

BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DOCKET NOs. UE-072300 and UG-072301

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR. (MJM-1T)

ON BEHALF OF

PUBLIC COUNSEL

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NON-CONFIDENTIAL

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR. (MM-1T)
DOCKET NOS. UE-072300 AND UG-072301
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MICHAEL J. MAJOROS, JR. EXHIBIT LIST

Exhibit No. ____ (MJM-2)	Summary of Qualifications and Experience
Exhibit No. ____ (MJM-3)	Appearances as an Expert Witness before State and Federal Regulatory Agencies
Exhibit No. ____ (MJM-4)	Public Counsel Recommendations and Adjustments
Exhibit No. ____ (MJM-5)	Confidential – Puget Energy and Affiliated Companies Consolidated Tax Adjustment
Exhibit No. ____ (MJM-6)	Summary Compensation Table - Puget Sound Energy 2007 Form 10-K

I. INTRODUCTION / SUMMARY

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Q: Please state your name, position, and business address.

A: My name is Michael J. Majoros, Jr. I am Vice President of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"), located at 1111 14TH Street, N.W., Suite 300, Washington, D.C. 20005.

Q: Describe Snavely King.

A: Snavely King is a progressive economic consulting firm, founded in 1970 to conduct research on a consulting basis into the rates, revenues, costs and economic performance of regulated firms and industries. Our clients include government agencies, businesses and individuals that purchase public utility, telecom and transportation services.

In addition to consumer cost and anti-trust issues, we have provided our expertise in support of a clean environment and personal damages resulting from discrimination in agricultural programs. We believe in accountability, fair competition and effective regulation. We seek and use new ideas and we challenge traditional methods based on flawed premises.

The firm has a professional staff of 11 economists, accountants, engineers and cost analysts. Most of our work involves the development, preparation and presentation of expert witness testimony before Federal and state regulatory agencies. Over the course of our 38-year history, members of the firm have participated in more than 1,000 proceedings before almost all of the state commissions and all Federal commissions that regulate utilities or transportation industries.

Q: Have you prepared a summary of your qualifications and experience?

1 A: Yes, Exhibit No.____ (MJM-2) is a summary of my qualifications and experience. Exhibit
2 No.____ (MJM-3) contains a tabulation of my appearances as an expert witness before
3 state and federal regulatory agencies.

4 **Q: For whom are you appearing in this proceeding?**

5 A: I am appearing on behalf of the Public Counsel Section of the Washington State Attorney
6 General's Office (Public Counsel).

7 **Q: Do you have any specific experience in the public utility field?**

8 A: Yes, I have been in the field of public utility regulation since the late 1970s. My
9 testimony has encompassed numerous complex revenue requirement issues.
10 Furthermore, I and other members of my firm specialize in the field of public utility
11 depreciation. We have appeared as expert witnesses on this subject before the regulatory
12 commissions of almost every state in the country.

13 **Q: Does your experience specifically include electric and gas utilities?**

14 A: Yes, I have appeared as an expert in several electric and gas utility proceedings.

15 **II. SUBJECT AND PURPOSE OF TESTIMONY**

16 **Q: What is the subject of your testimony?**

17 A: This case involves Puget Sound Energy, Inc.'s (PSE or the Company) 2007 general rate
18 case filing. My testimony addresses the Company's revenue requirement.

19 **Q: What is the purpose of your testimony?**

20 A: I have reviewed the Company's filing. Based upon my findings and the input of others, I
21 am recommending monetary adjustments to the Company's filed request.

22 **III. SUMMARY OF COMPANY'S FILING**

23 **Q: Summarize the Company's filing.**

1 A: The Company filed a case based on a revenue requirement model reflecting a test-year
2 ending September 30, 2007. The Company made several adjustments to the test-year
3 book numbers. These adjustments stretched into 2009 in some cases. Overall the
4 Company is requesting a \$179.7 million electric revenue increase and a \$58.1 million gas
5 increase for a total of \$237.8 million.

6 **IV. PSE'S RATIONALIZATION OF INCREASE**

7 **Q: How does the Company rationalize its requested electric revenue increase?**

8 A: According to PSE Witness, John H. Story, eight principle factors drive the electric
9 increase:¹

- 10 1. \$55.1 million for power costs expenses relating to the rate year;
- 11 2. \$10.7 million for production expenses relating to new plant additions;
- 12 3. \$8.5 million for transmission and distribution partially explained by increased
13 tree trimming and storm damage expense;
- 14 4. \$19.9 million for amortization of property losses including storm damage
15 amortization relating to the December 2006 storm;
- 16 5. \$9.5 million for salaries, outside service, and insurance;
- 17 6. \$12.8 million for increased depreciation including the \$8 million relating to a
18 new depreciation study;
- 19 7. \$6.8 million of additional amortization for capital additions for software
20 closings; and,
- 21 8. \$38.0 million for increased rate base, of which \$12.2 million results from the

¹ This information was provided by the Company in its original filing on December 3, 2007. (*See* Direct Testimony of John H. Story, Exhibit No.____ (JHS-1TC), pp. 6:18 - 7:18.) PSE provided a supplemental filing on April 11, 2008 that updated and added to its original request, however, in his supplemental testimony, Mr. Story did not provide a similar detailed summary of the factors driving the rate increase.

1 requested rate of return change.

2 **Q: How does the Company rationalize its requested gas revenue increase?**

3 A: According PSE Witness, Karl R. Karzmar, six principle factors drive the gas increase:²

- 4 1. \$7.0 million increase to distribution operating expense;
- 5 2. \$1.5 million increase to customer accounting expense;
- 6 3. \$18.9 million depreciation expense increase, of which \$13.7 million emanates
7 from a new depreciation study;
- 8 4. \$2.3 million amortization expense increase;
- 9 5. \$20.5 million relating to rate base increases, of which \$5.0 million is caused
10 by a requested rate of return change; and,
- 11 6. \$4.2 million for Everett Delta adjustment.

12 **Q: What are the results of your investigation of the Company's rate request?**

13 A: We have propounded numerous data requests related to the Company's rate request. We
14 also participated in a conference call regarding certain Towers Perrin studies underlying
15 PSE's executive compensation requests. As a result of this investigation and in
16 combination with the recommendations of Public Counsel witnesses, Stephen Hill,
17 Barbara Alexander, and Charles King, I recommend that the Company's base rates be
18 increased by \$4.3 million for electric, as shown on Exhibit No.____ (MJM-4) Schedule
19 1(E), and by \$7.0 million for natural gas as shown on Exhibit No.____(MJM-4) Schedule
20 1(G), which together amounts to \$11.3 million overall.

² This information was provided by the Company in its original filing on December 3, 2007. (See Direct Testimony of Karl R. Karzmar, Exhibit No.____(KRK-1T), pp. 15:17 – 16:9.) PSE provided a supplemental filing on April 11, 2008 that updated and added to its original request, however, in his supplemental testimony, Mr. Karzmar did not provide a similar detailed summary of the factors driving the rate increase.

1 When a company has a legal asset retirement obligation, SFAS No. 143 requires
2 capitalization of the discounted fair value of the liability and depreciation as a component
3 of the original asset cost. If it is determined, upon implementation that a regulated utility
4 has already collected too much depreciation relating to the asset retirement obligation, the
5 utility must report the excess as a regulatory liability.⁴ If a utility does not have a legal
6 obligation to incur asset retirement costs for which it has previously collected money in
7 the form of future cost of removal embedded in depreciation rates, SFAS No. 143 and the
8 SEC still require reporting the excess as a regulatory liability.⁵ In other words, if a
9 regulated utility has collected for future cost of removal in its depreciation rates, but does
10 not, and never had, a legal obligation to spend the money, it must segregate these
11 excesses and report them as a regulatory liability.⁶

12 FERC identified such amounts as “non-legal” asset retirement obligations,
13 meaning that utilities do not have an actual legal obligation to incur these costs in the
14 future. However, even though current GAAP and SEC accounting rules require reporting
15 these excess collections as regulatory liabilities, FERC Order No. 631 does not have the
16 same requirement. FERC Order No. 631 merely requires separate identification and
17 reporting within account No. 108-Accumulated Depreciation. Consequently, even
18 though SFAS No. 143 and the SEC require that excess collections amounts be reported as
19 a regulatory liability, PSE continues to include these amounts in accumulated
20 depreciation for regulatory accounting and ratemaking purposes.

21 **Q: How does GAAP define a regulatory liability?**

⁴ SFAS No. 143.

⁵ *Id.*, ¶ B.73.

⁶ *Id.*, ¶ B.73.

1 A: SFAS No. 71 – Accounting for the Effects of Certain Types of Regulation defines
2 regulatory liabilities from a GAAP perspective. I have summarized paragraph 11 below.
3 It provides the GAAP definition of a regulatory liability. Please note paragraphs 11 and
4 11.b.

5 **SFAS No. 71 – Regulatory Liabilities**⁷

6 11. Rate actions of a regulator can impose a liability on a
7 regulated enterprise. Such liabilities are usually obligations to
8 the enterprise’s customers. The following are the usual ways
9 in which liabilities can be imposed and the resulting
10 accounting:

11 a. A regulator may require refunds to customers

12 b. A regulator can provide current rates intended to recover
13 costs that are expected to be incurred in the future with the
14 understanding that if those costs are not incurred future rates
15 will be reduced by corresponding amounts. If current rates
16 are intended to recover such costs and the regulator requires
17 the enterprise to remain accountable for any amounts charged
18 pursuant to such rates and not yet expended for the intended
19 purpose, the enterprise shall not recognize as revenues
20 amounts charged pursuant to such rates. Those amounts shall
21 be recognized as liabilities and taken to income only when
22 associated costs are incurred.

