EXHIBIT NO. ___(KRK-11T)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: KARL R. KARZMAR

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
KARL R. KARZMAR
ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF KARL R. KARZMAR

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Are you the same Karl R. Karzmar 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. ___(KRK-1T), and five exhibits supporting such direct testimony, Exhibit No. ___(KRK-2) through Exhibit No. ___(KRK-6). On April 11, 2008, I filed supplemental direct testimony, Exhibit No. ___(KRK-7T), and three exhibits supporting such supplemental direct testimony, Exhibit No. ___(KRK-8) through Exhibit No. ___(KRK-10).

Q. Please summarize the purpose of your rebuttal testimony.

A. This rebuttal testimony discusses revised gas working capital and various proforma and restating adjustments that the Company is proposing in response to testimony filed by Commission Staff and Public Counsel. First, I discuss the revised gas working capital. Second, I discuss the adjustments proposed by Commission Staff and other parties to which the Company agrees and has incorporated in its updated gas revenue requirement determination. Third, I discuss the adjustments proposed by Commission Staff and other parties that the Company feels are inappropriate, and I explain why the Company disagrees.

Based on the changes to rate base and working capital and the proforma and restating adjustments proposed by the Company and presented in Exhibit No. ___(KRK-13), there is a gas revenue deficiency of $55,523,937. If approved, this would represent an average 5.20% rate increase.

II. REVISIONS TO WORKING CAPITAL

Q. Please explain Exhibit No. ___(KRK-12).

A. Exhibit No. ___(KRK-12) presents similar information as Exhibit No. ___(KRK-3) and Exhibit No. ___(KRK-8). The only change in this computation from that provided in Exhibit No. ___(KRK-8) is a conforming change in the calculation of gas working capital to be consistent with that of electric working capital, the reasons for which I will discuss later in my testimony. As a result of this revision, gas working capital increases by $445,263 to $37,506,872 as shown on Exhibit No. ___(KRK-12), page 12.04 and on line 13, Exhibit No. ___(KRK-12), page 12.03 compared to the $37,061,609 as shown on line 13, Exhibit No. ___(KRK-8), page 8.03. As a result of this revision, gas rate base changes by the same amount and is now $1,351,825,342 as shown on line 14, Exhibit No. ___(KRK-12), page 12.03. Electric working capital and rate base did not change and remain as previously provided on Exhibit No. ___(JHS-10), pages 10.03 and 10.04, submitted by PSE in its supplemental filing.

III. COMPARISON BETWEEN THE COMPANY'S GAS REVENUE DEFICIENCY AND COMMISSION STAFF'S REVENUE DEFICIENCY

Q. Have you prepared a reconciliation between the gas revenue deficiency filed by the Company and that filed by Commission Staff?

A. Yes. The following table highlights the differences between the Company's supplemental filing, the Company's rebuttal filing and the Commission Staff's filing.

PSE Supplemental Filing Gas Revenue Deficiency	**$58,066,055**
Changes proposed by/agreed to by PSE in Rebuttal:	
Change Rate of Return to 8.51% per Mr. Gaines	(1,243,368)
Update Property Tax Levy	(883,441)
Various Adjustments Under $500,000	(415,309)
PSE Rebuttal Filing Gas Revenue Deficiency	**$55,523,937**
Difference in Cost of Equity	(7,798,568)
Staff Adjustment to Working Capital	(4,057,178)
Incentive Pay – Staff removed 50% of amount tied to EPS from 2005 to 2007	(1,391,954)
Billing Discounts - adjustment proposed by Staff	(1,228,265)
Difference in Cost of Debt	1,243,368
Property Tax – update levy rates	883,440
Difference in rate base treatment in Depreciation Study	782,561
Various Adjustments Under $500,000	(205,971)
Commission Staff Gas Revenue Deficiency	**$43,751,370**

Q. What are the major differences between the Company's gas revenue deficiency and the Commission Staff's gas revenue deficiency?

A. The major differences between the Company and Commission Staff are the cost of equity, the incentive pay reduction proposed by Ms. Joanna Huang and the working capital adjustment proposed by Mr. Thomas Schooley and supported by Mr. Danny Kermode. There are other smaller differences that will be discussed in the relevant proforma or restating adjustment. The $43.8 million revenue deficiency recommended by Commission Staff includes an adjustment to reduce the cost of equity by nearly $7.8 million. As discussed by Mr. Eric Markell, Dr. Roger Morin and Mr. Donald Gaines, Commission Staff's proposed adjustment to return on equity should not be accepted by the Commission. Mr. Thomas Hunt discusses the Company's incentive plan and why this $1.4 million Commission Staff adjustment is not appropriate and should not be accepted by the Commission. I will discuss the Commission Staff's adjustment to working capital and why this $4.1 million adjustment is not appropriate and should not be accepted.

