BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION

In the Matter of the Proposal by)
)
PUGET SOUND POWER & LIGHT)
COMPANY)
) DOCKET NO. UE-951270
to Transfer Revenues from PRAM)
Rates to General Rates.)
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In the Matter of the Application)
of)
)
PUGET SOUND POWER & LIGHT)
and)
WASHINGTON NATURAL GAS COMPANY) DOCKET NO. UE-960195
) VOLUME 4
For an Order Authorizing the) Pages 289 - 519
Merger of WASHINGTON ENERGY)
COMPANY and WASHINGTON NATURAL)
GAS COMPANY with and into PUGET)
SOUND POWER & LIGHT COMPANY, and)
Authorizing the Issuance of)
Securities, Assumption of)
Obligations, Adoption of)
Tariffs, and Authorizations)
in Connection Therewith.)
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A hearing in the above matter was held on August 1, 1996, at 9:05 a.m. at 1300 South Evergreen Park Drive Southwest, Olympia, Washington before Chairman SHARON L. NELSON, Commissioners RICHARD HEMSTAD and WILLIAM R. GILLIS and Administrative Law Judges MARJORIE R. SCHAER and JOHN PRUSIA.

Cheryl Macdonald, CSR
Court Reporter

The parties were present as follows:

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION STAFF, by ROBERT CEDARBAUM, Assistant Attorney General, 1400 South Evergreen Park Drive Southwest, Olympia, Washington 98504.

FOR THE PUBLIC, ROBERT F. MANIFOLD, Assistant Attorney General, 900 Fourth Avenue, Suite 2000, Seattle, Washington 98164.

PUGET SOUND POWER & LIGHT COMPANY, by JAMES M. VAN NOSTRAND, Attorney at Law, 411 - 108th Avenue NE, Bellevue, Washington 98004.

WASHINGTON NATURAL GAS COMPANY, by MATTHEW R. HARRIS, Attorney at Law, 6100 Columbia Center, 701 Fifth Avenue, Seattle, Washington 98104.

NORTHWEST INDUSTRIAL GAS USERS, by EDWARD FINKLEA, Attorney at Law, 101 SW Main, Suite 1100, Portland, Oregon 97204.

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES, by CLYDE H. MACIVER, Attorney at Law, 601 Union Street, 4400 Two Union Square, Seattle, Washington 98101.

WASHINGTON WATER POWER COMPANY, by DAVID MEYER, Attorney at Law, 1200 Washington Trust Building, Spokane, Washington 99204.

PUBLIC POWER COUNCIL, by SHELLY RICHARDSON, Attorney at Law, 1300 SW Fifth Avenue, Suite 2300, Portland, Oregon 97201.

SEATTLE STEAM COMPANY, by FREDERICK O. FREDERICKSON, Attorney at Law, 33rd Floor, 1420 Fifth Avenue, Seattle, Washington 98101.

WASHINGTON PUD ASSOCIATION, by JOEL MERKEL, Attorney at Law, 1910 One Union Square, 600 University Street, Seattle, Washington 98101.

CITY OF SEATTLE, by WILLIAM H. PATTON, Director Utilities Section, 10th Floor Municipal Building, 600 Fourth Avenue, Seattle, Washington 98104.

APPEARANCES (Cont'd.)

PUD NO. 1 OF SNOHOMISH COUNTY, by ERIC E. FREEDMAN, Associate General Counsel, 2320 California Street, Everett, Washington 98201.

IBEW LOCAL 77, by LEWIS ELLSWORTH, Attorney at Law, 27th Floor, One Union Square, 600 University Street, Seattle, Washington 98101.

I N D E X

P R O C E E D I N G S

JUDGE SCHAER: The hearing will come to order. This is a second day of hearing in docket No. UE-951270 and docket No. 960195. Would you like to call your witness to the stand, Mr. Van Nostrand.

MR. VAN NOSTRAND: Thank you, Your Honor. The joint applicants call Richard Sonstelie.

Whereupon,

RICHARD SONSTELIE,

having been first duly sworn, was called as a witness herein and was examined and testified as follows:

DIRECT EXAMINATION

BY MR. VAN NOSTRAND:

Q. Can you state your name and spell it for the record, please.

A. It's Richard R. Sonstelie, S O N S T E L I E.

Q. And you have before you what's been marked for identification as Exhibits T-1 and T-36?

A. Yes, I do.

Q. And do you recognize those documents as your prefiled direct testimony and supplemental direct testimony in this case?

A. Yes, I do.

Q. And if I asked you the questions set forth in those exhibits today, would you give the answers as set forth in that exhibit?

A. Yes, I would.

Q. And do you also have before you what's been marked for identification as Exhibit 2?

A. Yes.

Q. And was that prepared under your direction and supervision?

A. Well, it's a map, and the map wasn't prepared under my supervision, but the exhibit was forwarded under my supervision and direction.

Q. Is it true and correct to the best of your knowledge?

A. Yes, it is.

MR. VAN NOSTRAND: Your Honor, I would move the admission of Exhibits T-1 and T-36 and 2.

JUDGE SCHAER: While we were off the record I indicated that Mr. Sonstelie's supplemental testimony would be identified as Exhibit 36, and it is so identified. Is there any objection to the entry of these documents? Hearing none Exhibits T-1, 2 and T-36 are admitted.

(Marked and Admitted Exhibit T-36.)

(Admitted Exhibits T-1 and 2.)

MR. VAN NOSTRAND: Mr. Sonstelie is available for cross-examination.

JUDGE SCHAER: Before we begin the cross, let me note that the appearances of counsel here today are the same as yesterday with the exception of Mr. Finklea appears to be here for Ms. Pyron. Would you like to briefly appear, Mr. Finklea.

MR. FINKLEA: Thank you, Your Honor. I am Edward A. Finklea from the law firm of Ball Janik LLP in Portland, Oregon, and I am appearing here on behalf of Northwest Industrial Gas Users.

JUDGE SCHAER: Do you have questions for Mr. Sonstelie, Mr. Cedarbaum?

MR. CEDARBAUM: Yes, we do.

CROSS-EXAMINATION

BY MR. CEDARBAUM:

Q. Morning, Mr. Sonstelie.

A. Morning, Mr. Cedarbaum.

Q. You indicate on page 1 of your testimony that if the merger is approved that you will be the chairman and CEO of NewCo?

A. Yes, that's right.

Q. I would like to start off with a few questions about some general principles and your

understanding of those principles as chairman and CEO of NewCo. And would you agree with, first of all, with the principles -- with the principle that customers of both electric and gas operations should not be worse off with the merger than without the merger?
A. Yes.
Q. Would you also agree with the principle that because of the merger all customers of both electric and gas should benefit from cost savings that would keep rates lower than they would have otherwise been without the merger?
A. Yes.
Q. And would you agree with the principle that the anticipated benefits from merging of Puget/ Washington Natural should be equitably shared among gas and electric operations?
A. Yes, knowing that the word "equitably" is subject to some discussion, but the concept I certainly agree with.
Q. And would you also agree with the principle that the quality and reliability of service to customers should not be harmed?
A. Yes.
Q. And the safety of employees should not

suffer?

A. Absolutely.

Q. Do you agree that it's NewCo's burden to demonstrate that these principles are fulfilled by its merger?

A. I'm sorry, would you repeat the question.

Q. Do you agree that it is NewCo's burden to demonstrate that these principles have been satisfied by the proposal?

A. Mr. Cedarbaum, I'm not sure if the question gets to what the test is that the Commission has to apply, and I don't have a lot of expertise on that. I clearly think we will be able to show definitively in this case that the issues you went down are met, but if you're asking for some legal interpretation as to what standard, I don't know that, but we certainly believe we can and will prove that the tests that you went through are met.

Q. And you believe it's your responsibility to make that demonstration?

A. I don't know whether it's our legal responsibility but I think it is our -- my management responsibility, our management responsibility as a team to show that, yes.

Q. You don't -- okay. Looking at your direct

testimony at page 2, you state that the merger is good for investors. This is down at the bottom. Do you see that?
A. Yes.
Q. And then you also state on page 3 that the merger is good for communities because NewCo will be financially more flexible and stronger in meeting community's changing needs; is that right?
A. Yes, I did.
Q. Would you agree that stronger reputation and being more responsive in meeting community's needs will enhance NewCo's corporate image and that would also benefit shareholders?
A. I think it would benefit everybody if communities think of Puget Sound Energy as a strong corporate citizen. I think everyone would benefit from that. Shareholders would among others.
Q. So there's no doubt in your mind then that the merger would be a benefit for shareholders?
A. Let me answer it this way. If we are able to achieve the sorts of savings that we have indicated are our goals, it will be a benefit for shareholders, and it is my belief that with a lot of effort we can do that. We must do that, so if that happens it will be a benefit to shareholders.

Q. And then would you then agree with the principle that shareholders since they would benefit from the proposal should bear an equitable share of the costs to implement the proposal? Without quibbling over what equitable might mean?

A. Well, no, I don't think I would phrase it that way. I think what I would say is the risks associated with it -- this is not a riskless new venture. It's a venture with significant risks, and I think the risks among the parties must be appropriately balanced and some portion of that risk must clearly be risk that management and therefore the shareholders of the company bear.

Q. I guess what I'm talking about are costs related to implementing the merger such as the transaction costs that Mr. Flaherty refers to, severance pay packages, things like that, and my question is, if shareholders benefit from the merger, is it your testimony that they should or should not bear a portion of the costs, an equitable portion of the costs to implement the merger?

A. No, that isn't my testimony. I really believe it has to do with the risks. If the net in this merger is that there are costs rather than net benefits, then, you know, the merger shouldn't go through. It should go through on the basis that there are net benefits to the parties not net costs. So the key is an appropriate sharing of the risks of producing net benefits as opposed to an assigning of costs. I mean, the company will continue, Mr. Cedarbaum, to be, I believe, in the long run to be cost of service regulated. I mean, we're talking about distribution companies to a great extent, but the real issue I think in the proposal is the sharing of the risks.

Q. Do the risks --

JUDGE SCHAER: Mr. Cedarbaum, excuse me. We have persons listening in on this hearing through the Commission's bridge line which means that people need to be speaking into the microphones and someone has already called to complain that they can't hear you. Would you please pull your microphone up.

MR. CEDARBAUM: Sorry about that.

Q. Do the risks that you've just been discussing, Mr. Sonstelie, include the types of costs that are incurred to carry out the merger such as professional, legal fees, banker fees, severance pay packages, things like that?

A. Well, those costs are an aspect of the net of the benefits, so to the extent that those are costs that are netted against benefits, then they are a part of the merger. They're not unrelated to the merger.

Q. Switching to another topic. It is true that under the merger agreement this Commission's approval among other governmental authorizations is a condition to consummation of the merger?

A. That's correct.

Q. Is it true that Commission approval of a rate stability plan in the exact structure that you've submitted would not be a condition to consummation of the merger?

A. I don't know the answer to that because I don't know what other alternatives, you know, could be offered. I mean, we're not going to take the position at this point in the hearing that there is only one possible way that this merger could go through. On the other hand, we believe we submitted a very beneficial way for all parties to have this go through, and so we're not going to sit here and sort of start at this point bargaining as to what is necessary, but some sort of plan that deals with costs, risks, et cetera, must be part of the merger approval.

Q. So with respect to a rate stability plan, it is not necessary for the exact form of the proposal to be approved, but that something along the lines of the general goals and philosophy behind that proposal?

A. Well, I can't answer yes to that. I would state it this way if this is helpful. That we're not the kind of company now nor do we want Puget Sound Energy to be the kind of company that says there's only one way to do things and it's our way. We are certainly open to alternative ideas.

Q. And that would include alternative ideas with respect to a rate stability proposal?

A. Yes.

Q. Is it true that under the merger agreement consents or approvals must not impose terms or conditions that would have an adverse impact on the merger?

A. Yes, that's correct.

Q. Is it correct that the market transition plan that you've discussed in your Exhibit T-36 would not be a condition to consummation of the merger? At least there's no mention of it in the merger agreement.

A. That the specific market transition plan there is not a condition of the merger, that's correct.

Q. And so -- let me ask you directly, I guess.

Is approval of the market transition plan a condition of the merger?

A. I'm sorry, would you define what you mean by the market transition plan? Do you mean schedule 48?

Q. Well, the market transition plan that you describe in your testimony, and I believe Mr. -- I'm not sure. I think Mr. Amen has some discussion of that as well. I guess my question is, are the elements of those, of the market transition plan, for example, schedule 48, if those elements were not implemented, are those -- would that materially impact the parties to result in the merger being terminated?

A. Well, now I think I understand the question a little better. There's not a tie that says if schedule 48 is not approved that means the merger can't go through. I will tell you that I think dealing with the issues raised competitively for us right now is absolutely vital and must be done quickly, and schedule 48 is, I believe, a very responsible way to deal with that.

Now, the other elements of that what you refer to as the market transition plan that are beyond schedule 48, I don't think it's fair to characterize, Mr. Cedarbaum, that we've submitted a plan there. I mean, we've indicated here are additional steps that we're committed to. I don't think there's anything for the Commission to approve or disapprove.

Q. I understand now. With respect to schedule 48, is it correct that if schedule 48 is approved and subscribed to by all eligible customers there would be a short run material adverse impact on the applicant's financial condition? There would be an earnings loss?

A. There would start to be by 1998, and it would potentially increase beyond that. Again, you have to make assumptions about what the markets are.

Q. Do you know what that amount is?

A. Well, I don't know what that amount is because it will be what it's going to be, you know, out there, because that depends on if you're remarketing power that you're no longer marketing to that group, what can you market for, but I believe we have submitted some numbers in the discussion of schedule 48 that say with a certain set of assumptions -- and I don't remember them in detail -- by the end of that time, when the transition charge is gone that that revenue shortfall would be on the order of $30 million a year.

Q. Would you accept subject -- strike that. Does that type of negative impact trigger the company's ability to -- I don't know if it would be to terminate the merger but to request that rate stability proposal be eliminated?

A. Absolutely not. We're committed to the fact that we will take on the risk associated with mitigating those revenue losses and that those risks will not be passed on to other customers.

Q. In your supplemental testimony -- this is in Exhibit T-36 -- at page 3, line 5, you indicate that the direct and indirect benefits that would be produced by the merger make the transition plan possible under the market transition plan. Do I gather from that testimony, then, that if the merger is denied the market transition plan will not go forward?

A. No. I think we've made a bit of an adjustment in terms of what our thinking is on that, because I think we've indicated that it would be acceptable to us to have schedule 48 put in effect by the Commission with a date of -- a 1998 date that said that if the merger had not been approved that the schedule would be withdrawn, in other words, customers could go on the schedule with the understanding that that could be withdrawn at that point because that's the first time, 1998 is the first time, that there would start to be a revenue shortfall associated with schedule 48. So we would be comfortable doing that, and I don't think it changes the fact that the direct and indirect benefits are very critical to this, but that's somewhat of a variation on the original.

Q. So absent the merger, then, schedule 48 can go forward?

A. No. After the merger -- absent the merger what we're saying is we would -- we believe -- can I get a little bit of background? We believe that it's very important that we address this competitive issue that we have and the competitive issues that our customers, these large customers, have in competing in a global environment as quickly as possible and give them some assurance as to how that will be dealt with. Therefore, it would be acceptable to us if schedule 48 were put in place with a proviso that if the merger is not approved it would no longer apply unless Puget came back to the Commission and asked the Commission to continue it in 1998.

Q. Assuming that the merger is denied then, what would Puget's response be to solve the competitive problems that you've just identified?

A. I don't know. I think it would be much more difficult to produce the savings that would make that schedule 48 response, which I think is a very appropriate response to the competitive environment, to make that one that didn't cause significant financial harm, but the reason I say that we would maintain the ability to extend schedule 48 beyond '98 is we would certainly do everything we could to continue schedule 48 or some other alternative that addresses the very real competitive issues that are out there.

Q. Has a list of items been created other than schedule 48 that would outline what those actions might be?

A. No, I don't, because frankly, Mr. Cedarbaum, we've been working so hard since this time last year to put together a plan called this merger proposal that we think does address these issues that I haven't spent time, and I don't think anybody else has, developing alternative plans. It's taken our full energy to develop this plan and have the detail with it and the schedule 48 proposal itself, so we don't have those.

Q. Turning to page 2 of your testimony, at lines 8 through 10, you indicate that the merger will give customers more choice in energy options. Do you see that?

A. Is this my direct testimony?
Q. Yes, page 2 of your direct testimony.
A. Yes, I do see that.
Q. Is it your suggestion in that testimony that Washington Natural is not doing or has not been doing all it can to attract customers to gas use?
A. No, that's not my testimony. Matter of fact they're doing a very good job; where natural gas is available people are overwhelmingly choosing natural gas for heating and water heating. What this really indicates, Mr. Cedarbaum, is that we believe that Puget Sound Energy, because of the improved economics that we think are going to result from greater efficiencies, some other things covered in Mr. Vititoe's testimony, is going to in fact enhance, increase the availability of natural gas, so it will be a better situation than today not because Washington Natural Gas is doing a poor job in that. In fact I think they're doing an excellent job, but the economics of extension of natural gas service, I believe, will be significantly enhanced.
Q. I will ask you why you say that in a minute, but let me first ask you, is your answer essentially the same for Puget, that with respect to how Puget has been attracting customers in the past --

and currently your testimony doesn't suggest that it hasn't been doing whatever it can for that purpose?

A. I'm sorry. For the purpose of getting them to use natural gas?

Q. No, I'm sorry. Electricity.

A. No. I think we've been doing everything we can to keep our costs down to be able to extend service in as effective a way as we can. We have not been -- Mr. Cedarbaum, we have not been pushing electricity as the best choice for customers for heating and water heating for quite some time on the belief that that is not in fact the best choice for customers. We have very smart customers so they didn't need Puget to help them figure that out.

Q. Can you explain now why you testified earlier you think NewCo will enhance the ability for customer choice?

A. Yes, I will. Several different ways. One is I think by virtue of being able to work together in extending service with, for example, what's called unity trenching where you have a single crew that goes out and works on extending the service. We have some studies that indicate that that saves significantly over two different companies going out, or even if they go out simultaneously it's still less expensive to do it that way. That's a fundamental improvement in the economics of extending gas service.

A second example is we have ongoing a significant cable replacement program, and it's one that I think the Commission is aware of that extends over many years. There are real opportunities when that trench is open, again, to extend natural gas service in areas where it doesn't happen to be already, and again, the economics are just improved, so it's beyond sort of a -- there's one piece that's a philosophy of wanting to extend gas service because we believe giving customers those choices is going to be very important. It's also the fact that in a number of different ways -- and Mr. Vititoe can speak to this because he's really looked at a lot of the operations areas more than I have -- that the fundamental economics of extending that service will in fact be better.

Q. Let me follow that up with respect to the issue of competition. Is my understanding correct, then, that the competition we're talking about is not competition between Washington Natural and Puget but the competition of a joint utility, NewCo, versus others? Those others might be public utilities, other IOUs, whoever else might be out there on the landscape?

A. I'm not sure, Mr. Cedarbaum, what you mean by the competition we're talking about.

Q. Well, in your testimony you indicate that you didn't think there was really much competition anyway between Puget and Washington Natural Gas.

A. The fuels themselves -- I mean, the two alternative fuels themselves are pretty much complementary rather than competitive because there's not a great deal of refrigerators run by gas and things like that, but we're finding right now that when natural gas is available in our service territory for new houses now, and when they're going in the number I heard, from I think Mr. Torgerson, was that it's on the order of 99 percent of single family houses, which is where the major use of natural gas is, are using natural gas. So that tells me that, no, there is not competition going on for those uses between gas and electricity right now.

Q. I don't know if you have it in front of you, but in the application itself -- it's not an exhibit in this case, but in the application on page 8, line 15, it states that "Washington Natural and Puget believe the merger over the long-term will allow them to meet more effectively the challenge of the increasingly competitive environment in the utility industry." And I guess my question is only what would you define -- what is the competition you're talking about there? Apparently it's not between Puget and Washington Natural. It's something else?

A. That's right.

Q. So what is it?

A. Now I understand your question. There's lots of competition out there right now and there's going to continue to be. You know, on the electric side there's competition having to do with bypass. There's competition having to do with potential municipalization. There's competition having to do with customers who may want to self-generate. There's significant competition obviously being introduced at the wholesale level. I mean, the number of wholesale competitors out there is increasing astronomically here in recent years, and we believe that there will be competition introduced at the retail level. I mean, that's the -- when we talked about the transition plan earlier, that's the transition we're talking about is the transition to customer choice at the retail level.

And what I am uncertain about is exactly who all the competitors are going to be. I didn't think there would be somebody called PG/Enron until a week ago and I don't know what it will be, but at least it's a proposal here. So the number of players and the way they're going to compete, Mr. Cedarbaum, what markets they're going to aim for, et cetera, I think is very uncertain. I think what is not uncertain is that there will be significantly more competitors of probably different forms than we've ever seen before out there trying to meet customers' energy needs.

Q. Is it your testimony that it's critical for there to be, from your perspective, joint utility operations of gas and electric in order to enter that competitive world?

A. No, I don't think it's critical to enter the competitive world because we're right in the middle of it, but I do believe that that particular combination -- if customers -- if the key to serving customers successfully, which is what you're competing for, customers choosing you, I think the business is fairly simple. I think it's only two things. It's low price and it's high quality service that includes responsiveness, et cetera. I mean, that's what it's all about. I believe this proposal of ours keeps prices, costs and prices, lower than they would be, and improves service, and if both those can happen, then we will be able to do a better job for customers.

That applies whether it's a regulated environment or a competitive environment. In other words, if retail competition ever happens, nonetheless, in a regulated environment what do you want? You want to have fair prices, as low cost and prices as you can possibly have and you want to have good service, so that's the nice thing about the proposal, Mr. Cedarbaum. I believe it fits whatever environment is out there five or ten years from now, whether that's opened retail competition or whether that is continued regulation.

Q. I guess my question is, in order to achieve these goals of low prices and high quality service, are joint gas and electric operations necessary?

A. Well, the merger itself, which is joint gas and electric operations are part of that, is one of the best ways I can think of. It's the single best way I know of right now to produce the kinds of reductions in costs and improvements in service that customers demand.

Q. On page 2 of your testimony, line 19, you also state that the merger is good for the environment because it will facilitate fuel switching where appropriate. Are you suggesting in that testimony that either Puget or Washington Natural's current or past marketing efforts were not responsive to potential new business by informing customers when fuel switching would allow them to reduce their costs?

A. No, I'm not saying that. Actually, that goes back, I think, to the previous question you asked. I'm talking about an enhanced ability because, again, one of the keys in fuel switching is the availability of the gas. I mean, if the gas service is not extended, you know, fuel switching is impossible, so I think two things you can do better in this situation than the past. One is I think much more coordinated information for customers, much better customer information, and second is increasing the availability of natural gas, facilitating the extension of natural gas service because of the improved economics, so those two would mean, I think, you can do it better under this model than you could under the old models.

Q. You also state on page 2 with respect to the merger being food for the environment a second reason that it will allow the distribution system for the two services to be designed and sized in an integrated manner. Perhaps this gets to that last point, but are you suggesting in the testimony that neither Puget or Washington Natural were doing or are now doing actions that did not take into account relative demand of gas versus electricity in designing their distribution systems?

A. I think we try to do that today, but I think the degree of certainty you have when you're doing joint resource planning makes it just significantly -- you can do a significantly better job in this area, so these comments aren't meant to say that companies were doing a lousy job before. We're talking about a new entity with a new approach that I believe can do a better job than the two companies can working separately.

Q. But your testimony is that both Puget and Washington Natural were doing good jobs in the past and currently?

A. I believe generally they're very well run companies today.

Q. You state on pages 2 and 3 that the merger is good for investors because it will produce a financially stronger company with lower risk than either company standing alone. Do you have any studies that support that testimony?