23 c. A regulator can require that a gain or other reduction of net
24 allowable costs be given to customers over future periods

25
26
27
28
29 **Q: Does PSE agree that its collections for non-legal AROs result in a regulatory**
30 **liability?**

31 A: PSE states that it “has no opinion as to the treatment of legal or non-legal obligations of
32 costs of removal being treated as regulatory liabilities for rate-making purposes.”⁸

33 **Q: What do you recommend?**

⁷ SFAS No. 71, ¶ 11. Only the first sentence of each subparagraph is included.

⁸ PSE Response to Public Counsel Data Request No. 243.

1 A: The Commission must specifically recognize that PSE has a \$137.9 million regulatory
2 liability for these amounts.⁹ PSE should reclassify this from accumulated depreciation to
3 Account 254-Other Regulatory Liabilities for regulatory accounting, reporting and
4 ratemaking purposes. This will result in equivalent GAAP and regulatory accumulated
5 depreciation and regulatory liability amounts for “non-legal” cost of removal.¹⁰
6 Regardless of being included in accumulated depreciation, these amounts are dollars
7 *already* collected from ratepayers for future cost of removal. There is no reason that the
8 utility should be entitled to keep these dollars if it turns out they are never spent on future
9 costs of removal. The funds represent a refundable liability to ratepayers until spent on
10 their intended purpose. Now that SFAS No. 143 has identified them, they should be
11 recognized as the regulatory liability they are.

12 Furthermore, \$137.9 million is a substantial amount. By definition, the Company
13 has collected, but not spent, \$137.9 million for cost of removal. Therefore, the
14 Commission must protect this amount in Uniform System of Accounts (USOA) account
15 254-Other Regulatory Liabilities. Without that protection, current and future ratepayers
16 face the strong possibility of losing substantial prepaid funds they have submitted to the
17 Company for future cost of removal.

18 **Q: Why is it necessary for the WUTC to protect the \$137.9 million as a regulatory**
19 **liability?**

20 A: PSE, and virtually all other utilities, consider amounts in accumulated depreciation, even
21 excessive amounts, to be *their* money, i.e. capital recovery with no refund obligation. It

⁹ PSE Response to Public Counsel Data Request No 241.

¹⁰ The phrase “non-legal” emanates from the FERC’s Order No. 631. It is used to distinguish legally required asset retirement obligations from those which lead to the cost of removal regulatory liability discussed above. Importantly, the phrase “non-legal” should not be construed to imply any “illegality.”

1 is certainly fair and reasonable for any Commission to recognize excessive cost of
2 removal collections as a refundable regulatory liability until the utility spends them on
3 their intended purpose. The FERC rule to which PSE adheres is insufficient.

4 **Q: Why is FERC Order No. 631 insufficient?**

5 A: The FERC has recognized and identified the amounts involved and requires separate
6 accounting for those amounts.¹¹ However, the FERC has deferred recognition of the
7 regulatory liability to the states. Consequently, until the Commission provides it, there is
8 no *regulatory* recognition of the liability. Accordingly, there is no provision for a refund
9 to ratepayers if PSE does not spend the cost of removal amounts they have collected for
10 the intended purpose. In fact, I can assure the Commission that PSE has actually already
11 spent that money for things other than cost of removal.¹²

12 In other words, nothing holds PSE directly accountable for these excess
13 collections from a regulatory standpoint. Regardless of the transparency provided by
14 FERC, PSE failed to mention the regulatory liability in its depreciation study or in the
15 rate case in general. This is wrong. Experience indicates that it is highly unlikely that
16 these amounts will be spent for cost of removal in the magnitude they have been
17 collected. Furthermore, even if it was highly probable that PSE would spend all this
18 money for cost of removal, it is fair and reasonable for the Commission to recognize the
19 ratepayers' security interest in these monies until spent on their intended purpose.

20 Otherwise, the money is at risk.

¹¹ FERC Docket No. RM02-7-000, Order No. 631, ¶ 38.

¹² This is the obvious result since what PSE reports as a regulatory liability is the excess of what they have collected versus what they have spent for non-legal cost of removal.

1 **Q: Have any other Commissions recognized non-legal asset retirement obligations as**
2 **regulatory liabilities?**

3 A: Yes. Recently, in Docket No. A.04-12-014, involving Southern California Edison
4 Company, the California Public Utilities Commission specifically recognized that
5 Company's non-legal asset retirement obligations collections as a regulatory liability.

6 **Q: Do you have an exhibit showing your recommended reclassification?**

7 A: Yes, on page 8 of Exhibit No.____ (MJM-4), Adjustments No. 1(E) and 1(G) on Schedule
8 4, show the reclassification of the SFAS No. 143 Regulatory Liability.

9 **Q: Does this adjustment have any revenue requirement effect?**

10 A: No, it is merely a revenue neutral reclassification of a rate base reduction from one
11 account to another. However, as I will discuss later, I recommend using a portion of the
12 regulatory liability to offset storm damages. This will result in a slight increase to rate
13 base.

14 **B. Adjustment Nos. 2 through 5(E) – Disallow Out of Period Plant from Rate**
15 **Base**

16
17 **Q: Describe Adjustment Nos. 2 through 5 (E).**

18 A: These adjustments, shown on pages 9 and 10 of Exhibit No.____(MJM-4),¹³ either reverse
19 or reduce several of the out of period plant additions PSE proposes to include in its rate
20 base, and where applicable, implement Mr. King's recommended depreciation rates.

21 **Q: Why are these adjustments necessary?**

¹³ Adjustments 2(E), 3(E) and 2(G) are straight reversals of PSE's adjustments, with the exception of FIT, which is calculated using my recommended 30.67 percent tax rate. As such I have not included a page in Exhibit No.____ (MJM-4), Schedule 4 for these adjustments.

1 A: Mr. Story attributes much of the electric revenue requirement increase to growth in rate
2 base. In fact, Mr. Story proposes several plant additions which further increase the rate
3 base. Most of these, however, are out of period. Although PSE selected a test year
4 ending September 30, 2007, most of the rate base additions Mr. Story proposes are
5 estimated to occur in 2008 and some of them will not be booked until 2009. In my
6 opinion, Mr. Story’s approach stretches the known and measurable standard too far.

7 **Q: Are you proposing to disallow any of these additions?**

8 A: Yes. I applied the following standard. I have accepted any project with an anticipated
9 closing date of October 30, 2008 or sooner. In my opinion, anything beyond that violates
10 the known and measurable standard.

11 **Q: Does Mr. Story agree with you?**

12 A: No, Mr. Story does not agree with me. PSE’s Response to Public Counsel Data Request
13 No. 318 states, “[f]or further discussion on rate base treatment of known and measurable
14 proforma adjustments for generating plants, please refer to the prefiled direct Testimony
15 of John Story Exhibit No.____ (JHS-1CT).”

16 I went to those pages of Mr. Story’s testimony to locate the phrase “known and
17 measurable” but I did not find it. I *did* find a statement on page 20 that “[t]his pro forma
18 and restating adjustment includes the estimated cost of Goldendale Generating Station as
19 of the rate year, November 2008 through October 2009” I also found other
20 references to his so-called “rate year.”

21 In an effort to determine how the known and measurable concept relates to “rate
22 year,” I reviewed WAC 480-07-510. I found reference to “restating actual adjustments”
23 (not proforma), and I found reference to “pro-forma adjustments,” however that reference

1 does not refer to any “rate year” concept. In fact, I found several references to “test
2 period,” but no references to “rate year.” Consequently, I assume Mr. Story does not
3 agree with my interpretation of the known and measurable standard.

4 I believe that my interpretation is closer in keeping with the statute than Mr.
5 Story’s. The intent of any known and measurable standard is to protect ratepayers. The
6 inclusion of potential expenditures a year beyond the end of a future test (October 2008)
7 year is speculative and does not provide protection for ratepayers. Instead, it provides a
8 gift to PSE’s management and major stockholders, particularly given the pending
9 purchase of the Company.

10 **Q: Have you applied your interpretation of WAC 480-07-510 to PSE’s proposed plant**
11 **additions?**

12 A: Yes, I have.

13 **Q: What are the results?**

14 A: Based on my interpretation of WAC 480-07-510, I am disallowing the Whitethorn
15 Generating Station addition,¹⁴ which is not scheduled to be in service until February 2009.

16 **Q: Have you disallowed any of Mr. Story’s other rate base additions?**

17 A: Yes, I have disallowed Mr. Story’s addition for the Goldendale Generating Station.¹⁵

18 This adjustment is merely the result of an inconsistent averaging approach Mr. Story
19 applied to the Goldendale acquisition costs versus the accumulated depreciation balance.
20 Goldendale was in service for seven months of the test year, for a net book value of
21 approximately \$121 million for each of those months. Mr. Story’s internal averaging

¹⁴ Adjustment No. 2(E) not included in Schedule 4 see n. 13.

¹⁵ Adjustment No. 3(E) not included in Schedule 4 see n. 13.

