**Exhibit T- ___ (JMR-7T)**
**Docket Nos. UE-060266/UG-060267**
**Witness: James M. Russell**

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| **WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,**<br><br>**Complainant,**<br><br>**v.**<br><br>**PUGET SOUND ENERGY, INC.**<br><br>**Respondent.** | **DOCKET NO. UE-060266**<br>**DOCKET NO. UG-060267**<br>***(consolidated)*** |

**SURREBUTTAL TESTIMONY OF**

**JAMES M. RUSSELL**

**STAFF OF THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**PSE Alternative Proposal for Post-Test Period Plant Additions**

**September 8, 2006**
**Revised September 14, 2006**

**Q. Are you the same James M. Russell who submitted response testimony on July 25, 2006 on behalf of Commission Staff?**

A. Yes.

**Q. Please summarize the purpose of your surrebuttal testimony.**

A. My surrebuttal testimony responds to the Company's proposed rate base adjustment for non-revenue producing, non-expense reducing post test year additions to transmission and distribution plant. This adjustment is described in the rebuttal testimony of Company witness John H. Story as an alternative to the depreciation tracker the Company proposed in its direct case.

**Q. Please summarize Staff's recommendation regarding the Company's alternative adjustment for post-test-period plant additions.**

A. Staff recommends that the Commission reject the Company's adjustment for the reasons I discuss later in this testimony.

**Q. Please describe the differences between Puget's original proposal for a depreciation tracker and the alternative adjustment for post-test-period plant additions described by Mr. Story in his rebuttal testimony.**

A. The original tracker proposal is described at page 24 of my response testimony, Exhibit No. __ (JMR-1T). In essence, it is a perpetual annual filing that applies a (virtually automatic) rate increase to recover the annual growth in total transmission and distribution depreciation expense. Puget's alternative proposal is a one-time revenue increase associated with certain rate base additions made during the nine month period that follows the test year in this case (October 2005 through June 2006). This alternative proposal includes recovery of depreciation expense and the return on the post-test-period rate base additions.

**Q. What concerns do you have with PSE's alternative adjustment for post-test-year plant additions?**

A. In my response testimony, I explained that the depreciation tracker should be rejected because it would set bad precedent, constitutes inappropriate single issue ratemaking, and is unnecessary given the Company's current utility earnings position and rate case frequency. Those concerns apply equally to Puget's alternative proposal. Three additional concerns I have with Puget's alternative proposal are that: 1) the rate base additions included in the proposal go beyond the test period in violation of the test period matching principle; 2) there is no way to verify, at this late stage of the proceeding (or ever), that the projects included in the proposal are in fact pure non-revenue producing and non-expense reducing rate base additions; and 3) non-revenue producing and non-expense reducing investments are made every year as part of the normal course of business.

**Q. Is Puget's alternative proposal the same as the alternative proposal offered by FEA's witness Mr. Smith?**

A. No, there are several major differences. The first is that Mr. Smith strongly opposes any adjustment for investments beyond December 2005. His main argument for that position is the same argument advocated by many other parties opposing the depreciation tracker: by going beyond the test period at all, the test-period matching principle is violated. I agree with that assessment.

Mr. Smith's proposal also excludes capacity enhancing plant additions because they are associated with customer growth (additional revenue). Puget's proposal unfairly includes capacity additions. Mr. Smith's proposal also includes an offset to account for the change in accumulated depreciation on existing transmission and distribution plant. Puget's proposal excludes this benefit. Finally, Mr. Smith's proposal would include only capital additions that are both non-revenue producing and non-expense reducing. In contrast, it appears from the workpaper underlying the Company's proposal that PSE included "non-revenue producing" capital investments which are expense reducing.[1]

**Q. Can the Commission verify whether the capital additions included within Puget's proposed alternative adjustment are truly non-revenue producing and non-expense reducing projects.**

A. No. Plant additions cannot be strictly classified in this manner since virtually every particular capital addition may have a range of revenue producing and/or cost reducing benefits associated with it. Therefore, verifying both whether each capital addition is truly non-revenue producing and non-expense reducing, and the amount of those benefits if any, will be extremely difficult, if not futile, and potentially

[1] The Company's workpaper is entitled "Non-revenue producing T&D investments Oct 1 05 to June 30 06". Staff Data Request No. 393(b) confirmed that that workpaper, filed in support of Ms. McLain's Exhibit No. __ (SML-5T), listed each project contained within PSE's alternative adjustment for post test period plant additions.

controversial. This assessment is not as black and white as Mr. Story would lead the Commission to believe.

