EXHIBIT NO. ___(DWH-10T)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: DAVID W. HOFF

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF DAVID W. HOFF ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

PUGET SOUND ENERGY, INC.

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CONTENTS

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I. INTRODUCTION

Q. Are you the same David W. Hoff who provided prefiled direct testimony in this proceeding on December 3, 2007, on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes. On December 3, 2007, I filed direct testimony, Exhibit No. ___(DWH-1T), and eight exhibits supporting such direct testimony, Exhibit No. ___(DWH-2) through Exhibit No. ___(DWH-9).

Q. Please summarize the purpose of your rebuttal testimony.

A. This rebuttal testimony responds to

1. the prefiled direct testimony of Thomas Schooley, Exhibit No. ___(TES-1T), on behalf of the Washington Utilities and Transportation Commission Staff ("Commission Staff");
2. the prefiled direct testimony of Glenn A. Watkins, Exhibit No. ___(GAW-1TC), on behalf of Public Counsel; and
3. the prefiled direct testimony of Barbara R. Alexander, Exhibit No. ___(BRA-1TC), on behalf of Public Counsel and the Energy Project;

with respect to the nature of risk in rate design, the appropriate costs to be included in the basic charge (also referred to as the "customer charge"), and the

impact of the Company's residential rate proposal on low income customer. I also discuss cost of service issues raised by Mr. Watkins and in the prefiled direct testimony of Donald W. Schoenbeck, on behalf of the Industrial Customers of Northwest Utilities.

II. RESPONSE TO COMMISSION STAFF TESTIMONY

Q. Please describe the testimony of Commission Staff witness Mr. Schooley as it relates to electric cost of service, electric rate spread and electric rate design.

A. Mr. Schooley

(i) accepts the Company's electric cost of service results, with one exception;

(ii) accepts the Company's classification of line transformers as a customer expense;

(iii) accepts the Company's electric rate spread proposal; and

(iv) proposes either

(a) no increase in the monthly electric residential basic charge, or

(b) a residential basic charge of $7.25.[1]

[1] Mr. Schooley's alternative gas residential basic would be $14.83, as calculated by Ms. Phelps. See Exhibit No. ___(JPK-14T) at page 43.

A. Cost of Service

Q. What is the exception to the Company's electric cost of service results that Mr. Schooley proposes?

A. He proposes to remove the administrative and general ("A&G") plant and expenses from the customer charge calculation, in essence changing its classification. He does not indicate how the A&G plant and expenses should be reclassified, but recommends they be recovered on a cents per kWh basis.

Q. Does the Company include all A&G plant and expenses in the calculation of customer charges?

A. No, the Company includes in the calculation of customer charges only those A&G plant and expenses that are classified as customer related. All remaining A&G plant and expenses (those classified as demand or energy related) are recovered by volumetric demand and energy charges.

Q. What is the justification given by Mr. Schooley for excluding all A&G plant and expenses from the customer charge?

A. His justification appears to be based on the notion that, because A&G costs do not vary directly with the number of customers or kWh sales, they should be assigned based on control and risk (with eventual recovery from kWh sales). At page 17 of his testimony Mr. Schooley states:

> While most costs assigned to the customer charge, such as meters, underground and overhead lines, and meter reading, directly vary with the number of customers, A&G costs do not. Neither do A&G costs vary with kwh sales. It then becomes a question of how much control does the utility have over these expenses and who should bear the risk of recovery of that expense.

Q. Do you agree with Mr. Schooley's concept of cost allocation as stated above?

A. No, I do not agree for several reasons.

First, the fact that costs do not vary directly with kWh sales or the number of customers cannot be used to prevent classification of the costs as demand, energy or customer related. If this requirement were to be imposed, a large amount of the Company's costs, particularly its capital cost, would remain unclassified.

Second, I disagree with the notion that allocation of costs ever "becomes a question of how much control does a utility have over the cost". I do not know of any cost allocation method that allocates cost based on control.

Third, there should be very little, if any, risk of recovery of the portion of A&G costs that are classified as customer costs. Once these costs are included in rates, the only legitimate risk that should accompany recovery of these costs is the change in the number of customers. At a bare minimum, there should be absolutely no risk of recovery based on kWh or therm sales, since these costs do not vary with – and are not related to – sales. It is appropriate for A&G costs that are classified as demand and energy to be at risk for these sales, but not the A&G costs classified as customer costs.

Fourth, I believe the true risk related to A&G costs classified as customer costs – risks that relate to customer growth, inflation and control of customer related costs – should legitimately be born by the Company, and are born by the Company when the costs are recovered in the basic charge.

Finally, as discussed more fully below, recovering non-volumetric costs in volumetric rates does not address the issue of "who should bear the risk". Rather, it creates more risk for both customers and the Company. Rate design that needlessly increases risk should be rejected.

Q. Is the classification of a portion of A&G costs as customer related costs a standard practice?

A. Yes. I have reviewed the Company's cost of service filing going back to the rate design collaborative, which was first reviewed in Docket Nos. UE-920433, UE-920499 and UE-921262. The Company has classified a portion of A&G costs as a customer related cost in all of these filings, including the filing that implemented the recommendations of the collaborative.

B. Rate Design

Q. What changes did Mr. Schooley propose to the Company's rate design?

A. At page 15, lines 19-20 of his testimony, Mr. Schooley proposed either (1) no increase in monthly electric service customer charges, or (2) an increase to an amount of $7.25 "should the UTC consider an increase to the basic charge".

Q. What justification did Mr. Schooley present for eliminating any increase in the monthly electric service customer charges?