1 calculation reduced the net book value to approximately \$53 million. He then made a
2 rate base adjustment to write the net book value back up to where it always was to begin
3 with. This is inappropriate and, in my opinion, lacks credibility. The objective of
4 averaging is to reflect a rate base reduction given the average rate base during the test
5 period. Mr. Story's piece-part approach has the same result as no averaging at all.
6 Accordingly, I propose reversing Mr. Story's entire Goldendale adjustment.

7 **Q: Have you made any other adjustments to Mr. Story's rate base adjustments?**

8 A: Yes, I have adjusted all of Mr. Story's allowed rate base additions to reflect Mr. King's
9 recommended depreciation rates.¹⁶

10 **C. Adjustment No. 2(G) – Reverse Everett Delta Lease**

11 **Q: Describe Adjustment No. 2 (G).**

12 A: This adjustment reverses Mr. Karzmar's adjustment No. 9.03 related to the Everett Delta
13 pipeline lease.

14 **Q: Why have you reversed Mr. Karzmar's adjustment?**

15 A: Mr. Karzmar's adjustment relates to an early transfer of the recovery of the Everett Delta
16 pipeline expansion from the PGA mechanism into general rates.¹⁷ Mr. Karzmar notes
17 that, while the proposed adjustment will serve to increase the revenue deficiency in this
18 case, it will eventually be offset by a reduction in PSE's PGA rates, which are expected
19 to become effective on October 1, 2009.¹⁸

¹⁶ Adjustment Nos. 4(E) and 5(E) on pp. 9-10 of Exhibit No. ____ (MJM-4).

¹⁷ Exhibit No. ____ (KRK-1T), p. 20:9-10.

¹⁸ Exhibit No. ____ (KRK-1T), p. 20:17-21.

1 In my opinion this adjustment is premature. PSE will not take over the Everett
2 Delta pipeline until 2009, well outside the future test year in this case.¹⁹ The second part
3 of the equation, which is the change in PGA rates, will also take place outside the future
4 test year.²⁰ In fact, I believe I have been generous in my interpretation of the rate base
5 statutes. In reality, I have used a 2008 future test year. In other words, I have allowed
6 adjustments for resources expected to be in service by October 2008. As such, I have
7 reversed Mr. Karzmar's entire adjustment.²¹

8 **D. Adjustment No. 6(E) – Storm Damage**

9 **Q: Have you made any adjustments to PSE's storm damage requests?**

10 A: Yes, as shown on page 11 of Exhibit No. ____ (MJM-4), I am making two monetary
11 adjustments to PSE's quantification of the storm damage costs. I am also making an
12 offsetting amortization to eliminate the need for any storm damage increase in this
13 proceeding.

14 **Q: What is you first monetary adjustment to PSE's storm damage expense?**

15 A: My first adjustment holds the level of storms, as defined by the Institute of Electrical &
16 Electronics Engineers, to the \$7 million limit previously set by the Commission.²² It is
17 my understanding that this limit was set so that storm damage costs would be shared
18 between ratepayers and shareholders. I see no reason to increase it to \$8 million as Mr.
19 Story proposes.

20 **Q: What is the second monetary adjustment to PSE's storm damage expense?**

¹⁹ Exhibit No. ____ (KRK-1T), p. 19:2-16.

²⁰ Exhibit No. ____ (KRK-1T), p. 20:21.

²¹ See n. 13.

²² Direct Testimony of John H. Story, Exhibit No. ____ (JHS-1CT), p. 47:3-4.

1 A: The second monetary adjustment reflects Ms. Alexander’s recommendation to disallow
2 five percent of the Company’s request for recovery related to the December 2006
3 “Hanukkah Eve” windstorm.

4 **Q: Please explain the offsetting amortization you are proposing.**

5 A: I amortize a portion of PSE’s cost of removal regulatory liability to offset its net storm
6 damages claim in this proceeding.

7 **Q: What is your rationale for this adjustment?**

8 A: As discussed earlier, PSE has charged and collected excess amounts from ratepayers for
9 future cost of removal. PSE recognizes this regulatory liability (amount owed to
10 ratepayers) in its general purpose and SEC financial statements. The \$137.9 million
11 regulatory liability consists of those collections over and above PSE’s actual expenditures
12 for cost of removal. In my opinion, it is reasonable and appropriate to use a portion or all
13 of these amounts to offset the catastrophic storm damages charged to ratepayers.

14 **E. Adjustment Nos. 7(E) and 3(G) – Federal Income Taxes**

15 **Q: Have you made any adjustments to PSE’s federal income tax calculations?**

16 A: Yes, I have made two adjustments. I have reduced income tax expense to reflect PSE’s
17 effective corporate tax rate. I have also implemented flow-thru tax accounting for storm
18 damages. My adjustments are shown on page 12 of Exhibit No.____ (MJM-4).

19 **Q: Explain the tax rate adjustment.**

20 A: My tax rate adjustment reduces PSE’s federal statutory tax rate from 35.00 percent to its
21 30.67 percent average effective federal tax rate for the years 2004 to 2006.

22 **[Begin Confidential]**

23 **XX XXXXXXXXXXXXXXXXXXXXXXXXXXXX**

1 **XX** [REDACTED]

2 [REDACTED]

3 [REDACTED]

4 [REDACTED].²³ [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 [REDACTED].²⁴ [REDACTED]

8 [REDACTED]

9 [REDACTED].²⁵ [REDACTED]

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED] [End Confidential]

21 **Q:** Please explain your flow-thru adjustment.

²³ [Begin Confidential] [REDACTED] [End Confidential]
²⁴ [Begin Confidential] [REDACTED] [End Confidential]
²⁵ [Begin Confidential] [REDACTED]. [End Confidential]

1 A: My next income tax adjustment uses flow-thru (or actual) tax accounting, rather
2 normalization tax accounting, for the storm damages included in Mr. Story's federal
3 income tax calculation. Mr. Story's normalization adjustment is reflected in his original
4 adjustment No. 4.04 and his updated adjustment No. 11.04.²⁶

5 **Q: How does Mr. Story justify his normalization adjustment?**

6 A: Mr. Story says that his adjustment "recalculates the test year using expenses and tax
7 adjustments for the twelve months ending September 30, 2007. Taxable income is shown
8 as a loss in this adjustment as the electric income includes the current deduction
9 associated with the storm losses during the latter part of 2006 and beginning of 2007.
10 The tax benefits of these losses have been normalized and are provided to the customer in
11 the restating Storm Adjustment. The effect of this adjustment is to decrease net operating
12 income by \$12,165,039."²⁷ Mr. Story adjusts the total in his updated adjustment 11.04,
13 stating that this adjustment "corrects a cell reference in the original filing." This
14 correction reduces the adjustment to a \$9,826,242 reduction to operating income."²⁸

15 **Q: What is the revenue requirement effect of Mr. Story's normalization adjustment?**

16 A: Mr. Story's adjustment No. 4.31 and the updated adjustment No. 11.31 both increase
17 revenue requirements.

18 **Q: Why are you using flow-thru accounting for this adjustment?**

19

²⁶ Exhibit No.____ (JHS-11).

²⁷ Direct Testimony of John H. Story, Exhibit No.____(JHS-1CT), pp. 13:16-14:3.

²⁸ Exhibit No.____ (JHS-9T), p. 6:19.

1 A: I am using flow-thru accounting because Mr. Story's normalization adjustment
2 unnecessarily increases rates. There is no legal requirement to normalize these tax
3 benefits. Furthermore, as I explained above, I am proposing an offsetting amortization to
4 PSE's storm damage increase. One effect of this offset is to eliminate the need for a tax
5 adjustment relating to storm damages.

6 **F. Adjustment No. 8(E) – Amortization of Interest associated with Deferral of**
7 **Unrecovered Residential Exchange benefits Credited to Customers (UTC**
8 **Docket No. UE-071024**
9

10 **Q: Please explain Adjustment No. 8(E).**

11 A: Mr. Story's Miscellaneous Operating Income adjustment No. 4.14 (and updated
12 adjustment No. 11.4) includes several subcomponents. One of these subcomponents is
13 the amortization of interest discussed in the description of Adjustment No. 8(E) above. I
14 am not proposing to disallow this adjustment, but merely to use a different amortization
15 period. Adjustment No. 8(E) reduces Mr. Story's proposed amortization expense for this
16 item to provide for a seven-year amortization period instead of his two-year proposal. A
17 seven-year amortization period is consistent with the amortization period Mr. Story
18 proposes for his Summit Building adjustment that is also combined with his
19 Miscellaneous Operating Income adjustments. My recommendation, shown on page 13
20 of Exhibit No.____ (MJM-4), will alleviate the magnitude of the increase to ratepayers in
21 this proceeding.

22

1 **G. Adjustment Nos. 9(E) and 4(G) –Depreciation Expense**

2 **Q: Please explain Adjustment Nos. 9(E) and 4(G).**

3 A: These adjustments implement Mr. King’s depreciation rate recommendations. They
4 appear on page 14 of Exhibit No.____ (MJM-4).

5 **H. Adjustment Nos. 10(E) and 5(G) – Executive Compensation**

6 **Q: Please explain Adjustment Nos. 10(E) and 5(G).**

7 A: These adjustments, shown on page 15 of Exhibit No.____ (MJM-4), eliminate a portion of
8 the Company’s claim relating to executive compensation.

