Exhibit T- ___ (JMR-1T)
Docket Nos. UE-060266/UG-060267
Witness: James M. Russell

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** ***(consolidated)***

TESTIMONY OF

JAMES M. RUSSELL

STAFF OF THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Electric & Gas Revenue Requirements, Depreciation Trackers, and Power/Gas Supply Prudence

July 25, 2006
Revised August 8, 2006 (pp. 3-5, 7, 14-33)
Revised September 14, 2006 (pp. 11-13, 19)

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is James M. Russell. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504.

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

A. I am employed by the Washington Utilities and Transportation Commission as Manager - Energy Revenue Requirements.

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

A. Approximately 21 years, from June 1985 to the present.

Q. Would you please state your educational and professional background?

A. I graduated from Washington State University in 1983 receiving a Bachelor of Arts in Business Administration with a major in accounting.

My work at the Commission generally includes financial, accounting, cost of service, and other analysis surrounding general rate case proceedings, tariff filings, incentive proposals, special contracts, least cost plans, and various rulemaking proceedings involving investor-owned electric and natural gas utilities regulated by the Commission. Over my career at the Commission I have provided expert testimony in approximately 15 litigated general rate case proceedings and have helped resolve, and testified in, numerous negotiated electric and natural gas general rate case settlements before the Commission. I have also presented a wide range of Staff recommendations in many Commission open public meetings.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. Please describe the scope of your testimony and list the corresponding witnesses of Puget Sound Energy, Inc. (Puget, PSE, or Company) that you address.

A. I present Commission Staff's (Staff) recommendation regarding electric revenue requirement, gas revenue requirement, PSE's proposed electric and gas depreciation trackers, and continuation of the accounting for the Public Utility District No. 1 of Chelan County power supply contract and the Duke Energy Marketing and Trading pipeline capacity contract. I address issues covered in the testimony of Company witnesses Story, Karzmar, and McLain. I also explain that Staff has reviewed several new generation resources acquired by PSE, including the Wild Horse wind generation facility, and found them to be prudent.

Q. Please list the other Staff witnesses and their general area of responsibility in this proceeding?

A. There are three other Staff witnesses presenting testimony in this proceeding. Dr. Yohannes Mariam addresses the Company's proposed electric and gas weather normalization adjustment and underlying methodology. While he accepts the Company's adjustment for purposes of this case only, he proposes a number of recommendations for future rate cases in the area of data collection. Dr. Mariam also files joint testimony with Public Counsel and the Industrial Customers of Northwest

Utilities (ICNU) on adjustments related to power costs and the Company's proposed revisions to its Power Cost Adjustment mechanism.

Mr. Stephen G. Hill presents Staff's recommendation on fair rate of return. He recommends that rates be set using a return on common equity of 9.38% on a capital structure that contains 43% common equity. He recommends an overall rate of return of 7.85%.

Ms. Joelle Steward recommends that the Commission reject the Company's proposed gas decoupling proposal. In its place, she recommends a 3-year partial decoupling mechanism that, among other things, removes the protection from weather. Ms. Steward also recommends modifications to the Company's proposed Conservation Incentive Mechanism and Demand Response Program. Finally, Ms. Steward files joint testimony on gas rate spread, rate design and low income bill assistance with Public Counsel and the Northwest Industrial Gas Users (NWIGU). Her testimony on electric rate spread, rate design, and low income bill assistance will be filed jointly on August 23, 2006 with the Company, Public Counsel, ICNU, the NW Energy Coalition, the Federal Executive Agencies, the Energy Project and the Kroger Co., pursuant to the Partial Settlement Agreement filed today on those topics.

Q. Please summarize Staff's recommendation in these consolidated electric and natural gas dockets?

A. Staff recommends that the Commission:

1) Reduce the Company's electric service revenues by $40,700,000 (-2.4%) based on an overall rate of return of 7.85%.

2) Grant PSE an additional $19,349,000 (2.0%) in retail gas service revenues based on an overall rate of return of 7.85%.

3) Reject PSE's request for electric and gas transmission and distribution trackers.

4) Accept the joint recommendation of Staff, Public Counsel, and ICNU to keep the current Power Cost Adjustment (PCA) mechanism in place, but to include PSE's proposed revisions associated with its hedging line of credit.

5) Accept the Partial Settlement Agreement on electric rate spread, rate design, and low income bill assistance.

6) Accept the joint recommendation of Staff, Public Counsel and NWIGU on gas rate spread, rate design, and low income bill assistance.

7) Accept Staff's proposed partial gas decoupling pilot mechanism.

8) Accept Staff's proposal on the Conservation Incentive Mechanism and Demand Response Program.

