment plan adjustment resulted in an additional decrease in net operating income of $4,962 and $3,107 for PSE's electric and gas operations respectively, and in turn a total decrease in net operating income of $99,416 and $62,124.

IV. CONTESTED ADJUSTMENTS

Q. Would you please describe the difference between the Company and Commission Staff on the contested adjustments?

A. Yes. I will discuss the contested adjustments beginning with the adjustments that are common to both electric and gas service.

Revenues & Expenses gas adjustment 12.01

Q. Please explain your adjustment on revenues and purchased gas expenses.

A. The parties agree on this adjustment except for a minor difference resulting from a change in the way the Company calculates the minimum bill for Schedule No. 41. The change in methodology corrects for an error discovered in the course of this proceeding, as discussed by Mr. Amen in his prefiled rebuttal testimony, and results in a more accurate determination of normalized revenues.

This revision to revenues and expense increases the resulting net operating income adjustment by $32,531 and PSE does not expect the adjustment to be controversial to other parties.

Federal Income Tax (FIT) and Accumulated Deferred FIT electric adjustment 20.04 and gas adjustment 12.02

Q. Please explain PSE's position on current and deferred federal income tax accounting?

A. There is no dispute with respect to the current and deferred income tax accounting adjustments in this case. The Company does take issue however, with Staff's recommendation to defer with carrying costs, at PSE's authorized rate of return, the revenue requirement impacts of the actual Section 199 domestic production tax credit deductions beginning with tax year 2005 for consideration as either a direct offset to deferred power costs or to be reserved for consideration in a future rate proceeding. Staff argues, on the one hand--when it results in a deferred debit, that the Company's proposed depreciation tracker constitutes inappropriate single issue ratemaking because it ignores the fact that other cost of service elements may be creating downward pressure on rates.[1] But on the other hand, Staff proposes the very same thing, as in this instance, when it results in a deferred credit. In his prefiled rebuttal testimony, Mr. Story separately addresses this concern with respect to the Company's proposed depreciation tracker.

The Company does not object to special accounting treatment of specific issues when it is appropriate, but in this instance it is one sided to order the Company to single out and defer a future tax credit without taking into consideration offsetting and much more likely near-term tax debits which may occur. Staff presents no basis for the deferral, no basis for carrying costs to be imputed at the Company's authorized rate of return and provides for no consideration of offsetting debits.

If the Commission were to determine this type of tax credit should be deferred, it should not accrue interest because customers have not contributed any funds. The tax credit just means that the Company did not have to borrow the funds to make a tax payment.

The Company recommends the Commission reject staff's proposal to defer Section 199 tax credits, however, if the Commission orders deferred accounting treatment of Section 199 credits, there should be no interest accrual and the

[1] Exhibit No. ___(JMR-1T), at pages 25-26.

Company should be allowed to offset the deferral with emerging tax debits as they may develop. Alternatively, the Company should, at most, be directed instead to file a petition if and when such Section 199 credits materialize to determine if any special accounting treatment is appropriate.

Tax benefit of Proforma Interest electric adjustment 20.05 and gas adjustment 12.03

Q. What is the reason for the difference in the tax benefit of proforma interest?

A. As stated by Mr. Russell in his prefiled response testimony, this adjustment is not disputed as to methodology used in its calculation. The difference between the Company and the Commission Staff for this adjustment is based on the different rate base and weighted cost of debt proposed by the parties.

The Company's adjustment for the tax benefit of proforma interest resulted in decreases in PSE's electric and gas net operating income of $2,391,139 and $7,280,941 respectively.

Tree Watch electric adjustment 20.08.5

Q. Please explain PSE's position on the Tree Watch adjustment.

A. The amount of this adjustment is not in dispute. In the 2004 general rate case (consolidated Docket Nos. UG-040640 and UE-040641), the Commission approved a proposal to: (1) discontinue deferral and amortization treatment of costs related to Tree Watch on a prospective basis; (2) allow expensing of costs as incurred; and (3) include an annual normalized expense level of $2 million. Because the accounting for Tree Watch costs changed during the test year, the test period does not reflect the full $2 million expense level. Accordingly, the Company proposed to increase the test year expense by $983,429 to reflect the full $2 million pro forma amount.