A. Well, there are some projections that I

know you're aware of that got discussed yesterday as exhibits that were TS exhibits, and so those studies have been -- those studies have been provided to you, and those I think support that thesis.
Q. Nothing else that you're aware of or that were formed?
A. Nothing I'm aware of. You might ask Mr. Torgerson that question. He's generally more aware of what additional studies might have been made.
Q. You're aware of Washington Water Power as a combination gas and electric company; is that right?
A. Yes, I am.
Q. Is it your belief that the cost of equity for Washington Water Power is lower than Puget or Washington Natural's because Water Power is a combination company?
A. I have no idea what their cost of equity is.
Q. Have any studies been made by either you or by either company that show that a combination company such as NewCo would have lower capital costs than electric or gas companies standing alone?
A. I am not aware of any studies that have been done. I think there's a tremendous amount of logic that supports that. We didn't go -- I'm not

even sure how you'd perform the study but there's an eminent amount of logic that supports the idea that some degree of diversification of risk and other issues like this are perceived by investors as things that lower their risk and therefore that tends to reduce the cost of capital.

Q. On page 3 of your testimony in the first bullet you say that the merger is good for employees, and you don't mean -- do you mean from that testimony that employees' incomes will be higher under the merged company than under stand alone companies?

A. No, because employees' incomes are going to be based on paying people what, you know, what the market demands for jobs, and I don't believe that has an impact there. You could have some employees who in fact demand more in the market because of cross training they have, you know, skills they have beyond the ones that they have. That's something you pay for, and so we could well see a situation where we have a lot of employees with a significantly greater degree of skill in doing different kinds of jobs and that can definitely translate into higher pay, but that's not -- that wasn't the thrust of what those remarks meant, Mr. Cedarbaum.

Q. You state in that first bullet on page 3 that the merger will assemble a very strong market team and create a new enterprise that is more likely to succeed in the long run, and I guess my question centers around what you meant by succeed. Does that -- when you said succeed, do you mean survive or something else?

A. Oh, no. I certainly don't mean survive. I mean to be able to successfully meet customers' needs. Be able to earn fair returns for shareholders. Be able to be the sort of place that you can work and have a stimulating environment with opportunities. Creating a sense of opportunity for employees, because the employee part was what we're talking about there, is a very important thing for management to be doing right now.

Q. Embodied in your anwer, would succeed then mean the ability to compete as we've talked about it earlier?

A. Well, the ability -- compete is a little bit too much of a shorthand for it, in my opinion. It's a prosper to be able to in fact be the company that customers want to choose, to be the company that investors want to invest in, to be the company that employees want to work for. I mean, those are all measures to me of success. Compete is just too limited a word to me in many ways.

Q. But succeed versus the competitors that NewCo would face?

A. Well, as I indicated to you, I don't know whether there will be retail competition. There is not currently under Washington law, and the heart of our business is going to continue to be the retail business. There is a degree of retail competition, but it's certainly not the kind of open competition that I believe is going to happen, so my premise is, yes, there will be significant competitors at the retail level, but I think it's important to also recognize that succeed can also include satisfying a regulated obligation to serve all those public policies which may not be thought of as competing but they could be succeeding in just doing a very good job as a regulated utility. That also would be a measure of success.

Q. You indicated that you didn't think that under Washington law retail service was allowed -- I don't quite remember what your testimony was. What was the basis of that conclusion?

A. Just my general understanding. I mean, there is a degree of retail competition, but there is no requirement that we grant retail access to our

customers by others at this particular point in time, and I believe ultimately that will and should happen, that there should be choice available to retail customers.
Q. So under current Washington law, it's NewCo and Puget's position that retail service is not required?
A. I beg your pardon?
Q. That retail wheeling is not a required service?
A. To the best of my understanding. I don't have any awareness that it is -- that mandated retail wheeling is not a part of the law in this state to the best of my knowledge.
Q. Is it Puget and NewCo's position that under Washington state law that if a customer required or demanded that retail wheeling that Washington law does not require it to be provided?
A. I don't know the answer to that. I'm just not familiar enough with the detail of the law as to whether that would be required.
Q. I would like you to assume, Mr. Sonstelie -- probably a assumption you would like to assume -- that the merger as proposed by the company is accepted by the Commission but that Mr. Flaherty's savings

that he's estimated don't materialize. Under that scenario, do you know what would happen to NewCo's earned rate of return on its capital?

A. Well, unless we could produce other savings -- do you want me to assume we hold the other savings and we may be able to produce constant --

Q. Let's broaden it, I guess. That Mr. Flaherty's savings estimate don't materialize, the best practices savings don't materialize, and we talked yesterday about power stretch savings. Savings don't materialize. NewCo's earned rate of return on its capital would decline; is that right?

A. If all those happened it would decline dramatically, yes.

Q. Is it your testimony that NewCo would or would not petition the Commission for higher rates if those savings did not materialize during the rate stability period?

A. I think you need to ask Mr. Amen specifically that, but we have made it clear that the only condition we're putting at all on that continuation of the rate stability period that has to do with inability to achieve savings is that it would qualify under what the Commission normal practice would be for emergency rate relief.

Q. So in this case the company -- NewCo has made a proposal based upon savings -- it's telling the Commission to approve the merger based upon savings that it expects to get from various sources, including Mr. Flaherty's estimate, best practices and others, but that if those savings do not materialize causing an interim rate relief situation NewCo could come to the Commission and ask that the rate stability plan be terminated?

A. Well, if the situation got so severe that we in effect were not able to finance, I think it would be our responsibility to come back to the Commission. We would need to continue to provide service. We anticipate continuation of growth in the service territory and given that responsibility if it really reached that point we would have to come back, but I will tell you I would consider that, and our board and our investors would consider that a significant failure of management in not being able to achieve -- appropriately take on the kind of risk that we're talking about in the business.

Q. Let me ask you, Mr. Sonstelie, is it your position that without the merger Puget would not be able to maintain its financial integrity if it only received one percent per year in general rate increases through the year 2000? So again, no merger and through the year 2000 Puget gets a one percent general rate increase per year?

A. No. That wouldn't -- that would be a very bad idea and I don't believe is one that would provide a situation where we could maintain financial integrity, but I would have to look at the numbers, but we haven't done that study, but my reaction would be that I wouldn't do it.

Q. So you believe that Puget would not be able to maintain its financial integrity under those circumstances?

A. To the best of my knowledge -- I have not done a study. My reaction would be that we would not, but to be able to say definitively, I would have to take a look at it, but I know the sources of other savings that we're assuming need to be applied in addition to the one percent increases, and those are significantly dependent on achieving the merger, so I know those numbers well enough to say I don't see how you could possibly make up that sort of savings shortfall.

Q. Let me ask you then as the next record requisition in order --

JUDGE SCHAER: No. 11.

Q. -- No. 11 to provide us all studies, documentation and explanation for your answer. You indicated, I think -- it sounded to me like maybe it was maybe not off the top of your head but you don't have any studies in front of you and so I'm asking for documentary support for your answer.

A. Mr. Cedarbaum, I will be glad to do that, but I think the numbers are really provided in Ms. Lynch's testimony. She has a clear indication in that testimony of the nature of the costs -- as one of her exhibits of the nature of the cost pressures, the cost increases we're going to see on the electric side, and how much of that cost pressure we believe can be offset by the merger savings that Mr. Flaherty identified and by the one percent rate increases, and I think if you look at that -- I mean, that's what I'm relying on when I say additional studies. I'm fairly familiar with the numbers Ms. Lynch has in her testimony, and, as I remember, that would be a huge shortfall and with that sort of shortfall you could not maintain financial integrity.

Q. Let me keep the record requisition. If your response is "see Ms. Lynch's exhibit," that's fine. If there's something more that would give us the reasons for your answer, you can provide that.

A. That's fine. If there's anything more, I will.

(Record Requisition 11.)

Q. Do you know if Puget would be able to maintain its financial integrity if it froze its dividend per share through the year 2000 and got the one percent per year increase?

A. No. I would give the same answer that I did in the other one. My reaction would be that we would not.

Q. So your response to record requisition 11 would be the justification for that answer as well?

A. Well, it's the same justification I gave before. To the extent that there is something beyond the numbers I am aware of, which have already been provided in Ms. Lynch's testimony, then I will add to it.

Q. Is it correct that in 1993/1994 Puget sold new common stock?

A. Yes.

Q. And did you agree with the sale of those shares?

A. Yes.

Q. Would you accept subject to your check that the 1994 sale added about $5 million to Puget's dividend requirement?

A. I would accept that subject to check.

Q. Would you accept subject to check that Puget's year end 1995 common equity ratio including short-term debt was 47.5 percent?

A. I would accept that subject to check. That sounds right.

Q. Which would be above the currently authorized equity ratio before this Commission of 45 percent; is that right?

A. That was the target capital structure in the last general case, I believe, yes.

Q. I believe you were here when Mr. Torgerson testified yesterday?

A. Yes, I was.

Q. And he agreed that in fiscal year 1995 as shown in his Exhibit 5 Washington Energy Company lost about $41 million?

A. I remember that.

Q. Is it correct that that would be $1.72 per share loss?

A. I would accept that subject to check. I haven't done the arithmetic.

Q. Mr. Torgerson also stated, I think, that Washington Energy Company's earnings from continuing operations were insufficient to cover its dividend for fiscal year 1995. Do you recall that? Or is that --

A. I don't recall that specifically but I would accept it subject to check.

Q. I think we also established with Mr. Torgerson that WECO was and is paying a dollar dividend per share?

A. Yes, I do know that.

Q. So Washington Energy Company would have to increase its earnings in order to meet the dollar dividend per share requirement out of earnings; is that right?

A. Well, if in fact -- I think that's asking a prospective question. I mean, you asked about 1995 and what the performance was in 1995.

Q. Yeah, that's right.

A. Well, prospectively they're going to have to earn more than a dollar per share to pay a dividend at a dollar a share and not have it be below that, that is correct.

Q. Do you know if Puget's board of directors discussed Washington Energy Company's low earnings as part of the merger discussions?

A. We discussed virtually every aspect of Washington Energy Company.

Q. And would that discussion be reflected in the minutes?

A. No.

Q. Would it be reflected in any documentation?

A. No, I don't think so, because those discussions went on for several months. I think there's an indication in the proxy material as to discussions going on with boards, et cetera, and we don't keep detailed minutes of discussions that go on in board meetings. Never have.

Q. Do you or do you know of anyone else who kept notes of those discussions?

A. No, I don't. I didn't keep any and I am not aware of any. There are board minutes, and sometimes attached to the board minutes are specifically reports that were rendered but --

Q. We've already asked for the minutes in a data request. Let me ask as the next record requisition 12 for you to provide any notes that might exist of the board members or persons who presented information to the board members regarding Washington Energy Company's earnings situation.

A. Fine.

(Record Requisition 12.)

Q. On pages 15 and 16 of your testimony, you testify that the savings from the merger are not sufficient to allow NewCo to meet its rate stability program, and then you also go on to state that NewCo will have to strive to achieve savings beyond those projected by Mr. Flaherty to meet its rate stability promises. Is that correct?

A. Yes, that is correct.

Q. Is there a difference in your testimony between the word "strive" as you used and "must" or "have to"?

A. I guess if "has to" has some legal requirement then I wouldn't use "has to." I think what we're talking about here is goals, strive, stretch. A lot of words used like that yesterday, I think, Mr. Cedarbaum. I mean, I would use "has to" when I apply it to myself because that's my job vis-a-vis the board of directors and the investors in the company is to achieve results. So it's certainly a "have to" for me.

Q. So as used in your testimony we could replace the word "strive" with "must"?

A. I said "must" applied to me. This is Puget Sound Energy. It will have to strive to achieve. I mean, this was just a statement of whether or not one could earn a reasonable return on equity using just those merger savings identified by Mr. Flaherty, so that's just an arithmetic calculation, and the answer is that you could not achieve it without additional savings.

Q. So in order then to earn a fair return those savings have to be achieved?

A. That's correct.

Q. Do you know what return on equity NewCo would have to earn in order to pay a dividend comparable to what Puget and Washington Energy Company are currently paying?

A. No, I don't.

Q. Could that figure be calculated? Maybe you don't know that.

A. I don't know that. You might ask Mr. Torgerson.

Q. Let me make that a record requisition and if it turns out that he answers it he can so state.

JUDGE SCHAER: Record requisition No. 13.

(Record Requisition 13.)

Q. In your testimony at page 7 you have a chart at the top. I'll wait until you get there.

A. Yes.

Q. And it shows a reduction for 1997; is that right?

A. Yes, that's correct.

Q. Is it correct that that reduction is not a part of Puget's permanent rates but it's Puget's collection of PRAM deferrals for prior period earnings?

A. Yes, that's correct. That is the PRAM deferral going away, 5.6 percent.

Q. We had talked earlier about the situation where interim rate relief would be necessary during the rate stability period, and there are Commission standards for what that means, but do either of the companies or NewCo have any financial targets or standards that would be applied in their minds as to when interim rate relief is necessary?

A. No. So far as I know, and Mr. Amen would be a good follow-up on this Mr. Cedarbaum, our intention, and I think we wrote it that way, was to make it clear that it is as established by Commission precedent. It is what this Commission has applied, not some standard that we would make up but in fact what the Commission has applied.

Q. Suppose during the rate stability period, Mr. Sonstelie, the cost of equity capital were to fall significantly. Does the rate stability plan that you proposed eliminate any Commission ability to institute a show cause hearing as to why rates should not be reduced?

A. I don't know the answer to that as to what the authority of the Commission is.

Q. There's nothing in the plan that would impact the Commission's authority as far as you know?

A. I don't know.

Q. Is that kind of a rate reduction contemplated in the rate stability proposal?

A. No. Adjustment to rates associated with changes in the cost of capital upward or downward are not anticipated any more other than changes in other costs or revenues are anticipated.

MR. CEDARBAUM: Your Honor, I probably have about 45 minutes left of Mr. Sonstelie, and I am at a breaking point if you want to take a break. Doesn't matter to me.

JUDGE SCHAER: Well, I was planning to break about 10:30. Would you like to break now? Let's keep going.

Q. With respect to Puget's currently effective retail rates, would you agree that they are higher than other utilities in the region?

A. They are than most other utilities in the region, yes.

Q. What utilities are they not higher than?
A. I don't know. There are a lot of utilities in the region if you talk about every investor-owned utility, public, et cetera.
Q. Is it correct that Puget's large use customer rates are among the highest of any utility in the region?
A. They're certainly among the highest, I would agree.
Q. Would you also agree that the production costs embedded in Puget's industrial rates are twice as high as market rates?
A. I haven't the slightest idea.
Q. At page 4 of your supplemental testimony you have an estimate of 13.5 mills per kilowatt hour for nonfirm energy; is that right?
A. Yes, that's right.
Q. Would you accept subject to your check that in response to staff data request No. 8 in the Georgia-Pacific and Bellingham Cold Storage special contract dockets that the cost of production in Puget's industrial rates were estimated to 27 and a half mills per kilowatt hour?
A. I would accept that subject to check.
Q. Staying on page -- in your supplemental

testimony at pages 2 to 3 you discuss how schedule 48 in the market transition plan relates to the merger, and then on page 4 at the top you indicate an estimate of the realized rate for a large use customer taking service under schedule 48 once the transition charges are reduced to zero is 22 and a half mills per kilowatt hour; is that right?
A. Yes. That was making that assumption about what the market would be. The 13 and a half part of that, Mr. Cedarbaum is that assumption, which is a guess.
Q. With that assumption would you accept subject to check that that rate's about 55 percent lower than the current average rate for service under schedule 49?
A. I would accept that subject to check, yes.
Q. As proposed, is it correct that schedule 48 is a real time pricing initiative that would allow Puget's large use customers the opportunity to pay the market costs of nonfirm energy on an hourly basis instead of above market costs that are embedded in Puget's tariff rates?
A. I would agree with all the part of the question except your using the term right at the end, "above market costs." I mean, we're comparing two

different types of service, and so in moving to schedule 48 the customer is accepting service on a different basis than another schedule, so you're talking a little bit here apples and oranges when you're just jumping from one to the other and comparing markets. The 13 and a half mills number is calculated on a very different basis in terms of the risk associated with it than a schedule 49 number would be, for instance.

Q. Well, is it correct that schedule 48 offers the benefits of competitive wholesale market prices only to Puget's large use customers?

A. Yes.

Q. And according to the market transition plan that's referenced in your supplemental testimony, no later than four years and one month into the rate stability period Puget's expected to file a proposal allowing all customers to select their electric power provider; is that right?

A. Yes, but our preferred alternative is to have that be developed -- have a plan like that be developed collaboratively with a lot of the parties represented in this room and others who aren't here today. That four years and one month is, to my mind, Mr. Cedarbaum, a fall-back, that if the rest of

this didn't happen on that sort of schedule we would take the initiative -- and obviously it's the Commission's decision to implement whatever plan, not ours, but we would at least take the initiative to submit a plan ourselves.
Q. And when that occurs, at that time, all retail customers will have the opportunity that the large use customers would now have under schedule 48 if approved?
A. Well, I don't know that. We would offer a plan that retail choice is available to large customers -- or to all customers. How that would be structured, I don't know. I mean, making the analogy to schedule 48, schedule 48 is not open access.
Q. Can you explain to me how retail customers will realize the benefits of wholesale competition prior to this point in time in the future we've been talking about?
A. I believe to a very great extent retail customers, all customers throughout the northwest and other parts of the country, are already realizing significant benefits of wholesale competition, because in fact it's the first time in my 20-some years in the northwest that marginal cost of power is lower than embedded cost, and I certainly think that natural gas

prices are one reason and wholesale competition is another. So those benefits are being realized in many quarters right now.

Q. In Mr. Amen's supplemental testimony with respect to schedule 48 he states that that schedule balances the competitive situation related to Puget's large electric customers with the rate stability proposal for all other electric customers, and that's at page 2 of the supplemental.

A. This is my testimony or his?

Q. Mr. Amen's supplemental. Page 2 line 17.

A. I see the line, the transition plan -- "this balances the competitive situation related to Puget's large electric customers while providing the necessary rate stability for all other electric customers." Is that the line you're --

Q. Yes. Is it correct that the term -- in your mind is it correct that the term "competitive situation related to Puget's large electric customers" results mainly from the fact that the embedded costs for production in Puget's large industrial customer rates are higher than the price for power in the wholesale market?

A. Yes, not only ours but virtually everybody else's. With the current wholesale markets -- in fact most tariffed rates right now are higher than what is out there in the wholesale markets, and some sophisticated and capable customers are, I think, able to make informed choices to go take a different class of service, and the competitive part in there, Mr. Cedarbaum, refers to the fact that I believe we have a very real current competitive issue with those customers.

Q. I would like you to assume that an existing industrial customer has a legitimate competitive alternative to electric service from Puget. Would you expect that Puget would respond to that situation in some way?

A. Yes.

Q. And would Puget have to respond to that situation even if the merger did not go forward?

A. Yes.

Q. I assume that you would agree that the electric industry is evolving rapidly and that competition has become a significant factor in the electric industry; is that right?

A. I would agree with that.

Q. Would you accept that that competition has arisen due to the following circumstances: First

of all, various FERC initiatives including open access to transmission, that that's a factor causing competition?
A. That's a factor, yes.
Q. Another factor would be the presence of new participants such as power marketers and brokers?
A. Yes, that's a factor.
Q. Another factor would be excess generation capacity in the west and low natural gas prices?
A. Yes, particularly with an emphasis on the latter, the low natural gas prices are driving this.
Q. As we've been discussing, another factor would be customer's demand for choice?
A. Oh, yes. That grows out of the other factors, but there's no doubt about it that customers are aware of the economics and want choices.
Q. Can you tell me what initiatives if any Puget has undertaken to take advantage of the competitive bulk market power -- excuse me, bulk power market in the region?
A. Yeah. Just for the last several years we had been a participant in those markets both as a buyer and a seller, Mr. Cedarbaum, so that's something that is reflected in -- has been reflected in our cost of power. We've had a PRAM adjustment going on, but

both our ability to buy more cheaply in those markets, our ability to sell into them as opportunities exist, and the fact that there's a diversity of load, for instance, within the very large western market that's developed is an opportunity for a lot of players, and we've been very much participating in that on behalf of our customers.

Q. I recall a few weeks ago or perhaps months ago some articles that I've read about possible agreements with Duke Louie Dreyfuss and Puget. Can you inform me of the status of all of that?

A. Let me update you on where we are on that. The memorandum of understanding was just about exactly a year ago, I think July of '95, that indicated that we were going to work with -- memorandum of understanding to work with Duke Louie Dreyfuss. And looking at two areas. One was expanded participation in the wholesale markets, et cetera, and a second was sort of the whole energy services idea.

And to some extent, Mr. Cedarbaum, starting this fall when we were working on the merger that kind of took a back seat for a while just because the same people who were working with Duke Louie Dreyfuss were pretty much also working on the merger, but after some meetings here in the last couple of months, we're looking real hard right now at trying to see if we can push that a little harder, see if we in fact can turn it from just the memorandum of understanding that now exists to something that's a little more specific in terms of what can be done in sort of an alliance fashion. I tend to be a believer that alliances in this evolving world are things you need to look at very hard, and so we're looking at it very seriously right now.

Q. Have the hopes that you just referred to been discussed with Duke Louie Dreyfuss people or were you talking about just those were discussions within --

A. No. The meetings weren't just Puget Sound Energy people. They were with Duke Louie Dreyfuss people too.

Q. Is it correct that Puget's ownership share in the third AC intertie contributes to the increased wholesale marketing activity?

A. I would imagine that's true, yes.

Q. Can you describe how Puget's core market benefits from that increased activity in the wholesale market, including the use of a third AC intertie?

A. Now, I guess I don't know any -- I mean, we're right up on sort of the edge of my expertise and exactly how we use that transmission capacity and how we participate in the wholesale markets, and unfortunately, Mr. Cedarbaum we're missing a power supply witness for me to delegate this to, but again, my knowledge in exactly how we do that and how it involves a third AC is just very limited.

Q. What about if we took -- if I took out of the question the specific reference to the third AC intertie. Could you describe how Puget's core customers benefit from the company's increasing activity in the wholesale market?

A. Yes. Generally, I mean, as we participate more in the wholesale markets and are able to basically keep down the cost associated with the power supply with which we serve our customers, there's a benefit to customers any time we're able to do that.

Q. Let me go back for a few moments to the rate stability plan and specifically some of the carve-outs that are part of the plan. One of the carve-outs relates to the residential exchange with BPA that Puget participates in; is that right?

A. I don't know if I would call it a carve-out, but it's certainly -- our ability to say what the exchange credit will be is not a unilateral ability. Therefore, we can't make any commitments to what that would be and if you call that carve-out, that's okay.

Q. Can you give us your understanding of what will happen to the residential exchange during the rate stability period?

A. Yes. Let me give you the best I know on that, Mr. Cedarbaum, and there's a little better predicting in this, but there are two possibility -- going back to a year ago. I mean, a year ago with Bonneville's announcement and original filing it looked like there was just going to be originally no exchange benefits available at all in their position that they were triggering 7B2, and therefore there would be no benefits and, as you know, we and you and everybody I think around here was pretty outraged at that, and state attorney general wrote a letter on it and a lot of other things happened, and I think that had an effect because the first thing that occurred was a congressional action that reinstated benefits for federal fiscal year '97, so that starts this October 1st and goes through next year at a specified level.

And then I think as a result of a lot of outcries from public officials and customers and company management and congressional leaders and others, Bonneville since has taken a little more reasonable approach in trying to find some money that can continue to provide benefits to residential and small farm customers of the three investor-owned utilities in the exchange. I predict that will take one of two forms. We will either see Bonneville announce and implement their record of decision that sets a level exchange benefits for the five-year period they're talking about here in their rate case in which case each year the parties will still go in with average system cost filings, et cetera, but that they will limit the total dollars by this triggering of 7B2. The other option is that some settlement will be reached with Bonneville by the three investor-owned utilities, Pacific, Portland General and Puget. That's something that Mr. Swofford has been heavily involved in for us, and it's been a very intense series of negotiations that have broken off right now, but I will tell you that I personally don't believe the fact that they've broken off right means a settlement can't be reached.

So those are the two alternatives that I think are the possibilities here as we look at this five-year period covered -- it's coincidentally a five-year period. It is the five-year period of

Bonneville's announced rates not of the rate stability period but they overlap fairly extensively.

