EXHIBIT NO. ___(MJS-1T)
DOCKET NO. UE-09___/UG-09___
2009 PSE GENERAL RATE CASE
WITNESS: MICHAEL J. STRANIK

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-09____** **Docket No. UG-09____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF
MICHAEL J. STRANIK
ON BEHALF OF PUGET SOUND ENERGY, INC.

MAY 8, 2009

PUGET SOUND ENERGY, INC.

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Please state your name, business address, and present position with Puget Sound Energy.

A. My name is Michael J. Stranik. I am the Assistant Controller for Puget Sound Energy, Inc. ("PSE" or "the Company"). My business address is 10885 N.E. Fourth Street, Bellevue, Washington, 98009.

Q. Would you please provide a brief description of your educational and business experience?

A. Please see Exhibit No. ___(MJS-2).

Q. What topics are you covering in your testimony?

A. I describe the natural gas results of operations and natural gas revenue deficiency. I will describe the different allocation methods used to allocate common expenditures between electric and natural gas operations. I explain the various adjustments to the results of operations for the test year used for this proceeding, plus changes to ratebase, working capital, conversion factor and the overall revenue requirement and the resulting revenue deficiency. I will also discuss the current results of operations compared to the results of operations in the last general rate case and the resulting causes of the current revenue deficiency. Finally, I will discuss the Company's electric and gas savings as a result of the merger with Puget Holdings LLC.

Based upon the adjusted test year operating revenues of $1,228,490,778, the total requested gas general rate case revenue deficiency is $27,199,117, which represents a 2.2% average increase for natural gas customers.

II. TEST YEAR FINANCIAL STATEMENTS AND RATEBASE

Q. Would you please explain Exhibit No. ___(MJS-3)?

A. Exhibit No. ___(MJS-3) presents the actual financial statements for the test year before any pro forma or restating adjustments. Page 3.01 of Exhibit No. ___(MJS-3) presents a comparison between the unadjusted gas income statement for the test year ending September 30, 2007, in Docket No. UG-072301 et al. (the "2007 general rate case") and the unadjusted gas income statement for the test year ending December 31, 2008, the test year for this general rate case filing. Page 3.02 of Exhibit No. ___(MJS-3) presents the combined balance sheet for the same time periods, and page 3.03 of Exhibit No. ___(MJS-3) presents the ratebase calculation for the current test year prior to any pro forma and restating adjustments. Please see the second exhibit to the Prefiled Direct Testimony of Mr. John H. Story, Exhibit No. ___(JHS-3), for the equivalent schedules for electric operations.

Q. Is the ratebase calculation done in the same manner as allowed in the last general rate case?

A. Yes.

Q. Would you please explain the working capital calculation?

A. This is the measure, for ratemaking purposes, of investor funding of daily operating expenditures and a variety of non-plant investments that are necessary to sustain ongoing operations in order to bridge the gap between the time expenditures for services are required to be provided and the time cost recovery occurs. The purpose of this calculation is to provide a return on the funds the shareholders have invested in the Company for utility purposes that have not been accounted for elsewhere by investment in plant or that are not otherwise already earning a rate of return. The calculation is based on the average of the monthly averages of the actual amounts in the asset and liability accounts for the test year.

The first part of this adjustment calculates the total investor supplied working capital, which is the total average invested capital less the combination of both operating investment and non operating investment. Operating investments represent items for both natural gas and electric that earn a return, or are allowed to earn a return, and non-operating investments represent construction work in progress ("CWIP") and items that do not earn a return for utility purposes.

The natural gas portion of working capital is calculated by taking the relationship of the total investor supplied capital to the total average investments times the natural gas operating investment. An adjustment is made for determining the natural gas working capital ratio by deducting natural gas CWIP from total average investments using the same methodology that was proposed by the Company in rebuttal testimony in its 2007 general rate case. The resulting operating working capital represents the investor's average investment which is required to provide utility service but which would otherwise not earn a return. The resulting operating working capital represents the investor's average investment which is required to provide utility service but which would otherwise not earn a return. For example, this represents the capital needed for fuel inventory, such as underground storage, materials and supply inventories, prepayments and cash working capital. The gas working capital calculation is shown in Exhibit No. ___(MJS-3), page 3.04 and adds $51,102,877 to natural gas ratebase.

