Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

A. My name is Merton Lott and my business address is 1300 S Evergreen Park Dr SW, Olympia, Washington, 98504.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Washington Utilities and Transportation Commission as the Gas Industry Coordinator.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I support the following two adjustments which are included in Mr. Russell's results of operations exhibit: Adjustment (i), Working Capital, and Adjustment (p), Owned Capacity Property. Further, I address the subject of interjurisdictional allocations and support Staff's proposal to phase in over three years Northwest Natural Gas Company's (Northwest) transition from system pricing to allocated results.

QUALIFICATIONS

Q. HOW LONG HAVE YOU BEEN EMPLOYED BY THE COMMISSION?

A. Over 26 years.

Q. WOULD YOU PLEASE STATE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. I received a Bachelor of Arts Degree in Business Administration, with a major in accounting, from Seattle University in June 1973. I am a certified public accountant in the state of Washington and have taken numerous courses in accounting, management, and regulation theory and practice in order to maintain the continuing CPA education requirements of the state of Washington. I have been employed by the Commission since May 1974. Further, I have represented this Commission on the NARUC Staff Subcommittee on Accounts since approximately 1991.

Prior to July 1990, I was employed by the Utilities and Accounting Division of the Commission in first an auditing and then supervisory capacity. During this period, I performed various phases of accounting and financial analysis of both utility and transportation companies. I worked on the investigation of Washington Natural Gas Company (WNG) in Cause No. U-80-27. I was lead auditor in the filings of Pacific Power and Light (PacifiCorp), Cause Nos. U-82-12/35 and U-86-02; The Washington Water Power Company(WWP), Cause Nos. U-83-26, U-85-36, U-87-1570 and Docket No. UE-900093; and Puget Sound Power & Light (Puget), Cause No. U-83-54 and Docket No. U-89-2688. Further, I was in charge of Staff's analysis of attrition in Cause Nos. U-83-26, U-83-54, and U-86-02. I audited Spokane Suburban and Clarkston General Water companies in Cause Nos. U-84-45 and U-84-46. I participated as lead auditor in the determination of proper rates and principles negotiation with United

Telephone. I was also the lead auditor in the analysis of General Telephone (GTE) that led to its filing in Cause No. U-85-33. I was the lead analyst in Continental Telephone's (Contel) filing in Cause No. U-87-640-T. Further, I participated in and, in some cases, testified in various limited issue filings in gas, electric, and telephone proceedings including several Puget energy cost adjustment clause (ECAC) proceedings, the reopened Cause No. U-81-41, involving reconsideration of ECAC, PacifiCorp's merger proceeding in Cause No. U-87-1338-AT, and WWP's Power Cost Adjustment (PCA) proposal in Docket U-88-2363-P. I participated as either lead analyst or as a supervisor in 22 of Puget's ECAC proceedings, starting with the third trimester. During this period, I testified in several of the dockets listed above.

In July 1990, I transferred to the Regulatory Affairs Section as the Commission's accounting advisor. In this capacity, I advised the Commissioners and Administrative Law Judges on most of the formal dockets before the Commission, including major rate cases of WNG, Puget, Waste Management, and U S WEST Communications, Inc. (U S WEST); cost of service and rate design cases of WWP, Puget, WNG, and U S WEST; merger dockets of WWP, U S WEST, GTE, and Contel; purchased gas adjustment and deferral proceedings; all of Puget's Periodic Rate Adjustment Mechanism (PRAM) proceedings; and various rulemakings and notices of inquiries.

In June 1996, I transferred to my current position in the Regulatory Services Division, where I coordinate and supervise the Division's gas section. Under my supervision, Staff has processed several tariff filings and rulemakings, including the 1997 gas general rate filings of WWP and Northwest Natural Gas (Northwest). I also participated in several electric dockets including PacifiCorp's general rate case in Docket UE-991832 and, on occasion, acted as the accounting advisor to the Commission in a number of telephone proceedings.