Q. Are you sponsoring any exhibits in this proceeding?

A. Yes, I sponsor the following exhibits:

Exhibit No. ___ (JMR-2), Electric Result of Operations & Revenue Requirement
Exhibit No. ___ (JMR-3), PCA Baseline Rate
Exhibit No. ___ (JMR-4), Gas Result of Operations & Revenue Requirement
Exhibit No. ___ (JMR-5), PSE's Recent Utility Earnings
Exhibit No. ___ (JMR-6), Commission Order Excerpts on Attrition

III. ELECTRIC REVENUE REQUIREMENT

Q. Please begin by briefly describing Exhibit No. ___ (JMR-2), Electric Results of Operations and Revenue Requirement.

A. Page 1 of Exhibit___(JMR-2), the first column entitled "Actual Results of Operations", reflects the test year (October 2004 - September 2005) amounts and indicates that PSE earned a total rate of return of 9.20% on its electric operations in the test period (12.55% on equity). The second column entitled "Total Adjustments" is the sum of all the restating and pro forma adjustments shown on pages 2 through 5. The column entitled "Revenue Requirement Deficiency" shows the impact of Staff's recommended $40,700,000 retail revenue decrease, given the overall rate of return requirement of 7.85%, after accounting for the July 1, 2006 power cost increase of approximately $96 million in Docket No. UE-060783.

Pages 6 through 40 provide the back-up support for each of the restating or pro forma adjustments and the calculation of the revenue excess, overall rate of return, and conversion factor. For ease of comparison, the figures that have been shaded on my exhibit pages 6 through 40 indicate input differences from PSE's direct case, as revised on July 7, 2006, from those figures reflected in Mr. Story's Exhibit Nos. (JHS-4), (JHS-5), and (JHS-16).

Q. Turning to the restating and pro forma adjustments, please indicate which electric adjustments are uncontested by Staff.

A. The following adjustments are uncontested:

E.01 Temperature Normalization
E.04 Federal Income Taxes
E.06 Conservation
E.07 Bad Debts
E.08 Miscellaneous Operating Expense and Ratebase:
- .1 Amortization of Deferred Taxes Regulatory Asset
- .2 Amortization of Baker Hydro Project Seismic Studies
- .3 Oregon Property Taxes for 3rd AC
- .5 Tree Watch Expense
- .6 New York Stock Exchange Fees
- .7 Depreciation Expense on CWIP in Service
- .8 Ratebase Adjustments for CWIP in Service

E.09 Property Taxes
E.11 Excise Tax and Filing Fee
E.13 Montana Energy Tax
E.14 Interest on Customer Deposits

E.15 SFAS 133
E.17 Property Sales
E.18 Property and Liability Insurance
E.19 Pension Plan
E.20 Wage Increase
E.21 Investment Plan
E.22 Employee Insurance
E.23 Montana Corporate License Tax
E.24 Storm Damage
E.25 Regulatory Assets
E.28 General Office and Crossroads Relocation
E.29 Other Amortization
E.30 Demand Response Program
E.31 Depreciation and Amortizion

Q. Please indicate which electric adjustments are contested by Staff, either as to their amount or because of other related issues.

A. The following adjustments are contested:

E.02 Revenues and Expenses
E.03 Power Costs
E.05 Tax Benefit of Proforma Interest
E.08 Miscellaneous Operating Expense and Ratebase:
.4 Baker Hydro Project Relicensing Costs
E.10 Hopkins Ridge Wind Project
E.12 Director and Officer Insurance
E.16 Rate Case Expenses
E.26 Wild Horse Wind Plant
E.27 Incentive Pay
E.32 Production Adjustment

Q. Please describe the reason for the differences in amounts and/or theory for each of the contested electric adjustments, beginning with adjustment E.02 Revenues and Expenses.

A. **E.02 Revenues and Expenses**

My adjustment includes one revision to the Company's corresponding adjustment. Puget's pole attachment fees have increased since the test period. The Company did not make an adjustment to increase the level of revenue, so I have included a pro forma adjustment that increases revenues by $433,000 (see Exhibit No. ___ (JMR-2), page 7, line 13).

E.03 Power Costs

This adjustment restates power costs to the rate year level (January 2007 through December 2007) for purposes of calculating both the revenue requirement in this proceeding and for establishing a new Purchased Cost Adjustment (PCA) baseline rate. Through joint testimony with Public Counsel and ICNU, Staff witness Dr. Mariam addresses the calculation of the estimated rate year power costs, which are then factored back to the test year through "production factoring".

There are two other items that have been reflected in the Power Costs adjustment. One relates to a $1.4 million settlement payment PSE made to the Muckleshoot Indians during the test period. In its proposed adjustment, PSE spread this amount over 3 years and included one-third of the total amount. Staff's adjustment removes the settlement payment in its entirety since it is a non-recurring expense and is reflected in PSE's actual electric earnings during the test period of 9.20%. This expenditure should not be embedded in rates prospectively. If the

Commission allows some level of recovery, the costs should be spread over 5.4 years, which corresponds to the period covered by the settlement.

The second adjustment removes projected operating and maintenance cost (including contingencies) of $3.8 million that PSE pro formed into the rate year associated with re-licensing of the Baker River hydro-electric project. To date, Puget has not been granted a new license for the Baker hydro project from the Federal Energy Regulatory Commission (FERC). If the Company receives the FERC license prior to January 1, 2007, it would be appropriate to pro form an updated level of O&M expenses associated with the re-licensing requirements.