Q. Please explain the remaining page of Exhibit No. ___(MJS-3).

A. Page 3.05 of Exhibit No. ___(MJS-3) presents the Allocation Methods, or factors, used in allocating common expenditures between electric and natural gas.

Common utility plant is that portion of utility operating plant that is used for providing more than one commodity, i.e., both electricity and gas, to customers. Common plant includes costs associated with land, structures, and equipment, which are not charged specifically to electric or gas operations because the assets are used jointly in providing service to both commodities. The Company allocates its common utility plant in determining ratebase by using the four-factor allocation method as authorized in the stipulation approving the merger of Puget Sound Power & Light Company and Washington Natural Gas Company in 1997. Components of the four-factor allocator include the number of customers, direct labor charged to operations and maintenance ("O&M"), Transmission and Distribution O&M, and net classified plant (excluding general plant).

Common operating costs are those costs that are incurred on behalf of both electricity and gas customers. The Company incurs common costs related to: Customer Accounts Expenses; Customer Service Expenses; Administrative and General Expenses; Depreciation/Amortization; and Taxes Other Than Federal Income Tax. The most appropriate allocation method based on type of cost is applied to each type of common cost. Allocation methods used include: (1) twelve month customer average; (2) joint meter reading customers; (3) non-production plant; (4) four factor allocator; and (5) direct labor.

III. CAUSES OF THE NATURAL GAS REVENUE DEFICIENCY

Q. Would you please describe the causes of the natural gas revenue deficiency?

A. Yes. To determine the major causes of the changes between two regulatory filings the Company uses a unit cost analysis. This analysis is simply the major categories of the income statement and ratebase that have been pro formed and restated for each of the regulatory periods, divided by the delivered load for that period. This calculation determines the major categories' unit cost for that particular period. The prior period that is used in this calculation has also been adjusted for the restating and pro forma adjustments that were allowed in the 2007 general rate case. The differences between the current period and prior period unit costs are then multiplied by delivered loads for the current regulatory period. This product determines how much that major category has increased or decreased in cost since the last regulatory period taking into consideration load growth.

Exhibit No. ___(MJS-6) shows this calculation for the difference between the adjusted test year for this general rate filing, as determined in Exhibit No. ___(MJS-4) and the adjusted test year for the 2007 general rate case. Major cost drivers of the proposed revenue increase include: 1) increase of $9.3 million for distribution operating expenses, 2) increase of $6.2 million for other utility O&M and operating expenses, 3) a decrease of $6.6 million for revenues, and 4) the change in ratebase increases the revenue requirement by $18.3 million of which approximately $9.0 million is related to the requested change in cost of capital.

IV. GAS PRO FORMA AND RESTATING ADJUSTMENTS

Q. Please explain your Exhibit No. ___(MJS-4).

A. Exhibit No. ___(MJS-4) presents the impact of each of the gas pro forma and restating adjustments being made to the December 31, 2008 operating income statement and balance sheet. The first page of Exhibit No. ___(MJS-4), Summary page, presents the unadjusted operating income statement and average of the monthly-averages ratebase for the Company as of December 31, 2008 in the column labeled "Actual Results of Operation". The various line items are then adjusted for the summarized pro forma and restating adjustments, as shown in the column labeled "Adjusted Results of Operations". This column is the source used to calculate the revenue deficiency. In the second to last column the revenue deficiency is added to the adjusted income statement, and the impact on the operating income statement and ratebase is presented in the final column. The remainder of Exhibit No. ___(MJS-4) is composed of two sections, described below.

Pages 4-A through 4-D of Exhibit No. ___(MJS-4) present a summary schedule of all the pro forma and restating adjustments. The first column of numbers on page 4-A is the unadjusted net operating income for the year ended December 31, 2008 and the unadjusted ratebase for the same period. Each column to the right of the first column represents a pro forma and/or a restating adjustment to net operating income or ratebase. Each of these adjustments has a supporting schedule, which is referenced by the page number shown in each column title.