9 **Q: Why do you believe executive compensation is of particular concern?**

10 A: Excessive and escalating levels of executive compensation in general are coming under
11 increased attention and criticism by many parties: Congress, state Public Service
12 Commissions, including the UTC, the business community, and company shareholders.
13 For an unregulated corporation, executive compensation is presumably constrained by
14 what earnings and shareholders will tolerate. In my opinion, these checks and balances
15 are not working. Nevertheless, if the shareholders are not happy, they are free to vote on
16 the issue, or even elect a new executive. As regulated utility, PSE’s situation is unique in
17 that it can seek to charge ratepayers for whatever levels of compensation it chooses to
18 pay its executives. The only constraint here is what the Commission will allow as
19 reasonable.

20 **Q: What precedents are available regarding executive compensation?**

21 A: In general, a regulated utility may recover executive compensation from ratepayers to the
22 extent it is “reasonable” and contributes “to the better management or greater efficiency

1 of the utility.”²⁹ The Washington State Supreme Court adopted this principle, requiring
2 utilities to show that compensation is reasonable overall *and* that it provides a benefit to
3 ratepayers.³⁰

4 **Q: Do you have any specific concerns regarding PSE’s executive compensation?**

5 A: Yes. In addition to general concerns over increased executive compensation levels and
6 the widening gap between what is paid to executives versus non-executives, I have
7 specific concerns with how PSE determines the compensation it pays its executives.
8 Recently, there has been increased scrutiny regarding the use of consultants hired to assist
9 companies in setting executive pay levels.³¹ PSE has hired Towers Perrin to assist in this
10 task. Towers Perrin performs two separate functions. First, a Towers Perrin consultant
11 assists PSE’s Board of Directors’ Compensation Committee in its compensation
12 decisions. Second, PSE’s compensation levels are influenced heavily by Towers Perrin
13 compensation studies. As I discuss below, these studies are unreliable because they are
14 circular, and because they use an inappropriate proxy group in evaluating and making
15 recommendations on PSE’s compensation levels.

16 **Q: What is the primary concern relating to the use of compensation consultants such as**
17 **Towers Perrin?**

18 A: The primary concern is possible conflicts of interest. A December 2007 report prepared
19 for Rep. Henry A. Waxman, the Chairman of the Committee on Oversight and
20 Government Reform, found widespread conflicts of interest among compensation
21 consultants. Many of these consultants provided additional services to companies, and

²⁹ 78 C.J.S. Public Utilities Section 92.

³⁰ *US West v. UTC*, 134 Wn.2d 74, 125 (1997).

³¹ Executive Pay: Conflicts of Interest Among Compensation Consultants, United States House of Representatives, Committee on Oversight and Government Reform, December 2007, Executive Summary.

1 fees relating to those services often outweighed fees relating to compensation
2 consulting.³² In other words, the compensation consultants were not truly independent.

3 This is similar to the auditor independence issues Sarbanes-Oxley addressed. The
4 Committee's report actually found a correlation between the extent of conflict of interest
5 and the level of CEO pay.

6 **Q: Have you investigated whether or not Towers Perrin provides additional services to**
7 **PSE?**

8 A: Yes. Public Counsel's Data Request No. 523 asked for a schedule of all amounts paid to
9 Towers Perrin for 2004 through 2007. ~~Begin Confidential~~ PSE's confidential response
10 indicates that, of the total paid to Towers Perrin during this timeframe, 38 percent was for
11 non-compensation support. ~~End Confidential~~ However, those payments were made in
12 2004 and 2005 and none were made in 2006 and 2007.³³

13 **Q: Did PSE make any payments to Towers Perrin relating to the proposed sale?**

14 A: Yes, however it appears that those payments are not included in the total for 2007.³⁴

15 **Q: Has the UTC addressed the subject of executive compensation and the use of**
16 **compensation consultants?**

17 A: Yes, the Commission has addressed the issue several times. In its Final Order in
18 PacifiCorp's 2005 rate case, the Commission provided its overall strategy regarding
19 executive compensation, stating:

20 In determining the reasonableness of executive compensation,
21 the Commission will *consider compensation as a whole, not*
22 *limited to whether executive incentive compensation is paid in*

³² *Id.*

³³ PSE Response to Public Counsel Data Request No. 523.

³⁴ *Id.*

1 *stock or whether compensation is similar in level or benefits to*
2 *that of other comparable companies.*³⁵
3

4 In its Final Order for PacifiCorp’s 2006 rate case, the Commission noted the
5 “increasing attention to and criticism of excessive levels of executive compensation and
6 bloated severance packages.” The Commission also noted the ongoing investigation into
7 that matter and the use of compensation consultants by Congress.³⁶ In sum, the
8 Commission stated, “we are inclined to be wary of studies by consultants that potentially
9 are self-serving and may not provide objective information that is useful to us.”³⁷ In my
10 opinion, both of these Orders indicate that an “everyone else is doing it” argument is not
11 persuasive when it comes to executive compensation.

12 **1. Overall Executive Salary Levels**

13 **Q: Given the increased concern over excessive executive compensation, did you**
14 **specifically look at the compensation of PSE’s CEO and other top executives?**

15 **A:** Yes, I did. PSE’s top six executives are: Stephen Reynolds (CEO), Bertrand Valdman
16 (COO), Eric Markell (CFO), Susan McLain (Sr. VP – Operations), Jennifer O’Connor
17 (General Counsel) and Kimberly Harris (CRO). The total compensation for these
18 individuals is reported in the Summary Compensation Table included in the PSE’s 10-K.
19 I have attached the 2007 table as Exhibit No.____ (MJM-6) to my testimony. To
20 summarize the table, the executives reported the following compensation in 2006 and
21

³⁵ PacifiCorp GRC, Docket No. UE-050684, Order 04 at ¶ 350 (emphasis added).

³⁶ Final Order UE-061546 and UE-060817, ¶ 174.

³⁷ Final Order UE-061546 and UE-060817, ¶ 174.

1 2007, showing an overall 35 percent increase in total compensation:

<u>Executive</u>	<u>2006</u>	<u>2007</u>	<u>Increase</u>	<u>Percent</u>
Reynolds	\$ 3,548,438	\$ 4,817,727	\$ 1,269,289	36%
Valdman	1,070,111	1,514,995	444,884	42%
Markell	766,611	1,118,194	351,583	46%
McLain	803,276	975,133	171,857	21%
O'Connor	745,188	944,088	198,900	27%
Harris	<u>655,101</u>	<u>876,326</u>	<u>221,225</u>	34%
Total	\$ 7,588,725	\$10,246,463	\$ 2,657,738	35%

Source: PSE December 31, 2007 10-K, p. 148.

2

3 **Q: What forms of compensation are included in the above amounts?**

4 A: The amounts above include: (a) salary, (b) stock awards, (c) option awards, (d) non-
5 equity incentive plan compensation, (e) change in pension value and above market DCP
6 and (f) other compensation, which includes perquisites and other personal benefits,
7 registrant contributions to defined contribution plans and the imputed income on life
8 insurance.³⁸

9 **Q: Are all of these components included in the rate case?**

10 A: No. As I will discuss below, not all are included.

11 **Q: If the amounts in the table above are not included in the rate case, why have you**
12 **included Table 1?**

13 A: I included Table 1 because I wanted the Commission to be fully aware of the total
14 compensation package for these executives.

³⁸ PSE December 31, 2007 10-K, pp. 148-149.

1 **Q: Has the Commission expressed any interest in total executive compensation in the**
2 **past?**

3 A: Yes. The PacifiCorp Order quoted above clearly indicates that the Commission intends
4 to review executive compensation as a whole, including stock and other forms of
5 compensation in addition to salaries.³⁹ Table 1 provides that necessary information.

6 **Q: Do these executives stand to receive additional compensation if the sale is approved?**

7 A: Yes, substantially so. PSE's response to Public Counsel's Data Request No. 530
8 provides the change in control benefits estimated to be paid if the sale is approved. The
9 benefits include an automatic "cash severance" payment of \$4.6 million, estimated excise
10 tax gross-up of \$3.4 million to Mr. Reynolds, and an acceleration of the long term
11 incentive plan (LTIP) for all the executives amounting to \$22.6 million.⁴⁰

12 However, it should be noted that this answer provides only a narrow discussion of
13 the compensation that PSE executives will receive if the sale is approved. According to
14 the Company's February 16, 2008 merger proxy, Mr. Reynolds alone would receive
15 approximately \$20 million in total compensation by the close of the sale.⁴¹ Other PSE
16 executives will also gain substantial financial benefits, estimated in the millions of
17 dollars, as a result of the sale. Additionally, the February 16, 2008 merger proxy also
18 provides information about the levels of compensation—above and beyond these
19 additional millions of dollars not mentioned in PSE's response to Public Counsel's Data
20 Request No. 530—promised to the top executives if they are terminated after the sale.

³⁹ PacifiCorp GRC, Docket No. UE-050684, Order 04 at ¶ 350.

⁴⁰ PSE Response to Public Counsel Data Request No. 530.