E.04 Federal Income Tax (FIT) and Accumulated Deferred FIT

In its revised case, Puget removed the tax reduction associated with the Section 199 domestic production tax credit. Staff does not dispute this change or the Federal Income Tax calculation itself. However, the revenue requirement impacts of the actual Section 199 deduction beginning with tax year 2005 should be deferred with carrying costs at PSE's authorized rate of return and considered as either a direct offset to deferred power costs or reserved for consideration in a future rate proceeding, whichever method would be more convenient and timely.

On a related topic, PSE proposes to reflect as a rate base reduction the average-of-monthly-averages (AMA) balance of accumulated deferred income taxes, rather than an end-of-period (EOP) balance. Staff does not contest this proposal. It is Staff's understanding that PSE is currently seeking a ruling from the Internal Revenue Service regarding whether the use of EOP deferred tax balances violates the current tax code in Puget's case. The use of AMA versus EOP deferred taxes also makes little difference in the overall revenue requirement determination in this case.

Finally, Staff accepts the Company's removal from rate base of the balance of the deferred tax accounts that were related to indirect overheads, consistent with the Commission's Order in Docket Nos. UE-051527 and UG-051528.

E.05 Tax Benefit of Pro Forma Interest

This is a standard ratemaking adjustment, also known as "interest synchronization", that adjusts the interest expense for tax purposes given the adjusted rate base and weighted cost of debt embedded in the overall rate of return calculation. The difference in the adjustment between Staff and the Company results from differences in the level of rate base and the weighted cost of debt proposed by Mr. Hill. The detailed calculation of this adjustment is shown on page 10 of Exhibit No. ___(JMR-2).

E.08.4 Baker Hydro Project Re-licensing Costs

This adjustment pro forms amortization expense and includes in rate base the net unamortized balance of the costs associated with the re-licensing of the Baker hydroelectric project, as discussed in adjustment E.4.03. Although Staff does not question the prudence of the project re-licensing, Staff opposes the Company's adjustment because it is still unknown whether FERC will grant the license by the time the revised rates from this proceeding go into effect. Therefore, PSE's adjustment is inappropriate because it presumes that the costs will be closed to plant in service with amortization starting in May 2006 and continuing over the 45 year life of the license. There are still pending licensing requirements to be satisfied, which warrant continued treatment of the costs as Construction Work in Progress (CWIP) until the license is granted.

E.08.5 Tree Watch

The amount of this adjustment is not in dispute. However, 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. Therefore, PSE proposes 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 subject to the following condition: 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.

Q. Why does Staff recommend this condition?

A. Staff is concerned that PSE may expend funds for the Tree Watch program at a level below the pro forma amount embedded in rates. This concern is validated by the fact that during the rate year following the 2004 general rate case, the Company actually spent approximately $111,000 less than the $2 million level. Therefore, Staff's recommended condition is fair and reasonable because any necessary under-spending would be applied against the deferred Tree Watch costs.

Q. Please resume your discussion of the contested adjustments, beginning with Hopkins Ridge.

A. **E.10 Hopkins Ridge**

The only difference in this adjustment is that I recommend the Commission require the Company to use a 25 year book life for accounting and ratemaking purposes, pending a depreciation study, rather than the 20 years assumed by the Company. It is my understanding that PSE is currently processing a comprehensive depreciation study. Pending this study a more conservative book life of 25 years should be adopted. Once a depreciation study is complete, the approriate book lives and resulting depreciation for these plants can be revised.

E.12 Director and Officer Insurance

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 directors and officers were also covered. My proposed adjustment allocates directors and officers insurance to Puget Energy's subsidiaries based on ~~the number of~~ an average of the following three factors between PSE and InfrastruX: 1) number of officers and directors; 2) assets; and 3) employees.

E.16 Rate Case Expenses

I have made two revisions to the Company's electric Rate Case adjustment that are reflected in my Exhibit No. ___(JMR-2), page 21. The first is to extend the amortization of the 2001 and 2004 rate case costs from 14 months to 24 months and 48 months, respectively (lines 7 and 15). I make this adjustment because PSE is in a transition period of "double recovery" of rate case costs. In Puget's last rate case, the Commission ordered the Company to stop deferring rate case costs and implement a "normlized" ratemaking approach for cost recovery. Both Puget's and my adjustment propose both an amortization and a "normalized" level going forward. Puget still has deferred rate case costs on its books that are being amortized through FERC account 928, Regulatory Commission Expenses. In order to minimize the effect of amortizating these prior deferred costs, I propose longer amortization periods for these deferred costs remaining on Puget's books.

The second change 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 Mr. Dubin's hydro analysis in the 2004 general rate case, Docket Nos. UG-040640 and UE-040641. These consulting fees are excessive for ratepayers given the inadequate contribution they made to the case, as reflected in the discussion of the Commission's Order in that Docket.[1] During the preparation of Puget's case in those dockets, the Company had less incentive to reduce rate case costs because it assumed that these costs would be deferred and amortized, dollar for dollar in prospective rates. In this case, the total estimate for Puget's rate of return witness, Dr. Morin is

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[1]The Commission stated, "We find that we can give little or no weight to Dr. Cichetti's DCF analysis or results.". *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640 and UE-040641, Order No. 06 at ¶ 51 (February 18, 2005). The Commission also stated, "Given that we accord little weight to Dr. Cichetti's DCF results, his CAPM and Risk Premium analyses stand for very little. We find we should give little weight to the results Dr. Cichetti reports or the basis of his CAPM and Risk Premium analyses." *Id.* at ¶ 58.