The second to the last column, shown on page 4-D of the summary schedule, summarizes all of the adjustments and the final column shows the adjusted test period results used to calculate the revenue deficiency.

Q. Please describe each adjustment, explain why it is necessary, and identify the effect on operating income or ratebase.

A. I will explain the adjustments in the order as they are shown on the summary schedule, by reference to the column number and title of each adjustment.

4.01 Temperature Normalization

This restating adjustment, as shown on Exhibit No. ___(MJS-4), page 4-A, column 4.01, normalizes weather sensitive gas therm sales by eliminating the effect of temperature deviation above or below historical normals. It restates therms delivered to reflect the temperature normalized therms and then reprices the adjusted therms delivered based upon the authorized rates. Please see Ms. Lorin Molander's Prefiled Direct Testimony, Exhibit No. ___(LIM-1T), for detailed discussion of the weather normalization methodology. Please see Ms. Janet Phelps' Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), and Exhibit No. ___(JKP-3) for further details on the Company's weather normalization adjustment.

This adjustment decreases net operating income by $8,781,321.

4.02 Revenue and Purchased Gas Expenses

This restating and pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-A, column 4.02, restates sales revenues and purchased gas costs to reflect only those rate schedules included in the general rate case and to pro form in the full year effect of the general rate increase that occurred during the test year. It also includes other necessary test year true up adjustments. Please refer to Ms. Phelps' Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), for a discussion of these adjustments.

In addition to adjustments that were consistent with prior rate cases, a new adjustment was added to pro form in the full year effect of the phase-in of test year Company sponsored conservation measures. Please refer to Mr. Jon Piliaris's Prefiled Direct Testimony, Exhibit No. ___(JAP-1T), for a further discussion on the conservation phase-in adjustment.

This adjustment increases net operating income by $22,535,434.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustments are:

4.03 Net Interest due to IRS for Simple Service Cost Method ("SSCM")

This pro forma adjustment is the result of the final settlement deductions taken for capitalized overheads that were subsequently disallowed by the IRS. A settlement was reached in which net interest payments were due to the IRS. This adjustment is done in the same manner as requested in the accounting petition filed November 6, 2008 and is Docket No. UE-082012. The accounting petition has not come before the Commission as of the filing date for this proceeding. Please refer to Mr. Matthew Marcelia's Prefiled Direct Testimony, Exhibit No. ___(MRM-1T), for a more in depth discussion of this adjustment.

This adjustment decreases net operating income by $1,018,402 and decreases ratebase by $915,968.

4.04 Federal Income Taxes

This schedule adjusts actual federal income tax ("FIT") expense to the test year for this case. Mr. Marcelia discusses this adjustment in his Prefiled Direct Testimony, Exhibit No. ___(MRM-1T).

The effect of this restating adjustment, shown on Exhibit No. ___(MJS-4), page 4-A, column 4.04, is to increase net operating income by $915,758.

4.05 Tax Benefit of Pro Forma Interest

This pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-A, column 4.05, uses a ratebase method for calculating the tax benefit of pro forma interest. The effect of this adjustment is to decrease net operating income by $8,358,141. The Company proposes a change to the calculation by removing

CWIP from the calculation. Please refer to Mr. Marcelia's Prefiled Direct Testimony, Exhibit No. ___(MRM-1T), for a more in depth discussion of this adjustment and this change in methodology. A workpaper has been provided to all parties that shows the prior method of calculating this adjustment.

4.06 Depreciation and Amortization

This restating adjustment, shown on the Third Exhibit to my Prefiled Direct Testimony, Exhibit No. ___(MJS-4), page 4-B, column 4.06, calculates the impact of implementing the depreciation study over the test year as approved in the 2007 general rate case. The new depreciation rates went into effect November 1, 2008. This adjustment recalculates the depreciation expense as if the rates were in effect for the entire test year. The new depreciation rates were applied against the depreciable balance from January to December 2008 and compared to the actual test year amounts to determine the adjustment for the test period. Lines 7 through 9 and Lines 13 through 15 of this adjustment demonstrate the impact of the Statement of Financial Accounting Standard No. 143, Accounting for Asset Retirement Obligations recorded in accounts 403.1 and 411.1. Because salvage is considered in the approved depreciation rates, there is no effect on net operating income for this accounting pronouncement.