⁴¹ PSE Response to WUTC Staff Data Request No. 1003 in Docket U-072375. The February 16, 2008 merger proxy is also available online at: <http://www.pugetenergy.com/files/reports/ProxyStatement/SpecialProxy.pdf>

1 **Q: Does the fact that Mr. Reynolds’s \$4.6 million sale payday is referred to as a “cash**
2 **severance” mean that he will be leaving the Company if the sale is consummated?**

3 A: No. Mr. Reynolds will receive that amount regardless.

4 **Q: Were you able to compare the overall 35 percent increase in total compensation**
5 **received by these executives to the overall increase received by other employees in**
6 **the Company?**

7 A: No. Public Counsel’s Data Request No. 591 requested the increase in total compensation
8 for employees broken into union and non-union groups, with the non-union employees
9 further broken down between the CEO, executives making more than \$150,000, and
10 employees making less than \$150,000. PSE objected, claiming the groups in question
11 had different compensation packages and thus, such a comparison was not possible. The
12 information PSE did provide indicates that, although the percent in base salary increase
13 received by executives was similar to that received by other employees, the incentive
14 executives received as a percent of base salary was far higher than the percentage
15 received by other employees.⁴² In other words, in comparing just incentive awards, the
16 Company’s executives received significantly larger increases.

17 **Q: Do you think PSE’s overall executive compensation levels are excessive?**

18 A: Yes. As I will discuss in detail below, PSE’s executive compensation is pegged to the
19 compensation at much larger companies. This alone would cause PSE’s executive
20 compensation to be excessive. In addition, the increase in total compensation received by
21 the top executives is far greater than that received by other employees.

22

⁴² PSE Response to Public Counsel Data Request Nos. 362 and 591.

1 **2. Towers Perrin Studies**

2 **Q: What are the Towers Perrin compensation studies you mentioned above?**

3 A: According to PSE witness, Tom M. Hunt, “PSE participates in numerous confidential
4 salary surveys provided by third-party consulting firms in order to compare PSE’s pay
5 programs – both base salary and variable pay – to other companies in [PSE’s] labor
6 markets.”⁴³ The Company provided a list of the surveys in its response to Staff Data
7 Request No. 111. Although the list contained surveys from several organizations, the
8 primary surveys used by PSE appear to be those prepared by Towers Perrin.

9 **Q: How does PSE use these studies to set compensation levels?**

10 A: According to its 2007 10-K, the Company “annually compares executive pay to external
11 market data from similar companies in [its] industry. Base pay and total direct
12 compensation are targeted to the 50th percentile of [PSE’s] comparator group.”⁴⁴

13 Although the target is the 50th percentile, individual compensation is adjusted according
14 to experience, performance, and responsibilities.⁴⁵ In addition, total cash compensation
15 can reach the 75th percentile if PSE exceeds its performance goals.⁴⁶ In other words, PSE
16 selects a comparison group of utility companies and sets its target pay for each executive
17 to approximately the 50th percentile of similar executives in those companies.

18 **Q: In general, do you see a problem with the use of compensation studies?**

19 A: Yes. These types of studies are circular in nature. The data included is from companies
20 that choose to participate by providing their data and in paying for access to the database.
21 A company that does not set compensation levels based on industry data would not have

⁴³ Exhibit No. ____ (TMH-1T), p. 7:5-6.

⁴⁴ PSE’s December 31, 2007 Form 10-K, p. 139.

⁴⁵ *Id.*

⁴⁶ *Id.*, p. 141.

1 any incentive to participate. If each participant sets its compensation levels at the 50th
2 percentile or higher, such as PSE does, the average will ratchet up each year.

3 Compensation set in this manner becomes artificial—it will no longer be based on
4 business factors specific to PSE, only on what is being paid at the next company down
5 the road. If companies base compensation on data from larger companies such as PSE
6 does, the database becomes even more skewed.

7 **Q: Were you given access to the studies used by PSE?**

8 A: Public Counsel Data Request No. 517 requested copies of the studies. In response, PSE
9 stated that it was prohibited from distributing copies of the studies due to confidentiality
10 constraints and instead would make the studies available for review at its headquarters in
11 Bellevue.⁴⁷ Due to the time and distance involved, my client viewed the studies on my
12 behalf. PSE also arranged a web presentation on April 24, 2008 to demonstrate how it
13 uses the Towers Perrin data. In addition, we were provided an MS Excel file entitled
14 “Towers Perrin Peer Group 2006 Data (C)” and a report dated October 2006 entitled
15 “2006 CDB Energy Services Industry Executive Compensation Database Puget Energy
16 Custom Analysis – 2006 Executive Peer Group.” These documents represent PSE’s
17 custom analysis using the Towers Perrin database and are considered confidential. We
18 were not provided access to the database itself. In addition, Towers Perrin declined to
19 allow PSE to perform any analysis on behalf of Public Counsel using its compensation
20 database.

21 **Q: What did you learn during the presentation?**

⁴⁷ PSE Response to Staff Data Request No. 111.

1 A: During the presentation, I learned that PSE has access to Towers Perrin's online database
2 of compensation information. After selecting a peer group of energy companies (which
3 is then approved by PSE's Towers Perrin consultant), PSE is able to perform queries that
4 provide compensation information by both the highest paid positions and by job type.

5 **Q: How did PSE select its peer group?**

6 A: The peer group selected consisted of utility companies with revenues between \$1.5
7 billion and \$7.0 billion, and assets between \$4.0 billion and \$10.0 billion.⁴⁸

8 **Q: Do you believe the peer group selected by PSE is a reasonable proxy for PSE?**

9 A: No. In my opinion, PSE has selected a peer group of companies that are in many cases
10 much larger than PSE in terms of assets, employees, and revenues. As I discussed above,
11 there are problems inherent in using compensation studies such as the one by Towers
12 Perrin to set compensation levels. The use of an inappropriate peer group merely adds to
13 those problems.

14 **Q: What are some specific flaws with PSE's peer group?**

15 A: According to confidential information provided in PSE's response to Public Counsel's
16 Data Request No. 522, the median 2006 revenue for the peer group was ~~Begin~~
17 ~~Confidential~~ \$3.12 billion ~~End Confidential~~, with the average revenue being ~~Begin~~
18 ~~Confidential~~ \$3.40 billion ~~End Confidential~~. In contrast, PSE's 2006 revenue was only
19 \$2.91 billion. Based on revenue alone, PSE is smaller than the both the median and
20 average of the peer group. PSE also is quite a bit smaller when using other metrics as
21 well. For instance, the median 2006 market capitalization for the peer group was ~~Begin~~
22 ~~Confidential~~ \$3.06 billion ~~End Confidential~~, with the average being ~~Begin~~

⁴⁸ PSE's December 31, 2007 10-K, p. 141.

1 ~~Confidential~~ \$3.74 billion ~~End Confidential~~. PSE's 2006 market capitalization was
2 only \$2.70 billion.⁴⁹ Finally, a comparison of the number of employees supervised by
3 PSE's CEO versus the average number of employees supervised by the CEOs of the peer
4 companies shows that while Mr. Reynolds supervises ~~Begin confidential~~ 2,316 ~~End~~
5 ~~Confidential~~ employees, the CEOs of the peer group supervise ~~Begin Confidential~~
6 4,586 ~~End Confidential~~ employees on average.⁵⁰

7 **Q: Why is the use of larger companies in the proxy group a problem?**

8 A: Because the peer group companies are so much larger, they are not truly comparable to
9 PSE. Executive pay may be tied somewhat to the size and complexity of a company. If
10 PSE sets its executive pay to be comparable with that of larger companies, PSE will
11 naturally end up paying its executives more than what is a correct market rate for a
12 company of PSE's size. For instance, as mentioned above, there is an enormous
13 discrepancy between the numbers of employees Steve Reynolds supervises versus the
14 average number supervised by the CEOs of the peer group. Based on the data provided
15 in PSE's response to Public Counsel's Data Request No. 521, the number of employees at
16 PSE falls between the ~~Begin Confidential~~ 10th and 25th percentile, closer to the 10th
17 percentile ~~End Confidential~~. However, Mr. Reynolds's total direct compensation falls
18 closer to ~~Begin Confidential~~ the median ~~End Confidential~~ for the companies.

19 **Q: What parameters should PSE use in selecting a peer group?**

20 A: PSE used a range of \$1.5 billion to \$7.0 billion in revenue to select its peer group, when
21 its own 2006 revenue was \$2.91 billion. This is a range of 51 percent to 240 percent of

⁴⁹ Confidential PSE Response to Public Counsel Data Request No. 522.

⁵⁰ Confidential PSE Response to Public Counsel Data Request No. 521 Supplemental.

1 PSE's revenue. A more appropriate range would have been between 75 percent and 125
2 percent of PSE's revenue, in other words, \$2.2 billion to \$3.6 billion. Furthermore,
3 revenue is not necessarily the best indication of similarities between companies. PSE
4 should give more weight to other factors such as number of employees, amount of
5 regulated versus non-regulated business, value of assets, and market capitalization, in
6 selecting a comparison group.

7 **Q: Did you have the opportunity to select a different proxy group and perform your**
8 **own compensation analysis using the Towers Perrin database?**

9 A: No. Towers Perrin declined to allow PSE to either provide access to the database or
10 perform additional analyses using peer groups selected by the intervenors in this case. As
11 such, the only information I have available is the summary information used by PSE.

12 **Q: What do you recommend regarding PSE's use of compensation studies?**

13 A: I do not recommend setting executive compensation based on what is being done at other
14 companies. As I have discussed above, I believe the sort of compensation studies PSE
15 relies upon are circular in nature, and can lead to compensation levels that would
16 otherwise not occur if normal economic factors were at play. Because PSE has relied
17 upon compensation levels at much larger companies in determining the compensation for
18 its own executives, in my opinion PSE's compensation levels are suspect.

