

Exhibit No. DPK-1T
Dockets UE-090704 UG-090705
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

DOCKET UE-090704
DOCKET UG-090705
(Consolidated)

TESTIMONY OF

DANNY P. KERMODE

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Working Capital

November 17, 2009

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Exhibit No. DPK-2, Staff Schedule of Investor-Supplied Working Capital

Exhibit No. DPK-3, Staff Schedule of the Allocation of Investor-Supplied Working Capital

1 I. INTRODUCTION

2
3 **Q. Please state your name and business address.**

4 A. My name is Danny P. Kermode. My business address is The Richard Hemstad
5 Building, 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA
6 98504. My email address is dkermode@utc.wa.gov.

7
8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Washington Utilities and Transportation Commission
10 (“Commission”) as a Regulatory Analyst.

11
12 **Q. How long have you been employed by the Commission?**

13 A. I have been employed by the Commission since 1996.

14
15 **Q. Please describe your educational background.**

16 A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a
17 Bachelor of Science in Accounting. Later that same year, I attended San Carlos
18 University in the Philippines for postgraduate studies in economic analysis and
19 quantitative business analysis. I am licensed in Washington as a Certified Public
20 Accountant (“CPA”).

21 In 1992 and 1993, I was a member of the faculty at the National Association
22 of Regulatory Utility Commissioners (“NARUC”) Annual Regulatory Studies
23 Program, held at Michigan State University in East Lansing, Michigan. I taught

1 classes in Financial and Regulatory Accounting Standards and in Deferred Tax
2 Accounting. In 2008 and 2009, I was a member of the faculty at the NARUC Utility
3 Rate School in San Diego, California. In addition, in 2008 and 2009 I also taught
4 regulatory accounting at the Institute of Public Utilities' Advanced Regulatory
5 Studies Program.

6 I published an article in the Journal of the American Water Works
7 Association titled *Contributions in Aid of Construction: IRS Final Regulations*
8 (2002). I later published an article in the National Regulatory Research Institute's
9 Journal of Applied Regulation titled *Regulatory Provision of Income Taxes for S*
10 *Corporations and Other Nontaxable Business Forms* (2004).

11
12 **Q. Please describe your professional background.**

13 A. I am a financial professional with 25-plus years experience in private practice,
14 industry, and government. I spent 10 years as a CPA in private practice in Phoenix,
15 Arizona, from 1983 to 1993, where I was an expert witness in a number of utility
16 cases before the Arizona Corporation Commission, the state's public utility
17 regulatory body.

18 From 1994 to 1996, I was the controller for the Rocky Mountain Institute, a
19 large internationally-recognized non-profit organization that conducts research and
20 performs services in the energy field.

21 Since my employment at the Commission in 1996, I have testified in
22 numerous cases including three PacifiCorp general rate cases, Dockets UE-032065,
23 UE-050684, and UE-061546, and two Avista general rate cases, Dockets UE-070804

1 and UE-090134. I testified on accounting and income tax issues in the 2001 rate
2 case of Olympic Pipeline Company, Docket TO-011472. I also testified in four
3 water company general rate cases: American Water Resources, Docket UW-980258;
4 Rainier View Water Co., Inc, Docket UW-010877; Marbello Water Company,
5 Docket UW-041181, and Iliad Water Service, Inc., Docket UW-060343. I also
6 testified regarding income taxes in the Verizon Northwest, Inc. general rate case,
7 Docket UT-040788.

8 9 II. SCOPE AND SUMMARY OF TESTIMONY

10
11 **Q. What is the purpose of your testimony in this general rate case of Puget Sound
12 Energy, Inc. (“PSE” or “the Company”)?**

13 A. The purpose of my testimony is to address the allowances for investor-supplied
14 working capital, as presented by PSE for its electric operations on line 45 in
15 Company witness Story’s Exhibit JHS-4, Page 4-A and for its natural gas operations
16 on line 45 in Company witness Stranik’s Exhibit No. MJS-4, Page 4-A. I propose
17 corrections to the beginning amounts for working capital in the columns labeled
18 “Actual Results of Operations” of their exhibits. The results of these corrections are
19 incorporated into Staff witness Breda’s Exhibit No. KHB-2, Page 2.1, Line 40 and
20 Exhibit No. KHB-3, Page 3.1, Line 37.