A. He does not justify the elimination based on cost of service principles. Indeed, he agrees with the Company that the appropriate residential basic customer charge should increase a significant amount, albeit less than the Company's proposal. Instead, he bases this proposal on: (1) a belief that any increase in the customer charge would immunize the Company from the need to fully and promptly solve alleged problems PSE has in metering and bills; and (2) a belief that PSE will have a greater incentive to cure these alleged problems if a greater portion of its revenues is collected through volumetric charges.

Q. Do you agree?

A. No. As discussed below, the Company currently has an incentive to solve the problems, and is working to correct those problems, as is discussed in the prefiled rebuttal testimonies of Mr. Bert Valdman and Ms. Booga Gilbertson. Also, an increase in the residential monthly customer charge by $2.98 a month as the Company is proposing, compared to an average monthly bill of approximately $95, is not going to provide the Company immunity from resolving these problems.

Q. Mr. Schooley believes that the recognition of unbilled revenues means there is currently no financial incentive for the Company to properly identify and resolve meter problems. Do you agree?

A. No. While these revenues might be on the books, they are not cash until PSE resolves the issues and bill customers. The improvement of cash flow provides a financial incentive to the Company to resolve these meter problems.

Q. Will the Company be incented to lower A&G costs if recovery of allocated A&G cost is placed in the volumetric charge?

A. No. The incentive to lower costs does not change whether or not a portion of A&G costs are placed in the volumetric charge. What does change is the amount of net revenue the Company will receive if it sells more gas or electricity. If the Company wants to "recover" more A&G costs, it must sell more product. Revenues related to A&G costs will increase by the amount of A&G in volumetric rates, while actual A&G costs will remain unchanged by the sale. This, unfortunately, incents the Company to sell more.

Once rates are set, the Company always has an incentive to lower costs as long as it does not, by doing so, lower revenues more. These lower costs will eventually benefit customers when rates are set again in a future rate case.

Q. Is it beneficial to customers to put the Company at risk for cost recovery by recovering non-volumetric costs with volumetric rates?

A. No. Regarding recovery of these costs, when the Company is at risk, customers are also at risk. The risk is symmetrical, but of opposite sign. The risk that the Company will not recover its non-volumetric costs over a warm winter is matched by the risk that customers will overpay for non-volumetric costs during a cold winter. Removing the non-volumetric costs from the volumetric rate removes this risk from both parties.

Q. Are you saying that the Company's proposal lowers risk to both customers and the Company, rather than shifting risk as Mr. Schooley and Ms. Alexander apparently believe?

A. Yes. All parties agree that the Company's proposal to increase the fixed monthly basic charge for residential customers lowers the Company's risk of revenue underrecovery. However, what Mr. Schooley and Ms. Alexander fail to recognize is that the Company's proposal also lowers customers' risk of overpayment of costs in the same aggregate amount.

Q. You say the Company's proposal reduces risk to both the Company and customers. Do the rate design proposals in the testimony of Mr. Schooley do the same?

A. No. His proposals actually create risk. For example, Mr. Schooley proposes to

"return" an "element of risk" to the Company by placing recovery of allocated A&G cost in the volumetric charge, Exhibit __ (TES-1T), pages 17-18, even though he admits these costs do not vary by volume. By proposing that revenues should vary by volume even though the costs associated with those revenues do not, Mr. Schooley is creating risk for both customers and the Company where there otherwise is none.

Q. Do you have an additional example of where the rate design proposals in the testimony of Mr. Schooley create risk when there is no risk?

A. Yes. Mr. Schooley not only proposes to remove a portion of allocated A&G cost from the non-volumetric charge, thus increasing risk, he proposes to remove other costs as well. These other costs are removed, not because of the nature of the costs (which Mr. Schooley believes are legitimate customer costs), but to give PSE a greater incentive to solve problems in metering and billing customers. Unfortunately, in doing so, he creates an even greater risk that customers will overpay non-volumetric customer related costs. This is a clear example of creating a risk for customers through rate design when there is no underlying risk. And, in doing so he creates an incentive for the Company to sell more kWhs.

III. RESPONSE TO PUBLIC COUNSEL TESTIMONY

A. Correction of Misleading Statements Regarding PSE's Proposed Rate Design

Q. Do you agree with the rate design, rate spread and cost of service analysis as set forth in the testimony of Public Counsel and the Energy Project witnesses Barbara Alexander and Glen Watkins?

A. No. I do not agree with the analysis of these witnesses, and I discovered several misleading and inaccurate statements in their testimony. These misleading and inaccurate statements are particularly disappointing in that they come from witnesses who have many years of experience, and they perpetuate the myth that high customer charges are harmful to customers, particularly to low income customers.

For example, at page 40 of Exhibit No. ___(BRA-1T) Ms. Alexander states:

> As a result, there is certainly no price signal to use less with this proposed approach to rate design. . . .PSE's proposal turns the notion of what most customers understand to be the basis for their bill on its head—under PSE's proposal, the more you use, the less you pay and the less you use, the more you pay

This statement is clearly false and, in my opinion, inflammatory. Ms. Alexander is certainly aware that as long as there is a per therm or per kWh charge, the more you use, the more you pay, and the less you use, the less you pay. For instance, under the Company's proposal an average residential customer will pay, or save, at least 10.3 cents for each kWh purchased or conserved. If the customer could

conserve 5% of her usage, the savings would be over $5 per month, or $60 annually. Conversely, if she were to use 5% more, she would pay $5 more each month, on average. For gas, the comparable numbers are $1.06 per therm, over $3.60 a month each month and over $43 annually.