Q. Did any other parties have adjustments to the Company's gas revenue deficiency?

A. Yes. Some of the adjustments proposed by other parties have been accepted and included in the Company's rebuttal revenue deficiency, which I will discuss in the context of the relevant proforma or restating adjustment. Later in my testimony I will discuss the adjustments that the Company disagrees with or provide a reference to other Company witnesses that have testimony that discusses why a particular adjustment is inappropriate.

IV. UNCONTESTED GAS ADJUSTMENTS BETWEEN THE COMPANY AND COMMISSION STAFF

Q. Have you prepared an exhibit which details the updated restating and pro forma adjustments that the Company is proposing?

A. Yes. Exhibit No. ___(KRK-13) summarizes the Company's restating and pro forma adjustments. This exhibit is presented in the same format as my Exhibit No. ___(KRK-4), Exhibit No. ___(KRK-9) and Mr. William Weinman's Exhibit No. ___(WHW-5), and Exhibit No. ___(WHW-8).

Q. Please explain the adjustments where the Company is in agreement with Commission Staff.

A. The adjustments and their impact on Net Operating Income ("NOI") or rate base are:

Adjustment	NOI	Rate Base
Actual Results of Operations	$103,964,432	$1,351,825,342
13.01 Temperature Normalization	(15,227,800)	
13.02 Revenue and Expenses	16,968,370	
13.03 Everett Delta	(2,697,729)	
13.04 Federal Income Tax	378,373	
13.06 Depreciation Study	(14,032,673)	(contested)
13.07 Pass Through Revenue and Expense	1,432,025	
13.08 Bad Debt	(276,135)	
13.09 Miscellaneous Operating Expense	(contested)	2,458,688
13.11 Excise Tax & Filing Fee	304,305	
13.13 Interest on Customer Deposits	(187,784)	
13.14 Rate Case Expenses	(43,996)	
13.17 Pension Plan	265,753	
13.18 Wage Increase	(1,474,301)	
13.19 Investment Plan	(61,592)	
13.20 Employee Insurance	(577,422)	

Q. Is this list of uncontested adjustments different than the list of uncontested adjustments that Mr. William Weinman presents in his prefiled testimony?

A. Yes. There are four adjustments that Mr. Weinman lists as uncontested that the Company has updated for changes in estimates to actual amounts. Although the adjustments are still calculated in the same manner as the Company and Commission Staff proposed, the impact of the adjustment has changed. I discuss the differences between these Company adjustments and Commission Staff adjustments for the gas deficiency, and Mr. John Story discusses the differences for the electric deficiency in his prefiled rebuttal testimony, Exhibit No. ___(JHS-14T).

Q. Would you please identify the adjustments that are on Mr. Weinman's uncontested adjustments list that are different in the Company's rebuttal exhibits?

A. Yes. The adjustments are 13.10 Property Taxes, 13.12 D&O Insurance, 13.15 Deferred Gain/Loss on Property Sales and 13.16 Property and Liability Insurance.

V. CONTESTED ADJUSTMENTS

Q. Would you please describe the difference between the Company and other parties on the contested adjustments?

A. Yes.

A. <u>Federal Income Tax, Adjustment 13.04</u>

This adjustment is not contested between the Company and Commission Staff. Public Counsel has contested PSE's adjustment. Mr. Matthew Marcelia, Director of Tax for PSE, will be taking over responsibility for this adjustment which was prepared by his department for this rate proceeding. Mr. Marcelia's prefiled rebuttal testimony, Exhibit No. __ (MM-1T), explains numerous errors made by Public Counsel witness Mr. Michael Majoros in his calculation of federal income tax.

B. <u>Tax Benefit of Proforma Interest, Adjustment 13.05</u>

Mr. Kermode, on behalf of Commission Staff, lists this adjustment as uncontested and it is not disputed as to the methodology used in the calculation. The difference between the Company and the Commission Staff for this adjustment is based on the different rate base proposed by the parties.

Based on the Company's rate base, this adjustment reduces net operating income $7,670,706, as can be seen on Exhibit No. ___ (KRK-13) at page 13-A, column 13.05, line 33.

C. <u>Depreciation Study 13.06</u>

The Company and Commission Staff agree on the change in gas depreciation rates and the increase in depreciation expense on this adjustment and its impact on net operating income. The Company and Commission Staff however disagree on the treatment of rate base as a result of this change in depreciation and the effective date of the new depreciation rates. Mr. Story discusses in his testimony why the Company's treatment is appropriate with respect to rate base and the effective date of new depreciation rates going into effect. PSE witnesses Mr. C. Richard Clarke, Mr. Jan Umbaugh and Mr. William Stout also address the depreciation adjustments proposed by Public Counsel witness Mr. Charles King – which deals with net salvage values and Mr. King's misapplication of financial accounting concepts presented in SFAS 143, Accounting for Asset Retirement

Costs, FIN 47, Accounting for Conditional Asset Retirement Obligations (an interpretation of FASB Statement No. 143, and FERC Order 631).