21
22 **Q. Have you prepared any exhibits in support of your testimony?**

23 A. Yes. I have prepared the following exhibits in support of my testimony:

- 1 • Exhibit No. DPK-2, Staff Computation of Total Investor-Supplied Working Capital
- 2 • Exhibit No. DPK-3, Staff Allocation of Total Investor-Supplied Working Capital.

3 4 III. DISCUSSION

5 6 A. Overview of Investor-Supplied Working Capital

7 8 Q. Does the Company provide for working capital in its filing?

9 A. Yes. PSE included working capital in its electric operations rate base in the amount
10 of \$130.7 million, as shown in Company witness Story's Exhibit JHS-3, Page 3.04.
11 For its natural gas operations, rate base includes \$51.1 million for working capital, as
12 shown in Company witness Stranik's Exhibit No. MJS-3, Page 3.04.

13 14 Q. Please briefly discuss working capital and its significance in rate making.

15 A. Working capital is a measure of financial liquidity reflecting a company's ability to
16 meet its day-to-day operational requirements inherent in a business cycle. A
17 business cycle is made up of three basic stages – production, sales and collection of
18 revenue from customers. The costs of production and sales are incurred prior to
19 collection of the related revenues. Working capital is customarily defined as the
20 funds needed by a company to pay its current obligations while waiting for payment
21 from its customers.

22 From the regulatory perspective, working capital is measured to quantify the
23 amount of investment associated with it. This measured amount is then included in

1 rate base in order to provide a return on the related investment.

2
3 **Q. What methodology did PSE use to compute its proposed working capital**
4 **amounts?**

5 A. The Company used the balance-sheet approach, more commonly known as the
6 “Investor-Supplied Working Capital” approach, for both its electric and natural gas
7 operations.

8
9 **Q. Please explain the basic concept of the Investor-Supplied Working Capital**
10 **method.**

11 A. Broadly speaking, the Investor-Supplied Working Capital method measures the
12 difference between the capital invested in a business and the long-term investments
13 in the business. Investor-supplied working capital is the amount of invested capital
14 that is provided by investors, and available for the Company’s use, over and above
15 the Company’s investments in operating plant, non-operating plant, and other
16 specific items of investment. The excess of invested capital over total investment
17 represents investor-supplied working capital.

18 Commonly, investor-supplied working capital is first derived as a total
19 company amount and then that total amount is allocated to the different operating
20 and non-operating segments of the business.

1 accounts of PSE's trial balance for the test year and compiled each grouping of
2 accounts directly from that data. This allowed me not only to confirm the groupings
3 provided by PSE in its working capital computation, but also to review the reasoning
4 the Company used for its classifications
5

6 **Q. Does Staff propose any adjustment to the Company's calculation of total
7 investor-supplied working capital?**

8 A. Yes. Exhibit No. DPK-2, Staff Computation of Total Investor-Supplied Working
9 Capital, presents an adjustment to the Company's computation of its beginning total
10 investor-supplied working capital.
11

12 **Q. Please generally describe Exhibit No. DPK-2.**

13 A. Exhibit No. DPK-2 is a one-page exhibit that is based upon the Company's average-
14 of-monthly averages ("AMA") of its balance sheet accounts for the test year ended
15 December 31, 2008. Column (a) of the schedule provides a description of the line
16 items in the schedule. Column (b) shows PSE's computation of Total Investor-
17 Supplied Working Capital for the test year. Column (c) reflects Staff's adjustment to
18 total investor-supplied working capital. Column (d) is the Staff adjusted total
19 investor-supplied working capital amount. The schedule follows the same Investor-
20 Supplied Working Capital format used by the Company in its case.