The following statements at pages 45-46 of Ms. Alexander's testimony are also inaccurate:

> PSE's proposal to increase its fixed monthly customer charge is an effort to shift risk from its shareholders to its customers.
>
> . . . .
>
> PSE should not be allowed to shift significant costs and risks to residential customers with this proposed increase in monthly charges.

As pointed out earlier in my testimony, the Company's proposal lowers risk to both shareholders and customers.

Q. Are there other statements by Ms. Alexander that concern you?

A. Yes. At page 43 Ms. Alexander states:

> The obvious signal when a utility seeks to increase the fixed monthly charge and then remove the corresponding revenues from volumetric rates is that conservation is not important, because conservation or lower usage will result in a higher bill compared to the customer's current usage.

This statement is both erroneous and misleading. First, it repeats the same error pointed out earlier. Ms. Alexander certainly knows that conservation will result in a lower bill, not a higher bill. But, more troubling, Ms. Alexander makes a

statement about the importance of conservation to PSE that is just simply wrong. Those who know this Company and its history know that conservation is important to PSE.

What is important to the Company when it comes to rate design is that rates reflect costs, so that customers will pay as close to the cost of serving them as practical, and the Company's revenues will reflect those costs. PSE believes this is also of prime importance to its customers and the Commission. What PSE has proposed is a rate design that removes from volumetric rates a portion of the costs that do not belong in volumetric rates, but leaves in the costs that do belong. The costs remaining in volumetric rates are very substantial and provide a strong incentive to conserve. For instance, all of the costs, both fixed and variable, of generating and transmitting electricity are in volumetric rates (including demand rates), as well as all of the cost of acquiring and transporting gas.

I would like to add one more comment regarding incentive. As I am sure Ms. Alexander is aware, the duality that I talked about earlier regarding risk is also present regarding conservation incentives. Costs to a customer are revenues to the Company. When a company relies on volumetric rates to recover non-volumetric costs, the company's opportunity to recover its costs is compromised. This issue is sometimes called the decoupling issue, and many methods have been devised to address it. The Company's proposal addresses this issue in perhaps its most simple form – to remove at least a portion of non-volumetric costs from volumetric rates. Ms. Alexander's testimony does not address the issue at all.

Q. What conclusion should be reached from Ms. Alexander's noting that the basic charges of other WUTC regulated gas and electric companies are lower than what are being proposed by the Company in this case?

A. The basic charges for gas and electricity should be decided by the cost evidence for this company in this case, and should not be influenced by the costs of other companies presented in other cases.

Q. At page 39 of her testimony, Ms. Alexander states her opinion that the Company's customer charge proposal is not appropriate, fair, understandable or necessary. Do you agree?

A. No. I believe the Company's proposal is appropriate because it recovers customer costs – and only customer costs – from the customer charge. I believe it is fair because, unlike Public Counsel's proposal, it would not have customers pay more (or less) of non-varying customer costs based on variations in weather, seasons, or the number and use of appliances. It is understandable because customers can readily understand a fixed monthly charge that recovers non-varying customer costs should have no relationship to weather, season, and the customer's actual usage. I believe the charge is necessary in order for rates to be fair, just and reasonable. I discuss the fairness issue at length in my direct testimony, Exhibit No. ____ (DWH-1T), at page 52.

Q. Does Mr. Watkins make any misleading or inaccurate statements in his testimony?

A. Yes. At page 30 of his testimony, Mr. Watkins states:

> Fixed monthly customer charges represent guaranteed revenue to PSE.

Given Mr. Watkins's twenty-eight years of experience in the industry, he should know nothing is guaranteed in the electric utility business. Customers come and customers go. The revenue Mr. Watkins says is "guaranteed" goes away when customers leave, and is only returned if the customer returns or is replaced by another customer. I agree that customer charges provide a more stable source of revenue than volumetric charges, as is fully appropriate given the nature of the costs these charges represent. But, it is inaccurate and misleading to call this "guaranteed revenue."

Additionally, at page 32 of his testimony Mr. Watkins makes a statement, fundamental to his position:

> Mr. Hoff and Mrs. Phelps's positions, that most of PSE's fixed costs should be recovered through fixed monthly charges. . . .

This is completely false. PSE's position is that customer related costs, and customer related costs only, should be recovered through a fixed monthly charge, regardless of whether the cost is "fixed" or not. PSE does not propose, for instance, to recover the large amounts of "fixed" capital costs that are classified as demand or energy related in the fixed monthly charge. These "fixed" costs

include billions of dollars of production, transmission and distribution plant that are recovered over energy and demand charges, not the fixed customer charge. Thus, Mr. Watkins's discourse on long run versus short run fixed versus variable costs is completely irrelevant.

Q. Are there any other statements by Mr. Watkins that are inaccurate and misleading?

A. Yes. At page 32, lines 13-15, when discussing "virtually every capital intensive industry" Mr. Watkins states the following:

> Prices for competitive products and services in these industries are invariably established on a volumetric basis, including those that were once regulated; e.g., airline travel and rail service.

It is surprising that Mr. Watkins promotes the airline industry as an example of competitive pricing that should serve as a "surrogate" for pricing decisions of this Commission. It is unlikely that the price Mr. Watkins paid on his last trip from Washington, D.C. to the West Coast was the same price paid by all the other passengers on his flight who traveled exactly the same "volume" of miles as he did.