Also in that case, the Commission adopted Dr. Mariam's use of 50 year hydro because of his superior screening of the available hydro data, to which the Company ultimately agreed.

$55,000. There are no costs for hydro analysis because the precedent has been established.

E.26 Wild Horse Wind Plant

Like the Hopkins Ridge adjustment above, I recommend that the Commission adopt the use of a 25 year book life for the Wild Horse wind project depreciation, also pending the depreciation study being conducted by the Company.

E.27 Incentive Pay

Q. First, please describe "incentive pay" as the term is used in this case.

A. "Incentive pay" refers to compensation paid to an employee that is conditioned on the employee or the Company meeting certain results or goals that are specified in advance.

Q. Did PSE give compensation to its employees in the form of incentive pay in the test period?

A. Yes. PSE has two incentive pay plans. PSE "Goals & Incentive Plan" is available to all employees and payments are made in cash. The payments made under the Goals & Incentive Plan are spread to O&M accounts based on the overall labor charge distributions.

The "Long Term Incentive Compensation Plan" is available only to officers, and incorporates awards of common stock. Awards given under this plan are charged to FERC account 417 and, therefore, are not included for ratemaking purposes.

Q. Please discuss your adjustment to incentive pay.

A. I reduce electric O&M expenses by $1,597,000 by replacing the test year incentive payment with a 4-year average of incentive payments for the years 2003 through estimated 2006. Puget's adjustment reflects the average incentive payments for the years 2002 through 2005. Staff's updated average is more representative of expenses the Company will incur during the rate year because it removes the incentive payments related to an outdated plan and includes in the average an expected (normal) level under the current incentive payment plan.

My adjustment to incentive pay also includes removing stock equivalent payments made to Chief Executive Officer Steven Reynolds in lieu of the performance share grants awarded to other PSE executives, which are treated as non-operating expenses for ratemaking purposes.

Q. Please discuss the final contested adjustment, E.32 Production Adjustment, and your revisions.

A. The production factor is used to complete the pro forming of production costs from the forward looking "rate year" (January /07-December/07) level back to the pro forma "test year" (October/04-September/05) amount. In the power supply model run to support Dr. Mariam's pro forma rate year calculations, rate year levels of consumption are used rather than the test year level of consumption. In the model, and in other pro forma calculations, the costs for the future rate year amounts are considered. As that future rate year has a different level of consumption than the normalized historic test period, the production factor is applied to the rate year amounts to bring those pro forma rate year costs, on a unit basis, back to the historic test year.

This adjustment is a fallout adjustment that has been updated for Staff's rate year power cost expenses and production rate base levels. The production factor used in this adjustment is not at issue. This adjustment increases net operating income by $783,200 and decreases rate base by $10,868,000.

Q. Do you agree with Puget's proposed electric conversion factor of .62073?

A. Yes, the conversion factor used to convert electric net operating income to a revenue requirement level (accounting for taxes and other revenue sensitive costs) is not at issue.

Q. Have you prepared an exhibit page summarizing the differences between Puget's direct case, as revised, and the Staff revenue deficiency for Puget's electric operations in these dockets?

A. Yes, page 41 of Exhibit No.___ (JMR-2) compares PSE's proposed revenue deficiency of $42.9 million (excluding the Depreciation Tracker) reflected in its direct case, as revised, and Staff's proposed revenue excess of $40.7 million, by line item. It begins on line 1 with Puget's and Staff's actual "Per Book" net operating income revenue excess of $17.8 million (PSE) and $54.7 million (Staff) given overall pro forma rates of return of 8.76% and 7.85%, respectively. The net operating income, rate base, and revenue requirement impact of each subsequent restating or pro forma adjustment are shown on lines 2 through 41 that ultimately sum to the overall revenue deficiency amounts. This exhibit page is for illustrative purposes to indicate (in the last column) the differences between the Company's revised direct case at a positive $42.9 million and that of Staff's at a negative $40.7 million.

Q. Please explain Exhibit No. ___ (JMR-3), entitled "PCA Baseline Rate".

A. This exhibit is an accumulation of all the Power Cost Adjustment (PCA) elements, which are used as the basis for sharing in the PCA mechanism. This exhibit calculates the PCA baseline rate of $56.677 per Mwh at Staff's revenue requirement.

IV. GAS REVENUE REQUIREMENT

Q. Would you please briefly describe your Exhibit No. ___ (JMR-4), Gas Results of Operations and Revenue Requirement?

A. Page 1 of Exhibit___(JMR-4), the first column entitled "Actual Results of Operations", reflects the test year (October 2004- September 2005) amounts and indicates that PSE earned a total rate of return of 6.15% on its gas operations in the test period. The second column, entitled "Total Adjustments" is the sum of all the restating and pro forma adjustments shown on pages 2 through 4. The column entitled "Revenue Requirement Deficiency" shows the impact of Staff's recommended $19.3 million retail revenue increase, given the overall rate of return requirement of 7.85% recommended by Mr. Hill.