The impact of the depreciation expense adjustment is to decrease net operating income by $14,032,673 and to decrease rate base, based on the Company's calculation, by $7,016,336, as can be seen on Exhibit No. ___ (KRK-13), at page 13-B, column 13.06, lines 33 and 35 respectively.

D. <u>Miscellaneous Operating Expense, Adjustment 13.09</u>

The Company and Commission Staff agree on the majority of the adjustments to expense and rate base shown on this adjustment.

Mr. Roland Martin from Commission Staff has listed several items such as the cost of printing and distributing annual reports to shareholders, shareholders meetings and transfer agent fees totaling $188,240 that might be cost savings that the Company would experience if the merger is approved. These costs are similar to the New York Stock Exchange fees, $39,525, shown on my Adjustment 13.09, that are potential savings if the merger is approved and finalized. The Company does not contest these amounts if the merger is approved; however, these costs will be incurred by the Company if the merger is not approved. If the merger is not completed prior to the order for this proceeding, these costs should be removed from both the Company's and the Commission Staff's adjustment as the outcome will not be known. PSE is in agreement with Commission Staff that the savings will be deferred upon completion of the merger, with accrual of interest at the authorized net of tax rate of return.

The impact of the miscellaneous operating expense adjustment is to increase net operating income by $231,967 and to increase rate base by $2,458,688, as can be seen on Exhibit No. ___ (KRK-13), at page 13-B, column 13.09, lines 33 and 35, respectively.

E. <u>Property Taxes 13.10</u>

Commission Staff's adjustment and the Company’s adjustment in its supplemental filing are the same. Prior to filing rebuttal the Company was successful in having the levy rates adjusted downward from what was previously being assessed by the Department of Revenue. The Company’s rebuttal adjustment reflects this reduction in levy rates.

The impact of the Property Tax adjustment is to decrease net operating income by $685,328, as can be seen on Exhibit No. ___ (KRK-13), at page 13-B, column 13.09, line 33.

F. <u>Director and Officers Insurance, Adjustment 13.12</u>

Ms. Huang, on behalf of Commission Staff, lists this adjustment as uncontested and states there is no dispute as to the methodology used in the calculation. Mr. Majoros of Public Counsel proposes to remove the impacts of increased premiums brought on by pending litigation that was not related to regulated operations. The Company has accepted Mr. Majoros' adjustment.

This adjustment now increases net operating income by $13,402 versus the decrease to net operating income of $16,002 in the supplemental filing, as can be seen on Exhibit No. ___ (KRK-13) at page 13-B, column 13.12, line 33.

G. <u>Deferred Gains and Losses on Property Sales, Adjustment 13.15</u>

This is an uncontested adjustment between the Company's supplemental filing and Commission Staff's filing. The Company has updated the deferred gains and losses on property sales since the supplemental filing to reflect their balances as of May 31, 2008.

This adjustment now decreases net operating income by $141,571 versus the decrease to net operating income of $142,791 in the supplemental filing, as can be seen on Exhibit No. ___ (KRK-13) at page 13-C, column 13.15, line 33.

H. <u>Property and Liability Insurance, Adjustment 13.16</u>

This is an uncontested adjustment between the Company's supplemental filing and Commission Staff's filing. In rebuttal the Company has updated the premium amounts to actual known premiums versus the estimated premiums used in the Company's supplemental filing.

This adjustment now decreases net operating income by $106,770 versus the decrease to net operating income of $85,111 in the supplemental filing, as can be seen on Exhibit No. ___ (KRK-13) at page 13-B, column 13.16, line 33.

I. <u>Incentive Pay, Adjustment 13.21</u>

Ms. Huang, in her prefiled testimony, proposes to remove 50% of the incentive payments she has determined are tied directly to earnings per share from 2005 to 2007 and is proposing recovery of only the incentive payments she has determined are tied to customer service oriented benefits. Mr. Majoros also argues that incentive payments should be disallowed when they are based on earnings per share. Mr. Hunt's prefiled rebuttal testimony describes the incentive plan and why it should be a recoverable cost of employee compensation. Mr. Hunt also discusses the funding criteria for the incentive program and explains why these funding criteria should not result in disallowance of 50% of the incentive payments as Commission Staff proposes, nor should it result in a total disallowance of incentive payments as proposed by Mr. Majoros for Public Counsel.

Mr. Story explains why the Company's incentive plan meets the Commission criteria for recovery in rates, and his testimony also explains that the methodology used by the Company in calculating the incentive pay adjustment is consistent with the procedure established in Docket Nos. UG-040640 and UE-040641.