Any change in book deprecation has no effect on tax deprecation, and therefore there is no adjustment to current taxes. In addition, no corresponding change was made to deferred taxes consistent with normalization principles.

The depreciation expense adjustment decreases net operating income by $6,218,349 and decreases rate base by $3,109,174.

4.07 <u>Pass Through Revenues and Expenses</u>

This restating adjustment, shown on Exhibit No. ___(MJS-4), page 4-B, column 4.07, removes from operating revenues all rate schedules that are a direct pass through of specifically identified costs or credits to customers, such as the conservation tracker, municipal taxes and the low income program. The associated expenses for these direct pass through tariffs are also removed in this adjustment. The schedules for these revenues are not adjusted in a general rate case filing; therefore their impact on net operating income is being removed.

This adjustment increases net operating income by $342,920.

4.08 <u>Bad Debts</u>

This restating adjustment, as shown on Exhibit No. ___(MJS-4), page 4-B, column 4.08, calculates the appropriate bad debt rate by using the average bad debt percentage for three of the last five years after removing the high and low years. There is a modification to this calculation to capture the lag effect of when the write-off occurred versus the month the write-off was billed. Since it takes four months to write-off a bill, the ratio of the write-off versus revenue was offset four months. In other words, a write-off booked in December 2008 really related to revenue that was recognized during twelve months ending August 2008. Using this relationship between August income and December write-offs results in the calculation of an appropriate percentage of write-offs associated with revenues.

The bad debt percentage for a given year is calculated by taking the actual write-offs for that year and dividing them by the net revenues for twelve months ending in August for each of the years. The net test year revenues from line 7 are multiplied by the average bad debt percentage, line 9, to determine the amount of bad debt expense. This amount is compared to the actual test year level of bad debt expense on line 12 to determine the effect on income. This bad debt percentage is also used in the conversion factor when determining the final revenue requirement.

This adjustment increases net operating income by $454,572.

4.09 <u>Miscellaneous Operating Expense and Ratebase</u>

This restating and pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-B, column 4.09, adjusts the test year for several different items.

1. <u>Amortization of Summit Buyout Purchase Option Summit Building</u>

This pro forma adjustment is made to reflect the deferred accounting treatment approved in Docket No. UE-071876 for the proceeds, net of incremental transaction costs, resulting from a settlement agreement to amend the PSE lease for its corporate headquarters buildings. The lease was modified by terminating and removing a purchase option and by extending the existing lease terms in consideration of a $20 million payment to the Company by Summit REIT, Inc. The proceeds net of transaction costs were approximately $18.9 million, which is to be amortized over 12 years, and which will spread the benefit over the remaining life of the lease. This adjustment is offset by the adjustment shown on line 15 for contractual rent increases for the corporate headquarters. This adjustment increases the test year operating revenues for the amortization of the lease termination by $464,363.

2. <u>Amortization of Deferred Taxes on Indirect Overheads Regulatory Asset (WUTC Docket No. UE-051527)</u>

In prior years the Company had taken a deduction for certain general overhead costs associated with construction, which created a deferred tax balance. The IRS then changed the method of deduction for indirect overhead costs and required any utility that had previously deducted these items to reverse the deductions over the 2005 and 2006 tax years. The Commission’s order on October 26, 2005, approved the Company’s accounting petition in Dockets UE-051527 and UG-051528, allowed the Company to set up a regulatory asset to track the carrying costs associated with the tax payments based on the turn around of the deductions associated with these overheads. The Commission allowed the Company to defer the carrying costs, with interest, associated with the deferred taxes that had to be repaid to the federal government in 2005 and 2006.