EXHIBITS

Q. PLEASE DESCRIBE THE EXHIBITS YOU PREPARED TO SUPPORT YOUR TESTIMONY?

A Exhibit ____ (MRL-2) is my calculation of investor supplied working capital, which is included as Adjustment (i) in Mr. Russell's Results of Operations exhibit. Exhibit ____ (MRL-3) is my calculation of the Owned Capacity Property Adjustment, which is included as Adjustment (p) in Mr. Russell's results of operations exhibit. Exhibit ____ (MRL-4) is a Commission Staff letter and attached agreement dated January 6, 2000 related to the implementation of the revised allocation procedure. Exhibit ____ (MRL-5) includes two graphs measuring the change in customer mix and a review of margin revenue and direct cost over the period 1988 through 1997.

REVENUE REQUIREMENT ISSUES

Q. PLEASE DESCRIBE GENERALLY THE METHODOLOGY YOU USED TO CALCULATE YOUR WORKING CAPITAL ADJUSTMENT?

A. The methodology used by both the Company and Staff is referred to as the "balance sheet" or "investor supplied" working capital approach. This approach does not attempt merely to measure the standard accounting definition of working capital (current assets less current liabilities) but, instead, measures the capital required from investors, either equity or debt, to keep the business running, in addition to the capital required for those assets directly included in rate base.

The investor supplied working capital approach identifies all capital that requires a return and subtracts investments. Invested capital includes debt and equity net of any unamortized premiums, discounts or expenses, and, due to the tax laws, unamortized investment tax credits. Investments include all items included in net rate base and similar items that are invested in non-utility activities, such as plant less accumulated depreciation and deferred taxes. Further, investments include items on the balance sheet that have been specifically excluded from earning a return, or which earn a return independent of general rates. An unamortized abandoned nuclear plant being amortized over 10 years is an example of an item specifically excluded from earning a return. Construction work in progress (CWIP) and deferred gas costs are examples of items which earn a return independent of general rates. CWIP does not represent investment in an operating asset and the company's earnings associated with it are accumulated as AFUDC or interest. If working capital were attributed to CWIP, then the company would not be able to earn a return on that portion of working capital, since AFUDC is only accumulated on construction balances. In this proceeding, many of these same points also apply to unamortized PGA deferral balances.

Q. PLEASE EXPLAIN THE MAJOR DIFFERENCES BETWEEN YOUR CALCULATION AND MR. MCVAY'S FOR NORTHWEST?

A. First, I will describe those items which impact the calculation of total working capital. Mr. McVay's working capital is approximately $31.2 million. Exhibit 6, page 21. This amount excludes inventories allocated directly to non-utilities of $1.3 million, for a total Company working capital of $32.5 million. My calculation reveals total Company working capital of just over $31.7 million, approximately $800,000 less than the Company's. Two prepaid Purchase Gas Adjustments (PGA) accounts make up twice this amount at $1.65 million, with the remainder of my adjustments actually favoring the Company by over $800,000. PGA costs do not properly belong in the general rates of the Company. Balances of unamortized deferred PGA costs can quickly reverse. The inconsistency in the PGA deferral balances is one reason why the deferrals accumulate interest on the net balances to be credited or surcharged to the customers through the technical correction tariff filings.

The next major difference is in the allocation of this working capital to the utility. Typically, the Commission has allocated working capital to the utility by calculating the ratio of total calculated working capital to the total investments in the calculation. The resulting ratio is then multiplied times the net per books rate base, excluding working capital, to determine the portion of total working capital attributable to utility operations. In most of the proceedings where I have calculated working capital, a small modification to this allocation has been made so as not to allocate working capital to a company's investment in CWIP and PGA deferral balances for reasons previously explained. Therefore, before calculating the ratio of working capital to total investments, I subtracted approximately $40 million of CWIP and PGA deferrals from the investment total. This amendment to Mr. McVay's calculation would increase his $9,134,020 of non-inventory working capital by over $500,000. It should be noted that Mr. McVay improperly divided working capital by invested capital, as opposed to investment, to arrive at his 1.15 percent.

Q. DOES THE COMPANY PROPOSE ANY CHANGES TO THE NORMAL WORKING CAPITAL ALLOCATION PROCESS?

A. Yes, the Company proposes two changes to the normal process adopted by this Commission.

Q. PLEASE DESCRIBE THE FIRST CHANGE.

A. The Company proposes to directly allocate all inventory accounts to either utility or non-utility operations. This includes $22,059,278 directly allocated to the utility, plus the $1.3 million allocated to non-utilities.