J. Crystal Mountain Diesel Spill, Adjustment 13.22

Q. Please explain the Company's Crystal Mountain Diesel Spill adjustment?

A. As discussed by Mr. Mills in his prefiled direct testimony, costs related to the Crystal Mountain diesel spill have been removed from the Company's operating expenses. However, during response to data requests after the original filing the Company discovered that some legal costs associated with this item had also been misclassified to natural gas operations, and this adjustment removes these costs. This adjustment increases net operating income by $103,249, as can be seen on Exhibit No. ___ (KRK-13) at page 13-D, column 13.22, line 33.

Q. Are you the Company witness that will discuss the Commission Staff's adjustments shown for billing discounts and a working capital disallowance related to metering problems?

A. Yes. As I will explain, the Company does not believe these adjustments are appropriate and requests the Commission reject them for both electric and natural gas operations.

K. Revenue Requirement Adjustments for Meter Malfunctions

1. Billing Discounts, Adjustment 11.36

Q. Please explain why you disagree with Commission Staff's adjustment to revenue related to malfunctioning meters?

A. Mr. Schooley proposes to adjust revenues for bills that are settled for less than the total amount related to metering issues. First of all, there are two types of billing adjustments. The first type is where only the billing amount is adjusted. For this type of adjustment, revenues in a general rate case correct for this, as the restating revenue calculation re-prices the billed kWhs or therms in the test year using current tariff rates. This restating adjustment effectively increases the billed revenues eliminating this discount.

The second adjustment is where the Company reverses and re-bills the customer using different kWhs or therms than were estimated in the original billing. This change in kWhs or therms is picked up in the unbilled calculation and would be reflected in the unbilled kWhs or therms. These additional unbilled kWhs or therms would be included in the unbilled revenue calculation for the test period.

Mr. Schooley's revenue adjustment is inappropriate in that it would double count these revenues in the test period.

Q. Does the Company use a "sliding scale" to adjust billings as discussed by Mr. Schooley?

A. It is my understanding that a "sliding scale" to establish a range that might be considered reasonable when considering such adjustments had previously been discussed with the WUTC Consumer Affairs Staff in response to their request to provide transparency and a more consistent approach to negotiating these disputes and adjusting bills. While some PSE staff may have used the "sliding scale" concept as one of the factors in determining a back-billing amount to settle a dispute, the practice has never been officially adopted by the Company and is no longer being considered by the Consumer Affairs Staff.

2. Working Capital Disallowance, Adjustments Exhibit No. __(WHW-7), Page 6, Column 11.38, Exhibit No. __(WHW- 8), Page 5, Column 9.23 and Exhibit No. __(DPK-2)

Q. Please explain why you disagree with Commission Staff's working capital adjustments related to metering problems?

A. Mr. Schooley, on behalf of Commission Staff, proposes to subtract $117 million from rate base to provide a strong incentive for the Company to promptly identify and resolve meter problems because he does not believe the Company has made meaningful progress in addressing this issue. Not only is this unwarranted and punitive, but his method of adjustment is unprecedented and theoretically unsound.

Ms. Booga Gilbertson in her prefiled rebuttal testimony discusses how PSE has been actively working to address metering and back-billing issues.

Q. Why is this treatment unwarranted and punitive?

A. This adjustment unjustly and arbitrarily reduces the electric and gas revenue requirement by $10.4 million and $4.1 million respectively, based on the Company's filed case. Mr. Schooley does not even attempt to quantify how a $14.5 million annual revenue reduction is justified.

Q. Why is this treatment theoretically unsound?

A. It is theoretically unsound for a number of reasons. First, it is not appropriate to adjust working capital in the manner proposed by Mr. Schooley. The accepted method of determining working capital in the State of Washington is the balance sheet method. Once working capital has been determined, it is then apportioned between the various operating and non-operating investments. Mr. Schooley makes a one-sided adjustment and simply subtracts unbilled revenues from working capital without taking into account how unbilled revenues are booked on the balance sheet. During a given billing period the Company has billed revenues that are based on actual meter reads. As these meters are read throughout the month there is a considerable amount of energy and natural gas that has been delivered but not billed to the customers at the end of the month. This energy and natural gas is priced out and included in the period's revenues through the unbilled calculation. If these unbilled revenues were backed out or reversed on the Company's income statement and the balance sheet (double-sided approach), instead of Mr. Schooley's one-sided adjustment to the balance sheet, the revenues for the period would decrease and the revenue requirement would increase dramatically.

The second factor Mr. Schooley ignores is, in the balance sheet working capital methodology, it is inconsistent to treat the receivable associated with unbilled revenues as a non-operating category on the balance sheet but treat the other side of the accounting entry as a contribution to operating income on the income statement. The principles used to determine the Company's results of operations and balance sheet, for ratemaking purposes, must be consistently applied (i.e., if it is operating on the income statement, then it must also be operating on the balance sheet. If it is non-operating on the balance sheet, then it must also be non-operating on the income statement.