In accordance with the order, the Company is amortizing this deferral over a two year period, including the amortization of the carrying costs associated with the declining balance of the regulatory asset. Because the balance in the regulatory asset will be fully amortized by the rate year, this restating adjustment decreases operating expense by $1,414,931 for the removal of the amortization from the test year.

3. <u>Service Contract Baseline Charges</u>

Similar to an adjustment made in the 2007 general rate case, baseline charges on service contracts are expected to increase. This pro forma adjustment, which increases transmission expense by $3,005 and distribution expense by $695,231, represents the expected percentage increase over test year costs. These amounts may be trued-up for changes to contract price increases during the course of these proceedings as warranted.

4. <u>Company Store, Athletic Events & Airport Parking</u>

In restating adjustments, the Company has removed the net effect of expenses related to the Company Store (an increase in operating expense of $1,301), Athletic Events (a decrease in operating expense of $7,394) and Airport Parking (a decrease in operating expense of $7,193) resulting in total combined effect of a decrease in operating expense of $13,286.

5. <u>Summit Building Fourth Floor Contractual Rent Increase</u>

PSE has entered into a lease agreement for additional space in the Summit

Building. This additional space is incremental and has been entered into in order to alleviate overcrowding of existing space. This restating and pro forma adjustment, shown on line 13, increases operating expense by $171,143 to adjust the test year rent for the additional fourth floor space by the contractual annual rent increases between August 2008 and March 2011.

6. Summit Building Contractual Rent Increases

This statement and pro forma adjustment shown on line 15 adjusts the test year rent expense for the Company's headquarters by the contractual annual rent increases between August 2008 and March 2011. This increase to lease expense of offset by the adjustment shown on line 4. This adjustment increases operating expenses by $344,895. The net impact before taxes for adjustments 1 and 6 is an increase to operating revenue of $119,468.

The combined effect of all the miscellaneous adjustments increases net operating income by $440,899.

4.10 Property Taxes

This pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-B, column 4.10, reflects the estimated property tax levy rates to be paid in 2009 based upon 2008 value. This adjustment is done in the same manner as in the last general rate case, and the levy rates will be adjusted to actual during the course of this proceeding.

This adjustment decreases net operating income by $850,450.

4.11 Excise Tax and Filing Fee

This restating adjustment, shown on Exhibit No. ___(MJS-4), page 4-B, column 4.11, adjusts the test year to actual expense for the Washington State excise tax and WUTC filing fee that should be recorded for these costs.

This adjustment increases net operating income by $693,130.

4.12 Director and Officer Insurance

This restating and pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-B, column 4.12, removes the portion of Director and Officer insurance that should be allocated to Company subsidiaries. This adjustment also reflects the current premium for Directors and Officers insurance as it related to Company Directors after the merger. The cost of a carry over insurance policy for Company Directors prior to the merger has been charged to Puget Energy and is not included in this proceeding.

The portion allocable to Company subsidiaries is determined by dividing non-utility assets by total PSE assets and applying that percentage to the pro forma insurance cost. This result is then compared to what was actually booked during the test year.

This adjustment increases net operating income by $142,454.

4.13 Interest on Customer Deposits

This pro forma adjustment to operating income, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.13, is the expense impact associated with using customer deposits as a reduction to ratebase. This pro forma adjustment adds to operating expense the cost of interest for this item based on the most currently implemented annual interest rate which is 0.42%. Pursuant to WAC 480-100-113(9), the interest rate paid on customer deposits is determined annually based on the interest rate for a one year Treasury Constant Maturity as of the fifteenth day of January of that year. This approach is consistent with decisions in prior general rate cases.

This adjustment decreases net operating income by $30,273.

4.14 Rate Case Expenses

This restating adjustment, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.14, restates rate case expense to a normalized level. In the Company's 2004 general rate case the Commission changed the method for future recovery of rate case expenses to a "normalized" methodology. Based on prior general rate cases, a "normal" level of expense was determined and divided by an estimated time interval of three years to determine the annual amount to set in rates (half of which was included in the electric revenue requirement and half of which was included in the gas revenue requirement).