Staff does not oppose the Company's adjustment in this case, but proposes a condition that beginning with the rate year in this case, and every year thereafter, any amount below the $2 million expenditure level allowed in rates should be credited to the unamortized balance of the previously deferred Tree Watch program costs. Staff claims this condition is necessary because during the rate year following the 2004 general rate case, the Company actually spent approximately $111,000 less than the $2 million level.

In making this argument, Staff disregards the fact that the Company was on track to spend the entire target amount by year end. In addition, Staff's proposal is one-sided. Staff is proposing special treatment of Tree Watch costs if the Company spends less than the program target of $2 million annually, but proposes no additional cost recovery if the Company exceeds the spending target. As Ms. McLain explains in her prefiled rebuttal testimony, it is difficult to manage the programs and projects for Tree Watch such that costs come in exactly at $2 million each year, but PSE's implementation plans for Tree Watch are to spend within plus or minus 5% of the $2 million.

If the Commission nevertheless accepts Staff's proposal, the Company should also be able to add to the deferred costs it is recovering for the Tree Watch program any costs it spends for the program in a given year in excess of the $2 million that is embedded in rates.

<u>Director and Officer Insurance electric adjustment 20.12 and gas adjustment 12.20</u>

Q. Does the Company agree with Staff's adjustment to Director and Officer Insurance?

A. No. Staff claims that during the test period, all of the director and officer insurance for the parent, Puget Energy, was assigned to the regulated operations of Puget Sound Energy, even though InfrastuX's directors and officers were also covered.[2] Mr. Russell also states that his proposed adjustment allocates directors and officers insurance to Puget Energy's subsidiaries based on the number of officers and directors of PSE and InfrastruX.

There are a number of problems with Commission Staff's prefiled response testimony and adjustment. First of all, it is not true that all of the director and officer insurance for the parent, Puget Energy, was assigned to the regulated operations of Puget Sound Energy. During the test year, $46,974 of director and officer insurance was charged directly per books to InfrastruX. The remainder

[2] Exhibit No. ___(JMR-1T) at page 11.

was allocated to the utility and its subsidiaries, Puget Western, Inc. and Hydro Energy Development Corp., based on the relationship of the assets of each company, consistent with the long standing precedent set in rate proceedings for allocating PSE's director and officer insurance. PSE, in its allocation of director and officer insurance, is following the precedent that was approved by the Commission in Docket Nos. UE-920433, UE-920499, and UE-921262.

Second, Mr. Russell did not make the allocation based on the number of PSE and InfrastruX officers and directors as he states in his prefiled response testimony. Had he done so, he would have apportioned 69% to InfrastruX and only 31% to PSE. Instead, he made the allocation based on the simple average of the percentage relationship between PSE and InfrastruX of 1) their total assets, 2) their number of employees; and 3) their number of directors and officers. This simple average results in a 43% allocation to InfrastruX. However, there is no relationship between the number of employees and director and officer insurance and Mr. Russell provides no basis or support for either of those allocation methods.

Third, Puget Energy sold InfrastruX on May 7, 2006 and there is no longer a reason to allocate any insurance expense to InfrastruX since it will not exist in any prospective rate year. The insurance premium liability did not change as a result of the sale of InfrastruX and director and officer insurance should now be allocated based on the remaining subsidiaries of Puget Sound Energy. Given this known and measurable change, using Mr. Russell's allocation method would result in a 100 percent allocation to Puget Sound Energy, because there is no provision in his calculation to exclude non InfrastruX subsidiaries. The Company proposes instead to apply the traditional allocation method based on the relationship of assets of Puget Sound Energy and its non utility subsidiaries, Puget Western, Inc. and Hydro Energy Development Corp.

Additionally, the Company has updated this adjustment since its July 10th supplemental filing to allocate the total premiums including that charged directly to InfrastruX in the test year. This change has resulted in an additional decrease to net operating income of $18,032 and $12,137 for PSE's electric and gas operations respectively. Properly allocating director and officer insurance in this manner results in a decrease in net operating income of $13,291 and $8,946 for PSE's electric and gas operations respectively.