Q. To the extent the exchange benefits are limited from what they otherwise would have been either by BPA's action or by negotiated settlement, is it correct that residential and small farm customers' rates would increase more than what they otherwise would have increased if the exchange stayed under its current form?

A. Well, their rates wouldn't but their bills would, because you've got -- that's a separate credit, as you know, that is provided in the bills and so that's what we've been so hopping mad about for the last year is what we consider significant cost shifting by BPA.

Q. Another one of the what I've called carve-outs involves on the gas side the PGA mechanism for gas costs; is that right?

A. That's correct.

Q. And is it correct that gas costs for Washington Natural are a significant, probably the most significant, cost of their doing business?

A. You've got the wrong witness on that, Mr. Cedarbaum. Mr. Amen has specifics on the carve-outs, and I would answer it and say gas costs are a significant part of their costs but that's all I know about that.

Q. The part of the rate stability plan is that gas rates will be stable; is that right?

A. Is that general gas rates would be held constant with the purchased gas adjustment clause continuing to operate during this time period. That's the proposal.

Q. So gas customers' bills may still increase?

A. They may decrease, too. I mean, they would change with the purchase gas adjustment clause.

JUDGE SCHAER: Is this a good place to break, Mr. Cedarbaum?

MR. CEDARBAUM: Sure.

JUDGE SCHAER: Let's take our morning recess at this time. Please be back in the room promptly at quarter to 11. We'll be off the record.

(Recess.)

JUDGE SCHAER: Let's be back on the record after our morning recess. I would like to make a scheduling announcement at this time. It looks from our estimates of time for witnesses like we're going to spend most of today with Mr. Sonstelie. Chairman Nelson is unable to be here tomorrow and wishes to be here for the testimony of Mr. Vititoe, so we are going to take Mr. Vititoe's testimony beginning Monday and we'll be taking -- finishing with Mr. Torgerson and then proceeding with other witnesses for the rest of today and tomorrow until we are able to take his testimony on Monday.

Please proceed with your questions, Mr. Cedarbaum.

MR. CEDARBAUM: Thank you.

Q. Mr. Sonstelie, one of the benefits that is claimed for the merger is enhanced customer services; is that right?

A. Yes.

Q. Is it true that that benefit would accrue only where Puget and Washington Natural overlap?

A. No, I don't think so, because, you know, I think the things we're going to be able to -- the best practices we're going to be able to develop, the ideas we're going to be able to share, the economies that I think we can develop will actually have payoffs where they just serve electric or just serve gas too. They probably won't be as dramatic as where we serve both but I think they will be there.

Q. If you could look back at the application again at page 8, line 40, you discuss enhanced -- or

the application has a bullet, "enhanced customer service and operational efficiencies," and it states, "By coordinating and integrating certain operations of Puget's and Washington Natural Gas's utility businesses to take advantage of the company's overlapping service territories, NewCo will be able to provide its customers enhanced service and choice." Is that right? That's what the application states?
A. Oh, I see it, yes, the first sentence there starting -- yes, that is what it says. I would still stick by the fact that it also is a benefit in other areas but that particular point is specifically relating to overlap.
Q. Is it correct that gas customers who are located in Snohomish County or Tacoma or Seattle would not be able to take advantage of the enhanced customer services that are discussed at that part of the application?
A. No, that is not correct.
Q. Why is that?
A. Because, again, as I indicated, I think when you work with each other in better ways to get things done, and you apply them specifically, as this indicates, apply them specifically to the overlap service territory you end up with practices that are

better and that can benefit all customers, and you tend to then apply those throughout your business, so I believe there will be an impact everywhere.

Q. Going to your testimony now at page 5, line 7, you discuss offering customers information regarding both natural gas and electricity. I assume, are we talking about there advertising or at least part of what we're talking about there is advertising?

A. It could be. I guess my view of it is I don't think advertising is the most effective way to do that. I think this has to do with customer understanding because -- just my own bias. I mean, I think advertising is sort of convincing customers on something. I think this is something where if customers have good information it's pretty clear what the right choices are for customers, so I think it's just a question of getting high quality credible information into the hands of customers who then make choices that really are the best choice for them, and I don't think that's typically advertising that does that.

Q. Would you consider that information to be promotional at all?

A. I don't know what the definition of promotional is. I think it's educational is how I

would characterize it, because I don't -- I believe it would be very factual, it would be the kind of information that really helps customers make good choices, and I guess I don't consider that promotional. I consider that educational.
Q. Has the offering of that information been considered by Puget or Washington Natural in light of the Commission's rules governing advertising?
A. I don't know. I don't know that, the specifics of any ideas that people have as to how they do this and how this would impact the Commission rules on advertising.
Q. Would the cost of providing that information be utility cost in your view?
A. I think you better ask Mr. Amen that question.
Q. Looking at your Exhibit 2, which is the map, is it correct that most of Eastern Washington is not included here?
A. That most of Eastern Washington is not included? Yes, this is just -- in fact none of Eastern Washington is included in this map.
Q. Do you consider Eastern Washington to be part of your retail market that NewCo would serve?
A. The part that is -- we serve parts in the

Kittitas County and to the extent that you consider that Eastern Washington -- I guess I call it central Washington but that is part of our retail service structure.

Q. And no other areas east of Kittitas you would consider to be part of NewCo service territory?

A. Not at this point in time. I don't know what the world is going to bring, but at this point in time, no, we do not serve that area. Do not consider that part of our retail service territory.

Q. Just so I'm clear, your answers would apply both to Puget currently and NewCo in the foreseeable future?

A. Well, let's see. It applies to Puget. It applies to at least the electric part. I am not aware of whether Washington Natural Gas has any specific -- I don't know if franchise is the right word with the gas company, and outside this area if they do I am not aware of that. The foreseeable future piece is the only question I would have with your question because that foreseeable future could be -- that could change very quickly in terms of how retail competition occurs.

Q. There are no current plans that you know of for NewCo to provide retail service in Eastern

Washington?

A. That's correct, there are none.

Q. On page 3 of your direct testimony -- I'm sorry, not page 3 of your testimony but the section of your testimony dealing with DSM.

A. 19?

Q. Page 20. We're talking about new programs for low income customers?

A. Yes.

Q. And you state that NewCo plans to fulfill its commitment to provide energy efficient services to low income households; is that right?

A. I'm sorry, what line are you on?

Q. Well, I guess it's implied in the question which says. "How does NewCo plan," and you have an answer, so presumably NewCo does have a commitment to provide energy efficiency services to low income households?

A. Yes, we do.

Q. And is it correct that the NewCo also will begin to target manufactured housing?

A. I don't know for sure that we will, but I believe that is -- I say will also begin -- I think that is probably one of the areas that's been most neglected so far, and I think that's pretty high on our priority list. We would like to develop -- the reason I'm hesitant is we would like to develop this program in partnership with, for instance, community trade and economic development to help us decide where the greatest needs are and with community action agencies and others like that, so my feeling is that's probably an area that ought to be targeted.

Q. Are there any studies that have been prepared within the company that show that that type of a program would be cost-effective or that deal at least with that issue?

A. There may be but I am not aware of them.

Q. Why don't I make that as the next record requisition in order.

JUDGE SCHAER: No. 14.

Q. Provide them if they exist. If they don't you can just tell us that they don't.

(Record Requisition 14.)

Q. Is it correct that with respect to these programs for manufactured housing that the company would file for approval of those programs outside of this merger docket?

A. Any specific programs that we did under the normal schedules on which we operate we clearly will file with the Commission for either updating the schedules or new schedules, et cetera. We also, as you know, Mr. Cedarbaum, have a commitment that we will provide a million dollars a year during this period specifically targeted at the low income group for meeting their specific needs. We're not planning on -- we're covering that through some tariff. That is something that we're planning on just expensing during the time period and not asking for separate recovery on.

Q. You refer elsewhere in your testimony to developing programs for fuel switching. Is the development of those types of programs tied necessarily to the merger? In other words, can those programs go forward without the merger?

A. Probably not nearly as effectively. For instance, if I consider the two companies right now, as they are right now, Puget has not been, as I think you're aware, out trying to get electric heating load or water heating load or even, frankly, trying to convince customers not to switch. That's a little different than actively promoting fuel switching, and I think the Puget Sound Energy plan would be much more actively promoting that as opposed to sort of, if you will, Puget Power not opposing. I think there's a big difference there.

Q. Do you know or would you accept subject to your check that Washington Natural Gas has participated with Snohomish County PUD in a water heater conversion program?

A. I would accept that subject to check.

MR. CEDARBAUM: Thank you, Mr. Sonstelie, those are all my questions.

JUDGE SCHAER: Mr. Manifold, did you have questions?

MR. MANIFOLD: Yes.

CROSS-EXAMINATION

BY MR. MANIFOLD:

Q. Good morning.

A. Morning, Mr. Manifold.

Q. Do you have before you the exhibit I passed out earlier which was marked as Exhibit 37?

A. Yes, I do.

Q. And do you recognize that to be the company response to public counsel's data request No. 31?

A. Yes.

MR. MANIFOLD: Your Honor, I would move for admission of Exhibit 37.

JUDGE SCHAER: I believe this document was distributed off the record but has not been identified on the record yet. So let me identify this as a multi-page document which is, as Mr. Manifold said, the response to public counsel data request No. 31, and it has been offered into the record. Is there any objection? Document is admitted.

(Marked and Admitted Exhibit 37.)

Q. Mr. Sonstelie, we discussed off the record that obviously this was produced some time ago. Did you have some updates to the information in here?

A. Yes. Let me give you some factual updates in terms of if we were writing this right now for public consumption, which is what it is, we would make a couple of additions, and perhaps I could refer us to the -- let's see, page -- the little tiny number is page 6, but PC 31, 4 of 5. Use your numbering system there. We start at the top with the Montana Power contract. The factual write-up there is correct. I think the addition would be we actually have some mediation discussions going on in the month of August, but all the rest of it is still correct. FERC declining to take jurisdiction, which unfortunately may make the resolution take a little longer than if they had taken jurisdiction, but that would be the addition I would make, that is, we are in mediation discussions with Montana Power Company, not arbitration, nothing compulsory, just strictly mediation.

Q. Are you using an independent mediator?

A. Yes. I don't know who it is but we are. Then if I went down to, I guess it's the next page. Let me in this one refer to both March Point, which is the biggest, longest paragraph there, the second paragraph, and then two below that, Encogen. In both cases we have asked the parties to provide displacement savings assuming a shut down, both those parties. They have declined to provide that. We are still looking at what our options might be to try to compel them to provide that information to us, and we're still looking at that right now.

Then the third paragraph on that page which refers to Sumas and the one that starts on March 20, 1991 that refers to Tonasket, again, those statements are correct, but in addition to that we have also made the same request of both those parties and we are talking with them as opposed to they refuse, and that's it, and that's relatively recent that all this has happened.

The rest of the statements to the best of my knowledge, Mr. Manifold, are correct. It's not that this changes what's already in there. It's just the addition.

Q. Let me ask you, since it appears these will be a dynamic situation as this case is progressing, let me ask you if you could in response to a record requisition provide us updated factual information as the facts develop on those situations that you've just mentioned.

A. I would be glad to do that.

JUDGE SCHAER: That will be record requisition 15.

(Record Requisition 15.)

Q. Are the company's efforts in this regard what we were referring to yesterday as a power stretch? Is that the term?

A. Stretch power costs. Well, these efforts are certainly a part of that, yes, an important part of that.

Q. One part of it?

A. Yes.

Q. Do you consider the merger application as part of what you've now described as the market transition plan? Is that one element of it?

A. I think that's fair to say. I think the market transition plan, you know, schedule 48 --

remember, we don't have the details of a plan, but the concepts of a plan are very much offered in the atmosphere of the merger proposal. They assume to a very great extent that the merger goes forward.

Q. What I would like to explore a little bit is the relationship between those two things. I assume you would agree that the market transformation -- some of which none of this room have control over and some parts of it we do -- is occurring and events will continue to occur whether or not there is a merger proposed or consummated?

A. I would agree with that.

Q. And the merger -- to what extent do you regard the merger as part of the company's response to that market changes?

A. I regard it as a very important part of it because the biggest single reason, Mr. Manifold, being the opportunity to produce savings that I don't believe we can produce absent the merger, which will have a significant effect on positioning the new company to successfully accomplish that transition.

Q. As I understand it, there are at least three pots of -- don't mean to get back to the honey analogy necessarily, but at least three pools of savings or benefits that the company has identified as we've discussed here. One would be merger savings as have been identified by Mr. Flaherty. Second one would be power stretch savings, and a third one would be what the companies call best practices. Is that --

A. That's correct.

Q. And should there be -- I mean, is that -- should there be a fourth or fifth on that?

A. I think those are three good categories to use. I think you can group most potential cost savings into one of those three categories.

Q. There may be other cost savings but those are the big ones?

A. I think so. I think they're appropriate categorizations.

Q. The merger savings obviously are dependent upon the merger being consummated presumably?

A. Very clearly.

Q. The power stretch savings, would it be accurate to say that those will be pursued independent of whether or not there's a merger?

A. It would be accurate to say they will be pursued, but I think it would also be accurate to say that our ability to achieve them may well be enhanced and potentially significantly by accomplishing the merger.

Q. Could you expand upon that?

A. Sure. A couple of ways that I can think of. One is just the expertise that the gas company people bring in terms of gas markets, et cetera. I mean, these are the most problematic of these contracts are ones that utilize natural gas as the fuel. To the extent that there are ways to perhaps look at alternative fuel supplies, et cetera, and I don't know that there are, but if that's true, then we have a partner here with significant expertise in helping look at that, and I think that can be a real plus.

Secondly, the fact is that we also have a proposed merger partner with some significant background and expertise in market transformation and in looking at issues like long-term obligations versus buying in the open market, et cetera. They've already been a significant help in looking at issues around schedule 48, for instance, so it's both an expertise of experience in going through some things that aren't exactly analogous from the gas business but have some analogy and the expertise in a specific part, which has to do with natural gas contracts, availability types of contracts.

Q. Moving to the best practices. First of all, this refers to, as I understand it, each company looking at what the other company does in particular areas or the combined company looking at each and picking which one is better.

A. Not quite. It's that or -- and this is what we've been really trying to educate ourselves on, the ability to do that and to try to draw on the best experience, the best information we have from the gas industry, from the electric industry. In other words, beyond just these two we have access to couple of industries that do have a lot of shared data. Also, hopefully, we'll be imaginative enough to think that maybe the utility industries aren't the best possible sources of best practices. It may very well be that there are a lot of other companies in other industries that will be a source there. So it's beyond just short of choosing the best of two companies's practices.

Q. That's why it's termed best not better?

A. Right.

Q. I would assume that this -- you're in sort of a difficult position, it seems to me, because you're here to defend and propose that there's going to be benefits coming from doing this and you have to at the same time say that we've been doing this all along, because presumably my next question is, you've been attempting to adopt best practices as long as you've been at Puget, and what it seems to me you have some difficulty in explaining to us is how a merger with this gas company changes the commitment or the ability of your company, of Puget, to pursue the best industry practices possible.

A. I don't think that is difficult to explain. Let me try it and you can judge afterward whether it was difficult or not. Both these companies -- and I've learned enough about the gas company I think I can speak for both of us. Over the last two or three years -- three or four years -- you've seen significant effort by the management of both these companies to reduce their costs of doing business, their cost of operating those companies. Puget Power, we serve 38 percent more customers per employee than we did in 1992. That's significant efforts at best practices, a lot of other things associated with it.

There are very similar numbers, very strong numbers in the gas company side. You reach the point, Mr. Manifold, when you're continuing to look at ways to get better at what you're doing in recognition of both regulatory responsibility and uncertain competitive future you can't keep doing it that way.

You need breakthrough ways to look for additional ways to get better at it, to get more productive, et cetera.

And so that's why this merger makes so much sense is you've now got an opportunity to really significantly rethink the business, to redefine the business, and things like unity trenching and crews that are able to do multiple things and elimination of duplications, obviously, is a part of merger. Those aren't things you can do as two separate companies, and I think you've seen two companies who have both a common vision of where they need to get, but also have frankly gotten to the point -- and I am not going to overstate it by saying we've done everything we can possibly do to reduce all our costs in all areas, but we've made significant efforts and significant headway in both these companies, and I think as we looked at the idea that we've got to do even more, you now have to do it in some innovative breakthrough way. You've got to rethink the business not just keep trying to get just a little better incrementally at everything you do.

Q. Have you considered bringing in expertise from competitive markets?

A. Well, in fact --

Q. And I will explain a little more. One of the obvious things is that both the gas company and the electric company operate in essentially regulated environments. There is a large economy out there from Proctor & Gamble to Microsoft to a number of other companies which operate in significantly greater competitive environments, and many think that that's the way that these regulated companies are going to be going and that the best practices from those sorts of industries need to be brought into these formerly and present regulated companies.

A. I agree with you. I do think there are opportunities to draw on ideas from nonregulated companies. Just an example of that, I've kind of stopped going to the utility-sponsored get-togethers where everybody -- I still go to EEI meetings because I'm on the board, but I skip most of the other meetings where we all get together and tell war stories and tell things we're doing.

Q. Talk about your regulators?

A. Right. How did you know? As a matter of fact, Mr. Vititoe and I together went to a meeting in June that was sponsored by a consulting firm who does most of their consulting with general industry. I think there were five utilities there, they were pretty much presidents and CEOs and there were 50 people total. Those were pretty stimulating. I find that hearing about that -- these are companies who have operated in fiercely competitive environments for years and years and years and we're anticipating more and more of that. That's good things to hear, and so I think at least the electric side has been a little too guilty of spending a little too much time just talking to each other as opposed to trying to draw on the experiences of other industries that have seen significant competition for much of their history.

Q. Would you expect if the electric industry does become competitive that the sort of events that have transpired in more competitive industries would be the sorts of things we would be looking for in the electric industry?

A. I'm not sure I know what you mean by that.

Q. Well, in other industries there's a great responsiveness to the consumer. People either meet consumers' needs or they are not successful and they do not have an opportunity to earn a return absent the ability to respond to consumers. All of their practices are geared towards survival in a consumer-oriented marketing industry as opposed to a monopoly-oriented industry, and that's just generally the sorts of things. We read all the time about re-engineering and downsizings and marketing efforts. You know, you can hardly have dinner without MCI calling you on the telephone and et cetera.

A. Let me respond as best I can to that. First place, the re-engineering, et cetera, efforts, those aren't something we have to do. Those are something both these companies have been extremely involved in. I gave you a sense for the degree to which we have relooked at our existing businesses and dramatically improved the efficiency of how we do those. I believe going forward, Mr. Manifold, that there will continue to be in the industry in which Puget Sound Energy is planning on operating a significant degree of public interest issues that always need to be balanced with sort of the get out there and compete and fight for every customer issues that are going to include issues around obligation to serve, nondiscrimination, et cetera, sorts of things, that are going to include environmental considerations.

You know, this is an industry, the electric side particularly, that potentially has significant environmental impact. I think we're going to have to continue and going to be required to continue to pay attention to that. So I think there will be significantly more elements of the competition you describe, but I also think it will be a significant number of elements of the public interest, and required things have to be done.

People have said, talked about what's happening, are going to happen in the electric industry is deregulation. I think that's a very inappropriate term, particularly for the distribution side. I think it is a different type of regulation. It is a degree of coexistence of regulation and competition, because I believe the public interest issues will continue to be very large, and that there will continue to be regulators who are involved in that.

Q. I would like to ask you a few questions about the proposed schedule 48 following up on some of the discussion you had with Mr. Cedarbaum. The company has offered to, in order to delink it somewhat from the merger case, to put a two-year roughly effective date on it so that the schedule 48 would expire in I think June of 1998 is the alternative offer?

A. That's correct.

Q. What I would like you to address is the

following sort of scenario. The schedule allows for customers to enter into contracts with the company, ten-year contracts. What happens to that -- if a company does that what happens to that ten-year contract when the schedule no longer is effective in June of 1998, if that were to come to pass? Is that contract then limited to that two years or does the contract continue but just no one new can get a contract?
A. I guess I haven't talked to anybody about that particular question, Mr. Manifold. My reaction would be the schedule 48, to the extent that it was was withdrawn, you would not be expecting your holding customers to have some sort of contract whether schedule 48 is withdrawn or not, so that would be unfair to the customers involved that somehow they are committed to continue to take, in effect, transportation services from you when in fact you've withdrawn the schedule that was part of what you bargained out with those customers.
Q. So if the two-year option, if I may call it that, were to be what came to pass, a customer who entered into a contract under schedule 48 would have a two-year contract?
A. Well, remember --

Q. If the company exercised the option to not renew it into June of 1998?

A. Okay. And if the merger were not approved. Remember that this option doesn't say we'll make it only a two-year agreement. It says that if the merger is approved then schedule 48 would continue. If the merger is not approved then there would be -- I don't know if sunset clause is right but that sort of concept, unless the company asked and obviously the Commission agreed to extend it. So it wouldn't be -- I mean, if it were put into effect by the Commission in September, I don't think it would be right to say it's a two-year contract. I think it's one that if the merger goes through, it is the same thing we've been talking about all the time. The proviso, though, is if the merger does not go through then we have the capability to, in effect, end that contract in 1998.

Q. In the July 15 company letter on this schedule 48, and I have a copy if you want it, but on page 5 there's a couple of references to allowing the company time to "align its resources with the new proposed class of service." Could you explain what's meant by that?

A. Yes. Remember that this class of service is different than what we offer, and so it is different in a number of different ways. But as we free up power that we would currently be using that wasn't based on that market price determination, that index determination, we believe that there will be a revenue shortfall. We provided estimates of that in here, and so what we're trying to do is, frankly, to find a way to produce sufficient cost savings in our total resource mix that we either eliminate or minimize the revenue shortfall associated with this, because we are absolutely pledged not to ask to pass that through to other customers during the rate stability period or after, so that's what that means. It aligns resources, really has to do with produced cost savings out of that resource mix. That means that there's not a revenue shortfall or minimizing.

Q. We earlier spoke about three general categories of cost savings that the company was looking at. Is the replacing of the lost revenue to schedule 48 coming out of one of those three categories?

A. Yes, the power cost one.

Q. And those would be savings that would otherwise be available for some other purpose if they did not go to replenish lost revenues from schedule 48?

A. Well, during the rate stability period I suppose those savings would be available to allow us to have appropriate returns during the rate stability period, but in fact we have to, as a minimum, produce a level of savings that offset this, and I will tell you we have to do more than that to produce satisfactory earnings during that period.

Q. My understanding is that under schedule 48 customers selecting to contract with the company continue to obtain their power from the company, if you will. The electrons are not color-coded, we both know, but for this purpose if we can assume they are. They're still going to be Puget electrons that are going to those customers that are going to be priced differently but the power supplier is still Puget. Is that correct?

A. Well, the power supplier is Puget if we have the supply. I mean, there is a supply risk that these customers take, but under ordinary normal circumstances one would expect that in effect we are supplying the power and it is the price that is tied to an index, but remember they are running a risk, Mr. Manifold, in terms of the availability of that power. They don't have the same degree of -- they're lower down the priority list than other customers in terms of the potential that that could be interrupted with notice, if we were unable to provide that.

Q. What I'm trying to understand is what -- I guess I don't understand what power it is that is released for the company to make other arrangements with in the first place; and secondly, given that Puget is one of the highest cost power producers in the region it's not clear to me how releasing some of Puget's power, which is presumably higher than market, provides any room to maneuver.

A. If you have a load, Mr. Manifold, that -- again, there are lots of different types of power. I mean, doing these comparisons between power that isn't guaranteed and firm versus power that is, those have different quality and therefore potentially different prices associated with them. So what you end up having is a situation where your firm obligation has changed by virtue of the fact that you now have customers who are interruptible, in effect, from your supply system.