**Q. In a general rate case review, does the Commission need to verify whether or not a particular capital project is non-revenue producing and non-expense reducing?**

A. No. In the standard rate-making formula the Commission does not have to address whether or not a particular capital project is non-revenue producing and non-expense reducing. All elements of the revenue requirement formula are measured over the same test period. If a capital addition produces revenue (or doesn't) the associated revenues received during the test period will be matched with the investment, and the relationship of ratebase, revenues and expenses will be maintained. This is the matching principle I referenced earlier that PSE's proposal violates.

**Q. Do you have any sense of the number of capital projects included within the nine-month period associated with Puget's proposal?**

A. Yes, the same Company workpaper I referenced earlier that underlies PSE's proposal includes over 20,000 separate projects. Neither Staff nor the Commission could possibly verify the Company's position that those projects (and the associated amounts) are non-revenue producing and non-expense reducing at this stage of the case or ever.

**Q. Does the Company make capital investments in non-revenue producing and non-expense reducing plant in the normal course of business, and, if so, can you give us a sense of the magnitude of those investments?**

A. Yes, there are non-revenue producing and non-expense reducing projects each year. That is the normal course of business in the utility industry. The Company was asked through Staff Data Request No. 393(c) to provide the amount of gas and electric capital additions classified in the same manner as in its alternative proposal for the years 2002 through 2005. The Company's response was:

> PSE does not keep fixed asset records that differentiate between "non revenue producing" assets and "revenue producing" assets. Data provided in Ms. McLain's non revenue producing workpaper were based on a specific customized analysis for the time period of October 2005 through June 2006 only.
>
> PSE data systems cannot automatically produce the net plant additions for 2002 through 2005. The customized analysis would take in excess of four weeks to complete.

**Q. Can non-revenue producing and non-expense reducing plant additions not result in the need to file rate cases every year?**

A. Yes. Customer growth usually provides incremental net margins that cover the revenue requirement associated with non-revenue producing and non-expense reducing plant additions. For instance, the incremental margin revenues associated with adding a new customer to the system is usually <u>higher</u> ~~lower~~ than the average net incremental cost.[2] This net incremental margin helps cover the investments that are at issue here.

[2] Costs net of line extension charges.

As I've stated previously in my response testimony, the ratemaking formula assumes a relatively constant relationship between revenues, costs, and rate base over time. Every so often a general rate case may be required to realign the relationship between these three elements.

**Q. Does standard regulatory accounting help address earnings impacts during periods of larger capital investment?**

A. Yes. Utilities are allowed to accrue interest and return costs (return rate) associated with funds supporting their construction activities. This is commonly referred to as accruing an Allowance for Funds Used During Construction (AFUDC). The return rate is applied to the Construction Work In Progress (CWIP) balance over the course of the year. One side of the accounting entry increases the CWIP balance as a result of capitalizing a return component. The other side of the entry is to the income statement and is reflected as interest income. This income statement impact results in higher earnings absent this regulatory accounting. Higher capital investments result in higher interest income, and therefore higher earnings, all else being equal. This accounting gives recognition to the investor for providing funds which support construction activities.

**Q. Please summarize your position on Puget's proposed alternative rate base adjustment.**

A. This proposal suffers from the same flaws as Puget's original depreciation tracker. In addition, the new proposal to go beyond the test period for rate base additions violates the ratemaking matching principle. Finally, there is no way for the Commission to verify whether all the proposed projects are truly non-revenue producing and non-expense reducing rate base additions. The alternative proposal should be rejected.

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

A. Yes it does.