The third factor Mr. Schooley ignores is that unbilled revenues are largely offset by liabilities, credits or reductions to working capital, for accounts payable associated with purchased gas costs, power purchases and other related items. It is again inconsistent to treat the receivable associated with unbilled revenues as non-operating and at the same time treat offsetting payables as an offset to working capital. Mr. Schooley's one-sided adjustment creates a mismatch of benefits and costs.

Q. Are there any other reasons Mr. Schooley’s approach to adjusting working capital is inappropriate.

A. Yes. Unbilled revenues related to non-registering meters represent only a small fraction of total unbilled revenues. As Ms. Gilbertson points out in her prefiled rebuttal testimony, among PSE's 1.8 million natural gas and electric meters, only a fraction of a percent of the meters currently indicate failure as a stopped meter. Most of the unbilled revenues are related to the electricity and natural gas that has been consumed by customers since their last bill during the test year and for which the Company has already paid. To put Mr. Schooley’s adjustment into perspective, even if you took this to an extreme and assumed an excessive backlog of 5,000 non-registering meters, the net margin for a full year would only amount to one or two million dollars as opposed to the $139 million adjustment Mr. Schooley makes. The revenue impact of this type of allocation of unbilled revenues would be less than $200,000, rather than the $14.5 million Mr. Schooley proposes.

Q. Do you believe any adjustment is appropriate for metering problems?

A. I believe an adjustment could be appropriate under certain circumstances, provided that reasoned metrics have been developed upon which to base such an adjustment. As I previously discussed, there are no such reasoned metrics supporting Mr. Schooley's proposed adjustment, and even if an adjustment were appropriate, it would be minor. Meters are mechanical devices subject to periodic failure in the ordinary course of business, and they will continue to fail. As Ms. Gilbertson points out, the Company acknowledges that the current backlog is unacceptable and that PSE has been working diligently and successfully to reduce the backlog. The Company is committed to aggressively seeking other means to mitigate the rising mechanical and technological metering failures, and Ms. Gilbertson's testimony proposes new standards to address this matter.

L. Commission Staff Working Capital Calculation

Q. Do you agree with Commission Staff's other adjustments to working capital?

A. No. Mr. Kermode, on behalf of Commission Staff, proposes four adjustments to working capital none of which are appropriate for determining balance sheet working capital.

Q. Please explain why Mr. Kermode's first adjustment to working capital is not appropriate.

A. Mr. Kermode transferred a $257 million credit related to PSE Funding from non-operating to invested capital and at the same time left the $257 million offsetting debit for PSE Funding as non-operating. For the purposes of working capital determination, these two offsetting items should be kept together wherever they are classified on the balance sheet, as they net to zero and should have no impact on working capital. In calculating working capital, it is not appropriate to classify one side of a two-sided transaction such as this differently than the other side.

Q. Please explain.

A. Mr. Kermode describes this first adjustment as a reclassification of additional paid in capital related to a PSE subsidiary, Rainier Receivable, from non-operating investments to average invested capital. As a factual matter, Rainier Receivable no longer exists and no balance remains on the Company's books for Rainier Receivable. The reclassification he proposed relates to PSE Funding instead. PSE Funding is another subsidiary set up for the Company's accounts receivable securitization program. As mentioned by Mr. Gaines in his direct testimony, it relates to an on-balance sheet liquidity facility that uses accounts receivable and unbilled revenues as collateral. Borrowings under the facility are used to fund the Company's operations until long-term capital is put in place. When the Company sets up such a subsidiary, it records the investment in account 12310000, Investment in Associated Companies and, on the subsidiaries books; it records an offsetting amount in account 21100210, Additional Paid in Capital. For consolidation purposes these two entries net to zero. Neither of these entries should be classified as PSE's additional paid in capital, as this is just an inter-company transaction. Both sides of this transaction are appropriately classified as non-operating for working capital purposes. By erroneously misclassifying one side of the transaction, Mr. Kermode creates a $515,364,280 distortion in the Company's working capital components. Regardless of where they are classified on the balance sheet, as long as they are both classified in the same place, working capital is not affected.

Q. Please explain why Mr. Kermode's second adjustment to working capital is not appropriate?

A. In his second adjustment, Mr. Kermode again takes the one side of a transaction, in this case $2.5 million related to fines and penalties, and subtracts it from non-operating in order to make it become part of working capital. He explains that he does this so that customers do not pay a return on these types of liabilities. This is very misleading in that the Company has already excluded it from working capital by classifying it as non-operating. In making his adjustment, Mr. Kermode has, in effect, subtracted something from working capital that is not there.

Q. Please explain why Mr. Kermode's third adjustment to working capital is not appropriate?

A. Mr. Kermode's third adjustment reduces working capital by $139 million, before allocation, in order to reflect Mr. Schooley's proposed adjustment for metering and billing problems. I have already explained why this adjustment is not appropriate in my previous discussion rebutting Mr. Schooley's proposal.