The Company has followed this method in the calculation of rate case expense for this case. The Company has used the history of expense levels for general rate cases from 2006 and 2007 to determine a normalized level of expenditures by averaging the costs associated with the last two general rate cases. This average level of costs was then spread over two years, which more accurately reflects the actual time frame that has been experienced between general rate case filings over the past several years. This same two year time frame was approved in the Company's 2007 general rate case and is the time frame that is consistent with the Company's anticipated timing of future rate case filings.

The average cost for a general rate case using this methodology is $2.279 million. This cost is allocated 50% to electric and 50% to natural gas, which results in a $1.139 million dollar average cost for each energy group.

The resulting amortization and normalized cost are then compared to the amount the Company had recorded in the test year for regulatory expense, and the result increases net operating income by $153,958.

4.15 Deferred Gains/Losses on Property Sales

This restatement and pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.15, provides the customer with the net gains or losses from sales of utility real property since the last general rate case. The gains and losses are allocated to natural gas and electric based on the use of the property. The amount of the net gain is amortized over a three-year period, with the deferred amount being included in working capital. This adjustment is done in compliance with the settlement agreement for property sales from Docket UE-89-2688-T.

This adjustment decreases net operating income by $313,412.

4.16 Property and Liability Insurance

This pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.16, reflects the actual and estimated premium increases for property and liability insurance expense. These costs are allocated between electric and natural gas depending on the purpose of the insurance. This adjustment will be updated to actual premiums during the course of the proceeding.

The effect of this adjustment is to increase net operating income by $233,199.

4.17 Pension Plan

This restating and pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.17, adjusts the test year to reflect cash contributions to the Company's qualified retirement fund. This restating adjustment restates the test year to reflect cash contributions to the Company's qualified retirement fund. As determined by the plan actuary, the Company made a $24.5 million tax deductible cash contribution in 2008. The Company expects to make an additional $18.4 million in cash contributions in 2009, of which $6 million cash contribution was made in April 2009, and the remaining contribution amount will be made by the end of the year. The calculation is consistent with previous general rate cases in which the Commission has used the normalized four year average of contributions to determine the amount that is to be included in operating expense. This adjustment includes the average of the four years ending September 2009. Amounts included for the twelve months ending September 2009 include estimates that will be trued up to actual during the course of this proceeding.

This adjustment also restates the expense associated with the Supplemental Executive Retirement Plan to an average of the four years expense ending September 2009.

Both the pension and the SERP are allocated to O&M based on wage distributions and then allocated between electric and natural gas based on the labor benefit assessment distribution allocator from Exhibit No. ___(MJS-03), page 3.05.

This adjustment decreases net operating income by $1,480,293.

4.18 <u>Wage Increase</u>

This pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-C, column 4.18, reflects the impact of wage increases, as described in the Prefiled Direct Testimony of Mr. Tom Hunt, Exhibit No. ___(TMH-1T). For represented (union) employees, the adjustment annualizes the wage increases granted in 2009, 2010, and 2011. The percentage of wage increase for International Brotherhood of Electrical Workers ("IBEW") union employees from the test year through the rate year are: 3.25%, effective April 1, 2008; 3.25% effective April 1, 2009; 3.00% effective January 1, 2010; and the estimated increase of 3.00% effective January 1, 2011. The percentage of wage increase for United Association of Plumbers and Pipefitters ("UA") union employees from the test period through the rate year are: 3.00% effective October 1, 2008; 3.00% effective October 1, 2009; and the estimated increase of 3.00% effective October 1, 2010. The IBEW contract runs through March 31, 2010, and the UA contract runs through September 30, 2010. Annual wage increases after the end of the contract are based on the percent increase for the year immediately prior to the end of the contract.

The percentage of wage increase for non-union employees from the test year through the rate year is 3.5% effective March 1 of each year from 2008 through 2011. These increases have been weighted by prior year actual salary increases, as in prior general rate cases. This is done in order to account for "slippage," as it is sometimes called, that occurs when new management employees are hired at lower salary rates than the more senior employees they are replacing.