That has benefits to the company. It has benefits in terms of needing less firm resource because that is not a firm commitment. That doesn't mean we wouldn't make appropriate efforts to get that power, et cetera. It does mean that the nature of the obligation is different. That's not different than we've seen I think in gas and certainly in electric in my experience of situations where people have interruptibility, and when you have that, you don't have to plan during those peaks, specifically, to meet that. You don't have to have a firm power supply that is set to meet that load because of that commitment, and that makes a different quality of service, but it also potentially makes it an opportunity for the company to have a portion of the load that we had to meet. Now we've got some of that freed up that can potentially be resold or something to again try to minimize that revenue shortfall.

Q. The company could resell it on a firm long-term contract, for instance.

A. Well --

Q. Multi-year contract?

A. Well, you could replace 250 megawatts. You could replace 250 megawatts of power that you had, firm contract with 250 megawatts, because you're serving a different kind of load, of different power, different obligation power, and in theory that guaranteed firm power has a higher value in the market than the other, and hopefully that will offset part of the cost difference.

Q. In that same letter the statement is made that -- well, you heard our concerns about cost shifting perhaps resulting from this end. There is a response here that the company represents that there would be no cost shifting either during the rate stability period -- and I think elsewhere maybe in the next letter -- nor after the rate stability period. And my question is how do we guarantee that? How do we measure that? How do we know that there has been both no shifting of costs and no shifting of benefits that otherwise might be accruing?
A. I think, you know, when the appropriate time comes, you know, and in fact these -- this period has gone on and these savings have occurred, we're going to have some responsibility, I think, to show that there are savings that were produced, that we are not pushing those costs over to other customers. That there are savings that were produced in that power cost area that you mentioned that in fact equal or exceed the revenue shortfall, or if it doesn't that somehow that differential is not being charged to other customers. I mean, I think there's going to have to be a way to show that.
Q. Would you agree that it would be useful, at least from our perspective, to get some of that method

of calculating or showing that established up front?

A. It may be useful from your perceptive but I'm not sure -- I thought about a good way to do it that doesn't end up being a bit of an accounting exercise, et cetera, that may or may not have validity.

Q. So you don't have any particular process in mind at this point?

A. No, I don't.

Q. What do you mean by open access in the year 2001?

A. I think by open access what we're referring to is that all customers would be able to in effect buy the commodity through other than Puget Sound Energy if they so desire, that we would on a -- on a cost-based rate be willing to offer them and therefore offer others who are trying to sell to them access to market, different from schedule 48, in fact real access to alternative suppliers of kilowatt hours.

Q. I will ask you the same question I'm going to ask Mr. Vititoe, and that is, do you envision this extending to the gas side of the business as well as to the electric side?

A. I think you better ask Mr. Vititoe that. We've been focusing so much in this schedule 48 on the electric side that I don't think I've even sat down and discussed that with Mr. Vititoe.

Q. Can you share with us what your vision of how open access, what principles or how it might look for commercial and residential customers -- in other words, those people who are not by definition eligible for schedule 48?

A. I can't resist the opportunity when you say principles to say at this point my assumption is that we would have to pay attention to the guiding principles this Commission established. I mean, I think there are clear principles that have been provided to all the parties in this state that indicate what we must address. I think we all together -- I don't think they just meant the Commission but what all parties must address in responding to what they saw as the emerging competitive business, which is what I think they called it, so we have to start with those, and I won't read them off. I think we're very familiar with what those are.

Q. Those are the principles the Commission enunciated in the NOI?

A. The guiding principles they put out in that two page paper, December 13, '95, those are the ones we looked at in working on schedule 48 in proposing the outlines of an open transition plan. As far as residential and commercial customers, one of the issues that they're going to have to look at, and they will have this choice, is what type of service do they want to get from their serving utility. Do they want to get fully bundled service, which I believe -- again I'm looking at five years but I believe will still be available -- fully bundled service where in effect you are not only the transporter, the pipes and wires company but in fact you're also the provider of the gas or the electricity in that environment, and that will be a type of service that is available, but I also believe that in that time period utilities and Puget Sound Energy in particular will be offering unbundled services, will be offering the option to take, for instance, a transportation type service where you do your own shopping, if you will.

I don't know if you will have people calling at 6:00 at night like MCI, et cetera, but it could be something like that. And I think there will be a lot of variations in between, Mr. Manifold, because I think there will be -- for instance, even in schedule 48 we anticipate the availability of market-based firming services and there's more than just commodity and transportation.

There are a lot of other pieces in between that that have to do with service, and I can't give you -- I don't have a crystal ball that's clear enough to tell you exactly what that will look like, but I firmly believe, and I think this new company's top management firmly believes that that will happen and should happen because I think it will create not only more options for customers, I think it will tend to drive prices down.

Q. Have you given any consideration to conducting some sort of pilot program of open access for residential and commercial customers in order to get experience with, test that market?

A. I haven't thought about that. I think that might be an interesting issue to bring up in the collaborative. I think the collaborative -- I'm hoping the collaborative works out well because I think this is one where everybody has got a lot at stake, and there aren't easy answers, and the Commission paper indicates how complex the issues are. And doing it on some pilot basis might be a very interesting thing to do. Schedule 48 to some extent is going to give us some experience that's going to be helpful. I mean, it's the first time we've had sort of a sale service rate and something that ties to an index and although it isn't open access per se, at least tests some of the ideas that may be part of an open access environment.

Q. My understanding is that PGE is in discussions to begin a pilot program. Are you familiar with that?

A. No, I am not.

Q. Do you believe that real time pricing is going to be necessary for people to participate in open access?

A. I think it is.

Q. Do you feel like the technology is available to allow that to happen at the residential/commercial level?

A. It's pretty expensive right now, but there's so much emphasis on the idea that this world is coming that I think the incentives for driving down the cost of that real time metering and et cetera are so strong right now that I really believe during the time frame we're talking about, Mr. Manifold, those prices will drop significantly.

Q. Back to schedule 48 for a moment. Part of schedule 48 creates the distinction between -- creates a core versus noncore class. How did you figure out where to draw that line, where to draw that line in the context of schedule 48, both in that certain people are eligible for 48 -- my understanding is that anybody who is above that line -- who is eligible for schedule 48 but were not to choose it remains a core customer?

A. Yes. Well, I will tell you I wasn't involved directly in the negotiations that occurred on this, but my best understanding of it is that we took a look at it in terms of a combination of being responsive to a group of customers who we believed had real competitive challenge and competitive alternatives; and secondly, being able to draw the line in a way that produced -- given we were not planning on passing on that risk -- that produced a level of risk that we thought was one that we could could live with or could try to find a way to live with, so I think it was -- I don't think it was some magic number, Mr. Manifold. I think it was a careful look at balancing and I was not directly involved.

Q. We have, I think, described that as a result of a negotiation with those customers. Is that accurate?

A. I think that's very fair. The schedule itself, the proposal itself, is a negotiated proposal.

There's no doubt about it.

Q. Does the company have plans at this point to propose legislation at the state level on open access this '97 session?

A. I don't know that -- we don't have anything drawn up if that's what you mean, but I do think it's going to take legislative action in this state, and obviously we want to be a player in that and we're looking at that issue right now, how would you accomplish, what would it take, et cetera, for a couple of reasons, if I could, to expand on it. One is, there will be transition issues to deal with. Those transition issues are called out in the guiding principles and a lot of other places.

Secondly, I think it's going to be very important, and one of the reasons that I think it's going to take a little bit of time is we can't just deal with Puget or Puget Sound Energy in isolation of what's going on in the rest of the state, the rest of the northwest, some degree of equity. I mean, these are issues that probably also go beyond jurisdiction of this Commission and perhaps go outside the state of Washington. So there is a recent review going on obviously that's certainly talking about some of these issues, but I think they're going to ultimately take some legislation-type fixes and maybe some regional cooperation as well.

Q. There's some discussion about potential changes in line extension policies. Who would be the best witness to ask about that?

A. Either Mr. Wiegand or Mr. Story from Puget. I don't remember who testifies, but as you may have noticed in the testimony, I actually haven't seen a proposal and which apparently is being worked on without having yet submitted it to top management, but we do have a couple of people that have been working on it, so I think it would be appropriate to ask whichever one happens first, Mr. Wiegand or Mr. Story.

Q. Don't feel lonely. I haven't seen it yet either.

A. Okay, good.

Q. What about customer bill frequency? Puget currently bills bimonthly. Washington Natural bills monthly. Residential and commercial customers. Obviously an issue in terms of combined companies is going to be what are you going to do?

A. We haven't developed the final answer to that, but I will give you where I think it's going to go, and I will end up with my personal opinion on it. I think we need to go to monthly billing. In fact a significant number of Puget customers are billed monthly because we have a lot of customers on budget payment plan. I'm on a budget payment plan and lots of other customers are, so we do get monthly bills. The effort -- the joint meter reading we're doing right now, Mr. Manifold, is being done on a monthly -- on a monthly basis.

I talked to a couple of Washington Natural Gas people I think last week or the week before about the studies they had done on monthly billing that clearly indicated to them -- I mean, to them it was definitively clear that monthly billing was in fact in total less expensive, less revenue requirement than bimonthly, and they seem very convinced of that. I have seen past studies in Puget, and there haven't been done any in a while that made it sound like it was a relative wash, but I also think that meter reading technology, et cetera, has improved pretty significantly during that period of time. So I am not here to announce that the new company has decided that, but I think the odds are very strong that we would go that way.

Q. Would one of the factors in that decision be the impact on the customer of the size of the bill from the joint operations? In other words, the larger the bill the more frequent one might want to have --

A. I guess I can think of that as one of the first ones but I think that would be true. When you have a total energy bill that's one of the reasons that customers like budget billing is they like to have some predictability. They like to be able to budget it out, and I would certainly expect that the new company offers some budget billing alternatives for customers.

Q. Is one of the scenarios that may be possible for a combined company, given the potential for a less regulated more competitive environment possibility, that NewCo, Puget Energy, might market outside of its existing service areas?

A. Certainly, depending on what direction a lot of these changes go. I mean, one of the reasons we're frankly talking to Duke Louie Dreyfuss and some of the others is the possibility that we could get involved in wholesale markets, Energy -- I'm trying to think of the name.

Q. Energy Services?

A. Energy Services Business or something like that certainly would include outside the service territory.

Q. That would be both wholesale and retail potentially?

A. Potentially. Again depending on how those changes are made.

Q. Have you made any attempt to quantify your growth or potential growth in those markets?

A. No, we haven't.

Q. Would you agree that the combined company will have more market power as a result of its -- the nexus between the two companies?

A. I'm not sure it has more market power because we don't end up with -- we don't end up with any more service territories than we currently have. I think what the combined company has is we have the potential to be more effective in the markets because of lower cost and better service. So I don't think it's a market power issue. I think it's an issue of capability to serve customers with greater efficiencies and better service. If you were talking about big dividends of territory or something like that it would be different, but I don't think so.

Q. A stronger competitor?

A. I would say a stronger competitor if the basis for competition becomes "keep your cost down and keep your service up." I think you heard me earlier. That's my assumption of what this business is all about. If so, if we're better at keeping our cost down and our service up then we will be a more effective competitor.

Q. From our earlier discussion regarding schedule 48, I assume the company has not -- it sounds like schedule 48 was a response by the company to a particular set of customers, and the company has not, at this point, considered how to offer something like that to other customers, if that's what you see being subject to a future collaborative?

A. That's correct.

Q. Would you agree that a big part of the challenge to the company right now -- some might say the largest but I will just say a big challenge -- is the power supply portfolio that Puget currently has?

A. Yes.

Q. You know, there's been a lot of talk lately about market price, and I don't think you're an economist, I'm not an economist. We both have had to become amateur economists. What's your sense of what market price means? I mean, there's talk about the COB, some say that's not really market price. That's a one-hour nonfirm price.

A. Well, you will hear from my answer that I am indeed not an economist, but I think the market pricing discussions that I am sort of seeing in the gearings-up, and things like that are remarkably simplistic in a way, because in fact there are a whole series of different kinds of potential service, and so the lack of differentiation between that particular commodity, what are the characteristics of it, what are the pluses and minuses associated with its reliability and its predictability of price and is it firm price over time, is it a regulated price or nonregulated, those are all pieces that affect what you're talking about. And I find that people sort of -- they're comparing apples and oranges without acknowledging that they're really different fruits they're comparing here, and I think the analysis of what is a market price versus embedded, for what? For what kind of service?

And that lack of sophistication in the discussion is one that surprises me a little bit, and I think that's going to -- that discussion will get more sophisticated as all of us get to understand the different nature. Different customers have very different kinds of requirements, Mr. Manifold, as I know you're well aware, and understanding the nature of how you price those sorts of requirements as opposed to what's sort of the market price out there at COB is something I think we need to understand a lot better.

Q. Am I correct that the merger itself doesn't reduce your power supply costs? It's the opportunities that partnering with Washington Natural presents to you that presents some of the opportunities that you're looking towards realigning your power costs, in other words --

A. I believe it's the merger that affords those opportunities, but an approval by the Commission of a -- of the merger does not in itself create some reduction in power costs.

Q. It's not a direct benefit, perhaps, as Mr. Flaherty has calculated various direct benefits of joint trenching and that sort of thing?

A. Well, you can't make quite as strong a tie as you can with the Mr. Flaherty-developed costs to the merger but I think you can make a pretty strong tie, but it's not as clear a tie that they are produced very directly by the merger, that's correct.

Q. A lot of the specific direct merger savings that Mr. Flaherty identifies are in the administrative/general expenses, and distribution level expenses generally?

A. And duplication of facilities and areas like that, but yes. It's true -- there's a lot of common sense to it. You don't have to hire an expert, but in fact, you think about it, you bring these two companies together. You don't pick on Mr. Torgerson. You don't need two finance departments. You don't need two human resources departments. It is not something that's caught up in -- his savings are not sort of producing additional efficiencies by doing the work dramatically differently. I mean, that's further along but it's in fact the overlaps that are dominant there and the ability to run the system more effectively.

Q. Would you agree that in looking at how the merger benefits are allocated, are shared among customers, customer classes, customers or the stockholders, it would be relevant to look at what the types of savings are that are being realized?

A. I don't know how critical that is. It may be, Mr. Manifold, but let me suggest to you that the proposal that we've put forth doesn't really try to make a big distinction there. What it says is that the benefits to the customer will in effect be guaranteed. They will be the following proposal. The ability to generate those savings, whether they're the ones Mr. Flaherty identified or stretch power costs or best practices, those are risks that are on the company and the company management to produce if they're going to have adequate returns during the rate stability period.

I think customers have a great incentive to have the company produce those because we're not trying to do this because of a five-year rate stability period. We're trying to do this because in the long run also we want to have costs as low as possible.

Q. Would you agree that generally most of the -- or many of the savings -- perhaps I should say most of the savings identified by Mr. Flaherty are at the distribution level and below portion of the business as opposed to the transmission and supply end of the business?

A. Most of them are actually in the administrative area, in general administration, et cetera, as opposed to distribution per se, but they're certainly not savings. Mr. Flaherty identified some parts. I know no savings associated with the generation side.

Q. And the administrative and general costs in cost of service studies generally go on things like customer counts, so residential and commercial

customers are the ones who tend to bear administrative and general costs in general?
A. I don't know that that's true. I think all customers bear administrative and general costs.
Q. In the transmission and delivery costs under schedule 48, are those fixed as of the date when contracts with the customer or can those be changed over time?
A. Those could be changed by the Commission.
Q. So those continue to be a tariff?
A. They're a cost-based tariff.
Q. So to the extent that there was to be any stranded cost recovery in the future that is a place where those could be charged?
A. Well, no, not necessarily, because what we're talking about here, I assume that if a tariff were set up to recover stranded investment that that tariff would be applied to those who choose open access. Schedule 48 isn't an open access tariff. Now, when I answered that the nine mill number could change, it could change based on, for instance, the one percent rate adjustment that's been proposed. That's the only thing I am aware of that could change that during the rate stability period, but this is not an open access tariff. If an open access tariff is

worked out and if it includes some sort of transition charges of whatever kind they are to recover unmitigated investment, whatever it might be, then I would assume the Commission would apply those charges to all those who choose to take that open access tariff.

JUDGE SCHAER: About how much more do you have, Mr. Manifold?

MR. MANIFOLD: I don't expect I would finish up before a reasonable break for lunch.

JUDGE SCHAER: Is this a good breaking point for you?

MR. MANIFOLD: Sure.

JUDGE SCHAER: We're going to break now for our lunch recess. Please be back and ready to go at 1:15. We'll be off the record.

(Lunch recess taken at 12:00 p.m.)

AFTERNOON SESSION

1:20 p.m.

JUDGE SCHAER: We're back on the record. At this time Ms. Richardson is distributing two exhibits for Mr. Sonstelie. First is a one-page exhibit which is response to public counsel data request No. 74. And I am going to mark that for identification as Exhibit No. 38.

Second is a multi-page exhibit. Heading at the top, Response to Public Counsel Data Request No. 82. I'm going to mark that for identification as Exhibit 39.

(Marked Exhibits 38 and 39.)

JUDGE SCHAER: Would you like to proceed with your questioning, then, Mr. Manifold.

MR. MANIFOLD: Yes, thank you.

Q. I would like to ask you sort of a long question and it's basically an assertion and ask you to respond to it, and it's an assertion I think we've made in some of our other comments here so it won't be a new one, I think, but it appears that the lost revenues to the company on a fully effective schedule 48 after the transition period would be about $30 million a year. There's already a special contract with ARCO and a special contract with Bellingham Cold

Storage and Georgia-Pacific which also result in less revenue than would otherwise be collected under the applicable tariffs. All of that put together is perhaps in the 40 to $45 million a year range. I guess let me stop there and see if we're in the right magnitude.

A.   I don't know if that's right. I know the $30 million number is correct. I don't know the other.

Q.   The merger benefits that have been identified have been stated on a ten-year basis as $370 million, which, without even doing subject to check, we could say was $37 million a year on an average basis. I understand that they're not necessarily going to be accrued on an average basis, but on an average basis. On a perhaps simplistic level it looks like out of $37 million of merger benefits at least $30 million of benefits have already been targeted for a particular purpose. From my perspective that doesn't leave much honey for other purposes, and I wondered if you could respond to that.

A.   Sure, let me comment on that. No. If in fact it were to be made to work that way it would be unfair in my opinion, and so I think what we were talking about is the fact that we need to identify $30 million in savings produced from power costs compared to where they are today, that that is where the shortfall occurs, and that is what is necessary to be produced to hold other customers harmless, if you will, from the impacts of implementation of schedule 48. And I am not proposing, and I don't think we would propose, that somehow because you produce some of the nonpower costs associated savings, hopefully all of them that are identified, that those would be counted as the savings necessary to offset the impacts of schedule 48.

Q. In order to ascertain -- assuming all of this goes as planned, as proposed by the company, and I am back to the point of how do we know in 2002, assuming you and I are both lucky enough to be in these same positions then, how do we know who is paying for what when? And that answer suggests to me that if one took a projection from now of the currently expected power supply costs and assuming those have been reduced in some manner in some way, $30 million of that is the schedule 48 make whole, I will call it, portion, and if they haven't been reduced in some way, $30 million of that is still the management/shareholder responsibility, whether that's achieved or not.

A. I think conceptually the idea that we take the power costs -- if I understand your point, we take the power costs projections that frankly are in this case, and talk about this is what is expected in terms of power costs, and we are able then to track reductions that I strongly believe will occur, must occur in power costs, and we assure ourselves that those have been at least $30 million, then I think that is a very good way to do it. I don't think -- again, I repeat, we're not talking about taking the other merger savings and counting those against the $30 million. I'm a little stumbling on the detail of exactly how you would set that up procedurally, et cetera, but it does seem to me that that's what we had in mind when we said hold other customers harmless, if you will, from this.

Q. And that's why you would assert that the benefits of the merger, other than as it relates to reducing power costs, aren't being already allocated through schedule 48 lost revenues?

A. That's correct.

Q. We already discussed that another witness would be appropriate witness to ask line extension questions. On a conceptual basis if the company were to change its line extension policies, and that was approved through whatever processes, such that it incurred fewer costs to accomplish line extensions and some of those costs were borne by some other as yet unnamed third parties, that would result in additional cost savings to the company?

A. There's a potential for that, yes. I mean, you could have a situation where you got more revenue from new connecting customers to cover the cost of connecting.

Q. Or if a municipality were requesting or requiring lines to be relocated if the municipality bore that cost -- I think there's some suggestion of that in somebody's testimony -- rather than the company bearing that then that would be another area of some amount of savings to the company?

A. Yes, that's potential.

Q. Is the company's purchase of power from Bonneville under the WPPSS 3 settlement arrangement one of the above cost resources which the company would be seeking to realign?

A. I don't know the answer to that, Mr. Manifold. I'm not sure what that cost is right now. You know, it was tied to some formulas, and I have not been involved directly in any discussions on that. I mean, the public update that you already referenced I don't believe has much discussion of that, so I just don't know what the cost of that is, but there are not significant efforts under way that I am aware of.

Q. Was there any -- the company proposed what we've been calling a five-year rate stability, rate predictability hold-out period, and I assume there's nothing particularly magic about five versus four and a half versus six. I mean, it was a relatively arbitrary number as opposed to some other number nearby?

A. I think that's a fair characterization. Nothing about five that makes it more magic than four and a half or five and a half. There's something about five that makes it more magic than two or ten.

Q. Just to take a question that may come up later, it isn't tied to anybody's tenure on the Commission?

A. No, it is not. The accomplishment of it may be tied to my tenure in the job but --

Q. Do you have anything -- have you or any of the transition teams, or anyone else in the company, developed any more information on market transition than the pretty bare bones conceptual point that you put forth in your supplemental testimony? That is, the legislation, collaborative, et cetera?

A. No, not at this point. I mean, the market transition plan is pretty much what we talked about in May. Quite conceptual in nature and indicating sort of the timing and -- would be involved, et cetera, but we don't have specific proposals developed yet.

Q. We spoke this morning some about a pilot program. I understand you don't have any plans to run a pilot program. You're obviously aware of other states have been doing that. New Hampshire most notably. Illinois I believe is running a pilot program. Are you generally familiar they've been doing that?

A. Very generally familiar. Sort of at the Electric Utility Week level. About five lines but that's about all.

Q. Would you regard that sort of program as something that would be useful in order to test the market to see what is going to be out there?

A. Well, given my knowledge of those programs is at the level I told you, I don't think I could answer that as to whether those make sense. I think what I indicated to you, Mr. Manifold, and I would repeat is that I think the plus of working together in a collaborative is for the collaborative to develop ideas that, for instance, try things out and learn. I think that's really valuable, and when you're all working together on that, I think it's a great opportunity for everybody to learn together, so I guess I was indicating that I think we would be very open to what should we try. Take a small step before the big step if we're going to an open access environment.

Q. Well, what I wanted to get your reaction to, if you're in a position to do that, is that the idea that some of that might be done earlier than in a collaborative starting about a year from now and that some of that might even be a condition for the merger going forward to get that sort of experimentation happening as soon as possible.

A. My hesitation on that is that I would like to design -- I mean, I would like to design something together. You know, I would like to work on something that really does provide a real test, provide the kind of information we need that is financially supportable, is a basic part of that, and I guess it's not so much the timing as the idea of working something out together. Maybe that could happen in a quicker time period. It doesn't have to wait 18 months, but it's more the idea of trying to work out something that everybody thought made sense and was really going to be a learning experience.

Q. Was there any particular reason for starting a collaborative six months after the merger, which I am reading as given the current status of this proceeding and the schedule I'm reading to be next July, was that intended to be after the legislative session was over or just to give you time to swallow the merger thing or what?

A. So far as I know, and again it was negotiated, a lot of aspects of schedule 48 I think the real thought was we want to have the right people involved, et cetera, and it takes some time after, assuming the merger is approved, to get a whole lot of things going, et cetera, and then be able to pull people aside, so I think it's more of a question of the time it takes to get the right people involved.

Q. Have you or has the company -- I'm switching subjects here. You've talked about the up sides of the merger, understandably. What sort of analysis have you done of the down sides if A, B and C don't take place? A sort of risk analysis. I will just talk on a moment so you can think about your answer.