21 Starting at the line 1 of the exhibit, the schedule begins with the computation
22 of Average Invested Capital. Following the Total Average Invested Capital (line
23 14), the computations for Average Operating Investments for Electric, Gas,

1 **Q. Did you review the Company's investor-supplied working capital amounts it**
2 **proposes to include in its electric and gas rate bases?**

3 A. Yes. My review encompassed PSE's *computation* of total investor-supplied working
4 capital and its *allocation* of that total to its gas and electric operations.
5

6 **B. Computation of Total Investor-Supplied Working Capital**
7

8 **Q. Is the methodology PSE used to *compute* total investor-supplied working capital**
9 **consistent with the method it used in its prior general rate case, Dockets UE-**
10 **072300 and UG-072301?**

11 A. Yes. As it did in that last general rate case, the Company develops a single
12 combined computation for its natural gas and electric operations, although the
13 schedule is filed as separate identical exhibits in each witness' testimony.¹ Prior to
14 its last general rate case, the Company computed investor-supplied working capital
15 for its electric and gas segments individually through separate schedules for each
16 segment. Performing separate computations of investor-supplied working capital
17 tended to understate the proper amount of investor-supplied working capital.
18

19 **Q. Please describe your review of the Company's computation of total investor-**
20 **supplied working capital.**

21 A. Total investor-supplied working capital is a computation involving balance sheet
22 accounts. In order to confirm the Company's numbers, I reviewed the balance sheet

¹ Exhibit No. JHS-3, Page 3.04 and Exhibit No. MJS-3, Page 3.04.

1 Construction Work in Progress, and Non-Operating Investments are shown. The
2 exhibit reflects the Total Average Investment at line 63. Lastly, line 65 shows Total
3 Investor-Supplied Working Capital before allocation.
4

5 **Q. Please explain the adjustment Staff proposes to the Company's computation of**
6 **total investor-supplied working capital?**

7 A. Staff's proposed adjustment removes from total working capital, two amounts related
8 to the Crystal Mountain environmental remediation: 1) a Crystal Mountain
9 insurance receivable of \$7.5 million; and 2) an offsetting accrued liability of
10 \$624,000. Removing these amounts from working capital results in their inclusion
11 in non-operating investments.

12 Staff removes these Crystal Mountain amounts from working capital because
13 Commission has not approved any deferral or petition for recovery of the costs.
14 Although the Company requested deferral of the costs in Docket UE-070724, the
15 request was later withdrawn.²

16 The net effect of Staff's adjustment increases non-operating investments by
17 \$6.9 million, which reduces total investor-supplied working capital by the same
18 amount and results in a Staff total investor-supplied working capital of \$188.5
19 million.
20

² In March 2008, PSE withdrew its petition explaining the insurance carrier agreed to cover the costs under PSE's general liability policy.

1 **C. Allocation of Total Investor-Supplied Working Capital**

2
3 **Q. Briefly describe how total investor-supplied working capital, once computed, is**
4 **allocated to the different business segments.**

5 A. Once total investor-supplied working capital is derived, it must be allocated to the
6 different operating and non-operating segments of the Company. To correctly
7 allocate, we must assume a relationship between the total working capital amount
8 and each of the operating segments. The assumption we make is that the relationship
9 of total investor-supplied working capital to total average investment is the same
10 relationship that each segment's working capital has to its related investment.

11 For example, if the computed total investor-supplied working capital is two
12 percent of the total average investment, then it is assumed that each segment's
13 working capital will also be two percent of each segment's average investment. This
14 relationship is called the "Working Capital Ratio". To allocate total investor-
15 supplied working capital, the Working Capital Ratio is applied to each operating
16 segment's total average investment. The result is the working capital allowance
17 included in rate base for PSE's electric and gas operations.

18
19 **Q. Please summarize the Company's proposed allocation of its total investor-**
20 **supplied working capital?**

21 A. PSE is proposing a total investor-supplied working capital of \$195 million. Of that
22 amount, the Company proposes to allocate \$130.7 million to its electric operations

1 and \$51.1 million to its gas operations. The remaining \$13.6 million is allocated to
2 non-operating.

3
4 **Q. Is the methodology used by PSE to *allocate* total investor-supplied working
5 capital consistent with the method it used in its prior general rate case?**

6 A. No. In the prior case, PSE did not reduce the gas operation's total investment by
7 Construction Work in Progress ("CWIP") in order to compute the Working Capital
8 Ratio, even though in the same case it reduced the electric operation's total
9 investment for CWIP.

10 In contrast, in the current case, the Company has proposed a CWIP deduction
11 for both operating segments including its gas segment.³ However, as discussed
12 below, that change did not go far enough to be fully consistent with Staff's position
13 that all CWIP should be removed prior to computing the Working Capital Ratio.
14 Staff, therefore, presents an adjustment to remove all CWIP from the development of
15 the Working Capital Ratio.