Q. Please explain why Mr. Kermode's fourth adjustment to working capital is not appropriate?

A. Mr. Kermode is proposing to change a method of allocation of working capital that was first proposed by WUTC Staff in 1984, accepted by the Commission at the time and used in the calculation of electric working capital since then. In

1984, it was Staff's contention that no working capital was required for construction work in progress ("CWIP").[1] The methodology that was proposed in 1984, and which has been used ever since that time for electric operations, was a compromise to arguments relating to whether or not working capital was needed to support CWIP.

However, Mr. Kermode states that CWIP "should continue to be included in non operating investments for allocation purposes." *See* Exhibit No. __ (DPK-1T) at page 12, line 8 and page 12, line 9, when, to the contrary, it is not currently being included in non-operating investments for allocation purposes. Mr. Kermode goes on to state that CWIP does not require or provide working capital because working capital was defined in a recent Commission order as "[capital provided] to bridge the gap between the time expenditures are required to provide service and the time collections are received for that service",[2] and CWIP does not fit that description. This is all true, but does not support Mr. Kermode's adjustment. His working capital adjustment actually allocates working capital to CWIP albeit nonutility working capital. In the Company's electric working capital adjustment not only is CWIP not included as part of working capital, it is specifically and properly excluded from the working capital allocation as it has been for years.

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[1] *See* testimony of Merton Lott, WUTC Accounting Analyst, June 1984 at page 13, beginning on line 6. "It should be noted that I have proposed a slightly different method of allocating working capital than was accepted by the Commission in Cause U-81-41, a prior Puget case. In that case, working capital was allocated to all investments including CWIP. The major reason I excluded CWIP from the allocation process is that I do not believe that construction activities would tend to have positive working capital related to them."

Commission Staff's proposed change is in direct contrast to the order Mr. Kermode cites in that his adjustment allocates working capital to CWIP.

In summary, Mr. Kermode's reasoning does nothing to support a change in the method of allocating electric working capital and in fact bolsters support for making no change.

Q. Please explain why the current methodology for calculating working capital is still appropriate

A. In practice, when measuring balance sheet working capital, the first step is to calculate the total average invested capital that has been utilized during the test year. Then, (1) the operating investment that is earning a return or is allowed to earn a return, (2) non-operating assets that are not earning a return, and (3) plant not in service, are all deducted from total average invested capital. The result is the total working capital provided by the shareholder, which in turn needs to be allocated or apportioned to the operating and non-operating components of the balance sheet. With the exception of CWIP, there is no disagreement that working capital allocated to operating investment, which is earning a return or is allowed to earn a return, should be included in the allowance for working capital and that working capital allocated to non-operating investment should be excluded. In the past, there were opposing arguments as to whether an allowance needed to be allocated for CWIP. Staff's proposed solution in 1984 was a

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[2] *See WUTC v. PacifiCorp,* Docket UE-061546, Order 08, 20 Glossary (June 21, 2007).

compromise to settle these arguments. Rather than arguing over whether or not CWIP was operating or non-operating, for working capital allowance apportionment purposes it was excluded from both. As I explained in my pre-filed direct testimony, this adjustment is made so as not to distort the remaining working capital associated with non-operating investments. If it is accepted that CWIP does not belong as part of utility operating property because it does not require working capital, then there is no basis to treat it as non-operating either, which would then skew the allocation of working capital to non-utility. The compromise took a middle ground position and allocates no working capital for CWIP to either the utility or nonutility.

Q. Is this CWIP allocation methodology appropriate for gas working capital as well as electric working capital?

A. Absolutely. As I explained in my prefiled direct testimony, the CWIP refinement that the Company proposed for electric is appropriate for both the gas and electric working capital. However, the Company did not propose a conforming change for gas when we filed the case because the Company wanted to fix the mechanical problem with the working capital calculation first, as explained in my direct testimony. The issue of allocating working capital to CWIP would be addressed in a later proceeding. Now that Staff argues to abrogate its middle ground approach and change back to an extreme methodology, the Company on rebuttal proposes the middle ground approach for both electric and gas.

Q. Can you further explain why this change is appropriate for gas working capital ?

A. The question to be determined is whether working capital is needed to support gas CWIP. Although it may have been different in the past, today more typical construction projects are built using standard materials and supplies carried in inventory. This is a strong indication that natural gas construction does indeed require inventory and other supporting working capital. Accordingly, the argument now exists to classify gas CWIP with utility operations in order to provide for working capital. Rather than move to this other extreme position, the Company believes it is appropriate, and is now proposing, to exclude allocation of any working capital to gas CWIP.