When I first started doing this work point forecasts were done by electric utilities, as you probably recall, and then things got a little more sophisticated and ranges were forecasted with high probability, low probability, mid ranges. It seems to me that what the company has presented is the probably high side or at least optimistic side of what it expects and hopes to accomplish through the merger and the other efforts that it's undertaking. What I would like to explore is whether -- what analysis you've done of what that range of options, possibilities. What's the low side look like? What's the high high side look like?

A. No. We haven't really done that in any study. We certainly had those discussions. Those types of discussions of what-if discussions, those are the kind you have with boards of directors. They're the kind you have with rating agencies that talk about, okay, if you can't accomplish all these savings, well, during the rate stability period, if you can't accomplish the savings you have a significant shortfall in earnings. I mean, that's why we talk about what our goals are and stretch and things like that.

Just using an example of the rating agency book which some people don't have, we don't send that out to the rating agencies and expect them to read it and understand. We send it out in advance and then we show up and we spend two hours with them, and I was involved in that trip, because they want to ask you, and you want to explore with them, what are the risks here, but I think it's important to understand for both the rating agencies, the boards of directors, et cetera, the risk that we discussed was the risk of not doing something, because a lot of the discussion has to do with when the merged companies are together, what do they look like compared to apart on sort of an historical basis. We're talking about managing in that environment that we all see out there that we have a lot of uncertainty about, and if I could give an example of that on a down side, there was significant discussion with Mr. Torgerson yesterday about bond rating.

I think one of the important considerations in that is that we have lots of warning that Puget Sound Power and Light Company on a stand alone basis, given the uncertainty in our situation, going forward, is probably not going to continue with an A minus bond rating, so comparing a bond rating that says would the bond rating go down, I think it would go down if we don't do anything, or if we don't do the merger I think there's a higher probability, and I use that just as one example. But yes, we've discussed each of the risk factors at one time or another. We haven't done a high forecast, a low forecast, et cetera, because just doesn't make sense. We really feel that the forecast we have is stretch but stretch doesn't mean not doable. It means tough to manage, and that's exactly the challenge we need to take on at this point in time.

Q. Am I correct -- I think you referenced this earlier but I want to be sure it's clear -- that the company's estimate of potential load that it would no longer have as firm commitment under schedule 48 is about 250 megawatts?

A. I believe that's correct, yes.

Q. Can you say anything about the difference between the company's obligation to its schedule 48 customer and an interruptible customer? You mentioned the relationship that -- which of those has higher call, if any, or are they pretty much the same?

A. Well, it depends on the nature of the tariff in the contract. There are specific tariffs associated with it that have their provisions in them. I mean, schedule 48, the obligation is what it states in the schedule in terms of how much notice you have to give on interruption and this sort of thing, and so

I'm not as familiar, especially recently, with the other interruptible customers we have since we've been mostly concentrating on this schedule, but it would depend again specifically on what's in those particular tariffs in terms of what the rights and responsibilities are of the company and of the customer, and of course these are voluntary tariffs. That is an important similarity between our current interruptible tariffs and schedule 48. They're not ones that customers are forced to take. They're ones that customers have the option to take and it's their decision, not ours, as to whether they take it.

Q. I have a couple of questions to ask you that aren't particularly easy either to ask or to answer and they concern the cogen contracts. I reviewed your direct examination and cross-examination in the prudence review case, and perhaps to make it as simple as possible, would you accept a characterization that in that testimony you felt that the contracts were excellent ones and that in particular the fuel risk had been handled in a very responsible and good way?

A. Yes. I think that's generally what I was testifying on, and obviously I was testifying about a period of time when a series of decisions were made which resulted in certain contracts, and it was my belief that at the time they were made, knowing what we do or could know, that they were good decisions.

Q. There was -- it's interesting to look back at such things. A comment that you made, and I think that Mr. Lauckhart made in his testimony as well, was that the value of the contracts would really be proven over time, that prudence review is a regulatory construct and that time would tell whether they were good or not. I take it that from today's perspective, as of the time now, these are not particularly good contracts, and by that I'm talking about as we see them now, and I am not attempting to reconsider the prudence or nonprudence at the time they were entered --

A. Making the separation, obviously prudence review has to do with looking at decision making at the time. I think the best way I could answer that question in terms of the contracts, all else being equal, obviously if I had known, if we had known that in fact, number one, gas prices were to continue to decline, number two, there would evolve a very large and very deep spot market for electricity, I mean, you would literally be trading electricity future. I mean, that sort of very intense market.

Q. Had you finished?
A. No. But if we really had pre-knowledge of the existence of that sort of market and those sort of prices, you would probably have more -- you would have an ability to rely more on that spot market which frankly didn't even exist at the time period.
Q. If those contracts, which are 20-, 15-year, various, as are in the exhibit, if those expired today -- if those had expired yesterday may I assume you would not renew those today under their existing terms?
A. Well, I'd try to renew them under different terms. I would not, Mr. Manifold, just go strictly recommend that we strictly shop in the spot market for all the power associated with those contracts. That wouldn't be prudent, but I do believe that we would try to -- given a different market today we would, I think, try to and probably be successful in negotiating different terms.
Q. And by different we're talking about cheaper terms especially on the gas supply side?
A. I think so. Different terms would likely be cheaper in this current market than they were then.
Q. The other thing I was struck by in reading testimony from two years ago, roughly, was the line-up

of witnesses in addition to yourself and outside witness Corey Knutsen who was vice-president of corporate planning. Is he still an officer of the company?
A. No. He left in September I think of last year.
Q. And Rich Lauckhart who was the vice-president for power planning, is he with the company?
A. He's still working with us on a consulting basis and has his own firm now. I'm trying to think when he took -- we have this voluntary separation program now available and I think he took that in June or July. I think it was June.
Q. Thank you very much.
JUDGE SCHAER: Mr. Finklea.
MR. FINKLEA: Thank you, Your Honor.

CROSS-EXAMINATION

BY MR. FINKLEA:
Q. Good afternoon Mr. Sonstelie.
A. Good afternoon.
Q. I'm Ed Finklea. I represent the Northwest Industrial Gas Users so my questions come from the perspective of gas customers of Washington Natural.

Would you agree with my characterization that many of the issues that are facing the electric side of this proposed new company have been faced by the gas side of the new company over the last several years?

A. I think there are a lot of parallels. I think they're clearly not identical, which I don't think your question is assuming, but I think there are similar type issues, yes.

Q. And would you also agree that Washington Natural today has many of the uncertainties and risks that Puget faces behind it?

A. It has some of them. And certainly has responded to, for instance, the unbundling aspect of being able to either be sales service transportation, full service, et cetera. I think there's a feeling in my discussions with the Washington Energy people that there's still some work to be done on that, and some work to be done on potential open access, a question I got earlier about open access for other, like, residential customers, et cetera. So some of the issues they're certainly further along than the electric side.

Q. Understand. And do you think that because of that Washington Natural faces any less business risk than Puget does over the course of the next five

years?
A. It probably does in that aspect. I mean, there are a lot of different areas of business risk beyond just that particular one, and I don't know all the business risks associated with Washington Energy Company, but I've certainly been working with them over the past few months, at least learned to spell gas, and so I do start to understand some of those, and I think there are some risks, different nature type risks associated with it. Risks that are not insignificant, but I do believe that they're a little different in nature than those in the electric side, and probably a little more -- put a few more bounds around it than you can the electric ones. I think there's more continuing uncertainty on the electric side.
Q. This morning in the discussion with Mr. Cedarbaum you were discussing whether the merger would make it easier for Puget to face the transition to a more open market than it would -- than the ability to face these same years that you have ahead of you without the merger. And I take it from that dialogue that one of the things that you believe is that Puget will be better off in going through this transition if it merges with Washington Natural and that there's

something about this merger that will enable the company to make that transition better, and I wanted to just in an open ended way to ask you to sort of elaborate on what you think it is.

A. Actually I think what it brings Puget is really what it brings Washington Energy Company. It brings an opportunity for both of us -- and I hate to sound like a broken record on this, but I think this is a theme -- it brings an opportunity for both of us to reduce costs and therefore prices below what they would be separately, and to improve service and responsiveness to customers above what it would be separately.

So I think, you know, I think that reduction of costs/improvement of service is something that benefits both gas and electric customers, and obviously those benefits must be appropriately divided according to where the costs occur. The benefits must follow the costs that are reduced and those go to either gas or electric customers. And so I really think that a type of benefit provided is quite similar to both companies and both sets of customers.

Q. From strictly a gas customer perspective, what is your reaction to the following concern? That gas customers may face greater risks with a merger than if they simply remain customers of Washington Energy with the implication in much of this electric discussion that somehow there will be savings that Puget will be able to capture if it's merged with Washington Energy that will help it make its way through this transition that without the merger from just the gas customer perspective perhaps we as gas customers would simply see ourselves?

A. I think as gas customers what I would recommend you look at on that is that Washington Energy Company generally believes, and I do too, that the merger -- you sort of said what it will produce for Puget. It will produce benefits for gas customers that include rates lower than they would be and improved service that have very real value, and I think it's important, and I got a question earlier, I think from Mr. Cedarbaum, about equitable sharing between the two groups of customers, et cetera. I mean, that clearly has to happen, and I think if that does happen and it's treated correctly gas customers will definitely benefit from this merger. I have no question in my mind on that.

Q. If the electric transition becomes a very rocky and expensive one, what assurances can you give your gas customers today that we won't be regretting this?

A. Well, I think the best assurance you're going to get on that is that I believe these businesses, since we're talking about largely distribution businesses, continue to be regulated. I think this Commission has an excellent track record of, number one, requiring that costs be properly allocated. Secondly, I think if there are other issues that go beyond just cost allocation that have to do with risk allocation, their precedence in this state for differential proforma capital structures and things like this being applied to one group of customers or another, so I think there are remedies if that sort of issue were to happen either direct for regulators to recognize that and both the prices and the capital structure particularly applied to one group of customers or another.

MR. FINKLEA: I have no further questions.

JUDGE SCHAER: Thank you. Mr. Frederickson, did you have any questions?

MR. FREDERICKSON: I have no questions, Your Honor.

JUDGE SCHAER: Would you please pass the microphone down to Mr. Patton then. Mr. Patton, I remind you that the Commission has a conference bridge that works from these microphones, so we do ask that all counsel to use the microphone and to try to speak directly into it so that you may be heard by the persons who aren't with us in the hearing room. Thank you.

MR. PATTON: Thank you.

CROSS-EXAMINATION

BY MR. PATTON:

Q. Good afternoon, Mr. Sonstelie. My name is Will Patton and I represent city of Seattle.

A. Good afternoon, Mr. Patton.

Q. Let me ask you just a question about what you were just talking with Mr. Manifold about before lunch about schedule 48 and your characterization of it as an interruptible type of rate. One of the proposed customers on schedule 48 is King County in operating their sewage treatment facility at Renton. Obviously not an interruptible load, and that contract provides that they take advantage of schedule 48 but they really don't get interrupted. Can you explain? Is that an oddity in that schedule 48 or are other customers similarly situated?

A. No. So as far as I know, we have a pledge to make best efforts never to interrupt and we have certain responsibilities to go get resources, but I'm not familiar with the details of that particular contract. I'm more familiar with the schedule itself.

Q. Well, it states in that contract on page 5 that Puget will deliver to King County pumping stations in the Renton facility priority delivery of firm electric power ahead of less essential loads in case of interruption under a different schedule, that is, schedule 80. But you're unaware of --

A. You know, Mr. Amen is scheduled to testify a little later who has a lot of rates background. I think he can answer that question, Mr. Patton. I don't know the answer to that.

Q. Generically you would agree, wouldn't you, that the Renton sewage treatment plant is not in the interruptible load?

A. Well, as a customer of that plant I would like not to see it interrupted, and I think that's pretty important.

Q. If you will turn to Exhibit 2 in your testimony, that is the map of the two companies' service areas. You have indicated in your testimony and other people testified that the overlap areas represents about 23 percent of the combined customers of the two utilities; is that right?

A. Yes. For about 250,000 joint customers in the overlap area, and there are about a little over a million total.

Q. and the Washington Natural Gas has approximately 450,000 customers so that must be 250 of the 450,000, right, leaving 200,000 gas customers not served by Puget?

A. I think it's a little over 200 but it's something like that, yes.

Q. Do you know what percentage of revenues from the Washington Natural Gas come from those 200,000 that are not covered by Puget?

A. No, I don't.

Q. Do you know how many customers of the gas company are in Seattle?

A. No, I don't.

Q. Presumably who would be the right person to ask those questions?

A. Well, Mr. Vititoe, the CEO of Washington Energy and Washington Natural Gas, is on the stand on Monday, I believe, Mr. Patton.

Q. Have you taken into account in your estimation of the savings the percentage revenue that comes from the overlapping territories versus those that are not?

A. Well, in the estimate of the savings, Mr. Patton, I mean, what we looked at was the nature of the costs that we incur, not the pattern of revenues, and so the overlap areas would have a significant percentage of the cost reductions, for instance. Mr. Flaherty indicated although there would be some in some other areas but mostly that applies to the overlap areas, including, for instance, administrative and general which applies everywhere even though it may be located in one place. In fact those costs are assigned pretty much across the board.

Q. In terms of your indication of the savings that are achievable through the combination of these companies, part of that is just due to combining two organizations of whatever nature they might be; isn't that true?

A. Yes, that's true.

Q. So, for example, you have one human services department instead of two?

A. Yes, that's a good example of ones that would occur in any sort of combination.

Q. So if you were combining with a telephone company, the same savings would occur in that arena?

A. Well, that type of savings would occur also in that arena, yes.

Q. What percentage of the savings are due to just big is better versus the two energy services?

A. You would have to ask Mr. Flaherty to characterize the nature of the $350 million in savings or 370 as to how he would characterize them. I don't think, Mr. Patton -- my recollection -- I don't think the big is better part is a significant part of the savings that he's estimated or we've estimated. I think more efficient is better is really what it's all about.

Q. So these efficiencies really derive from combining a gas utility with an electric utility?

A. They really have to do with operating a utility in different ways as a total energy company. Examples that we've talked about would include, for instance, unity trenching and things like that that, frankly, you can do much more efficiently for customers by virtue of the combination of the two companies.

Q. One of the two features that seems to be recommended by the financial advisors to the two companies as a premise for going forward, at least as I read the attachments to Mr. Torgerson's testimony, that is your prospectus for the stockholders is one that the accounting treatment be taken forward as the

book value of Washington Natural Gas Company merged into Puget without re-estimating that value based on the purchase price of the company; is that right?
A. Well, there are -- I'm not sure whether that's right. Let me give you what I understand it is, Mr. Patton, and maybe you can say whether that was the same thing you were saying. We are dealing with this from an accounting standpoint as a pooling of interest, not a purchase. To the extent that my understanding of purchase accounting is that in purchase accounting you recognize a premium paid specifically as something that's typically called goodwill, that is a cost that is then amortized over a period of time. We are doing pooling of interest accounting which does not create such an asset, an amortized asset that goes on the books.
Q. Well, as I calculated this, you are going to issue .86 shares of the new Puget company for every one share of Washington Natural Gas, right, at the time of the merger?
A. Yes.
Q. And if you take yesterday's close of Puget stock of about 22 and three quarters per share, the estimate of the amount you're going to pay for everything that Washington Natural Gas owns, that is,

the fair market value of that total company, including its nonutility aspects is about $500 million.

A. That sounds right in that when we made the announcement in -- it's not what we're paying for Washington Natural Gas but it is in fact the cost associated with the stock that is issued. I think $488 million was the number we quoted last fall.

Q. I was rounding that up to $500 million. That is, instead of offering Puget stock you just went to Bill Gates and said, "Can you buy Washington Natural Gas," if you bought all the shares on the market and they were available at the current price, it would be around $500 million to buy the whole company?

A. We never looked at that. This isn't a purchase of one company by another. This is a merger of equals and we've always approached it that way.

Q. That's the value of the new Puget stock you're going to give to the totality of the Washington Natural Gas stockholders is $500 million, right?

A. I think that's accurate, yes.

Q. Yet the book value of the assets of Washington Natural Gas is about $1 billion?

A. (No response.)

Q. Let me point you to page 21 of the

prospectus which is an exhibit.

A. I don't have that. That's not my exhibit. It's Mr. Torgerson's, I believe. What page again?

Q. 21.

A. Would you ask your question again now that I have it in front of me?

Q. The way I read this balance sheet for Washington Energy Company at the end of 1995, September 30th, 1995, halfway down the consolidated balance sheet, total assets is $989,490?

A. Uh-huh.

Q. I'm sorry -- $989,490,000 whereas the essential purchase price of the company is $500,000 -- million, I'm sorry. I'm forgetting the zeroes at the end here. 500 million, right? It is the amount of the stock of the new Puget company you're going to offer for the Washington Natural Gas shares is $500 million?

A. That I agree with.

Q. And I presume from what your financial advisor has recommended, that is, if the accounting method can be adopted whereby the same basis for rate of return is transferred instead of the purchase price that that's a good deal?

A. Mr. Patton, you've really lost me with this question. I think you're probably going to have to address these to Mr. Torgerson. That is his exhibit, and I think he's the one most familiar with those financials and how it transfers over. I'm just -- you're over my head on these.

Q. Well, let me try one more time to ask you this. That is, if the rate of return were premised on a value of the assets upon which the value -- the rate of return was calculated is half the existing value, that wouldn't be very attractive?

A. I'm sorry, I still don't follow the question.

Q. The second thing as I read it, one of the attractive features of this merger that it's not treated as a purchase but rather as a transfer of assets into the new company is the fact that the Commission approval of the merger and the acceptance by the companies of the Commission's approval would be premised on a five-year rate stability period. Is that also one of the features of this merger?

A. No. That's our proposal as to how to treat the merger with the Commission. I mean, that is the specific proposal we made with the regulatory Commission as to how we would treat this. I mean, there could have been alternative proposals, but that is the one that we believed was an appropriate way to deal with the benefits for the various parties associated with the merger. So that was -- it didn't have to happen that way, I guess, Mr. Patton, is what I'm saying but that was the specific proposal we came up with.

Q. That's offered, as I understand it, as a proposed benefit to the consumers of the new utility, that is, a five-year rate stability period?

A. That's correct.

Q. And if you're looking at that proposal from the vantage point of a consumer or representing a group of consumers of part of that utility, that would be an attractive offer if you faced a period of probably increasing costs?

A. Yes.

Q. But not so attractive an offer if you faced a period over the next five years of decreasing costs?

A. I would agree with that.

Q. So to have an analogy of -- if a computer manufacturer offered to sell you your requirements for computers over the next five years at a fixed price to be set today based on the current market price that might not be a very attractive deal to enter into given the experience of declining costs of computers over any period of time?

A. That's possible. I would have to -- I don't know quite that much about computers but analogy may well hold.

Q. Part of the testimony of Ms. Lynch and Mr. Story based on Puget assessment is that the costs of power over the next five years are expected to go up markedly by $80 million. Do you agree with that?

A. Yes. Ms. Lynch identifies cost of power and other costs that are expected to go up.

Q. Weren't you talking in your previous testimony this afternoon about the surprising emergence of a very low spot market for electricity which has a surprising depth of supply available?

A. Yes.

Q. So wouldn't you expect prices for electricity to actually go down over the next five years?

A. I would expect that spot market power is going to be available out there. I don't know whether it will be higher or lower than it is today, but for most utilities that spot market power is lower than current embedded costs for most utilities.

Q. So most electric utilities if they're able to escape embedded commitments and buy power on the market can expect to achieve lower costs over the next five years than they have now?

A. If everybody -- if you could just wave a magic wand and all your embedded commitments went away I think what you would then try to do is get some more embedded commitments and shop in the spot market. I think you would do a little bit of each. I think I answered that question from Mr. Manifold before about if you could stop these contracts now and you could renegotiate them would you do that and the answer is yes, if you had that opportunity.

Q. Is Puget in the position -- the current Puget Power entity -- in the position where its power commitments for the next five years are fully embedded and locked up, that is, there's no flexibility to take advantage of the spot market?

A. Not all its power commitments. As a matter of fact in the exhibit that you cite that Ms. Lynch has, the projections for what power costs will be is a mix of all our sources that we utilize to meet commitment out there, and that's a mix of existing contracts, existing owned resources, some use of the spot market certainly is included in there, both from a sales -- from a buy and a sales standpoint, so all that is in that.

Q. Part of the reason for the decline in electricity prices on the spot market is the continuing low price of natural gas?

A. That's correct.

Q. So you would expect over the next five years that if the current market conditions persist over the next five years that gas is also going to be cheap as a source of power?

A. I would think it is, yes.

Q. So that if you were solely a gas customer of this new utility you would expect to see lower prices over the next five years?

A. No. I don't think that -- you said gas would be cheap. I think gas will be cheap because I think it's cheap today. That doesn't mean it will be cheaper. I think it has probability of going up from where it is today. I personally don't believe that there's much probability that gas prices will go up very dramatically in the next few years, but I certainly think there's some significant probability that they'll move around. There will be some volatility.

Q. So in your view the five-year rate stability commitment is a protection for the consumer not for the company.

A. The proposal in total, Mr. Patton, is, I believe, an appropriate sharing of risks and benefits between consumers and investors, and one major piece of that, if you cite it, is the five-year rate stability period which provides lower prices during that period for both electric and gas customers than they would see if these two companies stayed separate. And there's a real benefit associated with that also, to the extent that these cost reductions are produced that are at the risk -- management's risk to produce. Those benefits since these are cost-of-service-regulated companies, those benefits ultimately will keep long-term prices down also for the customers of these two companies.

Q. It seems from reading your testimony and others that support that a large part of the savings that the company intends to produce over the next five years and beyond that is due to the synergies of the two fuel utilities working together. Is that a correct summarization of your view?

A. Yes. I think that's true. There are savings from other sources but that's certainly a very significant source, Mr. Patton.

Q. And some of the things you've indicated are the joint billing programs, joint trenching. Mr.

Torgerson indicated yesterday that there might be joint crews available.

A. Those are examples. There's a great deal of detail provided, for instance, in Mr. Flaherty's testimony of a whole bunch of assumptions he makes to get $370 million.

Q. Mr. Flaherty uses one example of an attempt to cooperate between the Washington Natural Gas and Puget in the Mercer Island service area, and indicated that whereas that worked out to some extent it really doesn't have the potential to work out in the same magnitude as when the two companies combined. Is that your experience as well?

A. Yes. I think that's true. I think there are -- we've already proven that there are some savings you can make by working together jointly. I think we also have in that experience recognized that there are also some limitations associated with that. You will find that Mr. Wiegand in particular who has been part of not only the effort on the merger so far, Mr. Patton, but was also very much part of the group that worked together with Washington Natural Gas from Puget, and I think he can give you some specifics in terms of his own experience in how far we could go, potential obstacles that we believe will be significantly removed by virtue of the merger.

Q. Can you give me some other examples of those?

A. I think one thing that was cited was trying to work on the joint billing and the idea of -- I think the very strong ownership we all have in that form of communication to the customer and the idea that ultimately obviously if you are the same company it's frankly a whole lot easier to implement something like that. If that weren't true there would be probably joint bills going on all over the country right now, and in fact that isn't true because that's an example of something that as much as you might be able to develop a theory that says, gee, you ought to be able to work that out, in fact it's human beings involved in this who are very concerned about how you allocate benefits, et cetera, and that kind of problem is significantly overcome when you have a merger situation.

Q. In addition to those situations of people working together on a joint project, if you are running through the same organizations it's easier to get people to cooperate to actually do a joint bill or cooperate in combining schedules of meter readers is another indication on the Mercer Island example where you had different schedules of meter reading between the gas company and Puget, I think you indicated this morning that there was also a certain inertia about fuel switching that would be overcome if the two companies were combined. That is, whereas Puget doesn't resist a conversion to gas now it would be much more actively encouraging of that if the income from that fuel switch also came back to the company?

A. I think I indicated, Mr. Patton, in that discussion that I believe the single biggest -- there's some benefit there but I believe the real big benefit is in the increasing availability of natural gas, because what keeps the example that I gave and that you just cited there from being an overwhelming benefit is most customers now in new single family houses who have the choice are opting for natural gas in our service territory, and so I really think that the biggest benefit is the ability to drive down costs and therefore be able to extend gas service into areas where it's just not as available right now.