Pages 5 through 29 provide the back-up support for each of the restating or pro forma adjustments and the calculation of the revenue deficiency, overall rate of return, and conversion factor. For ease of comparison, the figures that have been shaded on my exhibit pages 5 through 29 indicate input differences from PSE's direct case, as revised on July 7, 2006, from those figures that are reflected in Mr. Karzmar's Exhibit Nos. (KRK-4) and (KRK-9).

Q. Turning to the restating and pro forma adjustments, please indicate which gas adjustments are uncontested by Staff.

A. The following adjustments are uncontested:

G.02 Federal Income Taxes
G.04 Conservation
G.05 Bad Debts
G.06 Miscellaneous Operating Expenses and Ratebase:
- .1 New York Stock Exchange Fees
- .2 Amortization of Deferred Taxes Regulatory Asset
- .3 Depreciation Expense on CWIP in Service
- .4 Rate Base Adjustment for CWIP in Service

G.07 Property Taxes
G.08 Excise Tax and Filing Fee
G.10 Property and Liability Insurance
G.11 Pension Plan
G.12 Wage Increase
G.13 Investment Plan
G.14 Employee Insurance
G.16 Interest on Customer Deposits
G.17 Deferred Gains/Losses on Property Sales
G.18 General Office Relocation
G.19 Low Income Amortization

Q. Please indicate which gas adjustments are contested by Staff, either as to their amount or because of other related issues.

A. The following adjustments are contested:

G.01 Revenues and Expenses
G.03 Tax Benefit of Pro Forma Interest
G.09 Rate Case Expense
G.15 Incentive Compensation

G.20 Directors and Officers Insurance
G.21 Everett Delta Pipeline Expansion
G.22 Spirit Ridge Adjustment

Q. Please describe the reason for the differences in amounts and/or theory for each of the contested gas adjustments, beginning with adjustment G.01 Revenues and Expenses.

A. **<u>G.01 Revenues and Expenses</u>**

PSE's witness Mr. Karzmar did not price out water heater rental revenues correctly in his corresponding adjustment 4.01. My correction results in additional revenues of $300,600 reflected in Exhibit ___(JMR-4), page 5, line 1, under the column entitled "Restated".

<u>G.03 Tax Benefit of Pro Forma Interest</u>

Like Electric Adjustment E.05, this adjustment updates the interest expense for tax purposes given the adjusted rate base and weighted cost of debt embedded in the overall rate of return calculation. The calculation of this adjustment is shown on page 7 of Exhibit No. ___ (JMR-4).

<u>G.09 Rate Case Expense</u>

Consistent with the Electric Adjusment E.16, I have removed one-half of the $791,000 paid to Pacific Economic Group related to Dr. Cicchetti's testimony on rate of return and Mr. Dubin's hydro analysis in the 2004 general rate case, Dockets UG-040640 and UE-040641.

G.15 Incentive Compensation

This adjustment is consistent with the electric counterpart (adjustment E.27) discussed above by replacing the test year payment with a 4-year average of incentive amounts for the years 2003 through 2006, rather than the average incentive payments for the years 2002 through 2005 used by PSE in its adjustment. Staff's adjustment reduces gas O&M expenses by $992,954 and is more representative of expenses the Company will incur while the proposed rates are in effect.

G.20 Directors and Officers Insurance

This adjustment is consistent with the electric counterpart discussed above (adjustment E.12) by allocating directors and officers insurance to Puget Energy's subsidiaries based on the three factors indicated above ~~number of PSE and InfrastruX officers and directors~~. All of the costs of Puget Energy's directors and officers insurance should not be assigned to the regulated operations of Puget Sound Energy since InfrastuX directors and officers were also covered.

G.21 Everett Delta Pipeline Expansion

This adjustment is associated with a sale and lease back of a pipeline in Everett, which is explained in detail in Mr. Karzmar's direct testimony. The only difference in the calculation of Staff's adjustment is related to the appropriate rate of return.

G.22 Spirit Ridge Adjustment

In September 2004, a house in Bellevue tragically exploded from a natural gas leak. As a result, PSE was required to take subsequent preventive steps to eliminate the chances of a repeat occurrence. This proposed adjustment removes the incremental non-recurring costs incurred in the test period associated with the accident.

Q. Do you agree with Puget's proposed gas conversion factor of .62160?

A. Yes, the conversion factor used to convert gas net operating income to a revenue requirement level (accounting for taxes and other revenue sensitive costs) is not at issue.

Q. Have you prepared an exhibit summarizing the differences between Puget's direct filed case, as revised, and Staff's revenue deficiency for Puget's gas operations in these dockets?

A. Yes, page 30 of Exhibit No. ___ (JMR-4) is a comparison of PSE's proposed revenue deficiency of $39.2 million (excluding the Depreciation Tracker) and Staff's proposed revenue deficiency of $19.3 million, by line item. It begins on line 1 with Puget's and Staff's actual "Per Book" net operating income revenue deficiency of $49.6 million (PSE) and $32.3 million (Staff) given overall pro forma rates of return of 8.76% and 7.85%, respectively. It then indicates the net operating income, rate base, and revenue requirement impact of each subsequent restating or pro forma adjustment (lines 3 through 27) that ultimately sum to the overall revenue deficiency amounts.