Rate Case Expense electric adjustment 20.16 and gas adjustment 12.09

Q. Would you please provide some background regarding the treatment of general rate case expenses in rates?

A. In the Company's last general rate case filing in Docket Nos. UG-040640 and UE-040641, the Commission ordered the Company to 1) stop deferring rate case expense incurred after August 2004, 2) commence recovery of subsequent costs it incurs in prosecuting rate cases as a normalized expense going forward, and

3) commence amortization of costs deferred through August 2004 over three years, without the addition of any return on those costs.

As a result of these changes in recovery methods, the Company is recovering on an amortized basis the deferred costs associated with the 2001 and 2004 general rate cases that have not yet been recovered. At the same time, the Company is collecting in rates a "normalized" amount to cover its expenses for all rate case activity since August 31, 2004, including this general rate case. Commission Staff now proposes two adjustments to the treatment of general rate case expenses.

Q. Please explain PSE's position on Staff's first proposed general rate case expense adjustment.

A. In order to mitigate the rate impact of these coincident recovery methods, Staff proposes, in its first rate case expense adjustment, to lengthen the amortization periods for the 2001 and 2004 general rate cases from the 14 months remaining of the original 36 month amortization periods to 24 and 48 months, respectively. The Company does not object to lengthening the amortization of the 2001 expenses to 24 months, but believes the proposal to extend the amortization period for the 2004 costs to 48 months (for an overall total of nearly six years) is unreasonable in view of the current frequency of general rate case proceedings. As a compromise, the Company is agreeable to and proposes to lengthen the amortization periods for both the 2001 and 2004 general rate case expenses to 24 months.

Q. What is Staff's second general rate case adjustment proposal?

A. The second revision to general rate case expense that Staff proposes is to remove one-half of the $791,000 paid to Pacific Economic Group related to Dr. Cicchetti's testimony on rate of return and Dr. Dubin's testimony on hydro statistical analysis in the 2004 general rate case, Docket Nos. UG-040640 and UE-040641. Staff argues that the consulting fees are excessive for ratepayers given that the Commission gave little or no weight to Dr. Cichetti's analysis. Staff also claims that the Commission adopted Staff witness Dr. Mariam's use of 50 year hydro, which justifies reducing Dr. Dubin's fees. Staff also claims that the Company had less incentive to reduce rate case costs in the 2004 case because it assumed that these costs would be deferred and amortized, dollar for dollar in prospective rates, as compared to this case. Staff points as an example to the total cost estimate for PSE's rate of return witness, Dr. Morin, which is $55,000. Staff also states that no costs for a hydro witness is necessary in this case because the precedent has been established through the 2004 case.

Q. Please explain the Company's position on this proposal.

A. First, and most importantly, the 2004 general rate case expenses were already litigated in the 2004 general rate case. Public Counsel, ICNU and Commission

Staff sharply criticized the level of 2004 general rate case expenses and particularly costs for outside experts in that case. While Commission Staff did not propose any disallowance, ICNU proposed that the Company and customers share the rate case expenses included in rates on a 50/50 basis. Instead, the Commission expressly stated that it found no basis to adjust the level of general rate case expenses[3] and it did not order any disallowance. PSE believes it is inappropriate for Commission Staff to now reach back into the 2004 general rate case and seek to disallow expenses from that case, two years later.

PSE also disagrees with the substance of Staff's proposed disallowance. It is not reasonable to disallow rate case expenses merely because studies provided by an expert were not heavily relied upon by the Commissioners in deciding an issue. The burden of proof is on the Company in a rate case and the Company must be able to prepare and present evidence and defend its positions against the opposing parties on a wide variety of issues, without knowing in advance which issues may become the most contentious and therefore require the most support in litigation. In addition, experts fees are typically greatly increased by the need to respond to data requests of other parties, often including requests for additional analyses.