The total pro forma adjustment reflecting the impact of wage increases and payroll tax changes for both management (non-union) and represented (union) employees, as discussed above, decreases net operating income by $1,898,225.

Q. Please explain how these management increases are weighted by prior

increases in order to adjust for slippage?

A. Slippage is determined by measuring the difference between the average wage increase granted during each of a number of historical adjustment periods and the change between the average wage at the beginning and end of each of the same periods for the same class of employees. Projected wage increases for the same class of employees, are then weighted or reduced by the slippage differential. In order to perform the actual slippage calculation in this case, the Company first calculated the annualized payroll for all management employees for each of the last five years as of March 1 which is the effective date of annual management salary adjustments. From this, the Company determined the average annual salary per management employee, calculated the actual percent increase for management employees for years 2005 to 2008, and compared this to the projected percent wage increase for management employees. Average salary change per management employee as of March 1, for the years 2005 through 2008, was 1.87%, 2.95%, 4.42% and 1.29%, respectively, or 2.73% on average. This was compared to the average wage increase allowed for management employees during those same years of 3.00%, 3.00%, 3.50% and 3.50%, respectively, or 3.41% on average. The 2.73% average change between the beginning and end of each adjustment year is 79.93% of the 3.41% average increase at the beginning of each year. This percentage is applied to the expected compound wage increase of 8.06% from the end of the test year through the rate year ending March 31, 2011, to yield a 6.44% wage adjustment for management employees after considering slippage.

Q. Were there any other changes to the wage increase calculation?

A. Officer salaries were not included as part of the overage wage increase calculation since the wages for this group of employees are kept at 2008 levels.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustments are:

4.19 <u>Investment Plan</u>

This pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-D, column 4.19, adjusts the Company portion of investment plan expense to reflect the additional expense associated with the wage increases and is based on the current employee contribution rates. As with the wage increase, the investment plan does not include any added expenses associated with officers' contributions. Please see the Prefiled Direct Testimony of Mr. Tom Hunt, Exhibit No. ___(TMH-1T) for a further discussion on the Company's decision to freeze officers' pay and not to seek recovery of officers' incentive pay expense in this case.

This adjustment decreases net operating income by $100,005.

4.20 Employee Insurance

The effect of this pro forma adjustment, shown on Exhibit No. ___(MJS-4), page 4-D, column 4.20, updates the test year insurance payments to the amount for the rate year. For IBEW employees, the estimated cost is based on the average Company contribution amount of $843 per eligible employee per month for the months of January through December 2009. For January 2010 through March 2011, an estimated cost of $983 per eligible employee was used. The estimate was based on a historical trend of cost increases over the past five years. For UA employees, the estimated cost is based on the average Company contribution amount of $842 per eligible employee per months for the months of November and December 2008, and $910 per eligible employee per month for the months of January through December 2009. For January 2010 through March 2011, an estimated cost of $983, as explained above, was used. The amounts are the result of negotiations between PSE and the unions. The average rate applied to UA employees was also applied to salaried employees.

These costs are allocated to electric and natural gas based on the labor benefit assessment distribution allocator from the Second Exhibit to my Prefiled Direct Testimony, Exhibit No. ___(MJS-3), page 3.05 and then to O&M based on payroll distribution.

This adjustment decreases net operating income by $544,180.

4.21 Incentive Compensation

In his Prefiled Direct Testimony, Exhibit No. ___(TMH-1T), Mr. Hunt discusses why the incentive pay expense is appropriate for ratemaking consideration and how the program is similar to the previously allowed incentive compensation programs.

Q. Are there any changes in the calculation for incentive compensation from the previous general rate case?

A. Yes, in general the calculation is similar except that officer incentive pay is excluded from the calculation in the current rate case. For this calculation, the Company has used the years 2005 through 2008 and allocated the four-year average to electric and natural gas using the labor benefit assessment distribution allocator. The incentive payment is allocated to O&M expense and other accounts based on where payroll was charged during the test year. This O&M amount is then compared to actual incentive pay expenses during the test year.