Q. Do you have additional comments about Mr. Watkins's testimony regarding customer charges?

A. Yes. Mr. Watkins seems to imply that, if a fixed customer charge is not identified on a bill, it is not charged. I do not believe that is the case. For instance, in the

case of Mr. Watkins's example of airline travel, it is my belief that the price that Mr. Watkins believes is a volumetric charge actually contains at least two components, one relating to customer charges and one relating to the miles flown. I believe airlines are most likely recovering a minimum fixed amount from each ticket.

Q. Are there examples of markets that are presumably competitive in which customer or fixed monthly charges are used?

A. Yes. PSE provided this information to Pubic Counsel in PSE's Response to Public Counsel Data Request No. 077. This data request is attached as Exhibit No. ____(DWH-11).

B. <u>Bill Impacts of Company and Public Counsel Rate Design Proposals</u>

Q. Ms. Alexander discusses the impact of PSE's proposed fixed monthly customer charge at page 40. Is this a complete description?

A. No. Ms Alexander focuses only on annual impacts. A full discussion should include monthly impacts. PSE provided the monthly data to Public Counsel in the Company's Response to Public Counsel Data Request Nos. 60 and 483, which are Ms. Alexander's Exhibit No. ___(BRA-4) and Exhibit No. ___(BRA-5), respectively. It is in this monthly analysis that the benefits of increasing the fixed monthly customer charge (and correspondingly decreasing the per therm or per kWh variable charge), such as decreasing variability, volatility and unpedictibility

can more fully be appreciated. Ms. Alexander also ignores the benefits all customers receive because the Company's proposed pricing structure is fairer.

Q. Does Ms. Alexander make statements regarding the bill impacts of the Company's rate design proposal that are incorrect or misleading?

A. Yes. For example, at page 40 line 22 and page 41 lines 1-2, Ms. Alexander describes the bill impacts presented in PSE's response to Public Counsel Data Request No. 60, and states:

> The Company's response showed that a higher than average usage electric customer would see a total annual bill decrease of almost $12.00, but a lower than average usage electric customer would see a $16.29 annual increase. . . . The range of these bill impacts is significant and should be relied upon to reject this proposal.

It appears Ms. Alexander picked the wrong numbers from the table she references and as a result makes an erroneous conclusion. Contrary to Ms. Alexander's erroneous statement, all three groups of customers would see an average monthly increase. The dollar impacts that Ms. Alexander refers to are the differences between an illustrative equal percentage rate increase and the Company's proposed increase, not the bill impact of the Company's proposal over current rates as Ms. Alexander's statement implies. The bill impact of the Company's proposal over current rates, is shown at pages 5 and 7 of Ms. Alexander's Exhibit No.___ (BRA-4) in the column titled "Impact of Proposed Rate Increase".

Q. What does Public Counsel propose regarding residential rate design?

A. Public Counsel proposes a residential rate design that does not increase the basic charge, regardless of the approved revenue requirement, and instead loads the entire rate increase onto the per kWh or per therm charge. This is also one of two positions taken by WUTC Staff witness Thomas E. Schooley. Public Counsel would increase the volumetric unit cost, 0.435 cents per kWh in the tail block for electric and 14.789 cents per therm for gas, over what the charge would be under the Company's proposal.

Q. Have you compared the bill impacts of Public Counsel's proposal with the Company's residential rate design.

A. Yes. To analyze the impact of Public Counsel's proposal I have updated the tables found at pages 40 – 44 of my direct testimony. This update is based on the revised revenue requirement presented by Mr. John Story in Exhibit No.___(JHS–15) and the revised rate spread discussed later in my testimony. The tables compare bills at proposed rates to bills under existing rates and to bills under a residential rate design that does not increase the basic charge at all, as proposed by Public Counsel. The updated tables are found in Exhibit No.___(DWH-12). The impacts of Public Counsel's proposal are similar to those described in my direct testimony, but the magnitude of the benefits from the Company's proposal are even more striking. The increase in volumetric charges proposed by Public Counsel means that bills would be even higher in the winter and lower in the

summer than if all charges had been increased an equal percentage. As described in my direct testimony, this would be even more sensitive to weather, even more unpredictable, create even more risk for customers and the Company, and be more unfair.

Q. Has the Company considered the bill impacts of Public Counsel's proposed increased customer charge on its low income customers?

A. Yes. The Company has calculated the bill impacts for those customers who receive bill assistance. While the Company does not track the income of its customers and does not specifically identify those customers who qualify as "low income" under federal guidelines, it is my opinion that the Company's analysis of bill-assisted customers is a reasonable approximation of the bill impacts to PSE's low income customer base. The Company's analysis of bill-assisted customers includes the various usage levels (higher than average, average, and lower than average) similar to the overall customer impact analysis discussed above. These impacts are included in Exhibit No. ___(DWH-13).

Q. What is the impact of Public Counsel's rate design proposal on PSE's bill-assisted electric customers?

A. As discussed in my direct testimony, PSE's bill-assisted electric customer segment uses more kWhs annually on average than the overall electric population. This is confirmed by Ms. Alexander at page 53 where she states:

> This study (APPRISE – December 2007) also found that a high percentage of low-income households have "high" electric bills in Washington. . . The percentage of PSE's low income customers with "high" usage was estimated at 69 percent . . .

Because of this higher than average usage, Public Counsel's rate design proposal has a general negative impact on low income customers. As illustrated in Exhibit No. ___(DWH-13), the average bill-assisted customer would pay approximately $5.50 more each year under Public Counsel's proposal than under the Company's proposal, and the bill-assisted customer that has an above average usage pattern would pay over $21 more. For these customers, even though relative bills are slightly lower in the summer months, these decreases are more than offset by higher bills in the winter months – when these customers can least afford the higher bills The below average bill-assisted customer would pay less, but these savings are less than the additional $21.21 the above average customer would pay each year.