Q. But the ability to extend those lines has been available to Washington Natural Gas as a singly operating company?

A. But that extension policy is significantly based on the economics of being able to make that extension. I mean, the tariffs specifically have costs and economics factored into the tariffs, and to the extent that you can get more efficient in those operations you get a benefit of being able to extend gas service more readily, more quickly than you would otherwise.

Q. So if you looked again at this map of overlapping service territories, the dramatic efficiencies that you talked about being available, where those two companies overlap would be most attained in the totality if the Puget overlapped with Washington Natural Gas throughout the service territory?

A. (No response.)

Q. Let me ask it a different way while you're contemplating that. If you only overlap in 23 percent of the customer base then you can only achieve the most efficiencies of the company in that 23 percent of the territory; is that right?

A. I mean, there is a relationship between the degree of overlap and the amount of cost savings that can be achieved.

Q. Don't the arguments for why it's beneficial to have a dual fuel utility of electric and gas apply to Washington Water Power just as well as to Puget and

Washington Natural Gas?

A. Yes.

Q. And don't they also apply just as well to the city of Seattle if it operated both an electric utility and a gas utility?

A. Yes.

MR. PATTON: Thank you.

JUDGE SCHAER: Thank you. Mr. MacIver.

CROSS-EXAMINATION

BY MR. MACIVER:

Q. Just very briefly. Mr. Sonstelie, my name is Clyde MacIver. I represent ICNU. You testified in response to a question from public counsel when he was inquiring whether or not you had made any risk assessment in connection with the merger and part of your answer was that one of the greatest risks to Puget was to do nothing. Do you recall that?

A. Yes, I do.

Q. You also answered a question put to you by public counsel regarding how with respect to schedule 48 Puget determined which customers would be offered schedule 48, that you had made -- in your best judgment tried to determine which industrial customers had true competitive alternatives?

A. That's correct.

Q. So would it be fair to characterize schedule 48 in part as being a move by the company in effect to reduce its risks not only to the company but to its customers?

A. Yes, I think that's true. The discussion that's gone on has been one that says that the $30 million revenue shortfall would not be passed on to other customers. Therefore, they would be held harmless. I think the real point is that not doing something, the potential for revenue shortfall is dramatically higher.

Q. That was going to be my next question. That if the question that was put to you by Mr. Cedarbaum on that line is that if all eligible customers took 48 that there would be some revenue shortfall and that question was asked to you in a vacuum in the sense that and there was no corresponding benefit and that all industrial customers were left on the existing tariff. With those conditions there would be a revenue shortfall, correct?

A. Yes, I believe there would be a dramatic revenue shortfall.

Q. But Puget does not operate in a vacuum, does it?

A. No, we don't. We have to operate in the reality of what the market is.

Q. And is it your best judgment that if Puget does nothing with respect to this group of industrial customers that they would simply remain on existing tariff or would they exercise other options?

A. No. I think they're going to do whatever they can to try to develop other options and try to follow those options.

Q. And would those options include bypass and generation of power?

A. Yes. Those are two that would certainly be readily available in the current situation is bypass or self-generation.

MR. MACIVER: Thank you. I have no further questions.

JUDGE SCHAER: Mr. Freedman, did you have questions for this witness?

MR. FREEDMAN: I do not, Your Honor.

JUDGE SCHAER: Ms. Richardson.

CROSS-EXAMINATION

BY MS. RICHARDSON:

Q. Good afternoon, Mr. Sonstelie, Shelly

Richardson for the Public Power Council. The questions that I have deal with a small portion of your testimony, quite frankly, a rather minor portion of the case but one which Mr. Cedarbaum touched on this morning and which is I think worth a fair amount of money in terms of the merged company, and that's with the residential exchange program of which Puget Power has currently been a beneficiary. Before I get into the questions, though, I want to make sure that I don't get too deeply into the trivia of residential exchange lore, so let me ask you a couple of questions with respect to your background. I see from your direct testimony that you're president and chief executive officer of Puget Sound Power and Light Company. Can you tell me how long you've held that position?

A. Yes. Since 1992. Four years.

Q. And did you have a position within the company prior to that time and if so could you describe it for me?

A. Well, yes. I had probably a dozen positions within the company. I've been with the company a total of 22 years, and I've worked in major projects, not building nuclear plants. I've worked in corporate planning. I've worked in conservation, finance, engineering, divisions in customer service. The major areas I've had several jobs within those.

Q. That's helpful, thank you. Now, one of the things that Mr. Cedarbaum referenced this morning were certain what he called carve-outs from the rate stability plan, and one of those carve-outs he identified as the residential exchange program. Now, whether we consider that an appropriate carve-out or not, set that aside for a moment. Let me get to some of the comments that you made in that questioning of Mr. Cedarbaum. And I will try to do it in a manner so that it doesn't produce someone who is hopping mad about the issue as I understand the utility has been in the past.

In response to one of Mr. Cedarbaum's questions -- I'm paraphrasing here -- you indicated that for purposes of the residential exchange under the Puget/Washington Natural Gas merger that Bonneville was attempting to find some money to benefit the residential and small farm customers. Now, I take it that response was in context of the so-called freeze on the residential exchange that had everybody hopping mad?

A. Well, let me see. It had nothing to do with the merger, obviously, but in fact going back to a year ago the announcement out of Bonneville led us to believe -- and Mr. Hardy told me pretty directly so that's why I believed -- that there would be virtually no dollars available under the Bonneville proposed rate case for the residential exchange.

Q. And that would be the Bonneville rate case for the rate period beginning October 1 of 1996 and extending through September 30 of 2001?

A. That's correct. That five-year period.

Q. And could you describe to me your understanding of how the residential exchange will be administered during that five-year Bonneville rate period as has now been filed with the Federal Energy Regulatory Commission as of the 26th of last month?

A. My best understanding is that if no negotiated settlement is worked out that Bonneville's proposal is that it continues to be administered during that time period. There would be the normal average system costs submittals, et cetera, during that time period, and there would be -- what differs from what we've seen in the past is that there's sort of -- as I understand it now there are two PF rates. There's one that applies to the exchange and there's one -- there's always been some difference but there's a substantial difference between these two rates, one that applies to the exchange and one that applies to preference customers and that that gap is wide enough because of Bonneville's triggering of 7B2 that the exchange benefits would be significantly more limited than they have been in the past. That's my understanding.

Q. Now, given your tenure with Puget and accepting for a moment that the residential exchange program only came into being with the passage of the Northwest Power Act in the early 1980s, could you give me an idea of how long Puget has been a participant in the residential exchange program?

A. Pretty much from the beginning. There have been times that there have been no exchange benefits during that period, but we have been in it I believe almost from the beginning.

Q. And is it true, to the best of your understanding, that Bonneville since June of 1984 has applied a specific methodology for determining average system cost for resources that utilities such as Puget are operating that they submit through the residential exchange program?

A. That's my understanding, yes.

Q. So if we have a methodology that Bonneville has applied since roughly June of 1984 to date, is it your understanding that that methodology was applied for the rate period from October 1 of 1996 through September 30 of 2001 in the same manner as it had been applied previously, which is to say from June of '84 to this rate period?

A. I don't know whether it had technically, but I don't believe it has philosophically because I believe philosophically Bonneville really saw that their obligation under the regional act was to make sure that all customers in the northwest had an opportunity, residential and small farm customers --

Q. I appreciate that but is the philosophical aspect that you're referring to a component of the methodology that Bonneville uses when it calculates --

A. I don't know the methodology well enough.

Q. That's fair. Now, given all this background, I would like to apply it some to the issues that we're talking about in the merger, and really what I'm interested in knowing is what the impact of this proposed merger will be on the residential exchange program. Now, when I read your testimony on page 7 there's a chart -- this is of your prefiled direct testimony. There's a chart at the top of that page which describes -- and please correct me if I'm wrong, but I believe it describes increases in electricity and gas rates since 1991 and then compares that with the results that would be produced under the rate stability proposal.

A. That's correct.

Q. And this chart does not, according to the footnote on the chart, does not reflect any changes in the residential exchange credit?

A. That's correct. This is our rate.

Q. Now, could you tell me what the baseline of the exchange was when you prepared this chart?

A. No. I don't know. You know, I think the record requisition or the data request on this for the detail on it went to Mr. Story and he does know the detail of what the baselines were.

Q. Let me refer you to the document that was marked as Exhibit 38 after we came back from the lunch break. This is document described as response to public counsel data request No. 74. Have you got that in front of you?

A. Yes, I do.

Q. And was this prepared by you or under your direction?

A. No. I'm familiar with it but it wasn't -- although it said "in reference to your testimony," Ms.

Lynch was the one -- the witness and the one who would have seen the preparation and signed off on it, et cetera.

Q. So it's safe to say that while you didn't have direct supervisory control over Ms. Lynch in preparing this that it is something that you're familiar with enough to be able to address the materials it describes or is that not accurate?

A. Well, I will give it a try.

Q. Okay.

MS. RICHARDSON: How would you like me to proceed? Would you like me to move its admission? Wait until after the questions?

JUDGE SCHAER: I've got a couple concerns. First you have used the amount of time you had estimated. How much longer do you expect to be?

MS. RICHARDSON: Perhaps five minutes.

JUDGE SCHAER: Secondly, our normal practice is when a record request indicates who a response is by and the respondent is a witness in the proceeding usually have you offer that response through that witness, and Ms. Lynch will be testifying. You may offer it now and see if the company objects or if they are willing to let it go in, but I think that as far as any in-depth questioning on this or the next one, which I notice is indicated as being sponsored by a different witness who is also not Mr. Sonstelie, you might want to keep that in mind in some of the questioning.

MS. RICHARDSON: If I may then proceed. The inquiry I have I don't think is in depth, and if it's something that Mr. Sonstelie isn't comfortable or capable of answering then I will certainly address it at such time as is appropriate.

Q. The first sentence in this data request response indicates that the current impact of the residential exchange is to reduce the residential rate levels approximately 14 percent. Now, the last question I asked you with respect to the chart in your testimony was whether you could tell me what the baseline was for the residential exchange in that chart, and I think you indicated that you could not?

A. That's correct, I cannot.

Q. Would it be appropriate for me to assume that whatever that number is -- I don't know what it is -- that it would be a number that one could describe as impacting residential rate levels approximately 14 percent as Ms. Lynch describes in the response to the data request?

A. I'm sorry, I don't know what time period you're referring to. I mean, I think the nature of that response is right now --

Q. Current.

A. And so if you were asking what was it at any given time, I don't know, and it wouldn't be right to assume it was 14 percent.

Q. Okay, that's fair. In that case let's turn to exhibit that's been marked as Exhibit 39. In this case it's a response to public counsel data request regarding the testimony of Mr. Sonstelie. However, the response is provided by Mr. Story.

MS. RICHARDSON: Is it appropriate, Your Honor, for me to inquire with respect to this exhibit?

JUDGE SCHAER: You can inquire, but again, if the witness refers you to Mr. Story or if you want to get into any of the detail in the answer I think that you can direct it to Mr. Story and certainly if you ask Mr. Story those questions we won't let him off the hook with a reply that this is testimony of Mr. Sonstelie that he doesn't know.

MS. RICHARDSON: Very well, Your Honor, thank you.

Q. Second paragraph of the response on this data request, Mr. Sonstelie, indicates that Puget Power is currently negotiating with Bonneville regarding the exchange rate. Could you tell me the status of those negotiations?

A. Yes. I think I mentioned this morning Mr. Swofford from Puget has been the one involved in the negotiations, and he told me last week when I saw him that right now the negotiations were not continuing but his own personal expectation was it did not mean that they couldn't reach a negotiated settlement. He thought they would probably take them back up again. That is just what I heard from Mr. Swofford.

Q. Very briefly, then, a last couple of questions. Do you anticipate a change in the residential exchange benefits recieved by Puget as a result of the costs associated with the merger proceeding being flowed through the exchange?

A. Assuming -- assuming that there's not a negotiated settlement reached.

Q. Yes.

A. And that within that, I would expect, as has happened in other proceedings in front of this Commission, that we would sit down with Bonneville and look at the nature of the costs that go on during that rate stability period and work out a methodology as to how the exchange would affect those. We've successfully done that with Bonneville in the past.

Q. And when you say costs, are you referring broadly to both cost of the rate stability period and costs of the actual merger of the two companies?

A. Well, no. The way it works with Bonneville, typically they have looked at the rates as set by this Commission, rates as established by this Commission. And I guess I was particularly referring to, for instance, if the one percent increase in electric rates were implemented, et cetera, I'm sure Bonneville would want to sit down with us, find out the degree to which that does or does not affect average system cost, and that's typically what we've done with Bonneville before.

Q. Do you consider this proceeding before the Commission to be a jurisdictional rate filing with respect to the rate stability proposal?

A. I don't think this proceeding -- the rates -- the base rates were established in a previous general rate case, so those are still being carried over at this particular point in time.

Q. So that would be a no, you don't consider this to be a jurisdictional rate filing?

A. I don't know the answer to that. I think Mr. Amen could tell you. I don't know what "jurisdictional rate filing" exactly means legally. I think it's the one percent difference that I think we might be talking about, and given that I think since it's different than has typically happened in this state, that's why I think it would have to be sitting down with Bonneville and working out an agreement on how it would be handled, but again, there's some precedent. There was a periodic rate adjustment mechanism and decoupling and lot of other things that were unusual.

MS. RICHARDSON: Very well. Thank you. That's all, Your Honor.

JUDGE SCHAER: Thank you. Mr. Merkel.

MR. MERKEL: No questions.

JUDGE SCHAER: Mr. Ellsworth.

MR. VAN NOSTRAND: Your Honor, if I could interrupt, are we going to withhold the admission of Exhibits 38 and 39 to the record?

JUDGE SCHAER: They haven't been offered.

MR. VAN NOSTRAND: Are you going to offer them?

MS. RICHARDSON: I will offer them when the witness that offered the exhibits are up. If it would make it easier I would be delighted to offer them now.

MR. VAN NOSTRAND: I don't think we have any problem with admitting them now.

MS. RICHARDSON: In that case I would move the admission of the exhibits that are denominated in Exhibit 38 and 39.

JUDGE SCHAER: Is there any objection? Those documents are admitted.

(Admitted Exhibits 38 and 39.)

MS. RICHARDSON: Thank you, Mr. Van Nostrand.

CROSS-EXAMINATION

BY MR. ELLSWORTH:

Q. Good afternoon, I'm Lynn Ellsworth. I represent IBEW local 77.

A. Good afternoon.

Q. As you might assume, representing a labor organization, my questions are probably going to be qualitatively different than some of the other material you have been going through this morning.

If you could turn to page 15 of your prefiled testimony. Looking at lines 11 through 14, and in your testimony you recount that Puget has reduced its staff by 23 percent since 1992. Is that correct?

A. Yes.

Q. Were those reductions made pursuant to a plan or were they just ad hoc reductions over that four-year period?

A. No. They were very much made pursuant to -- actually more than one plan along the way, not a single plan.

Q. Does the company have documentation that establishes the levels that will be cut in particular job classifications?

A. No. It wasn't typically done that way. The plan was much more specifically tied to voluntary -- a voluntary separation program, actually three of them that were implemented during that time period with the thought that we would take a look at how many people signed up for it, how we would redistribute work, in terms of allowing people to leave under that program as opposed to setting a target at the beginning. So it was -- the plan was a voluntary separation programs themselves.

Q. Back in 1992 you didn't know that in 1995 there would be a 23 percent reduction in staff? That wasn't a targeted number?

A. No, that's correct. There was not a target going in in terms of staff reductions.

Q. From 1992 to date, has the company in its effort to reduce cost done any study or analysis of this level of staff reductions on issues relating to employee safety?

A. No, we haven't but -- we haven't done a separate study on that, Mr. Ellsworth, but we have continued to monitor. We have programs that monitor employee safety. As you're probably aware, the safety program in Puget Power is actually run by employees, by safety coordinators, and so we have continued that program and a review of every safety incident, et cetera, has gone on during that entire time period.

Q. The same question generally from 1992 to date. Has the company done any study or analysis of this level of staff reduction on the quality and reliability of service provided by Puget?

A. Well, again, we didn't do that sort of study, but we do keep statistics on things like customer outages, on the efficiency of our customer call center and others. We keep a lot of statistics that have to do with customer service. We do -- perhaps the most important of all we do surveys of customers to see levels of satisfaction, but we don't have some study that specifically ties that to employment levels.

Q. Have surveys been done on any kind of recurring regular basis from 1992 to date?

A. I believe so, yes. There are different kind of surveys and different kinds of statistics kept but they're certainly done on a fairly consistent basis.

Q. Have those results been retained by the company, to your knowledge?

A. So far as I know they have, yes.

Q. And the 625 individuals that have left the company over the last four years, has the company maintained data that shows the reductions by job classifications over that period of time?

A. We haven't by job classifications but we have by sort of more major categories of, for instance, I think management and supervision and this sort of thing but not by specific job classifications to the best of my knowledge.

Q. Has that been done on a year to year basis or what period of time have you been measuring those reductions?

A. I don't think it's been done year to year. I think the ones -- it may have been, Mr. Ellsworth. The ones I'm aware of are the ones we looked at specifically. See, many of these employees left during the specific early-out options that were offered, and we have -- we very much looked at what groups are leaving as a result of those programs, because they were all ones people signed up. Many of the rest of the reductions were really not replacing vacancies, and so that was less systematic than the one that said we're going to look at each one and see how many people have volunteered to leave.

Q. And you said since 1992 there have been three separate voluntary separations programs? Did I get that right?

A. That's correct. They were all in the same year, which was '93, I believe. There was one in about January, one later on in the spring and then the one offered to -- I'm sorry, there were two that year, one early in the year, one later in the year offered to lower level management and represented employees. Then there was another one that was offered in January of this year so there have been three.

MR. ELLSWORTH: Like to test what I've learned here the past couple of days. Can I make a record requisition for those documents?

JUDGE SCHAER: Yes, you may. You need to make it specific enough that the company knows what you're requesting. That would be record requisition 16.

Q. What I'm looking for is the written

documentation for the voluntary employee separation programs that you just described.

A. Yes, we have those.

(Record Requisition 16.)

MR. ELLSWORTH: This is a great system. This is wonderful.

Q. As in the voluntary separation programs, did the company attempt to set any levels below which it would not accept voluntary separations because of the impact it might have on quality and reliability of service?

A. We didn't preset those levels but when we looked at offering the program, for instance, particularly in the union ranks, we took a look at how many people will be eligible because that was a voluntary early retirement program, and took a look at acceptance levels and whether we could live with them. As an example, for line men, that's one example that we did take a look at, so before we offered that program one of the reasons there was a time period between the first program and the one where we made representative employees eligible is we had to take a look at whether -- how many people in those key craft areas we might possibly use who were eligible and decide whether that was something we could live with,

and our decision was that we could if that happened.
Q. Were those determinations in some written form, summaries or reports or memorandums?
A. I'm not sure if they were, Mr. Ellsworth. I remember being in on the discussions of them with the operating people in the company, but I don't remember whether they had specific studies or they were talking about the look they had taken at it and how they would redistribute the work. I remember the oral discussions, but I don't remember whether there was a written study on that.
Q. To the extent that any documents do exist that would reflect limits that would be placed on reductions in particular classifications, I would like to make you a records requisition for those documents.
JUDGE SCHAER: Record requisition No. 17.
(Record Requisition 17.)
Q. I think it was in response to a question by Mr. Manifold this morning, you said that you made a significant effort to reduce costs and you used the statistics that you serve 38 more customers per employee than at some point in the past. What was that number that you were referring to?
A. It was 38 percent more total customers served per employee from, I believe I said, 992 to

1995.

Q. Is that a ratio or a number that the company uses internally to measure quality and reliability of service?

A. No. It's just a number that's fairly readily available both to us and sort of -- it's a number you can get by taking anybody's annual report or FERC form one or something like that and looking at total number of employees and total number of customers, and so it's one that I don't think it's a definitive measure of productivity, et cetera, but it is one statistic that we do look at.

Q. If you could turn I think to page 3 of your prefiled testimony. And it looks like it's lines 4 and 5. You say that there will be some immediate staff reductions as a result of the merger. Mr. Flaherty has I think pegged that number at 301. Is that a number that you will accept?

A. Well, that's a number I accept as Mr. Flaherty's number. I'm not sure that's what it will be but that's Mr. Flaherty's best estimate.

Q. And as I understood your testimony earlier today that whatever that number is, those reductions are simply to reduce redundances or duplications between the two companies post-merger?

A. I think that's a fair characterization. I mean, it has to do with both the example like you don't need two human resources departments, which we had used a few times, and the idea of there is some operating areas where there is a degree of overlap and therefore there are some --

Q. So I assume that those reductions then are intended to have neither a positive or a negative impact on quality and reliability of service?

A. I think that's accurate to say. I think what we're talking about here -- unlike some of the earlier targeted things I think we have a situation where in fact once you merge the company you do haave potentially sort of two people in the job, which you don't really need. Call center could be an example of that. Certainly the finance department and others are examples of where you may not need as many.

Q. Are one or more of the merger task forces that have been set up studying that issue of the number of employees that will be needed post-merger by Puget Sound Energy?

A. They're not quite studying that. What they're studying is the issue of how do we get the work done in the new company as opposed to how the work has been done in the two old companies. We have not put an emphasis on coming up with -- we have not given them targets for staff reductions or things like that. We said, "Tell us the most effective way to get the work done in the new company."

Q. Is anyone studying what level of staffing the new company will need in order to not suffer any degradation in quality and reliability of service?

A. Well, I think eventually we're going to get to that because what we're now looking at, to use the operating areas as an example, we're looking at a plan for how we would run the operations, and once you start deciding how would you get the work done, ultimately you get to issues of and what staffing does it require to get that work done to meet your various targeted customer service objectives, et cetera.

Q. I would like to make a records requisition for documents in whatever form the company has them showing the by classification or broad classifications of these 625 employees that have left the company since 1992, and I don't know what form you keep those in but you said there might be broad classifications as opposed to lineman, secretary, in that level of detail.

A. We'll be glad to do that. I will just tell you in advance that the kind of detail there's going to be on that, for instance, every job that opened up and never got filled, et cetera, I am not sure you keep tracking that for years to come but we'll certainly do our best on putting that together.

MR. ELLSWORTH: I have nothing further.

(Record Requisition 18.)

JUDGE SCHAER: Mr. Meyer.

MR. MEYER: I have nothing.

(Recess.)

JUDGE SCHAER: Let's be back on the record. Commissioners, did you have any questions?

COMMISSIONER HEMSTAD: Yes. I will start.

EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. Good afternoon, Mr. Sonstelie.

A. Good afternoon, Commissioner Hemstad.

Q. I wanted to discuss first, explore a bit further, the issues dealing with the rate stability plan. The proposal is that there would be an increase of one percent per year, and I assume that would be applied to residential and commercial rates or across the board all rates?

A. That would be applied to all rates.

Q. Is it your expectation that that would be part of the final order approving the merger that we would here in advance approve a one percent rate increase per year for those prospective years?

A. Yes. You would approve a total plan for the five-year period that included that.

Q. And would that assume the company then would not in any of those -- in any of those years have to justify the one percent increase? In other words, in a typical kind of rate case environment?

A. Well, we would have to file it to the extent of confirming how the numbers would work, et cetera, but we could not file any more than the one percent and the one percent would be automatic, if you will, yes.

Q. Well, what if at least in an historical context -- perhaps this isn't quite the way to phrase it but the conclusion that you were making too much money?

A. Well, I think the proposal that we have, Commissioner, is in fact a departure from the normal ratemaking. It is a performance-based proposal. It's one that basically the Commission -- if they implemented it would be making a judgment on the nature of the risks and benefits for the next five years and have to make a judgment as to whether that proposal was a fair sharing of those risks and benefits.

Q. So all of that you will have to evaluate and assess and determine now in this proceeding, or at least that's your proposal?

A. That is our proposal.

Q. How does the proposal for one percent per year rate increase fit into the equation or the assumptions about increasing competition in the industry and -- it's come up in various questions here -- the downward pressure on pricing that that competition implies?