19 **3. Executive Compensation Included in Rate Case**

20 **Q: Please explain the components of PSE's executive compensation that have been**
21 **included in the rate case.**

22 A: Public Counsel's Data Request No. 528 requested the amounts of compensation by
23 component included in the revenue requirement for the Company's top five executives.

1 According to that response there are four types of executive compensation included in the
2 rate case: salary, employee insurance, incentive pay, and long term investment plan
3 (LTIP).

4 **Q: What do the incentive pay and investment plan components represent?**

5 A: The incentive pay portion is the amount related to the Company's 2007 Goals and
6 Incentive Plan, which I will discuss in depth later in my testimony. The investment plan
7 amounts appear to be related to PSE's 401(k) plan.

8 **Q: How were the salaries amounts, provided in PSE's Response to Public Counsel's**
9 **Data Request No. 528, calculated?**

10 A: Based on PSE's response, the salary amounts included in the revenue requirement were
11 increased by the overall effective increase for salaried employees. I was able to confirm
12 this using Mr. Story's workpapers. His workpaper "4.25E & 4.18G Wage Increase.xls"
13 includes the test year salary by employee, which I then multiplied by his overall effective
14 increase for salaried employees of 4.79 percent. In performing this check I noticed two
15 issues.

16 **Q: Please explain your findings.**

17 A: First, I noticed discrepancies in the various salary amounts I have been provided by the
18 Company. The salary amounts included in Mr. Story's workpapers are allegedly test year
19 amounts. I compared those amounts for the top five executives to the base salary
20 amounts, labeled as "Actuals from 10-1-06 to 9-30-07", found in PSE's confidential
21 Response to Public Counsel's Data Request No. 674, which based, on the label, should be
22 test year amounts as well. There were differences between the two amounts, which calls
23 into question the validity of the data used.

1 Second, and more importantly, I noticed that 100 percent of Mr. Reynolds' salary
2 has been charged to O&M, as well as the vast majority of the total salary amounts for the
3 other top five executives.

4 **Q: Why do you feel that charging Mr. Reynolds' entire salary to ratepayers is an issue?**

5 A: PSE's Response to UTC's Data Request No. 133 provided the percentages of each
6 executive's salary that were allocated either to utility operations or non-regulated
7 operations, by month, from January 2001 through December 2007. Per the response, the
8 source of the data was officer time-sheets and fixed assessment rules applied to each
9 officer's cost center. With the exception of one officer (Phil Bussey, Director of
10 Communications), the fixed assessment rules allocate 100 percent of the officer's time to
11 the regulated utility.

12 Even though Puget Energy does not have a large amount of non-regulated
13 operations, I believe that some portion of executive pay should be the responsibility of
14 the shareholders. In any investor-owned utility, one would expect the top executives to
15 spend at least some of their time on activities that provide no direct benefit to ratepayers.
16 These activities may include preparing shareholder reports and attending shareholder
17 meetings, monitoring stock performance, and cost reduction efforts where there is no
18 accompanying reduction in rates. Other activities might be designed to increase
19 shareholder value, such as the upcoming sale. In fact, although the executives allocated
20 100 percent of their time to regulated operations through the test year, I noticed that,
21 beginning around September 2007, more time was allocated to non-regulated operations.
22 The Commission should consider the specific duties of each executive and whether they
23 are actually serving ratepayers.

1 **Q: Were you able to determine the specific duties of each executive?**

2 A: No. Public Counsel’s Data Request No. 529 requested a listing of the common tasks
3 performed, along with the percentage of time spent on each task for the five top
4 executives. PSE was not able to provide this information, stating that the Company did
5 not have job descriptions for the top five executives. Instead, the Company suggested
6 reviewing the job descriptions of the employees who report to each executive and the
7 summaries of executive goals as related to the Goals and Incentive Plan.

8 **Q: Did you review these items as suggested?**

9 A: Yes. I found that many of the officer goals provided in PSE’s Response to Public
10 Counsel’s Data Request No. 31 were not directed towards areas that would provide a
11 direct benefit to ratepayers. For some officers, such as Phil Bussey (Corporate
12 Communications), Jennifer O’Connor (Legal), and Bert Valdman (COO), none of the
13 goals provide a direct benefit to ratepayers.

14 The job descriptions also showed few customer service related responsibilities.
15 For example, Mr. Bussey’s job summary, “[r]esponsible for leading and overseeing all
16 external and internal communications strategies, policies and activities supporting the
17 reputation and identity of Puget Energy, and its primary subsidiary, Puget Sound Energy”
18 clearly is directed towards shareholder value, not ratepayer benefit.⁵¹ Note that even
19 though Mr. Bussey’s position provides no direct benefit to ratepayers, he charges 80
20 percent of his time to regulated operations.⁵² According to his job description, Mr.

⁵¹ PSE Response to Public Counsel Data Request No. 129.

⁵² PSE Response to Public Counsel Data Request No. 133.

1 Bussey reports to the CEO.⁵³ Other job descriptions that are clearly aimed towards
2 shareholder benefit are the Director Investor Relations and Director Structuring Asset
3 Optimization and Analytics, all of whom report to the CFO, the Director Federal
4 Government (reporting to the CRO), and those directors that report to General Counsel.⁵⁴

5 This discussion demonstrates that, despite charging almost all of their time to
6 regulated operations, PSE's top executives have many responsibilities, some of which do
7 not provide benefit to the ratepayers.

8 **Q: Do you recommend that a portion of executive pay be disallowed based on your**
9 **discussion above?**

10 A: Yes. Using the information provided in PSE's Response to Public Counsel's Data
11 Request No. 528, I have eliminated 50 percent of the base salary included in the revenue
12 requirement for Mr. Reynolds, Mr. Valdman, Mr. Markell and Ms. O'Connor. I have not
13 eliminated any of Ms. McLain's base salary due to her position as Vice President of
14 Operations.

15 **Q: Why have you selected 50 percent as the amount to eliminate?**

16 A: PSE is not able to provide job descriptions for the executives listed above, nor is it able to
17 provide task breakdowns for the positions. In the past, the UTC has not permitted
18 companies to charge ratepayers for the entire amount of officer salaries, when it is clear
19 that the officers spend time on non-regulated activities, or activities that do not provide a
20 direct benefit to the ratepayers.⁵⁵ The preferable method of disallowing a portion of the
21 salaries would be to use direct assignment, which is not possible. Another preferred

⁵³ PSE Response to Public Counsel Data Request No. 129.

⁵⁴ *Id.*

⁵⁵ Final Order UE-991606 and UE-991607, ¶¶ 244-250.

1 method would be the use of an allocation factor, also not possible in this case. I have
2 selected 50 percent based on my judgment.

3 **Q: Have you reduced any other executive salaries?**

4 A: Yes. I have eliminated 25 percent of Ms. Kimberly Harris's salary. Ms. Harris is the
5 Chief Resource Officer. According to PSE's website, Ms. Harris heads Energy
6 Resources, including project development and contract management, Energy Efficiency
7 Services, and Federal Government Relations. My 25 percent elimination is related to her
8 role as head of Federal Government Relations. I would also eliminate the entire salary
9 for the Director, Federal Government, but do not have the necessary information to do so.
10 The other salary adjustment I have made related to this issue is to eliminate 100 percent
11 of Mr. Bussey's salary. As noted above, Mr. Bussey's position as head of Corporate
12 Communications does not appear to provide any direct benefit to ratepayers.

13 **I. Adjustment Nos. 11(E) and 6(G) – SERP and Deferred Compensation Plan**

14 **Q: Are PSE executives eligible to receive any additional compensation that was not**
15 **included in the response to Public Counsel's Data Request No. 528, but is included**
16 **in the revenue requirement?**

17 A: Yes. PSE's executives participate in a Supplemental Executive Retirement Program
18 (SERP) and a Deferred Compensation Plan. Both of these plans appear to serve the
19 purpose of allowing PSE to provide retirement contributions to executives that are greater
20 than those allowed by the Internal Revenue Service (IRS) under normal, tax-qualified
21 retirement plans.

22 **Q: Please explain the SERP.**

1 A: As described in PSE's 2007 Form 10-K, the SERP is designed to provide executives a
2 benefit that is coordinated with the tax-qualified PSE Retirement Plan.⁵⁶ The plan is open
3 only to those executives designated by the company. The monthly benefit, available to
4 the executive at age 62, is equal to "one-twelfth of the participant's highest average
5 earnings times the participant's years of credited service (not in excess of 15) times 31/3
6 percent," less the monthly amount payable under the Retirement Plan and the monthly
7 amount payable under any "pension-type rollover accounts within the Deferred
8 Compensation Plan."⁵⁷

9 **Q: What is your opinion regarding the SERP?**

10 A: PSE's SERP is an extremely generous retirement program open only to select executives.
11 It is far more lucrative than the Retirement Plan that PSE's regular salaried employees are
12 eligible to participate in. For instance, employees participating in the Retirement Plan
13 accrue a cash balance based on 3 to 8 percent of eligible compensation, up to an IRS
14 limit. Normal retirement age under that plan is 65 years, not 62 years as for the SERP.⁵⁸
15 Another indication of the generous nature of the SERP can be found in the schedule of
16 pension benefits for the Company's top six executives. With the exception of Mr.
17 Reynolds, who does not participate in the SERP, the total present value of the
18 accumulated benefit for the Retirement Plan is only 25 percent of the same amount for
19 the SERP.⁵⁹

20 **Q: Please explain the Deferred Compensation Plan.**

⁵⁶ PSE's December 31, 2007 Form 10-K, p. 145.