This analysis exposes the myth that higher customer charges are especially harmful to low income users. In the case of electricity, it is Public Counsel's proposal that produces negative impacts, not the Company's.

Q. What is the impact of Public Counsel's rate design proposal on PSE's bill-assisted gas customers?

A. For PSE's bill-assisted gas customers, the analysis shows the opposite of the results for electric. The average bill-assisted gas customer uses less than the

overall average gas customer. However, as with electric customers, all customers under Public Counsel's proposal would receive higher winter bills when bills are at their highest and their summer bills would be lower when bills are at their lowest. Their bills would be more subject to the vagaries of weather and be less predictable, and their bills would be less fair. Also, while on average bill-assisted gas customers use less than the overall average, many individual customers use more. Additionally, as discussed in Mr. Eric Markell's testimony, the Company is proposing an increase in low income assistance. This increase of approximately $1.8 million for gas customers is significantly greater than the amount proposed previously in my direct testimony at pages 45 through 47, which was intended to offset the adverse impact on a portion of our low income customers caused by our rate design proposal.

Q. Is Ms. Alexander's testimony regarding the energy use of low income customers based on national and census region data relevant to this case?

A. No. At page 41 of her testimony, Ms. Alexander states:

> On average, low income customers use less electricity and gas than high income customers.

This statement directly contradicts evidence she cites at page 53 of her testimony, where she states:

> This study (APPRISE – December 2007) also found that a high percentage of low-income households have "high" electric bills in Washington . . . . The percentage of PSE's low income customers with "high" usage was estimated at 69 percent . . . .

The source of the information cited at page 41 is a national and regional study of data by census region (Northeast, Midwest, South, and West), while the information at page 53 is Washington State data. The census region study reports electric customers in the West region who were not eligible for LIHEAP used an average of 8,822 kWh in 2001. Current consumption levels for the average electric PSE customer is 11,389 kWh. This difference of over 2,500 kWhs, or 29%, strongly suggests that census region data has very little, if any, relevance to issues in this case. The Washington State data in the APPRISE report and the Company's analysis of bill assisted PSE customer usage patterns are relevant to PSE low income customers, not Ms. Alexander's simple averages of national or census region statistic, which should be ignored.

Q. Why do you believe Ms. Alexander cites the national census region data if it is not relevant to PSE's customers?

A. I feel it is to perpetuate the widely held belief that low income customers are low users of energy. It seems only natural that people with more income will purchase more energy than people with less income – simply because they have more income and can afford more of everything, including energy. This simple concept is one of the reasons the belief is so widely held. The belief is also apparently supported by the Company's own data regarding its gas bill-assisted customers. The belief is, in my opinion, central to the myth that high customer charges are particularly harmful to low income customers. However, the belief does not hold up to rigorous analysis, certainly not for electric customers and,

based on a recent study conducted by the Company, not for all gas customers either.

Q. What does your analysis show regarding the relationship between energy use and income?

A. As shown above and in my direct testimony, real data on real customers who are in electric bill-assisted programs belie the myth that low income customers are necessarily low users of energy for electricity. Ms. Alexander makes light of this data, saying it is not representative of all low income users. In response to this testimony, PSE conducted additional research on the subject in which we discovered there is no statistically significant difference in the energy use of low income customers and customers in many higher income brackets.

In the analysis, PSE compared average usage of customers in various income grouping, based on household incomes reported in the Company's 2004 residential customer survey and provided in PSE's Response to Public Counsel Data Request No. 480. For electric customers, the median usage of the lowest income category (those earning less than $20,000 per household per year), was not statistically different from customers earning $70,000-$149,999 per household per year. It was also shown that median usage of the second-lowest household income category ($20,000-$29,999 per year) was not statistically different from any other income category, including those households earning in excess of $150,000 per year.

For gas customers, the median usage of the lowest income category was not statistically different from customers earning $20,000-$79,999 per household per year. The median usage of customers in the second-lowest income category was not statistically different from customers earning $30,000-$89,999 per household per year.

In summary, this analysis belies the myth that low income customers always use less electricity and gas than high income customers. Rigorous statistical analysis on actual data revealed that, for many income brackets and for both gas and electric customers, there simply is no significant difference between the average usage levels of customers in lower income brackets and many higher income brackets. Of course there are many low income customers who use less energy than their higher income counterparts – but on average, across many income levels, there is little difference.

C. Response to Public Counsel's Cost of Service Testimony

Q. Did Public Counsel Witness Glen Watkins make recommendation on the manner in which the Company calculated its electric cost of service?

A. Yes. Mr. Watkins proposed several changes to the region's long-standing cost of service calculations and practice. After giving these proposals careful review, I believe the Commission should reject them.