In the case of Dr. Dubin, PSE was required to present substantial statistical evidence in support of its proposed change of the Commission precedent for using a 40-year hydro data set in rate cases. A prior Commission order explicitly

[3] Order No. 06, Docket Nos. UG-040640, *et al.*, at ¶ 176 ("We find no basis in our record upon which to adjust the amount both PSE and Staff recommend be allowed for general rate case expense.").

instructed PSE to do so if it ever raised the issue with the Commission again. As further described by Dr. Dubin, his work was closely examined and heavily relied upon by Commission Staff's Dr. Mariam. Dr. Mariam ultimately recommended use of a 50-year data set rather than PSE's preferred 60-year data set for reasons unrelated to the soundness of Dr. Dubin's statistical analyses, and PSE's compromise on this position led to a Commission order that cites Dr. Mariam. This does not mean that Dr. Dubin's analysis was unnecessary, excessive, unreasonable, or that his fees should be disallowed.

Similarly, in the case of Dr. Cicchetti, PSE was required to and did present his extensive return on equity analysis in support of the Company on a central rate case issue in the 2004 case. Dr. Cicchetti was required to defend his position in extensive data requests by other parties, in rebuttal and in hearings. Dr. Cicchetti also assisted the Company with cross examination of other financial witnesses and in briefing. The Commission should not disallow expert expenses on issues that go to the heart of the disputes at issue in a rate case merely because it ultimately does not find a company's expert witness compelling. PSE also believes it is ironic that after criticizing the Company for employing an expert with fees that it views as too high, Commission Staff now essentially seeks to punish PSE by using its employment of an expert in this case with much lower fees to argue for a fee disallowance in a prior case.

Q. What would be the resulting general rate case amortization amount that the Company proposes?

A. The Company's proposal would result in annual amortization of general rate case expenses of $356,765 and $294,587 for PSE's electric and gas operations respectively, as opposed to the corresponding amortization amounts proposed by Mr. Russell of $251,952 and $247,936.

Q. What would be the resulting general rate case normalization amount that the Company proposes?

A. The Company's proposal, when also taking into consideration a small true up as the result of a final reconciliation of the 2004 general rate case expenses, would result in annual normalization amounts of general rate case expense of $1,080,500 and $1,080,500 for PSE's electric and gas operations respectively, instead of the $970,621 and $970,621 corresponding amortization amounts proposed by Mr. Russell.

Q. Does this complete the Company's issues with respect to rate case expense?

A. No. Mr. Russell does not discuss it in his prefiled response testimony, but he has also adjusted normalized Power Cost Only Rate Case ("PCORC") expenses by reducing the amount of expenses for the 2003 PCORC that is used to calculate a normalized level to one-half of the $1,300,000 estimated cost of the 2003 PCORC case. PSE understands that he does so based on the Commission's order in the

2004 general rate case, where the Commission reduced the amount of 2003 PCORC expenses to be used to determine a normalized level of PCORC expense because the 2003 PCORC was the first such case and had highly contentious prudence issues such that it was more expensive to litigate than was anticipated for future PCORC cases.[4]

The Company does not oppose Mr. Russell's adjustment in principle, but wishes now to true up the estimated 2003 PCORC expense amount that formed the basis of this adjustment in the 2004 general rate case order and that Mr. Russell has used for his response adjustment in this case to the actual expenditures incurred for the 2003 PCORC case. Accordingly, the Company's rebuttal adjustment on PCORC case expense excludes one-half of the $2,039,886 actual expenditures incurred in the 2003 PCORC, adds them to the expenses incurred for the 2005 PCORC case, and averages them for the PCORC expense normalization calculation. The result is a normalized PCORC expenses adjustment, assuming a two year normalization period, of $324,500 per year instead of the $232,016 per year proposed by Mr. Russell.

[4] Order No. 06, Docket No. UG-040640, *et al.*, at ¶ 184 ("The evidence also supports our finding that $650,000 is more representative of what this type of proceeding should cost than is the amount twice that high that PSE expended in its first proceeding, which was more expensive due to its novel and contentious nature.").

Q. What would be the result of the total general rate case amortization and normalization adjustments and PCORC amortization adjustment that the Company proposes?

A. The Company's proposed adjustments to rate case expense would result in an increase in net operating income of $226,966 and a reduction in net operating income of $144,106 for PSE's electric and gas operations respectively, instead of the increase of $426,631 and decrease of $42,361 proposed by Mr. Russell.