⁵⁷ *Id.*, p. 154.

⁵⁸ *Id.*, p. 153.

⁵⁹ *Id.*, p. 152.

1 A: Like the SERP, the Deferred Compensation Plan is only available to certain executives.
2 The Plan allows executives to defer up to 100 percent of his or her base salary, annual
3 incentive compensation, and vested performance shares. The plan also provides
4 participants with Company contributions designed “to restore benefits not available to
5 them under PSE’s tax-qualified plans due to limitations imposed by the Internal Revenue
6 Code.”⁶⁰

7 **Q: Are any additional payments made under the guise of the Deferred Compensation**
8 **Plan?**

9 A: Yes. PSE’s CEO, Mr. Reynolds, elected not to participate in the SERP. Instead, he
10 chose to receive “an annual credit of performance-based stock equivalents to his Deferred
11 Compensation Plan’s stock account.”⁶¹

12 **Q: What do you recommend regarding the SERP and Deferred Compensation Plan?**

13 A: I recommend that they be removed from the revenue requirement. PSE’s SERP and
14 Deferred Compensation Plan provide an additional level of compensation to its already
15 highly-paid executives. The SERP goes far and beyond any Retirement Plan available to
16 other Company employees, not to mention any retirement programs available to the
17 majority of its ratepayers. Contributions to the Deferred Compensation Plan appear to
18 serve the purpose of side-stepping limitations put in place by the IRS to curb excessive
19 executive compensation. If PSE feels that such programs are necessary then they should
20 be financed by the Company’s shareholders, not its ratepayers.

21 **Q: Have you seen these types of programs in any other recent cases?**

⁶⁰ PSE’s December 31, 2007 10-K, p. 155.

⁶¹ *Id.*, p. 155.

1 A: Yes. I recently prepared testimony in North Dakota Case No. PU-07-776.⁶² In North
2 Dakota, retirement plans such as the SERP are not included in the revenue requirement.

3 **Q: Have you calculated the amounts to be removed?**

4 A: Yes. According to PSE's pension plan related workpapers, the Company has adjusted its
5 SERP expense to reach a restated level of \$2,236,061 for electric and \$1,309,865 for gas,
6 a total of \$3,545,926. I have removed this entire amount from the revenue requirement.⁶³
7 My adjustment is shown on page 16 of Exhibit No.____ (MJM-4).

8 **J. Adjustment Nos. 12(E) and 7(G) - Remove Incentive Pay**

9 **Q: Explain Adjustment Nos. 12(E) and 7(G).**

10 A: These adjustments remove all amounts related to PSE's Goals and Incentive Plan. They
11 appear on page 17 of Exhibit No.____ (MJM-4).

12 **Q: What is PSE's Goals and Incentive Plan?**

13 A: Company witness, Thomas M. Hunt, describes PSE's Goals and Incentive Plan as
14 providing "all employees with the opportunity for incentive payment based on Company,
15 team and individual performance."⁶⁴ Essentially the plan puts some of each employee's
16 total compensation at risk – if certain corporate and individual goals are not met, the
17 incentive bonus is not distributed. The amount of compensation at risk is greater the
18 higher the position.

19 **Q: How is the overall incentive payout determined?**

⁶² Application of Northern States Power Company, a Minnesota Corporation, for Authority to Increase Rates for Electric Service in North Dakota, Case No. PU-07-776.

⁶³ We have requested PSE's deferred compensation in Public Counsel Data Request No. 697, however, we have not yet received a response.

⁶⁴ Exhibit No.____ (TMH-1T), p. 16:14-15.

1 A: The total amount of incentive payout to be distributed depends on two factors: earnings
2 per share (EPS) and Service Quality Index (SQI) goals. Mr. Hunt provides more detail in
3 his testimony:

4 For any incentive payment to be possible, two threshold
5 requirements must be met: First, PSE's earnings per share (EPS)
6 must exceed the "trigger" level (\$1.43/share in 2007). Second, PSE
7 must meet or exceed its required performance on at least 5 of 11 of
8 the Service Quality Index (SQI) goals.⁶⁵
9

10 **Q: What does this indicate about the Goals and Incentive Plan?**

11 A: The fact that Mr. Hunt lists EPS as the first factor involved in computing the incentive
12 payout indicates that, despite the inclusion of SQI goals in the formula, the primary driver
13 of *any* incentive payout is PSE's financial performance. In other words, if shareholder
14 expectations are not met through a certain level of earnings per share, *no incentive is paid*
15 *out at all.*

16 **Q: How do the SQI goals factor into the equation?**

17 A: Once the Company has determined the total amount of incentive pool available per its
18 EPS level, that amount is modified up or down based on how many SQI goals the
19 Company has achieved. In order for 100 percent of the EPS-related pool to be available
20 for payout, PSE must meet 10 out of 11 of its SQI goals. If the Company meets all 11,
21 the EPS-based pool is paid out at 120 percent. If it meets 4 or fewer SQI goals, the EPS-
22 based pool is not paid out at all.⁶⁶

23 While the achievement of SQI goals has the potential to increase or reduce the
24 incentive pool to be paid out, the actual payment of any incentive is primarily related to

⁶⁵ Exhibit No. ____ (TMH-1T), p. 18: 9-12.

⁶⁶ Exhibit No. ____ (TMH-4).

1 the achievement of EPS goals. If PSE meets 5 of its SQI goals, the incentive pool will be
2 paid out at 50 percent. In other words, PSE need only achieve 45 percent of important
3 SQI goals in order for a bonus to be paid out. In many situations, 60 percent is
4 considered a barely passing grade – 45 percent would be considered unacceptable.

5 **Q: Do any other Public Counsel witnesses address the Company’s SQI goals?**

6 A: Yes. Barbara Alexander addresses PSE’s customer service and SQI goals.

7 **Q: How do the individual and team goals factor into the incentive plan?**

8 A: Individual and team goals only help in determining how much of the incentive pool is
9 paid to an individual employee.⁶⁷ The goals have nothing to do with the overall payout
10 pool as calculated based on EPS and modified by SQI. Goals are nice to have, and they
11 can serve to direct Company strategy, but they can also be fairly subjective. Regardless,
12 the goals are not at issue in determining the overall amount to be paid out under the plan.

13 **Q: What is your overall impression of the Goals and Incentive Plan?**

14 A: My overall impression is that the Goals and Incentive Plan is first and foremost tied to
15 financial performance measures – a shareholder benefit, not a ratepayer benefit. Any
16 other factors discussed, including SQI and goals, only serve to modify the amount paid,
17 and not determine the starting point.

18 **Q: Has this Commission or Washington courts provided any guidance on these types of**
19 **programs?**

20 A: Yes. In PSE’s 1992 rate case, the Commission disallowed a “pay-at-risk” program for
21 the Company’s officers and directors, referring to the program as a “profit-sharing” plan.

⁶⁷ *Id.*

1 As described in the Commission’s Final Order, the “pay-at-risk” program sounds very
2 similar to PSE’s current “Goals and Incentive Plan.”⁶⁸

3 Additionally, in a 1997 decision, the Washington State Supreme Court upheld the
4 Commission’s decision to disallow recovery of U.S. West’s incentive program in rates.
5 In its Final Order below, the Commission noted that in U.S. West’s incentive plan,
6 employees could recoup any part of their bonus lost by poor service performance if the
7 Company’s earnings exceeded a certain level. It disallowed the plan because the
8 structure allowed financial rewards to eclipse customer service failures.⁶⁹

9 Finally, in its Final Order in Avista’s 1999 general rate case (disallowing recovery
10 of Avista’s incentive plan), the Commission noted that Avista’s incentive plan suffered
11 from the same flaws as U.S. West’s plan - Avista would not pay its incentive bonus if
12 certain earnings goals were not met, even if it exceeded customer service goals.⁷⁰

13 **Q: Does PSE’s plan suffer from the same flaws as U.S. West’s and Avista’s plans?**

14 A: Yes it does. As I have discussed above, the first criteria in determining the bonus payout
15 is EPS. For 100 percent of the target bonus to be funded, the Company must have an
16 EPS of \$1.57 and meet 10 out of 11 SQI goals. Using Tables 1 and 2 in Exhibit
17 No.____(TMH-4) and assuming PSE reaches \$1.65 EPS (the top of its earnings guidance),
18 the Company could achieve only 8 out of 11 SQI factors and still fund the bonus pool at
19 greater than 100 percent of its target. The bonus pool cap is 205 percent of target, which
20 is tied to an EPS figure of \$1.76. If PSE were to reach that figure, it would still fund over

⁶⁸ Puget Sound Power & Light, Docket No. UE-920499, Eleventh Supplemental Order, at p. 67.

⁶⁹ *US West v. UTC*, 134 Wn.2d 74, 125 (1997).

⁷⁰ Avista GRC, Docket No. UE-991606, Third Supplemental Order at ¶¶ 244-273.

1 100 percent of its bonus pool while achieving only 5 out of 11 SQI goals! This plan
2 suffers from the exact flaws as the plans disallowed in the U.S. West and Avista cases.

3 **Q: What do you recommend?**

4 A: Because the program's overall payout is first tied to EPS, a shareholder benefit, I
5 recommend that shareholders finance the program. As such, I have removed the entire
6 amount from the revenue requirement. This amounts to \$5.4 million for electric and \$3.1
7 million for gas.