Q. Please describe Mr. Watkins's first significant change?

A. Mr. Watkins would have the Company change the method of allocating income tax. The current method of allocating income tax was last discussed thoroughly by all parties in the rate design collaborative in 1992 and was approved by the Commission.[2]

Q. What does Mr. Watkins propose regarding the allocation of income tax?

A. Mr. Watkins proposes that the Company allocate income tax in both his electric and gas cost of service studies based on his hypothetical calculation of "profit" by rate class. While this is reasonable for some applications,[3] it suffers from several flaws when used for the calculation of parity ratios. The first obvious flaw is that the Company does not record profit by rate class. But, a more fundamental flaw is that his proposal denies the very purpose of cost of service analysis, in essence standing the analysis on its head. The purpose of cost of service analysis is the analysis of costs by rate class, with the objective of setting rates to cover those costs. As I believe Mr. Watkins well knows, under regulation it is rate base (and the allowed return on rate base) that determines return in any cost of service

[2] At page 42 of his revised testimony Mr. Watkins correctly points out that Ms. Phelps utilizes a different approach when allocating the income taxes that make up a component of expenses "at current rates". What he does not mention is that this difference has no effect on the Company's parity ratio calculation, which is not based on taxes related to revenues "at current rates", but is instead based on taxes that are related to the Company's full rate schedule revenue requirement. This revenue requirement includes income taxes based on revenues that would give the Company its required return. The Company's revenue requirement includes income taxes allocated on rate base in both cost of service analysis, gas and electric.

analysis, nothing more. This is why the Company allocates income taxes, which are created by return, based on the allocation of the rate making element that creates that return, rate base. Mr. Watkins proposal would introduce past rate spread decisions into an analysis that should only be based on current costs. For instance, if a past Commission had, for whatever reason, spread rates such that one class's rates were set significantly above its allocated cost of service, while another class's rates were set below its cost of service, Mr. Watkins would allocate more income taxes to the first class, reducing its parity ratio. If, on the other hand, a past Commission had done just the opposite, but all costs remain the same, Mr. Watkins's income tax allocation, and his parity ratios, would flip, regardless of the fact that there is no change in costs.

Put a different way, a cost of service study analyzes the cost to serve each rate class. The cost to serve each class should be a function of cost factors, not rate factors. It should not be a function of past rate spread decisions.

Q. Please describe Mr. Watkins's second significant change?

A. Mr. Watkins proposes that the Company change the long-standing practice used to allocate excise tax and WUTC fees. He would base the allocation on revenue, which in turn bases the allocation on past rate spread decisions rather than costs. For the same reasons as noted above in the discussion of income tax, the

[3] As mentioned above, Ms. Phelps uses a similar approach when allocating income taxes that are a component of total expenses at current rates. These allocated taxes are not used in the calculation of parity ratios.

Company believes such a change is not warranted.

Q. Please describe Mr. Watkins's third significant change.

A. Mr. Watkins would have the Company change its peak credit calculation used to classify production and transmission plant. Specifically, Mr. Watkins would (1) change the assumed hours of operation from a number based on planning assumptions to a number based on actual operation; and (2) reduce the peak responsibility of a simple cycle combustion turbine ("SCCT") by 50%. These two changes reduce Mr. Watkins's calculated peak credit factor to 14% demand and 86% energy (adjusted to 15% and 85%) rather than the Company's calculation of 26% demand and 74% energy. The result of this change is that more production and transmission plant costs are allocated based on energy factors than demand, resulting in less costs being allocated to low load factor customers, such as residential customers.

Q. Do you agree with this change in the peak credit factor?

A. I agree that the assumptions used in the calculation of the peak credit factor should be reviewed in each rate case and should reflect current thinking regarding the use of the system. Mr. Heidell did just that in 2006 when he proposed in his direct testimony in UE-060266, Exhibit No 191 (JAH-1T), which I adopted and incorporated in this filing. It is interesting that what Mr. Watkins is proposing in this case would move us back to the use of assumptions used in the cases prior to UE-060266. I do not agree with Mr. Watkins that we should turn back the clock

regarding these two critical peak credit assumptions. Of the two changed assumptions, by far the most significant is the second, which cuts his calculated peak credit factor by 50%, from 28% (after he makes his first adjustment) to 14%. The rational for this halving of the factor is "to recognize the magnitude of SCCT utilization during off-peak periods", even though the data he cites in support of his argument reveals the total utilization of these units, both on peak and off peak, to be a very small fraction of annual hours. The "magnitude of SCCT utilization during off peak periods" is almost infinitesimal. These units, with their heat rates in the neighborhood of 12,000 BTU/kWh, are by no stretch of the imagination base load units; they were not acquired to be base load units nor are they operated as base load units.

Q. Please describe Mr. Watkins's fourth significant change?

A. Mr. Watkins would re-classify certain costs as demand or energy related rather than customer related.

Q Please explain.

A. First, Mr. Watkins excludes line transformer costs from the customer cost classification. It appears his rational for doing this is based on a mischaracterization of my direct testimony.

> Mr. Hoff's rationale for inclusion of transformers in this case is solely due to the fact that every distribution customer is connected to a transformer and that, once installed, transformers represent a fixed cost of providing service to the customer or group of customers connected to the transformer.

Exhibit No. ___(GAW-1TC) at page 35:21-36:2. However, what I actually said at page 16 of my prefiled direct testimony is the following:

> In summary, transformer sizes are standardized, transformers are sized to serve a particular customer or group of customers and transformers are rarely re-sized for a particular customer or a group of customers. Therefore, transformer costs are appropriately characterized as customer related costs as opposed to demand related costs.

It should be noted that these are line transformers, not transmission or distribution substation transformers. These are the transformers at the end of the line that transform distribution voltage to the voltage used by the customers, such as 110/220 volts. They are the transformers that hang on the pole in the alley near your house. There is essentially a fixed relationship between line transformers and customers – if we have more customers, we need more transformers. There is no such relationship between line transformers and demand or energy. While we can easily contemplate having greater energy and demand costs without having more customers (existing customers use more), it is impossible to contemplate having more transformers without having more customers. The fact that, once installed, the cost of the transformer becomes fixed is not the determining factor in classifying transformers as a customer cost. The determining factor is the direct link between customers and transformers, just as there is a direct line between customers and meters and service lines. This conclusion was also reached by Commission Staff witness Thomas E. Schooley, at page 16 of Exhibit No.____(TES-1T):

Q. Does Staff agree with the inclusion of line transformer accounts in the basic charge calculation, if the charge is increased by the UTC?