Like the electric counterpart, this exhibit page is for illustrative purposes to indicate (in the last column) the differences between the Company's direct case revenue deficiency of $39.2 million versus Staff's revenue deficiency of $19.3 million.

V. UTILITY OPERATIONS, EARNINGS, AND PUGET'S EXISTING REGULATORY MECHANISMS

Q. Does Company witness Ms. McLain's testimony regarding cost and reliability benchmarks, cost pressures, or future capital investment result in any quantifiable impact on the revenue requirement in this case?

A. No. Ms. McLain discusses certain cost metrics, cost pressures, and capital investment requirements going forward. However, none of the issues she discusses are converted into revenue requirements by Mr. Story or Mr. Karzmar.

Q. Ms. McLain also addresses certain metrics supporting her contention that Puget is an efficient, low cost utility. Do you have any comment about her testimony in this area?

A. Yes. I do not dispute Ms. McLain's testimony that Puget has lower non-production O&M costs on a per customer basis than many of its peers, as indicated in her Exhibit No. ___(LSM-3). However, single dimensional statistical comparisons, such as those offered by Ms. McLain, should be taken with a grain of salt. Ms. McLain's exhibit simply shows one element of Puget's cost structure (non-production O&M) and does not account for geographic differences such as local labor and material cost inputs, differences in system configuration, or customer densities. Multi-dimensional benchmarking would provide better comparisons.

Q. Ms. McLain discusses at pages 9 through 17 of her direct testimony increasing cost pressures, mainly on the gas side. Do you have any comment?

A. Yes. Many of these cost items Ms. McLain addresses are reflected in the test period results of operations. They are part of the reason why certain gas operating and maintenance accounts have increased by over $17 million since Puget's last general rate case.

Q. Turning to the Company's actual earnings, was the test period warmer or colder than normal?

A. The test period was approximately 6% warmer than normal. The test period heating degree days (a cumulative annual sum of the deviation in temperature below 65 degrees F) were 5,085 based on readings from SeaTac. Normal heating degree days are 5,399. As indicated above, and despite a warmer than normal test period, Puget earned 9.20% and 6.15% rates of return on regulated electric and gas operations, respectively. Its overall achieved rate of return was 8.23% (10.14% on equity).

Q. What have been Puget's regulated utility returns in the past four years?

A. Exhibit No. ___(JMR-5) includes a chart and data indicating actual earnings reflected in "Commission basis" reports for electric and gas operations individually and on a combined basis. It also shows actual results from the other Washington regulated electric and gas utilities on pages 3 and 4.

Q. Would these earnings have been higher or lower given normal weather?

A. Actual earnings would have been higher in years 2003 through 2005 given normal weather.

Q. Do the Power Cost Adjustment Mechanism (PCA) and Purchased Gas Cost (PGA) mechanisms have implicit earnings stabilization mechanisms to help protect the Company from deviations from normal weather?

A. Yes. The PCA insulates approximately 72%[2] of the Company's sales revenue requirement from the effects of weather variability. The PGA insulates approximately 69% of the Company's sales revenue requirement from the effects of weather variability. Revenues derived from basic charges, demand charges, and base usage are also collected irrespective of weather.

Q. Are there regulatory mechanisms that Puget has that other Washington regulated electric utilities do not have?

A. Yes. Neither Avista nor PacifiCorp have a Power Cost Only Rate Case (PCORC) process or authority to defer storm damage costs. Puget's PCORC allows huge production and transmission assets and changes in power supply costs to be put in rates on an expedited basis. Puget's electric storm deferral insulates the Company from any storm-related costs above an annual amount of $7 million. PSE has already triggered the deferral of storm damage costs for this calendar year.

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[2]Prior to consideration of the sharing band feature of the PCA.

Q. Are there cost disallowances that the Company faces that create additional pressure for Puget to push for higher regulated returns or seek regulatory mechanisms that enhance earnings?

A. Yes. The Commission has disallowed certain power costs related to the Tenaska and March Point generation facilities in prior cases. These disallowances continue today. While they are not reflected in Puget's regulated rates of return discussed above, they are included in the returns reported to shareholders. PSE cannot otherwise offset these regulatory disallowances through the ratemaking formulae other than to continue to propose rate increases and seek other regulatory mechanisms.

VI. ELECTRIC AND GAS DEPRECIATION TRACKERS

Q. Please describe PSE's proposed electric and gas "Depreciation Tracker".

A. The Company proposes a surcharge and deferral mechanism for depreciation, a single cost element within the Company's total cost of service. The proposal is described in detail in Mr. Story's direct testimony at pages 72 through 78, but basically, the Company proposes an annual filing that results from comparing a <u>**forecast** of depreciation expense</u> with the <u>expected recovery</u> of depreciation for the coming year (expected recovery = the embedded unit depreciation rate times the forecast volumes for the coming year). The absolute difference between the forecast depreciation expense and the forecast recovery of depreciation forms the basis for determining the prospective tariff unit surcharge tracker rates beginning the first of each year (see table on page 74 of Mr. Story's testimony). The Company also proposes a deferral account to subsequently track the difference between the actual depreciation expense in the forecast period and the actual recovery of depreciation expense during the same period.