Q. DO YOU ACCEPT THE COMPANY'S PROPOSED MODIFICATION?

A. For the most part I have. Of the $22 million directly allocated to utility, $17.4 million represents gas storage inventory. This inventory is unquestionably related directly to the utility business and no such asset exists for non-utility operations. Therefore, it is reasonable to allocate the first portion of working capital to the gas inventory and assign it directly to the utility. The remainder of the inventory, both those identified as utility and non-utility, are left as part of the residual working capital to be allocated. Mr. McVay went on to allocate both parts of the utility working capital by allocating 10.26 percent to Washington operations.

Q. DO YOU AGREE WITH THE ALLOCATION OF GAS STORAGE INVENTORY AT 10.26 PERCENT TO WASHINGTON?

A. No. The storage inventory should be allocated as it is used. I have chosen to allocate this inventory based on sales volumes, or 7.28 percent to Washington. This difference represents over $517,000 of the $590,000 difference in rate base between Mr. McVay and myself.

Q. ARE THERE ANY OTHER DIFFERENCES? PLEASE EXPLAIN.

A. Yes. As indicated above, the Company allocated total utility working capital of 10.26 percent to Washington. My calculation utilizes the normal process of taking the residual working capital as a percentage of total investments and applying that percentage to the per books Washington rate base.

Q. TURNING TO YOUR OWNED CAPACITY PROPERTY ADJUSTMENT, PLEASE EXPLAIN WHY YOU PROPOSE THIS ADJUSTMENT IN THIS PROCEEDING.

A. To start, it would be valuable to explain how the Company recovers a majority of its gas costs, both commodity and capacity. Northwest, like the other gas companies in this state, utilizes a PGA mechanism to recover gas costs purchased from third parties. Northwest has a tariff which estimates the current cost of purchasing gas commodity and delivering that gas to its city gates. This tariff is updated from time-to-time, most often on an annual basis. During the time that a tariff is in effect, the Company compares the actual commodity and demand costs incurred to the estimated costs included in the tariff. The difference between the estimate and actual cost is deferred on the Company's books and subsequently recovered or refunded through a second tariff filing referred to as the technical adjustment. In essence, Northwest is allowed to recover exactly what it incurs from third parties, no more, no less.

The costs recovered through this mechanism include all purchased capacity costs, including transportation on the interstate pipelines and storage costs purchased from various vendors, including Williams Pipeline's Jackson Prairie facility.

In general, the Company has long-term contracts for its pipeline and storage capacity. Further, most of the charges for this capacity are charged on a fixed basis whether the facilities are utilized or not. Therefore, as the Company's firm load increases, the average capacity cost per therm delivered declines. Through the PGA mechanism, the Company is allowed to recover increasing costs, at the same time declining average capacity costs are also passed through to the customers. My Owned Capacity Property adjustment is intended, for at least the first year of rates, to mimic the impact of purchased capacity costs in the PGA for owned capacity costs in this proceeding.

Q. ARE THERE OTHER REASON'S FOR PROPOSING THIS ADJUSTMENT?

A. Yes. In this case the Company proposes to pro-form its Mist Phase III investment into rate base as if the facility were in place for the whole year. In reality, this property was not in rate base until December 1999. Staff does not disagree that it is appropriate to pro form new capacity resources such as Mist, but if such pro forma adjustments are to be made, all offsetting adjustments should also be made. Further, since the main purpose for any pro forma adjustment is to represent costs more closely to the future cost level, capacity costs like the addition of Mist need to be represented at their average cost during the prospective rate year. My adjustment accomplishes these purposes.

Q. PLEASE EXPLAIN HOW YOU CALCULATED THIS ADJUSTMENT.

A. To start, I obtained, from Mr. Russell, the per books and pro forma adjustments for the Company's costs related to its owned capacity properties. These facilities include Mist storage fields, Newport liquid storage, and the Gasco liquid storage north of Portland. Second, based on the Company's medium load forecast for the years 2000-2004 for firm volumes, I took the growth rate of 2.36 percent per year and compounded it for a 1 and one-half year period, from year-ended December 31, 1999 to the rate year-ended June 30, 2001. The resulting 3.56 percent growth rate was then used to factor the pro forma level costs from the assumed rate year back to the test year volume level.