A. Well, I think it's -- what we tried to do in coming up with that, Commissioner, is strike a balance between the degree of risk we have with costs that are going to increase during that time period, a clear necessity on the part of management to manage those costs and bring them down, and to try to decide what recommendation we could make to the Commission that we thought was in the public interest of a fair sharing of those particular costs and benefits.

And that's why we believe that with the known and measurable and other estimated costs that were going to occur during that time period that in fact the real price of electricity or real price associated with our rates would decline. There is a 5.6 percent decrease obviously going to happen because of the deferral, but I must tell you, of course, the other piece which we are concerned about is the residential exchange for a group of customers, and I am not trying to make light of that. It's a very real concern.

Q.   Well, are you relatively confident that you in this changing environment, including possible regulatory changes as well as surely possible legislative changes, both federal or state, that you will in fact be able to put into effect these one percent per year increases?

A.   I think that will make good sense because of the fact that we will be in the process during that time period of taking the steps that are necessary to drive down our total cost to offset the costs that are going to be occurring during that period. Commissioner, if we're unsuccessful in accomplishing that series of cost reductions during that time period then by the end of that period we're going to clearly be in big trouble in terms of responding to the competitive environment, especially if it includes open retail competition, but we're trying to buy a period of time to do that and to accomplish those cost reductions.

Q. I understand, but in a certain sense what your costs are in a competitive market are really irrelevant, I think. In other words, the market in the open competitive environment, if that's what we may have in the next five years, the market is determined by the market not by what your costs are.

A. Well, clearly that -- in my opinion that environment in which we're operating is going to be a mixed competitive/regulated environment. We are very much posturing ourselves as distribution companies, wires and pipes companies.

Q. I see. I understand. So you would expect the distribution system will remain a regulated environment in which the prices will be set here?

A. Yes, that's correct, and also that we propose that by the end of that period we would propose in effect unbundled type rates, and I believe the unbundled rates, the transportation or sales service portion of that would be cost-based and would continue to be regulated. That doesn't mean, incidentally, that we don't have to concentrate on getting that particular regulated rate as low as possible. We do. And that therefore if customers had choice of where to buy their commodity, Commissioner, that we are going to have to make sure that we have done everything we can to deal with the disconnect that exists right now between some of those commodity prices in the market right now and where we are on embedded cost.

Q. Do you foresee within the next five years that you could be subjected to competition from other combined energy service companies, in other words, that would be offering on a competitive basis combined electric and gas service?

A. Oh, I have no doubt about it, yes, sir.

Q. And if that were the case you would anticipate then there would be some kind of obligation that NewCo would be required to distribute those competitive services over your system?

A. Yes. I have no doubt that if retail competition goes in the direction that I believe it will, of open access, that we would in fact have a cost-based charge for delivering the products of others, if you will, and of course Washington Energy Company does some of that today.

Q. And in that kind of environment, in all probability there would be a set of arrangements calling for unbundled services?

A. Yes. I definitely think so.

Q. Would you consider making this merger contingent on fuller rate undbundling of your current services to be a deal breaker?

A. I guess I would have to look at what form. I mean, clearly schedule 48 is very specifically addressing that issue for our most at-risk group of customers right now, and it certainly is unbundled. It has both a separation between a commodity price and a sales service price. And our proposal is that we should go to the philosophy of unbundled rates in open access for other customers, not necessarily wait until after five years but do it as quickly as we can develop with the parties and hopefully with the Commission the right plan to get there. I think that would be the best way to do it is to do it together.

Q. Switching to the schedule 48. If I understood the question addressed to you by Mr. Manifold in your answer, if -- if the schedule 48 option was taken out by the customers who have access to it, it was the estimate that there would be a $30 million reduction in the power revenues. Is that --

A. By 2001, yes, there would be. Best estimate.

Q. And as I recall, if I understood your response, you would deal with that by getting your power costs down by something approximating that amount.

A. Well, I think we would try -- we would get the power -- our goal is to get the power cost down by far more than that amount, but I think my discussion with Mr. Manifold was that we ought to have to show -- I think he was suggesting that. I was responding that we ought to have to show that we have gotten them down by at least that amount in order to really be able to say we held other customers harmless from the benefits delivered to the one customer group of being able to access this power at market rates.

Q. And those savings are from the savings from the merger or are those savings from the power purchase contracts themselves?

A. They're very much from power costs. It might be power purchase contracts. It might be owned. It would have to be power costs because I don't think it would be fair for us, for instance, to go say, well, there are these synergy savings from the merger. We'll count those as the one that satisfy our obligation to do that. I think it would have to be specifically savings developed from our current level of power costs.

Q. Those are your contract commitments you would see in some form of renegotiation or restructure in those contracts?

A. I don't know what form the change in those contracts would take. They're not -- Commissioner, they're not necessarily the only source, either. We've been going after coal costs. I mean, there are a number of other sources, but those are certainly among the most important.

COMMISSIONER HEMSTAD: I will stop with that. I may have some more but I will hear what my colleagues have to say.

EXAMINATION

BY COMMISSIONER GILLIS:

Q. Mr. Sonstelie, this morning in your testimony you talked about the willingness of the company to revise your schedule 48 approach to make it no longer contingent on implementation of the merger but to possibly implement it sooner but if the merger were not approved that you would only make a two year commitment at this point; is that right?

A. Yes, Commissioner. The two-year piece is it's '98 by the time the first reductions occur in the transition charge that start to cause a revenue

shortfall.
Q. Have you talked to customers about that to see what their reaction would be to that proposal?
A. Yes. I know our staff people had some discussions with the customers with whom we had done that negotiation, as we were in the process of proposing it.
Q. So to the best of your knowledge the customers would go along with that change?
A. To the best of my knowledge they would, Commissioner, because I believe it doesn't -- originally it was just contingent on the merger. Now it would go in place and if the merger went through it would still stay in place, and if the merger didn't go through it would certainly nowhere solve for those customers.
Q. When you developed the schedule 48 proposal you did so in a collaborative nature with your larger customers; is that right?
A. Yes. I wouldn't say collaborative as much as negotiation.
Q. Negotiated.
A. It wasn't quite collaborative but it was negotiation.
Q. For the smaller customers you're only

proposing to go into a collaborative process if the merger is approved, is that correct, s a part of your transition plan?
A. Well, no. I don't think that's true. To me, approaching industry transition issues ought to be done with customers in a collaborative fashion whether the merger is approved or not. I mean, our merger transition plan -- I'm sorry, our transition plan specifically mentions working collaboratively, but I guess I feel like we would want to work collaboratively on that in any event to address those issues. They're not going to go away.
Q. Why hadn't you started on that sooner? If it's independent of the merger why hadn't you started on the collaborative negotiations with your smaller customers?
A. Well, I think the philosophical discussions have been going on for quite a while, Commissioner. Frankly people are very busy. I think that's a big piece. Collaboratives are very, very time-intensive. That's one of the reasons why I think the rate stability period affords all the parties a unique opportunity to hopefully have some time freed up to work on this because we wouldn't have -- I mean, we've been having PRAM filings and we've had some general

cases and prudency review. There's been a lot on the plate of everybody around electric issues that haven't been dealing directly with industry transition, and that's why I think that time period would be an ideal time period to work on this.
Q. In your supplemental testimony you mentioned that the collaborative would be with your customers. Would you also invite other parties such as the independent marketers, low income advocates, Commission employees?
A. Absolutely. I think -- this is, I think, one of the most significant issues that this Commission and this company and others have had to deal with in the history of regulation of the electric industry, and I think that broad participation is an absolute must.
Q. If the Commission were to approve your entire package of the schedule 48, the merger proposal, the rate stability plan, would you say that the -- a representative household customer of your utility would benefit to the same extent as a representative large user?
A. Yes, I really do, I think particularly in the longer run. In the shorter run to the extent that there wasn't immediate access, you know, open

access situation, although 48 isn't open access it's nonetheless -- it's at least access to some market-based power, but I believe that the cost savings that we could develop during that period and what I believe will be significant service and response time improvements, those benefits will be very real to all groups of customers.

And one other piece, if I could, I believe we have to compare it to what would happen if we don't do something, and I believe that the other customers, if we don't implement schedule 48, that our other customers will be significantly harmed by virtue of customers leaving the system, so I can't compare it to status quo because I don't think status quo has a chance to continue.

Q. You would see the benefits to the residential customers coming more in the long run, if I hear what you're saying is the real issue?

A. Well, I think in the short run they would come in not having the kind of rate increase that we had already proposed. That's very real and very quick. Secondly, by virtue of not losing large customers from the system who would take away their contribution to fixed costs so those are very real short run and so I think they are both short run and long run.

Q. The rate stability piece?

A. Yes.

Q. Picking up on some of the comments Commissioner Hemstad was making in his questions to you. If in retail wheeling we come to this state open access for all customers, say, in a shorter period than we might be thinking about, say within two years, would you have the option of raising your rates to recover your revenue requirements?

A. I think that Mr. Amen has some testimony that discusses that. If what happened was there was a legislatively imposed national Congressman Schafer, or whatever it might be, that said "Thou shalt do the following by this time period," I think then it would be important that given that the whole nature of the business would change so dramatically if that happened that we would have to have the capability to submit other plans that aren't tied to the rate stability program.

If, on the other hand, it was something that we worked out all together there may well be ways to work out things, that phased things in that preserved the rate stability program, et cetera. So a little bit depends on how it happened, but I think the reason we have the carve-out is we don't know what form some externally imposed mandate might take and what impact that could have on costs, and so that's why we have the hesitation is the unknown.

Q. What I am getting at, if your customers began having access to perhaps lower cost alternatives, would you have the opportunity to raise your rates to recover your revenues or would you have to either lower them or raise them, simply do what you're proposing to do anyway to keep them rate stable?

A. Well, if the customers' access to lower cost alternatives were caused by a major move, change in law, regulation, et cetera, in the state of Washington that enabled that I think that's different than saying if you're losing some individual customer to the fact that they're going for some other alternative. I would make a clear difference there. That latter case, I don't believe, is reason to say therefore we have to renege on the rate stability period. As a matter of fact, I think that's a part of the business risk that exists out there. So I want to distinguish between that and a significant change in policy law, et cetera, that causes a significant transformation in what the rules are around retail wheeling access in this state.

Q. Is it a fair statement to say that the notion of rate stability being a benefit to your customers and in particular your smaller customers that it's premised on the notion that -- your vision that the relatively naivete of those customers would continue at least in the short run for those customers; if your customers had access to competitive alternatives then they would benefit anyway from lower costs, wouldn't they, or at least stable rates?

A. Well, I think the answer to that, I would have to understand the basis on which the competitive alternatives were offered. If the proposal was one that said you sweep away and ignore all existing obligations you've undertaken on the part of customers, and just say now they're free to go get other alternatives ignoring the steps that have been taken to support them in the past, I suppose one could create some scenario where that's some sort of good deal, but I don't think, number one, that that would be appropriate to ignore whatever those past commitments have been. I don't think anybody has proposed that. I think the Commission has recognized a whole series of issues that it's not just you sweep it away. It's you deal with a whole series of important public issues, so I think that's a hypothetical that I don't believe is practical or appropriate.

Q. I wanted to ask you about in your discussions -- I think it was in your prefiled direct testimony on DSM. I believe that you indicated that the company is -- that the merged company is considering something that would be along the lines of a system charge to collect the funds upfront for those kind of activities. Did I read that right?

A. Yes, Commissioner, that's right, although it excludes the million dollar a year commitment for low income programs. We would not propose that that be part of any tracker that's created. That would just be expensed.

Q. Why do you separate those out and do them differently?

A. Well, because I think it's going to take a little while to get the other programs up and going and to relook at the economics associated with it. I don't think our philosophy on demand side management and having that be part of the resource picture has changed, but I think the economics have changed very significantly, and as a result I think it's going to be much, much harder to justify contributions by nonparticipating customers to programs like that, and I think that the discontinuity of that impact on our lowest income customers could be quite severe, and I think this -- I know that this proposal is to try to dampen that sort of impact, to make sure there's a degree of consideration for that particular customer group. That doesn't necessarily have to be something that you prove up the economics, et cetera. We may have to do some things that are more in nature of sort of a holding action or a contribution, et cetera, and that's why it would be inappropriate that those are picked up by the customers.

Q. You haven't established a level for the contemplated system charge at this point, have you?

A. No, we haven't, because we haven't established what the programs of Puget Sound Energy would be in that area. I think you have to do that by doing, you know, joint resource planning, et cetera, to see what's the best way to do that and that's going to take a little bit of time.

Q. Would you see that charge being in addition to the proposed rates, the one percent increment, whatever rates you're proposing for the merged company or is it embedded within the proposal?

A. Well, I think you would try to do it in a way that you didn't end up increasing rates over the level that they would be expected to be, and that might take some deferral accounting or things like that, but I don't know specifically how it would be handled. We're still talking about that.

COMMISSIONER GILLIS: That's all I have.

EXAMINATION

BY CHAIRMAN NELSON:

Q. Good afternoon.

A. Good afternoon, Chairman Nelson.

Q. I'm just following up on my colleagues' questions. We've just come a few weeks ago after the NARUC summer meetings, and I've been involved in the comprehensive review, and it appears in hallway discussions that we've had with our peers from other regulatory commissions around at least the region that there's some notion that the residential customer -- what's called in the comprehensive review the small trucks should get to go pretty quickly after the big trucks get to go in terms of getting access to better priced power. So some of our colleagues have been talking informally about by through using the utility as an aggregator to find the lower commodity prices portfolio standards, incentisizing green power experiment.

In short, there's a lot of talk about all kind of sort of residential pilots, and I am just wondering, I guess the questions you've heard so far is that waiting five years may seem too long a time, that we may lose an opportunity, and I guess not to hammer a dead horse but just to ask you one more time if a pilot might come from a company that's been regarded as innovative the previous five years earlier.

A. Let me start with the first part of the question. I think waiting five years may be too long too. Our five-year -- the piece that we have in the transition plan that says that we will file four years and a month, thereafter at 11 months for your review, and five years is, I think, a fall-back position. I mean, I think it's intended to be that way. It says that if we cannot work out something collaboratively that's the best idea we commit to the fact that we will unilaterally file an open access set of tariffs with this Commission. That's not the way I would like to have it done.

I agree with you, Chairman Nelson. I think these issues are issues that have to be dealt with relatively quickly. But I also think they have to be dealt with comprehensively. I mean, it's -- the Enron representative's remarks in the schedule 48 hearings just said, well, this can be done in just a few months. I don't think that's true. I think there are a lot of issues to be worked out, including transition, but I don't think that should take five years personally. I think it can happen more quickly than that, and this company and Puget Sound Energy's commitment as a new company is we feel we need to get on with that, and we feel this rate stability period is an ideal time to do it.

Q. Well, good. We'll see if there's any new ideas that appear in this proceeding as we go through time. Speaking of Enron and the PGE acquisition, can you just give me a sense of how that changes your view of the competitive landscape in the northwest or if you've already answered this question once this morning --

A. No, I didn't. Not really. The form of it surprises me a little bit. I didn't particularly expect a sort of a -- there's been a lot of talk of disaggregating. Now we almost have a re-aggregation, which is a little bit different than the talk that we have a disaggregation in the industry. Certainly Enron and PGE combination is a formidable player in any competitive situation if the acquisition is approved, but Enron is already a very active player in the Pacific Northwest, it's not like we're introducing somebody who has never been here. They've been very active in the northwest and Portland General is a very active marketer. They have been very strong with a lot of transmission, et cetera, particularly in wholesale markets back and forth.

So it's -- the form of it surprised me a little bit just because probably I hadn't thought through it as to whether that kind of combination would occur, but I think there are going to be additional players that I couldn't name right now that will be out active in these markets here in the northwest, and in the rest of the country, too. So I don't know if that helps but it's certainly an additional element of competition that we're going to have to be sensitive to.

Q. Does it scare you?

A. It pushes me to factor in whatever that competition is with the other sets of assumptions that I think we've all been making about the form the competition will take and who the competitors will be. I did mention, I believe you were here for the discussion this morning, about our continuing discussions with Duke Louie Dreyfuss.

Q. I missed that, sorry.

A. But I did indicate to the group this morning that a year ago we had their memorandum of understanding, and that had been a little bit on the back burner because working so hard with Washington Natural Gas in looking at the merger and the fact that those discussions with Duke Louie Dreyfuss were now very much more back on track, and we've got people working on that very hard right now.

CHAIRMAN NELSON: Thank you.

EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. I have a couple more. In your supplemental testimony at page 2 you reference at line 3 a commitment to work with interested parties to develop legislation necessary to foster open access to competitive energy markets on an economic basis for all electric customers. What does the phrase "on an economic basis" mean?

A. Well, what I mean by that is that there would be a clear -- that's as contrasted to just a system that allows noneconomic bypass. I mean, it just says that we should provide such access with appropriate accounting for the costs associated with providing that access, and I think on an economic basis means not on an uneconomic basis more than anything else. It's this discussion around if all we're doing is swapping such customers around and isolating series of costs as opposed to getting more efficient then we haven't done anything really for the economy as a whole.

Q. When you use the term "all electric customers," does this mean that customers of public and municipal utilities must also have open access at the same time as IOU customers?

A. I believe they should.

Q. Would you see that as part of any legislation?

A. I don't know that that would be part of whatever we work on. I think that should be the final outcome. Whether that would be in whatever we work up with others in terms of the legislative approaches I think is a separate question. I don't know the answer to that, but I think ultimately that ought to be in there. Whether it would be in the first phase, Commissioner, I don't know.

Q. Is in your opinion legislation necessary for IOU customers to gain open access or does the

Commission have the authority at the present time to do that?

A. I don't believe the Commission has the authority to order the company to provide access to our customers across our distribution system currently. Customers clearly have the ability to serve our customers at retail by building other facilities, et cetera. I mean, that's present today and that could happen, but I don't believe the Commission has the authority to order us to let others use our facilities to serve our customers, our distribution facilities.

Q. Further pursuing the legislative issue, with your schedule 48, the proposal would be that companies opting for that or customers opting for that to become noncore customers. Do you have any concern about the ability to make that stick or do they have a statutory entitlement or, phrasing it the other way around, does the company have a statutory duty to service them?

A. I believe we can make that stick because, number one, it's an optional tariff and there are provisions for how customers who decide to come back on a different schedule can do that and can pay costs associated with that so it doesn't limit their ability to come back. It does have a notice provision and does have a cost provision, so if we didn't have that then I think it would be more problematic but in fact that is there.

Q. And one last question with regard to 48. Your proposal would have the customer pay a transition charge in addition to the commodity cost. Doesn't that transition charge lead to the result that -- well, what is the advantage to the customer if they pay the transition charge that's the net of the difference between market and your current costs, other than to increase the risk for the customer?

A. For the participating customer the one who signs up on schedule 48?

Q. Yeah.

A. Well, Commissioner, I'm sure for those customers -- it was negotiated, very hard negotiations, and I'm sure those customers would prefer that it happen immediately with no transition, and frankly, that was negotiated to give us some time to produce the cost savings necessary to, number one, be able to propose not to let those impact other customers, and secondly to have an opportunity to do that that didn't have a severe impact on us financially. So what that was all about was negotiating with those customers as to the timing of that and the balance between the amount of risk we were taking on on the part of our shareholders and their need to improve their competitive situation.

Q. Well, my point is, after they paid the transition charge, will they be better off than they are in your current tariffs?

A. Oh, significantly better off than under the current tariff if they are capable, which I believe these customers are, of successfully managing. I mean, they have a greater degree of responsibility to accept market risks, et cetera, but I think these are customers who are -- who understand those risks very well, and so I believe that's something that they can very much manage, and it is optional. I mean, they're going to make that choice.

COMMISSIONER HEMSTAD: That's all I have.

JUDGE SCHAER: Anything else from the commissioners?

Let's take our afternoon recess at this time. Let's go off the record and return at 4:00, please.

(Recess.)

JUDGE SCHAER: Let's be back on the record after our afternoon recess. While we were off the record we had a brief discussion of two housekeeping matters. The first was parties have been provided with language that would reflect the change approved yesterday in the protective order in the modification to the company's language suggested by Mr. Manifold, and all parties have had an opportunity to review that language now, and I will ask again on the record, does anyone have any problem with any of that language? And hearing none that language will be incorporated in an order that modifies the current protective order in this proceeding.

As a second housekeeping matter, if it becomes necessary in order to conclude this hearing, we may be continuing the hearing sessions next Wednesday. I understand that there's an unavoidable conflict for Mr. Manifold. I want the other parties to know that so that they can check their calendars and see what changes they need to make in order to accommodate having someone here to represent their interests.

We're at the point where I get to ask questions, Mr. Sonstelie, and I have one question for you. In the second supplemental order, which was entered on May 23, 1996, Commission instructed Puget and the other parties who were involved with the PRAM transfer portion of this proceeding to propose both a method and a time schedule by which the methodology to use in determining appropriate levels of recovery of PRAM revenues related to ARCO load could be determined. And on July 11 of 1996 having received no response to that instruction in the order and getting concerned about getting that done in a timely manner the Commission sent a letter to the parties which followed up on that.

The Commission wants to have the methodology issue resolved before October 1, 1996 so that when a PRAM filing comes in it can be dealt with without having order of this nature delaying things. I think that's probably a shared interest of everyone in this room. So I want to ask you if you know what the company's plan is as far as getting some kind of schedule put together by which that issue can be addressed and resolved in the time remaining before September 30.

THE WITNESS: Yes, Your Honor. I am aware of what the plan is on that, and we would plan -- we are working -- we being specifically Mr. Story -- has been working with staff on this, and my understanding is that the plan is to submit a proposal from the company and staff as quickly as possible after these hearings conclude because the people who have been working on it, I believe, are also significantly or have been significantly involved in these hearings, this particular set of hearings. And so I believe that's the plan and Mr. Story is the one who has been specifically working on this, and he is a witness in this case.

JUDGE SCHAER: So that by the time Mr. Story takes the stand, and I check with him, he can possibly have a specific date to promise me that will be here by?

THE WITNESS: Yes. We will have Mr. Story give his best estimate from the company's standpoint of what the date would be. We're trying to work with staff on this, and it's the only hesitation I have, but I will indicate to Mr. Story -- I think he hears me now but after the hearing that we should do that.

JUDGE SCHAER: Thank you.

MR. CEDARBAUM: Your Honor, if I could just pipe in on this, because Mr. Sonstelie was speaking from the company's perspective and he might be correct even from the staff's perspective, I'm just not sure, because there have been meetings between staff, specifically Mr. Martin and Mr. Story, about this issue, and I know they're trying to work it out so that we can present that to the Commission and get that issue behind us. I'm not sure about the issue that Mr. Sonstelie just stated, so I would like to at least not leave the impression on the record that that is going to happen according to that schedule but it will certainly happen as soon as it can and it will be the schedule that he indicated. We're working on it as best we can.

JUDGE SCHAER: Thank you, and maybe you could encourage Mr. Martin to find some time to talk to Mr. Story and when Mr. Story takes the stand -- I'm not looking for a resolution to the issue so much as I'm looking for just a schedule for how or a plan for how we're going to get that resolution, and I think it's getting to be time where we knew how that was going to be accomplished.

MR. CEDARBAUM: I understand, and we have the same concerns. I just didn't want to raise the hopes that it was going to be presented when Mr. Story takes the stand next week. We'll do the best we can as soon as we can.

JUDGE SCHAER: Thank you. Mr. Van Nostrand, did you have any redirect?

MR. VAN NOSTRAND: I just have a couple of questions, Your Honor.

REDIRECT EXAMINATION

BY MR. VAN NOSTRAND:

Q. Mr. Sonstelie, do you recall the questions from city of Seattle's attorney, Mr. Patton, regarding the King County/Renton municipal waste facility?

A. Yes, I do.

Q. And is it your understanding that under schedule 48 that customers have the option of selecting a firming service?

A. Yes. That's my understanding.

Q. And what is your understanding with respect to King County's election to pursue firming service as to that Renton facility?

A. I believe that King County indicated to us their intent for at least a significant portion of that load that they would definitely be electing firming service for that. I think they're looking at some part of the load perhaps being under a nonfirm rate but that they did indicate that they would be purchasing firming service, which gets to Mr. Patton's point about the noninterruptible nature of that load.