Q. What is your position on PSE's proposed depreciation trackers?

A. The proposed depreciation trackers should be rejected for several basic, but very important reasons. First, the proposed depreciation trackers would set bad precedent. Second, they constitute inappropriate single issue ratemaking. Lastly, they are not necessary given PSE's current earnings position and rate case frequency.

Q. Why do you believe approval of the proposed depreciation trackers would set bad precedent?

A. The Commission's general policy is to approve trackers, deferrals, and the creation of regulatory assets only on a very limited basis for the following circumstances:

- To address narrow, material, cost items that have no offsetting savings and are beyond the utility's control, such as certain energy costs;

- To spread certain major cost items over the proper generation of ratepayers, such as the deferral of the $89 million Chelan Payment (See Mr. Story's direct testimony beginning at page 78); and

- To create the proper incentives in narrow targeted areas, such as certain demand side management costs.

If the Commission broadens its policy to include trackers for such basic cost of service items like depreciation, it sets bad precedent because trackers generally remove the incentive to achieve offsetting efficiencies associated with the particular cost item being tracked. It would also send a bad signal to regulated utilities and potentially open the door for all kinds of single cost item tracker proposals.

Q. Please expand upon your contention that the depreciation trackers constitute single issue ratemaking.

A. As I've indicated above, depreciation is a single cost element within Puget's total cost of service. To allow guaranteed recovery of this broad cost element constitutes "single issue ratemaking" that ignores the fact that other cost of service elements may be creating downward pressure on rates. For instance, as plant depreciates into the future, the return requirement declines. When new plant replaces old plant there are generally offsetting operation and maintenance savings and the depreciation on the old plant ceases. Increases in plant associated with adding customers create offsetting revenue benefits. Tax depreciation associated with adding new plant creates federal income tax benefits. A prudent utility continually seeks opportunities for cost savings and efficiency improvements. The proposed depreciation trackers reduce the incentive of a utility to pursue those opportunities.

In summary, all offsetting cost savings and efficiencies realized by the utility are kept for shareholders, while a single cost element that might be increasing, depreciation expense, is passed directly on to customers through the tracker. The general rate case process, rather than a tracker, is the appropriate arena to address whether new capital investments, and the associated depreciation, are prudent and used and useful before allowing the appropriate return of, and on, such investments (as well as all other net changes in costs and revenues) to be included in customers' rates.

Q. PSE has filed "attrition studies" to support its need for the depreciation trackers. Would you define "earnings attrition" in the ratemaking setting?

A. Earnings attrition (attrition) is a material reduction in return as a result of adverse changes in the relationship between revenues, expenses, and rate base that is expected to occur in the first year rates become effective. If the relationship between revenues, expenses, and rate base is expected to materially effect the rate year rate of return from the fully pro formed historical test period, there may be positive or negative attrition in earnings going forward.

Q. Why do you claim that a "material reduction in return" is the standard for allowing an attrition adjustment?

A. Attrition adjustments are very subjective, because they go well beyond the established "known and measurable" test[3] in ratemaking. The Commission has accepted attrition adjustments where there is clear and convincing evidence that the utility has no reasonable opportunity to earn a fair rate of return in the rate year. Excerpts of relevant Commission decisions are contained in Exhibit No. __ (JMR-6).

Q. Are PSE's "attrition studies" in Mr. Story's Exhibit No. ___ (JHS-12) (electric) and Mr. Karzmar's Exhibit No. ___ (KRK-6) (gas) the standard, comprehensive studies historically accepted by the Commission to support an attrition adjustment?

[3]See WAC 480-07-510 (3)(b)(ii).

A. Attrition adjustments have not been proposed by any energy utilities in Washington since Washington Natural Gas Company's general rate case in 1992 (Docket No. UG-92840). However, the answer to your question is "No", again based on the more recent Commission Orders that resulted in Commission acceptance of an attrition adjustment. Puget's analyses are not representative of attrition studies accepted by the Commission, but, rather, are simply forward projections based on comparisons between two rate case test periods. The 2005 test period is based upon Puget's position as reflected in its direct case. I will address later whether these studies support the depreciation tracker proposed by the Company.

Q. How have the most recent attrition studies been done in prior cases before the Commission?

A. Based on my review of the record, attrition studies have been very rigorous, complex (and contentious) economic studies that project a utility's ability to earn its authorized rate of return in a future period. The rate of return deficiency between the fully pro formed test period, after the effect of new rates, and the projected period earnings is calculated and converted into revenue requirement, which is then added to the total revenue deficiency. An attrition adjustment basically takes the leap to future test period ratemaking. There are many economic variables and assumptions that went into attrition adjustments accepted by the Commission to determine whether a utility has the ability to earn its authorized return in a future period, not just a comparison, like PSE's, between two historical test periods.