Q. HAS THIS ADJUSTMENT BEEN MADE IN OTHER RATE CASES BEFORE THIS COMMISSION?

A. Yes, but by a different name: "production property adjustment." Puget pro-forms its power costs, including secondary sales revenues and production property to future year levels. (Cause Nos. U-81-41, and U-83-54, and Docket No. U-89-2688, among others.) To be consistent with this treatment, a production property adjustment was fashioned moving all power costs, including fixed costs, to the average cost level of the prospective rate year. It should be noted that power costs for PacifiCorp and Avista Utilities (Avista) have not been set at the future year level considering the impact of growth on secondary sales and other costs and, thus, this adjustment has not been adopted for those companies.

Q. DOES NORTHWEST'S SITUATION MORE CLOSELY ALIGN ITSELF WITH PUGET OR THE OTHER ELECTRIC UTILITIES?

A. I believe that Northwest and the other gas companies are more similar to Puget. As far as variable costs are concerned, each of the gas companies including Northwest recovers 100 percent of their gas costs through the PGA process. Further, in this proceeding Northwest proposes to pro-form the Mist facility as if it had been in service for the entire year. It is my position that any gas company that pro-forms new capacity facilities into its general rate proceedings should also be subject to this adjustment.

ALLOCATION PROCESS

Q. PLEASE SUMMARIZE YOUR RECOMMENDATION ON STATE ALLOCATIONS.

A. The Commission should reject the Company's proposal to implement, by December 1, 2000, the allocation process for determining Washington revenue requirements. The Commission should, instead, phase-in the Company's allocation process over a three year period ending December 1, 2002.

Q. MR. DEBOLT, THE COMPANY'S POLICY WITNESS, STATES THAT ONE OF THE PRIMARY PURPOSES OF THIS RATE CASE IS TO IMPLEMENT A STATE ALLOCATION PROCESS FOR THE COMPANY'S WASHINGTON AND OREGON JURISDICTIONS. PLEASE SUMMARIZE YOUR RESPONSE TO HIS TESTIMONY.

A. This is a very significant issue for Washington customers. While Mr. DeBolt attempts to provide context for the Commission on the issue, he doesn't fully explain the reasons for the Company's prior use of the system approach for determining revenue requirements. Furthermore, he does not adequately explain why the Commission should implement, in one fell swoop, such a fundamental change in the way revenue requirements are calculated for the Company's Washington jurisdiction.

Q. WHAT ARE THE REASONS CITED BY MR. DEBOLT FOR THIS CHANGE?

A. The Company states that it agreed to implement a state allocation methodology at the request of the Oregon Staff. Exhibit T-1, page 8. Given the magnitude that such a change would have upon the Company's Washington customers, it should never have made that agreement without first involving this Commission in the implementation plan. Furthermore, the Company should have pursued joint hearings with the Oregon and Washington Commissions in order to fully discuss the ramifications of this change in both jurisdictions, in accordance with RCW 80.01.070.

Q. WHAT IS YOUR ESTIMATE OF THE AMOUNT OF COSTS THAT WOULD BE SHIFTED TO WASHINGTON UNDER THE COMPANY'S PROPOSAL?

A. The allocation methodology shifts roughly $3 million from the Oregon system to the Washington system. Since Washington has a small revenue base, the allocation significantly affects Washington customers. To put the impact into context between the two systems, Northwest's total system revenues for the test year are $433 million. Washington contributes about $30 million to this total, or 7 percent. Fully implementing a state allocation methodology in this case results in a 10 percent increase in rates to Washington customers, but the impact to Oregon customers is only 0.7 percent. This dramatic impact on Washington customers deserves special consideration by both the Commission and the Company. It is unreasonable to expect Washington customers to absorb this change in one rate case.

Q. HOW LONG HAS THE COMPANY DETERMINED WASHINGTON REVENUE REQUIREMENTS ON A SYSTEM BASIS?

A. Due to the highly integrated nature of its system, the Company, to my knowledge, has never considered its Washington operations distinct from its Oregon operations and, therefore, has always determined revenue requirements on a system basis.

Q. PLEASE DESCRIBE THE SYSTEM METHOD UTILIZED IN PREVIOUS RATE PROCEEDINGS.

A. In previous proceedings, rates have been set by measuring costs on a system basis. As discussed below, the Company used this method because the Company was operated as a single system.