8 **K. Adjustment Nos. 13(E) and 8(G) - Remove Expenses Related to Shareholders**

9 **Q: Explain Adjustment Nos. 13(E) and 8(G).**

10 A: These adjustments, shown on page 18 of Exhibit No.____(MJM-4), remove certain
11 expenses associated with Puget Energy's (PE) status as a public company.

12 **Q: Why have you made these adjustments?**

13 A: PSE is the only subsidiary of PE. PE incurs certain costs brought on solely by its status
14 as a public company. Included in these costs are: directors' fees and expenses; trustee,
15 registrar, and transfer agent fees and expenses; stockholder meeting expenses; expenses
16 related to dividend and other financial notices and printing and mailing dividend checks;
17 expenses related to publishing and distributing annual reports to stockholders; and,
18 expenses related to public notices of financial, operating and other data required by
19 regulatory statutes. Currently, PE's affiliate allocation methodology allocates 100
20 percent of most of these expenses to its subsidiary, PSE, and from there to its
21 ratepayers.⁷¹

⁷¹ PSE Response to Staff Data Request No. 026, Attachment F.

1 In my opinion, shareholders, not ratepayers, should incur these types of expenses.
2
3 Furthermore, should PE's proposed sale be approved I would expect that these expenses
4 would no longer be necessary at all. According to PSE's response to Staff Data Request
5 No. 026, the Company has not calculated the change in these expenses post-sale.

6 **Q: What do you recommend?**

7 A: I recommend the removal of 100 percent of PSE's expenses related to trustee, registrar,
8 and transfer agent fees, stockholder meetings, dividend and other financial notices, the
9 printing and mailing dividend checks, the publishing and distribution of annual reports to
10 stockholders and public notices of financial, operating and other data required by
11 regulatory statutes. Because I recognize that directors should play a role in the
12 management of a company, I have split directors' fees and expenses evenly between
13 shareholders and ratepayers. In total, I have removed \$1.8 million in related expenses
14 from PSE's electric and gas revenue requirements.

15 **L. Adjustment Nos. 14(E) and 9(G) - Remove Corporate Aircraft Expense**

16 **Q: Explain Adjustment Nos. 14(E) and 9(G).**

17 A: These adjustments remove all amounts related to PSE's corporate airplane and appear on
18 page 19 of Exhibit No.____ (MJM-4).

19 **Q: Why have you made these adjustments?**

20 A: According to PSE's Response to Public Counsel's Data Request No. 321 PSE owns a
21 corporate airplane and leases an airport hangar. Test Year amounts related to the aircraft
22 and hangar include \$472,523 in flight services expenses, \$969,352 net plant included in

1 rate base, \$50,982 in depreciation expense for the test year, and \$186,794 in deferred
2 federal income tax.⁷²

3 Although it is PSE's policy that the aircraft is only used for business purposes, a
4 review of the flight log indicates that much of its use is merely shuttling executives back
5 and forth to meetings and other events, including holiday parties. While it may be
6 convenient for Company executives to travel by private aircraft, it is not a necessity,
7 given PSE's service territory. Private aircraft travel should be done at shareholders'
8 expense, not ratepayers'. A corporate aircraft is not essential for the provision of safe,
9 reliable electric service.

10 **M. Adjustment Nos. 15(E) and 10(G) - Remove Expenses Relating to Athletic**
11 **Events**

12
13 **Q: Explain Adjustment Nos. 15(E) and 10(G).**

14 A: These adjustments remove \$17,849 in expenses relating to athletic events. They appear
15 on page 20 of Exhibit No.____ (MJM-4).

16 **Q: Why have you made these adjustments?**

17 A: PSE's Response to Public Counsel Data Request No. 598 indicates that the Company
18 incurred \$207,434 in expenses related to athletic and sporting activities. Of this amount,
19 \$189,584 was charged below the line, leaving \$17,849 in the rate case. The majority of
20 the total amount is related to PSE's corporate suite for the Seattle Mariners. The amount
21 included in the revenue requirement appears to be for various "employee games", which
22 involve PSE officers, directors and, employees drawn from an employee pool, and are

⁷² PSE Response to Public Counsel's Data Request Nos. 321 and 577. Total flight services expenses in rate case = \$294,039 grand total from Public Counsel Data Request No. 321 plus \$178,484 utility chargeback from Public Counsel Data Request No. 577.

1 **XXXXXXXXXXXXXXXXXX [End Confidential]** and as such should not be borne by

2 ratepayers.

3 **Q: How did you calculate the adjustment?**

4 A: I used PSE’s D&O workpapers and reduced the premium for AEGIS by \$112,182, which
5 set the premium to the 2006-2007 level. I did not attempt to reduce the premium further,
6 even though the other four insurers had reduced their premiums. The formulae in PSE’s
7 D&O workpapers produced the revised adjustment for electric and gas. My total
8 adjustment includes the elimination of PSE’s increase, as well as the decrease associated
9 with the effect of reduced premiums for the other four insurers.

10 **Q: What is the impact of your adjustment?**

11 A: My adjustment results in a decrease in D&O insurance of \$65,799 for electric and
12 \$45,236 for gas.

13 **O. Adjustment Nos. 17(E) and 12(G) - Remove Airport Parking Expense**

14 **Q: Explain Adjustment Nos. 17(E) and 12(G).**

15 A: These adjustments remove all amounts related to PSE’s lease of six parking spaces at
16 SeaTac Airport. They are shown on page 22 of Exhibit No.____ (MJM-4).

17 **Q: Why have you made these adjustments?**

18 A: PSE leases six parking spaces at SeaTac Airport, “to accommodate officers when they
19 travel to out-of-town meetings.”⁷⁴ Rate case expenses related to this perquisite are
20 \$21,541.⁷⁵ As with the use of a private aircraft, while it is certainly convenient for
21 Company officers to have pre-arranged parking available at the airport to the extent the

⁷⁴ PSE Response to Public Counsel Data Request No. 607.

⁷⁵ PSE Response to Public Counsel Data Request No. 433.

1 cost of these leased parking spots exceeds the cost of day-to-day parking, they should be
2 borne by shareholders, not ratepayers. PSE provided a usage log for the passes related to
3 the parking spaces, but it is impossible to determine from the log how many days an
4 individual actually parked at the airport.⁷⁶

5 **P. Adjustment Nos. 18(E) and 13(G) – Interest Synchronization**

6 **Q: Explain your interest synchronization adjustments as shown on Exhibit No.____**
7 **(MJM-4), p. 23.**

8 A: Adjustment Nos. 18(E) and 13(G) adjust the interest expense in the income tax
9 calculation to reflect Mr. Hill’s recommended composite weighted interest rate.

10 **Q. Rate of Return**

11 **Q. Have you implemented Mr. Hill’s recommended rate of return?**

12 A: Yes. I have implemented Mr. Hill’s recommended rate of return in Exhibit
13 No.____(MJM-4), Schedules 2(E) and 2(G). This results in a revenue requirement
14 reduction of \$36.8 million in electric and \$15.1 million in gas.

15 **VI. Summary**

16 **Q: Please summarize your recommendations.**

17 A: In addition to implementing Mr. Hill’s recommended rate of return, I have made 18
18 adjustments to the Company’s electric revenue requirement proposal and 13 adjustments
19 to its gas revenue requirement proposal. In summary:

- 20 • I recommend that the UTC specifically recognize that PSE has a \$137.9 million
21 regulatory liability related to its collection of excess future removal costs. PSE
22 should be required to reclassify this amount to Account 254-Other Regulatory

⁷⁶ PSE Response to Public Counsel Data Request No. 607.

1 Liabilities for regulatory accounting, reporting, and ratemaking purposes. This
2 adjustment is a revenue neutral reclassification, however, I recommend it be used
3 to offset storm expenses.

- 4 • I have disallowed certain out-of-period plant additions for PSE's electric plants,
5 as well as reversed Mr. Karzmar's premature Everett Delta Lease adjustment.
- 6 • I have made adjustments relating to PSE's storm damage expenses, including
7 amortizing a portion of its cost of removal regulatory liability to offset its net
8 storm damage claim.
- 9 • I have adjusted the Company's federal income tax rate to reflect its corporate tax
10 rate and implemented flow-thru tax accounting for storm damage costs.
- 11 • I have increased the amortization period for interest associated with the deferral of
12 unrecovered residential exchange benefits credited to customers from PSE's
13 proposed 2 years to 7 years.
- 14 • I have implemented Mr. King's depreciation rates.
- 15 • I have reduced PSE's requests for executive compensation and directors' fees –
16 splitting some of those expenses with shareholders. I have also reduced PSE's
17 requested increase to D&O insurance.
- 18 • I have eliminated PSE's requested amounts relating to its SERP, Goals and
19 Incentive Plan, shareholder services, corporate aircraft, athletic events, and airport
20 parking spaces.
- 21 • I have adjusted the interest expense in the income tax calculation to reflect Mr.
22 Hill's recommended composite weighted interest rate.

1 **Q: What is the impact of your adjustments?**

2 A: My adjustments reduce PSE's calculated revenue deficiency by \$175.4 million for
3 electric and \$51.0 million for gas. This results in a \$4.3 million electric revenue increase
4 and a \$7.0 million gas revenue increase.

5 **Q: Does his conclude your testimony?**

6 A: Yes, it does.