Q. Do you have any particular criticisms of PSE's gas attrition presentation reflected in Exhibit No. ___(KRK-6)?

A. Yes. The growth rate for revenues is grossly understated, especially in light of a decoupling mechanism. There were substantial, and steady price increases, in the cost of natural gas from the end of 2002 ($.28 per therm) to the end of the test period ($.68 per therm). As a result, the average use per customer declined. Since 2005 and 2006 commodity rates have stabilized and it is unreasonable to assume this same decline in customer use will continue into the rate year. In any event, if customer use does decline, the partial decoupling mechanism recommended by Ms. Steward will restore margins to the test period level. Revenues will grow in direct relationship with the number of customers, not on the difference reflected between the 2003 and 2005 test periods. In addition, it is speculative that cost increases of the magnitude incurred during these two periods will continue into the future.

Q: Would you address your last general point that the depreciation trackers are not necessary given PSE's current position and rate case frequency?

A. Yes. PSE's recent "Commission basis" utility earnings have been good, especially in light of warmer than normal weather. Exhibit No. ___ (JMR-5) shows Puget's actual achieved electric, gas and combined utility returns for the past four years. Each year from 2003 through 2005 was warmer than normal, which actually depressed earnings. PSE's electric operations are doing surprisingly well given these circumstances. Had there been normal temperature years, both the electric and gas earnings would have been higher. Over this same period, PSE's equity ratio increased from 33% to 40% (page 2). In addition, PSE is currently in a relatively low interest rate environment, has good customer growth rates, and has been filing rate cases on a regular basis.

Finally, the depreciation tracker proposed by PSE exceeds the limits of rationale and balanced ratemaking, given all the risk mitigating mechanisms currently available to PSE, including Puget's Purchased Gas Adjustment, Power Cost Only Rate Case procedure, Power Cost Adjustment, storm damage deferral, and the myriad of regulatory assets to go along with the partial gas decoupling mechanism and increases in the gas basic charges recommended by Ms. Steward.

VII. RESOURCE AND CONTRACT PRUDENCE

Q. Mr. Russell, does your Exhibit No. __ (JMR-2) reflect any new resources acquired by PSE to manage its electric supply portfolio?

A. Yes. Exhibit No. __ (JMR-2) includes the following three new resources:

- Acquisition of the Wild Horse Project wind generating facility located near Ellensburg, Washington;
- Execution of a new 20-year purchased power agreement with OrSumas, LLC for the entire output of a 4.95 MW recovered energy generation power facility at Sumas, Washington ("ORMAT PPA") and
- Relicensing of the Company's Baker River Hydroelectric Project.

Q. Are there other resources or contracts addressed in Puget's direct case?

A. Yes, Puget requests that the Commission deem prudent two additional contracts that will provide future benefits:

- Execution of a new 20-year purchased power agreement and related transmission agreement with Public Utility District No. 1 of Chelan County ("Chelan PUD"), Washington for 25% of the output from the Rock Island and Rocky Reach Hydroelectric Projects ("Chelan Contract") beginning in 2011;

- Acquisition, effective January 1, 2006, of additional long-term gas pipeline transportation capacity held by Duke Energy Trading and Marketing on the Westcoast Energy Pipeline and Northwest Pipeline ("DETM") that Puget expects will be needed immediately and beginning 2010, respectively.

Q. Did Staff evaluate the prudence of these five new resource acquisitions?

A. Yes. That evaluation was performed by Mr. Henry McIntosh using the Commission's established standard for reviewing the prudence of power generation asset acquisitions and certain contracts. Mr. McIntosh is no longer employed at the Commission. However, my understanding is that he concluded that the Company's new acquisitions were prudent. Should any other party present evidence that contradicts his conclusion, Staff will evaluate that evidence and respond if appropriate.

Q. When is the Wild Horse Project expected by PSE to become operational?

A. In December 2006.

Q. Do you have any recommendation if Wild Horse does not become operational until after January 1, 2007 when rates in this case are expected to go into effect?

A. Yes. Consistent with how Hopkins Ridge was treated for PCA accounting purposes in Docket No. 050870, I recommend that if the Wild Horse Project is not operational by January 1, 2007, PSE should add the fixed costs and rate base associated with that facility to its Power Cost accounting only as of the date that the facility is placed into service. In the interim, PSE should replace the projected Wild Horse Project fixed and variable costs with variable costs associated with obtaining any replacement power.

PSE should also true up its projected costs for the Wild Horse Project to actual in its PCA accounting. The Company would bear the burden in its annual PCA true up filings to show the prudence of any costs for Wild Horse above the amount included within the Company's compliance filing in this proceeding.

Q. Has the Commission already addressed the interim accounting for the Chelan and DETM contracts pending a prudence determination?

A. Yes. In Mr. Story's direct testimony at page 78 he states that the Company expects to file an accounting petition to request that the Commission grant authority to defer the costs associated with a one-time, up-front payment of $89 million to Chelan County PUD. On April 10, 2006, Puget filed that accounting petition in Docket UE-060539, which the Commission approved on April 26, 2006.

Company witness Mr. Donahue discusses the benefits of the DETM contract and the interim accounting that was approved by the Commission in Docket No. UG-060019 on January 25, 2006.

Q. Do you recommend that the interim accounting approved for the Chelan and DETM contracts, be approved on a going-forward basis?

A. Yes, if the Commission approves the prudence of these contracts, the temporary accounting authority approved in the two prior accounting petitions should be authorized going forward.

Q. Does this conclude your testimony?

A. Yes.