To calculate rates on a system basis, actual total system results are adjusted to present the results as if the whole system was regulated by this Commission. The most important adjustment in this analysis is imputing all non-jurisdictional sales at Washington rates. Other adjustments include the removal of costs, consistent with Washington regulation. These adjustments include removal of certain conservation measures not approved by this Commission and the modifications to special contracts to ensure that provisions of service are consistent with applicable procedures in this jurisdiction. It should also be noted that the use of system costing for the determination of rates is not unique to Northwest.

Q. PLEASE IDENTIFY OTHER CIRCUMSTANCES WHERE SYSTEM RESULTS HAVE BEEN USED TO SET RATES.

A. Several Commission-regulated solid waste companies provide service both in regulated territories, as well as small cities and towns where companies have contracts to provide service. In many of these cases, the system approach is utilized to set regulated rates. Typically this method is limited to situations where the unregulated operations are less than 10 percent. In this proceeding, Washington is generally less than 10 percent of Northwest's operations. In prior Puget rate cases, non-jurisdictional services, such as the service to the Port of Seattle, have been left in the results of operations with revenues imputed at the regulated level for like service in order to determine rates on a system basis.

Q. CAN SETTING RATES ON A SYSTEM BASIS PROVIDE FAIR, JUST, REASONABLE, AND SUFFICIENT RATES?

A. Yes. In effect, system-based rates represent a method of allocation. This allocation method would produce rates that are fair, just, reasonable, and sufficient if, within each jurisdiction, the resulting rates covered all incremental costs associated with providing service within that jurisdiction. The allocation process allocates embedded costs. Some of the embedded costs vary with the level of service provided. These costs include commodity costs, meters, meter reading, services, and some billing costs. Other costs do not vary directly with the units of service. A jurisdictional approach which covers all incremental costs and, over time, provides a fair share of the fixed costs produces fair, just, reasonable, and sufficient rates.

Q. HAS THE USE OF SYSTEM COSTS FOR NORTHWEST PROVIDED FAIR, JUST, REASONABLE, AND SUFFICIENT RATES FOR THE WASHINGTON JURISDICTION?

A. I believe it has. Rates in Washington have provided substantial recovery of common costs, historically maybe more than in relation to its size than the Oregon jurisdiction. This is not to say that, based on the current situation, Washington is still paying at the same level it has in the past. Further, both the Company and the Oregon Commission considered the rates set on a system basis to be adequate during the 1970's and 1980's when an allocated result may have lowered Washington rates.

Q. ARE THERE ANY OTHER FACTUAL ISSUES SURROUNDING THE CHANGE THAT WARRANT CONSIDERATION BY THE COMMISSION IN ITS EVALUATION OF THE ALLOCATION PROCESS AND THE IMPACT ON WASHINGTON CUSTOMERS?

A. Yes. The Washington load and revenue stream were principally the result of the Company serving industrial customers. The residential and commercial markets Northwest served in Washington were very small. For example, in 1984 Washington revenues were approximately $50 million, of which $40 million was from industrial customers. As a result, the traditional system method for determining revenue requirements treated this significant source of revenue and contribution margin for the benefit of all customers taking service from Northwest. In essence, Oregon customers realized significant benefits from Washington industrial customers taking service from the Company. With the advent of transportation services in the late 1980's, similar throughput figures suggest similar benefits to Oregon customers.

Q. HAVE THERE BEEN ANY SIGNIFICANT CHANGES IN THE COMPANY'S OPERATIONS SINCE THAT TIME?

A. Yes. First, Northwest has lost significant industrial load to bypass. Second, the Company has experienced significant growth in the residential and commercial markets in Washington, albeit at significant costs. The loss of industrial load in Washington, coupled with significant growth in the residential and commercial markets, dramatically altered the cost and revenue stream of Northwest's Washington system.

Q. DO YOU HAVE ANY OTHER CONCERNS ABOUT THE ALLOCATION ISSUE THAT WARRANTS CONSIDERATION BY THE COMMISSION IN EVALUATING THE RATES PROPOSED BY THE COMPANY IN THIS PROCEEDING?

A. Yes. The first issue concerns the Company's failure to meet a commitment to study this issue as early as 1985. In Cause U-85-41, Staff wanted to evaluate the impact of a state allocation result. The Company agreed at that time to produce a study in order to evaluate the results that allocations might have between the two systems. The Company never provided that study.