<u>**Incentive Pay electric adjustment 20.27 and gas adjustment 12.15**</u>

Q. Are there any issues with respect to the adjustment for incentive pay?

A. Yes. There are three issues to Staff's approach to the incentive pay adjustment.

First, Mr. Russell proposes to use the average of incentive payments for the four years 2003 through 2006, which by necessity includes only an estimate for 2006, instead of the four-year average of actual incentive payments for the years 2002 through 2005 that the Company used in its direct testimony.

Second, in projecting the estimate for 2006, Mr. Russell used the budget level payout of $6.3 million, which is the floor expectation for incentive payout as explained in Mr. Hunt's prefiled rebuttal testimony. By contrast, the updated projected payout of $[redacted] should be used if the Commission elects to use the four-year average based on the years 2003-2006. Mr. Hunt explains in his prefiled rebuttal testimony why, if an estimate were going to be used, the updated projected payout level rather than the budget level is more appropriate.

Third, Mr. Russell's adjustment to incentive pay also includes the removal of stock equivalent payments made to Chief Executive Officer Steven Reynolds, based on a mistaken belief that they were made in lieu of the performance share grants awarded to other PSE executives, which are treated as non-operating expenses for ratemaking purpose. Mr. Russell's understanding is not correct and the payments which total $110,149 should not be removed as also explained by Mr. Hunt in his prefiled rebuttal testimony.

Q. What would be the result if Staff had used the updated projection of a $[redacted] payout and not removed the stock equivalent payments?

A. The incentive adjustment would have resulted in increases in net operating income of $[redacted] and $[redacted] for PSE's electric and gas operations respectively, instead of the corresponding increases proposed by Mr. Russell of $1,038,186 and $645,420.

Q. Are these the adjustments you are proposing in rebuttal?

A. No. As Mr. Hunt explains in his prefiled rebuttal testimony, the appropriate four-year incentive payment periods to be averaged are the years 2002 through 2005. Using these years, with their actual, known payout amounts, avoids speculation about what may occur during 2006 and how that may ultimately impact the incentive payment payout level. Accordingly, the Company proposes the same incentive adjustments as supported in its prefiled supplemental testimony that result in increases in net operating income of $690,180 and $431,333 for PSE's electric and gas operations respectively.

<u>Everett Delta Pipeline Expansion gas adjustment 12.21</u>

Q. Turning now to adjustments that only affect gas operations, are there any issues with respect to the adjustment for the Everett Delta Pipeline Expansion?

A. There are no issues with this adjustment, which is related to the sale and lease back of a pipeline in Everett, except that, because of rate base implications and as pointed out by Mr. Russell, this adjustment is dependent in part on the final determination of the appropriate rate of return.

Additionally, the Company has revised this adjustment to exclude a portion of the rate base that is part of the pipeline but not under lease, and provided for the proper determination of revenue based taxes. In the process, the Company has also revised the mechanics of the calculation in order to prove the adjustment and make it easier to audit. The Company does not expect this revision to be controversial.

Spirit Ridge gas adjustment 22

Q. Mr. Russell proposes an adjustment for increased pipeline expenses related to preventive measures taken by the Company in the Spirit Ridge community. Does the Company agree with this adjustment?

A. No. Staff is proposing an adjustment related to expenses that were incurred in the test year to ensure gas distribution pipeline integrity and safety in the Spirit Ridge community following a tragic accident that occurred in that neighborhood. Staff's proposal is to disallow $760,714 of expenses on the basis that they are non-recurring. Ms. McLain explains the reasons for these expenses and how they were paid for.

It is not appropriate to remove such expenses on the basis of non recurrence. Non recurring expenses can be said to occur in every test year if the type of expense is viewed too narrowly. If such expenses are removed for ratemaking purposes, the funds available to the Company for undertaking particular projects would steadily decline until the Company is unable to fund the regular, ongoing work that needs to be done to provide service to its customers. The whole purpose of using a test year is to establish what representative level of costs the utility will spend to provide service to customers and need to be able to recover in rates. As Ms. McLain explains in her prefiled rebuttal testimony, the Company knows it will not incur the exact same costs in the Spirit Ridge neighborhood every year, but it also knows it will have unplanned expenses to respond to distribution system issues that arise in other places in its system. Additionally, the resources used in Spirit Ridge were diverted from other planned work and next year they will be needed elsewhere. Mr. Russell's proposed adjustment should be rejected and the Company proposes no corresponding adjustment in rebuttal.