A. Yes. The need for line transformers is directly related to the number of customers. The physics of the electrical system require a new line transformer for every half-dozen or so new customers. The recovery of this cost on a per customer basis would be reasonable.

Q Does Mr. Watkins re-classify other costs?

A. Yes. Mr. Watkins excludes an allocated amount of A&G costs from the customer cost classification. At page 37 of his testimony, he provides the following rational for this extraordinary exclusion:

> Because general plant represents the overhead investment required to conduct its public service obligations of selling electricity, such costs should not be considered in a customer cost analysis for purposes of justifying fixed customer charges.

It is difficult to understand this statement, which seems to indicate that serving customers is not part of the Company's public service obligation. As previously stated, PSE is proposing that only a portion of these costs be classified as customer costs, based on the classification of the underlying cost elements. Mr. Watkins similarly excludes A&G costs from his gas customer cost classification, but without comment.

Q. Are there any other costs that Mr. Watkins excludes from the basic charge calculation?

A. Yes. Mr. Watkins excludes a class of costs which are clearly customer related

and are virtually always classified as customer costs – the cost of service lines. He does this in both his gas and electric cost of service studies.

Q How does Mr. Watkins justify this adjustment?

A. He apparently believes PSE somehow double counts service line charges, and thus PSE should exclude service line expenses in the customer charge. It should be noted that the exclusion is not, and cannot be, based on the nature of the expense, which is clearly customer related.

Q. Does the Company double count service line charges?

A. No. The Company recovers service line expenses through two mechanisms, the customer charge and a charge for new service lines (electric Schedule 85, gas Schedule 7). All money collected through the service line charge in Schedules 85 and 7 is credited to the appropriate service line plant account. Only the amount remaining in this reduced service line plant account is classified as a customer cost and is recovered in the basic charge. There is no "double counting", and these costs are appropriately included in both the gas and electric basic charges.

D. <u>Response to Public Counsel's Rate Spread Testimony</u>

Q. Please discuss Mr. Watkin's electric rate spread testimony.

A. Even though Mr. Watkins's cost of service results differ significantly from the Company's, there are many similarities in the proposed rate spread, with one

significant exception. The similarities include applying an above average increase to the residential class, an average increase to Schedules 24, 31 and 43, 449, and a lower than average increase to lighting. We differ in the absolute amount of the relative increases (for instance, we would increase the residential rate by 125% of the average, while Mr. Watkins's proposal is for an increase that is about 108% of the average).

Q. What is the significant exception?

A. The significant exception is in the treatment of the Campus Rate, Schedule 40. The Schedule 40 rate was developed in the 2004 General Rate Case, Docket No. UE-040640, in response to customers with large loads, greater than 3 aMW, that are either typically in a campus configuration, or share a distribution feeder with other customers. The rate first became effective March 17, 2005. Under an agreement reached by parties in that case, the rates in the schedule are tied to the high voltage schedule and based on customer-specific distribution costs. The Company's proposal is based on that agreement, tying the rates to the high voltage schedule and company specific distribution costs. As a result, this rate class does not receive a "spread", or allocation, of the total rate increase. The amount of increase for this rate class is instead calculated. Mr. Watkins, on the other hand, would treat this class like all other classes and allocate a portion of the rate increase to the class based on the class's indexed rate of return, which is analogous to parity ratio. He would increase the class by 115% of the average increase. The net result is that, at the Company's proposed revenue increase, he

would allocate $4,264,090 to the Schedule 40 class, resulting in a 10.94% increase, while the Company allocated $1,947,000, resulting in a 5% increase.

Q. Do you agree with Mr. Watkins' rebuttal position regarding Schedule 40?

A. His approach has merit in that it treats all classes similarly, using cost of service results as a basis for rate spread decisions without exception. My approach attempts to remain faithful to a past agreement that is no longer binding. In doing so I was forced to ignore my cost of service information, in which the class parity ratio for the Campus Rate class was 1.01. Absent the past agreement, I would have proposed an increase to the class equal to the increase of the other classes that were within 5% of 100% parity.

Q. If the Commission was to agree with Mr. Watkins that the rate spread to Schedule 40 should be done in a manner similar to the other rate schedules, how much of an increase should the class see?

A. Based on my cost of service results the class should receive 100% of the average increase for all classes, or 9.51% under the Company's proposed revenue requirement.

IV. RESPONSE TO ICNU TESTIMONY

Q. Please describe the testimony of ICNU witness Mr. Donald W. Schoenbeck as it relates to electric cost of service, electric rate spread and electric rate design.

A. Mr. Schoenbeck:

(i) accepts the Company's electric cost of service results, with two exceptions;

(ii) accepts the Company's electric rate spread proposal, with one exception; and

(iii) regarding rate design for the Company's Retail Wheeling class, proposes

(a) no increase in the electric monthly electric service charge;

(b) no increase in the high voltage demand charge; and

(c) a decrease in the primary voltage demand charge for Schedule 449 customers.