Q. IS THERE ANYTHING RADICALLY DIFFERENT ABOUT THE TWO SYSTEMS TODAY THAT WOULD WARRANT IMPLEMENTING A CHANGE IN THE METHODOLOGY FOR DETERMINING REVENUE REQUIREMENTS, AS PROPOSED BY NORTHWEST?

A. No. In fact, given the Company's growth in Washington residential markets and the Company's investments in storage facilities and other infrastructure, the two systems are even more tightly integrated today than at any previous time.

Q. WHAT OPERATIONAL DIFFERENCES HAVE BEEN IDENTIFIED WHICH WOULD MAKE WASHINGTON COSTS HIGHER THAN OREGON COSTS?

A. None have been identified in this case. In fact, the Company's case is based on the proposition that both jurisdictions operate as a single system. Storage facilities Mist, Newport, and Gasco are allocated equally to both states, including the transportation lines to deliver Mist storage to Portland. Staff agrees with this assessment and is not opposed to Washington customers sharing in these costs. Further, the cost of extension for new service in the two states is similar.

Q. THEN WHY ARE WASHINGTON ALLOCATED COSTS HIGHER THAN SYSTEM COSTS?

A. In general, it appears to be because the Washington system is newer than the average Oregon system. Residential customers increased from 6,189 in 1988 to 28,107 in 1997;

an increase of more than 300 percent. During the same period, system residential customers increased from 249,000 customers to 407,000. This is a sizable increase, but less than a 100 percent increase, or a growth rate of less than one-third the growth rate in Washington.

Q. WHY DID THE OREGON STAFF REQUEST SUCH A CHANGE IN DETERMINING WASHINGTON REVENUE REQUIREMENTS?

A. I don't know, and Mr. DeBolt sheds no light on this issue. I suspect that the primary reason is that the change shifts costs from the Oregon system to the Washington system.

Q. CAN YOU DESCRIBE HOW THE WASHINGTON SYSTEM EXCESS MARGINAL REVENUE HAS CHANGED OVER TIME?

A. Yes. The shift in customer mix and the impact of that shift on margin revenue compared to incremental Washington costs has been quite dramatic over the past 10 years. My Exhibit ____ (MRL-5) includes two graphs containing statistics between the years 1988 and 1997. The first chart, "NWN WA Rate Pressure Analysis," compares the margin revenue generated in Washington to a calculation of various costs from the Washington system, namely, depreciation expense, transmission and distribution return, and operating and maintenance expense. As can be seen, the revenue margin has stayed relatively constant despite a 300 percent increase in residential customers. On the other hand, costs have increased by 200 percent to 300 percent. The second chart, "NWN Class Revenue," shows a substantial decrease in industrial revenues, while at the same time depicting a 300 percent increase in residential revenues.

Q. YOU INDICATED EARLIER THAT WASHINGTON HAS PRODUCED RESULTS USING SYSTEM RATES THAT YIELDED A HIGHER RETURN TO COMMON COSTS THAN AVERAGE. CAN YOU IDENTIFY FACTORS THAT HAVE IMPACTED THIS RECOVERY, OTHER THAN THE GROWTH IN RESIDENTIAL CUSTOMERS?

A. Yes. As identified earlier, the customer mix in Washington has drastically changed in the past 15 years. Even starting with 1988, after substantial hits to Washington industrial revenues had already happened, Washington residential customers accounted for only 13.1 percent of the Washington load, compared to 24.3 percent on a system basis. Today things have reversed, in 1997, residential throughput including transportation service has climbed to 34.7 percent of Washington load, while on a system basis it has increased to only 27.8 percent. Interestingly, Washington now looks more like the system on a customer mix basis than it did in the past, but the Company and Oregon are now pushing for allocated results while they utilized system results in the past.

Q. IS THE PROPOSED ALLOCATION PROCEDURE FAIR, JUST, AND REASONABLE?

A. There is no simple answer to that question. While the allocation process may yield results that are consistent with allocation methods used by other companies, the resulting impact on customers may be inconsistent with their expectation when they signed up for service. With end-of-year 1999 residential customers at nearly 35,000, the Company has experienced nearly a 500 percent increase over the 1988 average. Over 80 percent of Northwest's residential customers have joined the system in the past 11 years. They were offered line extensions and paid line extension fees based on marginal revenues generated from system calculated rates, which are now approximately 10 percent lower than the rates proposed with this allocation process. Each of those main extensions supposedly would produce sufficient revenue to cover its incremental costs. But now that the expansion has been successful, those customers are being asked to flash-cut to a new allocation system that will increase their costs but not increase the free allowances they received when they hooked up.