Q. Is this same analysis true for electric CWIP?

A. Today there is little doubt that electric CWIP will ultimately be used to support electric operations and Mr. Kermode offers no argument to the contrary. Thus, there is sound reason to classify it as operating investment for working capital allocation purposes as well. However, as with gas, rather than proposing in this case to treat it as operating for allocation purposes, the Company is willing to accept the compromise (middle ground) methodology that has been in effect for more than two decades. As a result, electric working capital does not change from the Company's original filing and remains at $95,445,435. The only better solution would be to sort CWIP into that which is either supported by working capital or not and then allocate accordingly. That, however, could result in substantial debate and the Company believes the middle ground, originally proposed by Commission Staff over 20 years ago, is more practical.

Q. Have you calculated the working capital allowance using this methodology for gas as well as electric?

A. Yes, I have calculated the gas working capital allowance using the same 1984 methodology as used for the electric working capital. Accordingly, gas working capital, using the middle ground methodology by excluding any apportionment of the allowance to CWIP for both electric and gas is $37,506,872 as can be seen on line 13 of Exhibit No. ___(KRK-12) at page 12.03, versus $37,061,609, as shown on line 13 of Exhibit No. ___(KRK-8) at page 8.03, based on the Company's supplemental filing.

M. Public Counsel Working Capital Calculation

Q. Does Public Counsel propose any adjustments to working capital?

A. No. However, Mr. Majoros, with reference to adjustment Nos. 11(E) and 6(G) recommends that expenses related to PSE's Supplemental Executive Retirement Program ("SERP") and Deferred Compensation Plan be removed from the revenue requirement. As a result, he removes expense in the amounts of $2,236,061 for electric and $1,309,865 for gas, for a total of $3,545,926 as shown in Exhibit No.___ (MJM-4) at page 16. As Mr. Hunt explains in his testimony, these disallowances are improper and the Company disagrees with these adjustments. However, if the Commission were to decide to accept Mr. Majoros' adjustments and disallow the SERP payments as operating expenses, then the underlying SERP liability on the balance sheet in the amount of $36,666,417 that currently is reflected as a reduction of working capital by that amount would then have to be reclassified as non-operating to be consistent with his proposed treatment on the income statement. This would cause electric and gas working capital to increase by $25,100,519 and $9,850,132, respectively, which would cause the electric and gas operating revenue deficiency to increase by $2,917,961 and $1,146,181, for a total of $4,064,142.

Q. Do you have any further discussion associated with proforma and restating adjustments?

A. Yes. Several parties have proposed adjustments to the Company's operating results some of which I have discussed above. Mr. Story explains why Mr. Majoros' adjustments related to shareholders' expenses and athletic events are inappropriate for both electric and gas operations. Mr. Eric Markell, Ms. Kimberly Harris and Mr. Thomas Hunt, in each of their prefiled rebuttal testimony, explain why Mr. Majoros' adjustments to executive compensation are inappropriate. I will discuss why his proposed adjustments related to the Everett Delta pipeline, the corporate aircraft and airport parking are not appropriate below.

N. Adjustments Proposed By Parties Other Than Commission Staff

Q. Do you agree with Mr. Majoros' adjustment related to the Everett Delta pipeline lease?

A. No. Public Counsel adjustment No. 2(G) proposes to reverse the Company's adjustment No. 9.03 related to the transfer of the Everett Delta pipeline recovery from PGA rates to general rates, because 1) the adjustment relates to an early transfer of the recovery of the Everett Delta pipeline expansion from the PGA mechanism into general rates, 2) the offsetting reduction in PSE's PGA rates is not expected to become effective until October 1, 2009, outside the future test year, and 3) PSE will not take over the Everett Delta pipeline until 2009, also outside the future test year in this case.

Mr. Majoros' recommendation is based on a simple misunderstanding about timing. In my original direct testimony, I indicated that new PGA rates are expected to go into effect coincident or nearly coincident with new general rates going into effect as a result of this proceeding. In fact, new PGA rates are expected to go into effect on October 1, 2008, rather than the following year as Mr. Majoros indicates, which is a full month before new rates are expected to go into effect as a result of this proceeding. As to Mr. Majoros' belief that PSE will not take over the Everett Delta pipeline until 2009, outside the future test year, that is also incorrect. PSE already owns the pipeline and it is now, and has been, included in rate base. Therefore, there is no reason to forestall the transfer of recovery from PGA to general rates I proposed in my original testimony. The sole purpose of transferring the recovery now is a matter of efficiency to eliminate the burden of a separate filing to do exactly the same thing in the future. The resulting impact on customers and the Company is neutral. Also, no other party opposes this adjustment at this time.

Q. Do you agree with Mr. Majoros' adjustment related to the corporate aircraft?

A. No. Public Counsel's adjustments No. 14(E) and 9(G) propose removal of $523,505 from PSE's test year pre-tax expense, allocated $341,064 to electric operations and $182,441 to gas operations. This $523,505 expense represents the operating costs of PSE's corporate aircraft and Renton hangar. The adjustments also propose removal of the net book value of the aircraft from rate base, $509,837 electric and $272,721 gas, for a total of $782,558. The Company does not agree with these adjustments.