MR. VAN NOSTRAND: I have no further questions, Your Honor.

JUDGE SCHAER: Okay. Is there any further cross?

MR. CEDARBAUM: Not from staff, Your Honor.

JUDGE SCHAER: Mr. Manifold.

MR. MANIFOLD: Yes. Just a few questions.

RECROSS-EXAMINATION

BY MR. MANIFOLD:

Q. Mr. Sonstelie, the $30 million that you testified to as the lost revenue after -- beginning in year 5 under schedule 48 on the assumptions that the company has made that under, is that the loss in revenue itself or is that the loss in revenue net of alternative power marketing arrangements with the released power?

A. It's the latter. So it's an assumption that we made about what you would be able to remarket for and then what would be the loss associated with that. Best estimate.

Q. So the lost revenue by itself is presumably larger than the $30 million?

A. No. I mean, that's the net revenue. I mean, it is revenue so if it's potentially offset by other revenue then it isn't --

Q. That's made up of two pieces. It's lost revenue from those customers and gained revenue from alternative power sales?

A. To calculate it you've got to make an assumption of what in fact those markets are, and the difference between what you could get from that power from the open market versus what you currently have in rates, and that difference itself is the $30 million.

Q. You made some statement about facilitating extension of gas service. I assume Mr. Vititoe might be the person to follow up with on that?

A. I think that would be right, yes.

Q. Correct me if I'm wrong, but I believe schedule 48 doesn't set out what sort of costs or fees would be charged to a schedule 48 electing customer who subsequently wanted to come back on as a core customer. That's left open at this point; is that correct?

A. Yes.

Q. Could you indicate what you -- I don't mean to cut you off, but I will tell you where I'm going and then you can do your thing. What sort of principles or -- I'm not asking you what that charge would be. Obviously if you know, fine, if you don't, fine. What sort of costs would you expect to be reflected in that re-entry charge?

A. What I am trying to find to answer the question, Mr. Manifold, is what we specifically say in here, because this is the nature of -- I think that's the best way to answer the question. I've got to find the right part.

Q. Are you looking for the Q and A that accompanied the schedule?

A. Actually I was looking for the service agreement, but it says the customer understands and acknowledges that such service may be subject to payment by such customer of any long run resource cost and any incremental capacity costs incurred by the company to provide such service. The idea is that whatever costs are incurred incrementally by the company to be able to go re-establish service to that customer under some other tariff would have to be borne by that customer.

I mean, the philosophy behind it is that if that customer returned they would pay the full costs associated with that return and that somehow other customers would not be disadvantaged in that. That's philosophically what that's all about. You're right. There's no calculation of that because it would depend on when it happened and how it happened.

Q. Finally, regarding the big trucks and little trucks. Are you prepared to commit that when a little truck offering is made it will be of equal benefit to the residential and commercial customers as schedule 48 is to the customers for whom it's available?

A. I think what should happen -- the reason I can't answer that yes or no is what should happen is in my belief that open access should be available to all customers. Schedule 48 is not an open access schedule tariff. Schedule 48 addresses a specific issue for a set of customers, so what I believe ought to happen is a fair open access tariff unbundled between the various parts of the costs associated with serving customers ought to occur and it ought to occur for all customers at the same time.

Q. If we wanted to explore further introducing some sort of pilot program prior to the schedule that you've indicated, who would be the appropriate person at the company to talk to?

A. I'd probably point you to two people because I think it's something we would want to talk about as Puget Sound Energy as opposed to just as Puget Power. I don't know if Puget Power is sort of the lead in this. One would be Ms. Omohundro from Puget and the other would be Mr. Davis from Washington Natural Gas. I think they would be, if you don't mind, two points of contact. I think that would be the best way to do it.

MR. MANIFOLD: That's all. Oh, no, I'm sorry.

Q. Exhibit 39, do I understand that you're in agreement that the best estimate at this point of the BPA residential exchange benefits as five years from now is that they will be zero?

A. No, not necessarily.

Q. You think they may still exist at some level?

A. Yes. As a matter of fact, if we reach a settlement with BPA, and I don't know whether we will or not, we are not -- and BPA knows this -- we are not remotely interested in anything that goes beyond that five-year period. We feel our customers have a right to benefits associated with the low cost federal power, that that was the philosophy behind the regional power act. I realize that the regional review is looking at that issue and a number of other issues, but maybe it will be in a different kind of form, Mr. Manifold, I don't know. But the philosophy that our customers as citizens of the northwest, taxpayers, et cetera, et cetera, have a right to some of the benefits associated with that I think is one that we still feel very strongly.

Q. Let me just -- you may have misstated. I thought I heard you say you're not interested in something that goes beyond the five years. I take it you are very interested? Something that goes much beyond the five years?

A. We're not interested in making some commitment that goes beyond that five -- making some deal or agreement with Bonneville that somehow after that five-year period indicates that we think there won't be benefits. On the contrary, we believe there should be, continue to be benefits. Whether they look exactly like the regional exchange, I don't know, but the principle should be that those benefits should be shared broadly in the northwest.

Q. Thank you.

JUDGE SCHAER: Any other recross for this witness? Mr. MacIver.

RECROSS-EXAMINATION

BY MR. MACIVER:

Q. Just very briefly. Mr. Sonstelie, Commissioner Hemstad asked you whether or not during the period that the transition charges applied, whether the industrial customers electing this noncore service would indeed have any benefit or whether it would be a six of one/half dozen proposition during that first period before the first transition charge. In your view is there any benefit for the industrial customers during that first 48 months and if so what would be it?

A. There is some benefit. Certainly not a dramatically as it would be once the transition charge drops away. But initially the way schedule 48 has been proposed, to the extent that those customers are successful in managing their load factors, et cetera, there are some real benefits to these customers by virtue of the fact that they could manage that and therefore reduce our costs and benefit from that, so it assumes successful management that these are pretty capable companies and will probably do that, so they would see some benefit from that standpoint. It wouldn't be a cost to Puget or a cost to anybody else but it would be a benefit. Thank you.

JUDGE SCHAER: Ms. Richardson.

MS. RICHARDSON: Thank you.

RECROSS-EXAMINATION

BY MS. RICHARDSON:

Q. Just a couple of follow-up questions, Mr. Sonstelie. With respect to the residential exchange, can you give me an idea of the order of magnitude of residential exchange benefits you might expect to realize over the next five years, appreciating that those forecasts aren't part of the testimony and haven't been done? I'm curious of the ballpark that you might expect.

A. No, I don't know for sure because I think that's one of the items still being debated back and forth. The complication is there's not just the issue of Bonneville's determination under 7B2, et cetera, as to the rate, but there's also an issue of how it's shared among the companies, how much of it is applied to true-ups from PRAM. There are a lot of issues here that determine that, and then also at least Bonneville's talking about options around shaping, that they may be willing to shape it in different ways, and so there are a number of complications there that keep me from saying I think it's going to come out this way, and that's a work in progress right now.

Q. In connection with these proceedings at the Commission, has Puget Power or any other entity filed a preliminary appendix one with Bonneville Power?

A. I don't know.

Q. Would you expect that -- again for reference, the preliminary appendix one being the filing with Bonneville, as I'm sure you're aware, that kicks off the exchange process, would you anticipate such a filing being made?

A. I have no idea. You just -- I have never heard of appendix one until you just mentioned it and I don't know the answer to that. Mr. Story would know the answer to that as to whether we have --

Q. Fine. I will check with him.

MS. RICHARDSON: No more, Your Honor.

JUDGE SCHAER: Anything else for this witness? Commissioners?.

CHAIRMAN NELSON: No.

COMMISSIONER HEMSTAD: No.

COMMISSIONER GILLIS: No.

JUDGE SCHAER: Thank you for your testimony, Mr. Sonstelie.

Let's go off the record while we change witnesses.

(Recess.)

JUDGE SCHAER: Let's be back on the record. While we were off the record Mr. Torgerson resumed the stand and let me remind you, sir, that you are still under oath. Please go ahead.

Whereupon,

JAMES TORGERSON,

having been previoulsy duly sworn, was called as a witness herein and was examined and testified further as follows:

CROSS-EXAMINATION

BY MR. MANIFOLD:

Q. Mr. Torgerson, do you have in front of you what was marked yesterday as Exhibit 32?

A. Yes, I do.

Q. And do you recognize that as a portion of the company's response to public counsel data request No. 110? It's one of the attachments to it?

A. Yes, I did.

Q. And is that an accurate representation of what it purports to be?

A. Yes, I believe it is.

MR. MANIFOLD: Your Honor, I would move for the admission of Exhibit 32.

JUDGE SCHAER: Any objection? Document is admitted.

(Admitted Exhibit 32.)

Q. Would you turn, please, to page 15.

JUDGE SCHAER: Of the exhibit or his testimony?

MR. MANIFOLD: Of the exhibit, thank you.

Q. My question here concerns the number at the bottom of the page, the proposed billings per month of 868,000. I guess we could all get rid of one of the zeroes in that number down there.

A. Probably, yes.

Q. Were you in the room when I asked Mr. Sonstelie about monthly versus bimonthly billing in the combined utility?

A. Yes, I was here.

Q. In your -- I'm going to phrase this correctly, but in the work that you've done and to the extent you know in the work Mr. Flaherty has done, has there been any recognition in that work of the benefits or costs of moving from a bimonthly to a monthly billing?

A. Not --

Q. In the projection of merger benefits?

A. Well, not in the work Mr. Flaherty did, because I think joint billing was being looked at before we even started the merger. You could look at it as one of the best practices, though. I mean, that is something you could associate with a best practice, so --

Q. Was this -- there's an estimate someplace of what the best practices savings would be. Was this

something that went into producing that estimate?
A. Not specifically. That's why I'm saying it could be considered a best practice.
Q. Have you looked at that -- would there be a benefit to the company's cash flow by having bills paid monthly rather than bimonthly?
A. I guess there should be. I mean you get -- at least initially you get your customers' payments, instead of waiting two months you get it monthly at least.
Q. Would that be in addition to the other benefits of the merger that have been discussed so far?
A. I think that would be part of this overall best practice. I mean, that's something you look at, different ways to accelerate your cash flow obviously are ways to improve your company's cash flow. It can help conceivably your earnings a little bit by accelerating cash flow. I mean, it is a best practice.
Q. Now, back to your testimony, at page 5 of your testimony, line 24. This has been touched on before, the Standard and Poor's indication of a potential downgrade of Puget's debt. Could you explain why you think that NewCo or Puget Energy would

be able to maintain or improve its rating, if you think that's the case?

A. What I said here or what S and P said was that they believed, at least preliminarily, that Puget's -- Puget Power/Puget Sound Energy ultimately would have a triple B plus rating. I think as Rich said, Mr. Sonstelie said, that's probably what's going to ultimately happen, I mean, if you look at it. I looked at the ratios and the numbers and it looked like the ratios that would support -- I mean, this is looking forward so obviously I had to look at some of our projections -- that they would support something in the range of an A minus. Looking at the numbers that S and P publishes as far as benchmarks, they're in that range. And that's why I said that ultimately over at some point in time we would have an A minus.

I also said that initially I thought it would be in the A minus range so that's why -- I mean, I feel that the company has the ratios or will -- again, this assumes that we achieve all of the savings we've talked about. As my testimony said that we would have an A minus rating or in the A minus range, but practically, S and P would be hard pressed now once they've said it's preliminarily going to be triple B plus to come back and say something differently. They may, I mean, after they saw all the analysis we've done, so I think that's where we're going to end up, as I said in my testimony, but the possibility that we end up with a triple B plus I think is there also.

Q. On page 2 of your testimony, line 19 you say that you think the combined company would have an improved ability to track capital. Can you explain why you believe that? And I recognize that your testimony was prepared six or seven, eight months ago, so to the extent that you have reason since then to support this, I'm happy to have those be incorporated as part of your answer.

A. Sure. What I felt at the time and still do today, if you look at Washington Natural Gas's bond rating, which was a triple B, even if we ended up with a triple B plus it was an improvement, so I think from a debt standpoint Washington Natural was going to end up with a higher rating as a merged company. I think the companies -- even if Puget Sound Energy starts out with a triple B plus and then I think over time it would move to an A minus if we don't get it right off, because the attainment of all of those goals and synergy benefits that we've been talking about all day would support being in the ranges. I mean, looking at the projections which we had. So I think having that rating and as a combined entity -- and then you have to look at all the other factors would end up with a rating. I would say that the access to capital will be improved at a minimum.

Now, I can also tell you we've had discussions with a number of banks looking at what kind of credit agreement we would have as a combined company. We actually got bids from a number of banks, and the banks themselves came back with bids related to the cost of the revolving credit agreement that were less than what Puget Power pays today on a combined basis. I mean, I will admit it was only a couple of basis points but still it's an indication at least the banks -- and this is recent, this just happened recently -- view the credit favorably. Now, it's probably also a function of the market today for credit agreements, but still I think that's a positive sign.

Q. At page 6, line 11 you say that you believe the combined company will have an improved business position assessment. What do you mean by "business position assessment" and could you explain that?

A. Certainly. Standard and Poor's provides an assessment of the business for all utilities, and they rate them on a scale of one to seven. Currently, Puget Power and Washington Natural both rate four, which is average. All the things we're looking at doing from the merger, the benefits we will get from the combination of the management, the synergy savings, our ability to keep rates stable, those things all added together plus providing additional customer choice, these are all things that rating agencies look at. And I think addressing, as we do in schedule 48, some of the industrial concerns related to the electric rates that industrial customers have, I think those are all broader issues that the rating agencies would look at and factor in as part of the business aspects for that particular company.

And that's what I mean by those -- the business position assessment. They look at not just the financial numbers but also the overall business and then provide a rating for that, and I think we should see an improvement because we are addressing a lot of the issues through Puget Sound Energy.

Q. Is the potential for one stop shopping for energy services one of the improvements?

A. I would have to say yes. Adding choice for customers is something that I think they even highlighted a little bit. They talk about -- and you will see in the testimony that I provided, the exhibits I provided from Moody's and Standard and Poor's, they talk about being able to provide choice to customers, and I think they consider that something that most utilities are going to have to do going forward.

Q. With Mr. Sonstelie, he made some comments in response to my questions about the potential for new retail and wholesale markets for the combined company. Would those also be examples of better business position?

A. To the extent we get into different retail and wholesale markets and can do it profitably, yes, I think that is.

Q. At page 13, I would ask if you could update the financial market reactions to the merger. Is your reading of those -- and "financial market" obviously is broader than rating agencies here. What is your sense of the message that the market has provided since you've provided your testimony or wrote your testimony?

A. Yes. The stock prices of the company -- and this was what I was referring to here and how the equity holders viewed the merger was try to take what the stock price did over time. It's traded in a fairly reasonable, narrow range. Since the announcement of the merger Washington Energy's price went up. Puget came down a little bit initially and then moved up again, and Puget Power's price has pretty much tracked the Dow Jones utility average. Actually it's done a little bit better, I think, since the day of the announcement of the merger. The Dow Jones utility average is down about five and a half percent or thereabouts. Puget's stock price is down four or five percent, something like that. So it's in a similar range.

I think the financial markets, and most of the analysts we talked to when you see some of the published reports, which we attached a couple, indicate that at least the analyst viewed the merger favorably. So I think the financial community's assessment is that it's positive.

Q. The case which Puget filed this past fall, which by their terms indicated a revenue requirement of need additional $74 million coupled with schedule 48, ARCO, Bellingham Cold Storage, Georgia-Pacific, other market developments, do these change your opinion about the ability of the combined companies to earn a reasonable rate of return under the market predictability program that's been proposed in this merger?

A. I think earning a reasonable rate of return is going to be a very big challenge for the company. I mean, we've laid out the synergy savings, the best practices, the power cost stretch goals, those are all challenges for the company, and they were before. Adding in schedule 48 and all the other things you mentioned just make the challenge, I think, even a little greater. I still believe, you know, we're up to the task as a management team, and as Mr. Sonstelie said, he has been -- he has responsibility for making sure that happens and so does the rest of the team, and I think as I said it's going to be a challenge but I think it's doable.

Q. Exhibit TS-34 has an estimate of best practices savings at page F25. Has there been any update of that since that document was prepared?

A. I can't find it right away but I know there has not been one.

Q. That's the critical information.

MR. MANIFOLD: Thank you. I have no other questions.

JUDGE SCHAER: Mr. Finklea, do you have questions?

MR. FINKLEA: I have just a few, Your

Honor.

CROSS-EXAMINATION

BY MR. FINKLEA:

Q. Good afternoon, Mr. Torgerson. I'm Ed Finklea. I represent the Northwest Industrial Gas Users. It's our understanding that it's the company's position that absent the merger the company would be seeking approximately a three to five percent increase in its gas rates; is that correct?

A. Yes, that's what we said.

Q. And if you could elaborate on the timing of that. When would you -- absent the merger when would you anticipate that the company would seek that?

A. We believe we would do it after the May 1997 date which we said would be -- we would stay out and not file until then. It would be sometime after then.

Q. After the May '97 moratorium?

A. Yes.

Q. And do you have an estimate today of what that translates to in terms of a revenue requirement?

A. Well, three to five percent on -- we have roughly $450 million in revenues so you could say it's in the 12 to $20 million range, ballpark.

Q. So when you said three to five percent, you were not focusing only on the distribution company's margin but on your total revenues?

A. You just asked what the revenue requirement would be. That's roughly what I was telling you.

Q. Let me back up then. When you estimate that the company would seek a three to five percent increase, are you talking about a three to five percent increase in your margin or a three to five percent increase in the total revenues that the company receives?

A. The revenue requirement. But again that's just ballpark estimate right now.

Q. So something in the range of 12 to 20 million dollars is what your estimate today is?

A. Right.

MR. FINKLEA: I have nothing further.

JUDGE SCHAER: Thank you. Mr. Frederickson, did you have any questions?

MR. FREDERICKSON: No questions, Your Honor.

JUDGE SCHAER: Mr. Patton.

MR. PATTON: I have a few, Your Honor.

CROSS-EXAMINATION

BY MR. PATTON:

Q. Good afternoon.

A. Afternoon.

Q. Can you turn to page 21 of the prospectus? This is the page I was trying to understand with Mr. Sonstelie.

A. I have it.

Q. Can you tell me from that summary of the balance sheet for Washington Energy Company what the company is worth?

MR. HARRIS: Your Honor, we would object to this entire line of questioning as being both irrelevant to the proceedings here and also beyond the scope of the interest raised by Seattle in their petition to intervene where they specifically identified three issues: protecting the citizens of Seattle against cross-subsidization of fuel, protecting the citizens of Seattle from some lessening of service, and exploring the company's willingness to engage in joint activities. This doesn't seem to have anything to do with any of that.

JUDGE SCHAER: Mr. Patton?

MR. PATTON: It seems to me it would have direct bearing on the rate of return that the new company expects from the gas portion of its new company.

JUDGE SCHAER: And how does that rate of return relate to the issues that you have raised?

MR. PATTON: Cross-subsidization of the customers. Because if the true value of the gas company is less than the -- than the base on which the rate of return is calculated now, then the rates to the customers in Seattle as well as elsewhere ought to go down.

JUDGE SCHAER: I'm going to overrule the objection and let you proceed.

A. Your question was asking what is Washington Energy worth?

Q. Yes.

A. That's a difficult question to answer in the first place. We've had a number of experts who provided fairness opinions to the company or one expert, Goldman Sachs. Looking at the balance sheet, you're looking at a number that says the common equity, or the book value, is $196.7 million. All that says is what we have on the books for common equity. What it's worth is you look at a whole host of things. When you're analyzing the worth of a company you look at prospective cash flows, you look at the business, you look at a number of things and in the merger, and you have to look at it specifically on the basis of a merger.

Our investment advisory Goldman Sachs said that a .86 exchange ratio in the merger was fair. That has nothing to do with a purchase or sale or what the overall business is worth because in a merger, especially the way we're doing it, which is a pooling of interests, you're combining the interests of two companies into one, and it's a totally -- it's not a sale. It's totally different. You're forming a new company, and so to come up with an answer of what the company is worth is a difficult one to answer right off the top.

Q. Well, let me direct your attention then to page 44 of the same exhibit. In the last paragraph where it discusses the payments that are to be made to Morgan Stanley?

A. Yes.

Q. Which is, as I understand it, in subsection D there a transaction fee if the merger is approved of approximately three and a half million dollars to Morgan Stanley for its investment banking services which is based on .71 percent of the aggregate consideration paid for shares of the Washington Energy

Company.

A. That's what it says, yes.

Q. So if we take that amount of money three and a half million as being .71 percent then the total value of the company is $489 million; is that right?

A. That is what it was calculated on based on the merger, and the value that was placed on it, and it was basically the number of shares times the Puget stock price at that time, times the exchange ratio, then figuring the fee that was paid based on that, so to say that's the value of the company, that was the value that was assigned based on a strategic merger of equals, which is entirely different than -- if you want to talk about a sale of purchase there are other ways to value it and other things you would do.

Q. But the amount that the Puget Energy Service Company is paying for Washington Energy is $489 million?

A. No. They're not paying that. It's a merger. There is no sale. That's the difference. I mean, the exchange ratio indicates that.

Q. When you were talking earlier about a best practice in terms of combined billings for the two companies, in the areas where the services don't overlap there wouldn't be any savings, would there?

A. Where the services don't overlap I think there are because you have -- you do have some synergy in total, because now you have one entity that's actually doing all the billing, so there are some best practices savings there. Instead of having -- right now we have two companies that do the billing for each one. Actually we've gone to where the bills are printed at Puget Power for both companies today.

Q. Well, let's take the example of either the city of Seattle or the city of Tacoma where at the moment when the merger is nonconsummated there is one company doing the billing for the gas customers; is that right?

A. Right.

Q. And presumably after -- if the merger is approved as you've proposed there will be one company doing the billing for the gas customers in both those cities?

A. That's true, but you have to remember, when you combine you also have some administrative savings too.

Q. Well, how is that a savings over what the single company Washington Energy Company does now?

A. Well, I mean, you look at the two companies, if each one is doing their own billing you're going to have two companies, you have supervision, you have administrative support, so when you combine you will have one set of administrative support for basically most of the activities, and this is just one. I don't know how significant of a savings this could be, but --

Q. Well, that might be a savings if you're in Seattle and Tacoma, wouldn't it, if you agreed to have joint billing with Tacoma Light Department or Seattle City Light?

A. I think we would probably like to look at that.

Q. But it wouldn't provide savings if you keep it separate whether it's done by a combined company or by the sole company that's there now?

A. I'm having trouble with your question, but I think if the question is getting to if we were to do combined billing with Seattle and Tacoma with Puget Sound Energy I think there would be some savings, sure.

Q. Back to the prospectus on page 49 on the accounting treatment of the pooling of interests. Essentially when you merge these companies you're not going to change the rate base for Washington Energy Company as it moves into Puget; is that correct?

A. That's correct. You take the balance sheets as they exist today and just merge them together with no changes.

Q. On page 60 -- 49 to 60 of the prospectus it indicates that "Washington Natural Gas possesses municipal franchises and environmental permits and licenses that may need to be renewed or replaced as a result of the merger." Do you know of any of those?

A. I specifically don't know of any -- which ones or what would have to be done, no, I don't know.

Q. So do you know if Washington Natural Gas has a franchise to operate in Mercer Island?

A. Off the top I assume we do but that I don't know at this point. We have franchises for a number of areas. I believe we have one there, but we have franchises for a number of jurisdictions, number of cities.

Q. And some areas in which you do not; is that right?

A. We probably have a franchise everywhere. It's a matter of whether we have to update them or assign them or what has to happen upon the merger.

Q. Are you aware that Washington Natural Gas Company does not have the franchise to operate in Seattle?

A. I believe that may be true, yes. I've heard that.

MR. PATTON: No further questions.

JUDGE SCHAER: This looks like a good time to break for the evening. Let's resume again at 9:00 in the morning. Mr. Torgerson, I think you can look forward to testimony on your third day with us, perhaps before lunch. We're off the record.

(Hearing adjourned at 5:00 p.m.)