Q. What are Mr. Schoenbeck's exceptions to the Company's cost of service analysis?

A. Mr. Schoenbeck takes exception to the Company's allocation of (1) the FERC 557 account and (2) the Montana Electric Energy Tax. These costs are currently allocated in the Company's cost of service study on total kWh, which include kWhs generated by others but delivered by the Company. As Mr. Schoenbeck describes in his testimony, the generation costs included in both the FERC 557 account and the Montana Energy Tax do not relate to the Company's Retail

Wheeling customers, who do not purchase energy from the Company.

Q. Do you agree with Mr. Schoenbeck's recommendations relating to the cost of service?

A. Yes, I agree to the changes.

Q. What is the effect of these changes?

A. The parity ratio for the Retail Wheeling customers served on Schedule 449 moves from a parity ratio of 0.96 (in Exhibit No.___(DWH-4)) to a parity ratio of 1.45 (in Exhibit No. ___(DWS-1T). Also, the parity ratio for Firm Resale customers moved from 0.85 in Exhibit __(DWH-4) to 1.01, as shown in Mr. Schoenbeck's workpapers and attached as Exhibit No.___(DWH-14).

Q. What is Mr. Schoenbeck's exception to the Company's proposal on rate spread

A. Mr. Schoenbeck proposes that the Retail Wheeling class of Schedules 448, 449 and 459 receive no increase because of their high parity ratio of 1.45.

Q. Do you agree with Mr. Schoenbeck's recommendations regarding rate spread?

A. Yes, but I would make one additional change. This change follows directly from Mr. Schoenbeck's analysis but was not recommended by him. Because the Firm Resale class is, under the Schoenbeck analysis, at a parity ratio of 1.01, I propose

they be given the average rate increase. This is necessary to keep them at full parity, which is what I recommend in my direct testimony. The increases of the other rate classes relative to the average increase remain the same as in my direct testimony, as shown on page 1 at column E of Exhibit No.___(DWH-5). The revised relative percentages are shown on page 1 at column E of Exhibit No.___(DWH-15).

Q. Do you agree with Mr. Schoenbeck's recommended rate design for the Retail Wheeling class?

A. No. While I believe some movement in the relative rates of primary and high voltage Retail Wheeling customers is justified, I believe his design, which results in a 26% decrease for Primary Schedule 449 customers, goes too far.[4]

V. RECALCULATION OF AVERAGE RATE INCREASE FOR ALL RATE SCHEDULES

Q. What effect does the rebuttal revenue requirement, coupled with the proposed changes to rate spread discussed above, have on the average rate increase of all electric schedules?

A. The effect is shown in the table below.

[4] *See* Exhibit No. __(DWS-1T) at page 14, line 1.

Customer Class	Rate Schedule	Proposed Rate Increase as filed in Exhibit No.__(DWH-5)	Proposed Supplemental Rate Increase as filed in Exhibit No.__(DWH-9)	Proposed Rebuttal Rate Increase Based on Exhibit No.__(JHS-15)
Residential	7	11.78%	12.11%	11.20%
General Service < 51 kW	24	9.43%	9.69%	8.96%
General Service 51 – 350 kW	25	4.71%	4.84%	4.48%
General Service > 350 kW	26	4.71%	4.84%	4.48%
Primary Service	31/35/43	9.43%	9.69%	8.96%
Campus Schedule*	40	5.00%	5.17%	4.64%
High Voltage Service	46/49	9.43%	9.69%	8.96%
Transportation	449	9.43%	9.69%	0.00%
Lights	50-59	7.07%	7.27%	6.72%
Small Firm Resale		29.47%	29.78%	8.96%
System Average	**All**	**9.51%**	**9.78%**	**8.99%**

*calculated

Q. How were these updates to the average rate increases calculated?

A. The above updates were calculated based on the method described at pages 2 – 3 of my prefiled supplemental direct testimony, Exhibit No.___(DWH-8T). The significant differences between the previous analysis and this analysis is the total revenue requirement as well as the application of an average increase applied to

the Small Firm Resale class and no increase to the Transportation class. The calculations are shown in Exhibit No.___(DWH-15).

Q. Is the Company calculating rates and filing revised tariff sheets to reflect these adjustments?

A. No. The Company will calculate specific rates and update the tariffs based on the Commission's final order in this docket determining the revenue deficiency.

VI. LOW INCOME

Q. Is the Company in its rebuttal testimony proposing a change to its Schedule 129, Low Income Program, for both gas and electric?

A. Yes. As discussed in the rebuttal testimony of Mr. Markell, Exhibit No.___(EMM-13T), the Company is proposing that the total aggregate funding cap for its low income gas and electric customer bill assistance program be increased to approximately $15 million per year from approximately $10.25 million per year.

Q. What is the projected impact of this proposal on the typical, average residential customer?

A. PSE projects the typical residential electric customer's bill would increase by 19 cents per month, and the average residential gas customer's bill would increase by 18 cents per month. The actual impact will be determined once we make a filing

to change Schedule 129 rates.

Q. Are you filing the change in Schedule 129 for both gas and electric at this time?

A. No. The Company is on an annual filing cycle for updates to Schedule 129, and we propose to maintain this cycle. The next filing is scheduled for September of this year, with an effective date of October 1, 2008. Our filing at that time will include the new increased funding cap, with the new rates calculated using the methodology outlined in Schedule 129 and Mr. Eric Markell's rebuttal testimony. Because our tariffs at the time of filing Schedule 129 will not include the new gas tariffs we proposed in this case (gas Schedules 31T, 41T, 85T, 86T, and 87T), we ask the Commission, if it approves the new tariffs proposed in this case, to also order an update to Schedule 129, which would include the new "T" Schedules.

VII. CONCLUSION

Q. Does that conclude your pre-filed rebuttal direct testimony?

A. Yes.