Q. Would you please explain Exhibit No. ___(KRK-13)?

A. Page 13.01 of Exhibit No. ___(KRK-13) presents the calculation of the revenue deficiency based on the proforma and restating adjustments discussed above.

Revenue Deficiency

As shown on page 1 of Exhibit No. ___(KRK-13), based on $1,180,351,743 invested in rate base and $79,151,170 of net operating income, the Company would have an overall gas revenue deficiency of $39,008,416 including an allocation to water heater rental of $840,230.

Cost of Capital

This schedule, shown on page 13.02 of Exhibit No. ___(KRK-13), reflects the proposed capital structure for the Company during the rate year and the associated costs for each capital category. The capital structure and costs are presented in the prefiled rebuttal testimony of Mr. Donald Gaines, Exhibit No. ___(DEG-7CT). The rate of return is 8.76%.

Conversion Factor

The conversion factor, shown on page 13.03 of Exhibit No. ___(KRK-13), is used to adjust the net operating income deficiency by revenue sensitive items and Federal income tax to determine the total revenue requirement. The revenue sensitive items are the Washington State utility tax, Washington WUTC filing fee, and bad debts. The conversion factor used in the revenue requirement calculation, taking into consideration the adjustments discussed earlier, is 62.1600% and is uncontested between the parties.

V. WEATHER VARIABILITY HAS A SUBSTANTIAL IMPACT ON PSE'S GAS REVENUES NOTWITHSTANDING THE PGA AND FIXED CHARGES

Q. Are there other issues you wish to address?

A. Yes. Mr. Russell states in his prefiled response testimony that the PGA insulates approximately 69% of the Company's sales revenue requirement from the effects of weather variability. He also states that revenues derived from basic charges, demand charges, and base usage are collected irrespective of weather.[5] He goes on to cite the PGA mechanism as one of the risk mitigation measures already available to the Company. He states that these existing mechanisms protect PSE sufficiently that the depreciation tracker should not be approved.[6] These observations also appear to be made in support of Staff's opposition to PSE's

[5] Exhibit No. ___(JMR-1T) at page 23.
[6] *Id.* at page 29.

proposals to include the impact of temperature variation in PSE's gas decoupling proposal as well as Staff's opposition to PSE's proposed increases in fixed charges for gas service.

Q. Do you disagree with Mr. Russell?

A. Yes. Mr. Russell fails to mention that the basic, demand, and base usage charges he cites only provide recovery of a fraction of the Company's fixed charges.

The 69% of the Company's sales revenue requirement to which the PGA mechanism applies merely passes through to customers the Company's cost of purchased gas without mark up and the Company does not earn anything on purchased gas costs, as Mr. Amen discusses in his prefiled rebuttal testimony. This means that all of the Company's operating income requirement of $103.4 million for its gas operations must be recovered within the remaining 31% layer of revenues.

Since most of these costs are fixed but recovered on a volumetric basis, the Company is exposed to a lot of weather variability and declining sales volume risk through the current rate design. In addition, because a substantial portion of the $103 million operating income requirement goes to cover the cost of financing the Company's investment in infrastructure, it doesn't take much weather variation to seriously affect operations or earnings.

Q. What is the magnitude of that risk?

A. As one example, the weather variation in the pending case alone resulted in a weather normalization operating revenue adjustment of $24.8 million when the test year was only 5% warmer than normal. With respect to PSE's gas operations, net of expenses, that represents almost 6% of the Company's earnings capability on common equity.

This unnecessary rate design consequence is not in the best interest of the Company or its customers.

Q. What do you mean by "unnecessary"?

A. Only that this risk could easily be addressed by recovering non-PGA fixed charges on more of a fixed charge basis, as Mr. Hoff discusses in his prefiled rebuttal testimony and through a properly designed decoupling mechanism, as Mr. Amen explains in his prefiled rebuttal testimony. Moreover, these changes would benefit customers as well as the Company, as Mr. Hoff and Mr. Amen explain.

VI. CONCLUSION

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.