16 Other than this change, the Company's methodology for the allocation of
17 total investor-supplied working capital is consistent with the prior case and has been
18 accepted by Staff.

19
20 **Q. Please discuss in more detail your adjustment to the Company's computation of
21 the Working Capital Ratio?**

³ Exhibit No. MJS-3, Page 3.04 at 2:68-94.

1 A. In Company witness Story's Exhibit No. JHS-3, Page 3.04 for PSE's electric
2 operations and Company witness Stranik's Exhibit No. MJS-3, Page 3.04 for PSE's
3 natural gas operations, the Company correctly reduces total investment by the
4 amount of its CWIP. However, the Company's CWIP adjustments only reduce the
5 electric computation by CWIP solely related to electric operations. Similarly, total
6 investment for gas is reduced only for gas-related CWIP.

7 The Working Capital Ratio should be computed without the inclusion of any
8 CWIP because CWIP does not use or produce working capital and, therefore, should
9 not be used as a component of a working capital allocator. Therefore, all CWIP must
10 be removed prior to the computation of the Working Capital Ratio. Staff's proposed
11 adjustment reduces total investment for the additional CWIP amounts not recognized
12 by the Company in its allocation to both its electric and gas operations.

13
14 **Q. Does Staff's adjustment affect the total investor-supplied working capital**
15 **computed on your Exhibit No. DPK-2?**

16 A. No. This adjustment does not affect Staff's total investor-supplied working capital,
17 which stays at \$188.5 million. It does, however, effect the allocation of the \$188.5
18 million to the different business segments, including non-operating.

19
20 **Q. What is the result of Staff's adjustment to the allocation of total working capital**
21 **to the different operating segments.**

22 A. This adjustment to the Working Capital Ratio, combined with the decrease in total
23 investor-supplied working capital, decreases the Company's amount allocated to

1 electric operations by \$3 million, whereas the Company's amount allocated to gas
2 operations increases by only \$173,813. The amount of total working capital allocated
3 by PSE to non-operating decreases by \$4.0 million, as a result of Staff's adjustment.
4

5 **Q. Have you prepared an exhibit that summarizes Staff's allocation of its total**
6 **investor-supplied working capital?**

7 A. Yes. Exhibit No. DPK-3, Staff Allocation of Total Investor-Supplied Working
8 Capital, compares the Company and Staff proposed allocation of total investor-
9 supplied working capital. As shown on Exhibit No. DPK-3, after its proposed
10 adjustments, Staff allocates \$127.7 million to electric operations, \$51.3 million to
11 gas operations, and the remaining \$9.5 million to non-operating.
12

13 **Q. Please describe your Exhibit No. DPK-3, Allocation of Total Investor-Supplied**
14 **Working Capital.**

15 A. Exhibit No. DPK-3 is a one-page exhibit that presents the allocation of total investor-
16 supplied working capital that was computed on Exhibit No. DPK-2. Column (a) of
17 the schedule provides a description of the line items in the schedule. Column (b)
18 shows the Company's proposed allocation computations and results. Column (c)
19 shows the Staff proposed adjustment for additional CWIP to the Company's
20 allocation. Column (d) is the result of Staff's adjusted allocation of its total investor-
21 supplied working capital amount.
22

1 **D. Summary**

2

3 **Q. Please describe the result of all Staff adjustments affecting investor-supplied**
4 **working capital.**

5 A. Staff's review of the Company's proposed total investor-supplied working capital
6 resulted in a change in the Allowance for Working Capital, as shown in the "Actual
7 Results of Operations" columns in Company witness Story's Exhibit JHS-4, Page 4-
8 A, line 45 for electric operations and in Company witness Stranik's Exhibit No.
9 MJS-4, Page 4-A, line 45 for natural gas operations.

10 The total result of Staff adjustments is a \$6.8 million decrease to total
11 investor-supplied working capital. Staff's proposals decrease electric revenue
12 requirement by \$377,957 and gas revenue requirement by \$22,052.

13

14 **Q. Does this conclude your testimony?**

15 A. Yes.

16

17