Q. Why do you disagree with these adjustments?

A. Mr. Majoros argues that a review of the flight log indicates that much of the aircraft's use is merely shuttling executives back and forth to meetings and other events, including holiday parties, and that travel by private aircraft is not essential for the provision of safe, reliable electric service, given PSE's service territory. He argues further that private aircraft travel should be done at shareholders' expense, not customers', but provides no basis for this position other than his opinion based on his review of the flight log. Mr. Majoros' testimony is misleading.

An officer of PSE was on board for approximately 50% of the flights during the test year but accounted for only 18% of total passengers flown. No flights were for the purpose of attending holiday parties as stated by Mr. Majoros. In December of 2007 (outside of the test year) PSE management employees Roger Garratt and Ed Odom traveled to, and were present at, the Hopkins Ridge holiday event in order to recognize employees who made significant contributions to the completion of the Hopkins Ridge Wind Project. The purpose of travel was unrelated to and only coincidental to the holiday event.

PSE's eight-passenger Beechcraft KingAir B200 propeller driven aircraft was purchased in 1986 and has been in continuous service since that time. It is used only for the Company business purposes. It provides access to generating resources located as far away as Colstrip, Montana, where no commercial aviation service is available. Without the aircraft, travel to Colstrip would take an entire day and would necessitate the added expense of rental cars and overnight lodging. During the test year, approximately 26% of the flights were made to or from locations that are not served by commercial airlines. The Company estimates the annual cost of airfare alone to the nearest commercial airport would be $165,685 at the current airline rates and does not include the additional costs mentioned above.

During the test year ended September 30, 2007, the aircraft made 129 trips, which included 284 legs and logged 354 hours of use. On average, three passengers were on board for each of the 129 trips. A detailed flight log is maintained and flight authorizations support the business purpose of each flight. Exhibit No. ___(KRK-15) contains the aircraft flight logs for 2006 and 2007.

The PSE aircraft is a useful business tool that maximizes passenger productivity by saving time, providing a secure work environment en route and has scheduling flexibility. PSE personnel avoid the extra travel time to and from SeaTac, early check-in, security, baggage lines and delays.

Q. Do you agree with Mr. Majoros' adjustment related to the Seattle-Tacoma Airport monthly parking cards?

A. No. Public Counsel's adjustments No. 17(E) and 12(G) remove $21,541 from PSE's test year pre-tax expense, allocated $14,034 to electric operations and $7,507 to gas operations. This $21,541 expense represents the costs of five Seattle-Tacoma Airport monthly parking cards, which are used for PSE business travel by officers of the Company. The current cost of the monthly parking cards is $350 and the daily parking rate is $26, with discounts available for parking over five days. During the test year, officers used the parking cards a total of 524 days, which would currently cost a total of $11,180 when discounts for parking over five days is considered.

Officers travel on business for numerous reasons including the need to secure energy supplies from counterparties, coordination of regional energy supply and transmission systems, meetings with regulators, the purchase of insurance, the need to raise capital, attendance at industry meetings, etc. The cost of these travel expenses, including parking costs at the Seattle Tacoma Airport are an appropriate business expense that should be recovered in customer rates.

VI. REVENUE DEFICIENCY

Q. Would you please explain Exhibit No. ___(KRK-14)?

A. Exhibit No. ___(KRK-14) presents the calculation of the revenue deficiency based on the proforma and restating adjustments proposed by the Company and that were discussed above. As shown on page 1 of this Exhibit No. ___(KRK-14), based on $1,347,267,694 invested in rate base and $80,120,478 of net operating income, the Company would have a gas retail revenue deficiency of $55,523,937.

A. <u>Cost of Capital</u>

This schedule, shown on page 2 of Exhibit No. ___(KRK-14), reflects the proposed capital structure for the Company during the rate year and the associated costs for each capital category. The capital structure and costs are presented in the prefiled rebuttal testimony of Mr. Donald Gaines, Exhibit No. ___(DEG-8CT). The rate of return is 8.51%.

B. <u>Conversion Factor</u>

The conversion factor, shown on page 3 of Exhibit No. ___(KRK-14), is used to adjust the net operating income deficiency by revenue sensitive items and federal income tax to determine the total revenue requirement. The revenue sensitive items are the Washington State utility tax, Washington WUTC filing fee, and bad debts. The conversion factor used in the revenue requirement calculation, taking into consideration the adjustments discussed earlier, is 0.6219300% and is uncontested between the Company and Commission Staff. Public Counsel witness Mr. Majoros uses his calculated effective tax rate to determine a conversion factor. Mr. Matthew Marcelia explains why Mr. Majoros' effective tax rate is erroneous and should not be accepted by the Commission.

VII. CONCLUSION

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.