This incentive pay adjustment increases net operating by $615,785.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustment is:

4.22 Merger Savings

The effect of this restating adjustment, shown on Exhibit No. ___(MJS-4), page 4-D, column 4.22, is to remove costs that are not expected to be incurred in the rate year.

The adjustment for merger savings increases net operating income by $311,112.

Q. Please describe the merger saving that you are proposing in this adjustment.

A. As a result of the merger with Puget Holdings LLC, the Company has identified several expenses that will result in merger savings in the rate year for electric and gas operating expenses. These expenses are included in the Sixth Exhibit to my Prefiled Direct Testimony, Exhibit No. ___(MJS-7), and total $1.35 million for combined electric and gas operating expenses. The expenses include reductions in the Board of Directors fees and expenses related to: outside independent directors, shareholder services fees associated with transfer agent and registrar function, annual report design and printing, New York Stock Exchange listing fees, and other accounting related fees required for a public company.

Q. Are there other savings that are not presented in this adjustment?

A. Yes. During 2008, employees throughout the Company charged their time to Puget Energy as they worked on merger related items. The labor and related labor overheads lowered PSE's operating expenses by $595,210 which is not being pro formed into operating costs. In addition, as a result of the merger PSE's

Directors and Officers ("D&O") insurance decreased a total of $535,179. Including these items, the total merger savings was $2,483,228.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustment is:

4.23 <u>Fleet Vehicles</u>

PSE received a letter, dated November 14, 2008, from GE Capital requesting the termination of the master operating lease agreement for fleet vehicles that PSE has used since 1988. Under the terms of the lease agreement, PSE can either sell the assets to a third party or buy them for the unamortized value no later than one year from the termination date. The termination date, which is January 14, 2009, is defined as sixty days from the date of the letter. PSE has notified GE Capital that the fleet vehicles would be purchased sometime prior to the lease termination date at their unamortized value.

The ratebase for this pro forma adjustment is calculated by using the estimated unamortized value of the vehicles as of January 1, 2010. Deducted from this purchase price, plus sales tax, are the estimated accumulated depreciation and deferred taxes on an average basis through the end of the rate year. Depreciation rates for the vehicles were based on the average service lives approved in the Company’s depreciation study in Docket No. UG-072301.

To determine operating expenses, lease payments occurring in the test year were removed and the estimated book depreciation expense as discussed above was added. This adjustment results in increased operating income of $696,545 and an increase of $4,077,858 in ratebase.

V. CALCULATION OF THE NATURAL GAS REVENUE DEFICIENCY

A Revenue Deficiency Based on the Pro Forma and Restated Test Period

Q. Would you please explain what is presented in the Fourth Exhibit to your Prefiled Direct Testimony, Exhibit No. ___(MJS-5)?

A. The Fourth Exhibit to my Prefiled Direct Testimony, Exhibit No. ___(MJS-5), presents the calculation of the natural gas revenue deficiency based on the pro forma and restated test period. The different pages in Exhibit No. ___(MJS-5) are:

5.01 General Rate Increase

This schedule, shown on Exhibit No. ___(MJS-5), page 5.01, shows the test period pro forma and restated ratebase, line 1, and net operating income, line 6. Based on $1,474,390,203 invested in ratebase, an 8.56% rate of return and $109,292,915 of net operating income the Company would have a revenue deficiency of $27,199,117.

5.02 Cost of Capital

This schedule, shown on Exhibit No. ___(MJS-5), page 5.02, 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 Direct Testimony of Mr. Donald E. Gaines, Exhibit No. ___(DEG-1T). The rate of return is 8.56% and 7.38% net of tax.

5.03 Conversion Factor

The conversion factor, shown on Exhibit No. ___(MJS-5), page 5.03, is used to adjust the net operating income deficiency by revenue sensitive items and federal income tax to determine the total revenue deficiency. The revenue sensitive items are the Washington State utility tax, WUTC filing fee, and bad debts. The conversion factor used in the revenue requirement calculation, taking into consideration the adjustments discussed earlier, is 62.1891%.

VI. CONCLUSION

Q. Does this conclude your testimony?

A. Yes, it does.