Q. IS THERE ANY UNIFORM WAY TO IMPLEMENT CHANGES IN ALLOCATION PROCEDURES?

A. No. For PacifiCorp before the Utah merger, a new allocation procedure was worked out between all of the states except Wyoming. The new allocation procedure was to be phased in over four years, beginning with PacifiCorp's 1986 rate case. Currently, the PacifiCorp allocation process as utilized by this Commission is changing gradually over time. However, other states have now flash-cut to their own allocation procedures creating a gap in cost recovery for PacifiCorp.

Q. WHAT HAS BEEN THE PROCEDURE IN NORTHWEST'S CHANGE IN ALLOCATIONS?

A. In general, the process has been a unilateral one run by the Oregon Commission. Mr. Russell and I did participate in the development of the allocations proposed in this proceeding, but that process did not include how the new allocators should be adopted. In addition, a letter from Staff, see Exhibit ____ (MRL-4), agreed in principle to the proposed approach, but subject to review in this rate proceeding. The letter specifically left the issue of how to implement the change open to further discussion.

Q. YOU HAVE INDICATED THAT THE SYSTEM ALLOCATION METHOD HAS PRODUCED FAIR, JUST, REASONABLE AND SUFFICIENT RATES IN THE PAST. WILL STATE ALLOCATED COSTS PRODUCE RATES WHICH ARE FAIR, JUST, REASONABLE, AND SUFFICIENT?

A. Yes. State allocated costs will produce rates that, over time, are fair, just, reasonable, and sufficient. Due to the age of plant in each jurisdiction and the density of their customer base, sometime rates will be lower, as they would have been in the 1980's, and at other times they will be higher, as they will be now. In the long run, each jurisdiction's customers need to be treated fairly and the Company needs to be given a reasonable chance to cover all its costs. Because both allocation methods are reasonable, and Oregon and the Company have already agreed to flash-cut to allocated costs in December

2001, it is only fair to the Company to move to the new allocation process, but only in a responsible fashion that does not create an unfair burden on the Washington rate payers.

Q. WHAT IS YOUR RECOMMENDATION REGARDING THE COMPANY'S PROPOSAL TO MOVE TO AN ALLOCATION PROCESS FOR DETERMINING WASHINGTON REVENUE REQUIREMENTS?

A. I propose that the Commission accept the state-allocated methodology, but that the implementation be phased-in over a three year period. This results, by itself, in a $1 million (approximately 3 percent a year) annual increase to Washington rate payers for each of the next three years which is not overly burdensome. The Company's flash-cut proposal, on the other hand, unfairly burdens Washington customers with a 10 percent increase in rates.

Q. MR. DEBOLT SUGGESTS THAT THE COMMISSION'S ACCOUNTING RULES IN BOTH WASHINGTON AND OREGON REQUIRE THE COMPANY TO SEPARATE THE TWO JURISDICTIONS. DO YOU HAVE ANY COMMENTS REGARDING THIS TESTIMONY?

A. Yes. Mr. DeBolt's testimony implies that adopting the results of the allocation process is required by WAC 480-90-031. Exhibit 1, page 8, lines 13-15. Section 3 of the rule does require a utility with multi-state operations to keep its records separate for its respective jurisdictions. However, that section only requires that investments in utility plant be separated on the basis of geographic boundaries. It does not state that the Commission will set rates on the basis of these separated investments.

Furthermore, Mr. DeBolt does not discuss Section 5 of this same rule. Section 5 requires any gas utility with multi-state operations to file with the Commission annual results of operations on the basis of allocated results. Northwest has consistently failed to provide this data which would have enabled the Commission, Staff, and other parties to see the impacts of an allocation process over time.

Q. PLEASE SUMMARIZE YOUR TESTIMONY AND RECOMMENDATION REGARDING THE ISSUE OF DETERMINING WASHINGTON REVENUE REQUIREMENTS ON THE BASIS OF ALLOCATIONS AND DIRECT ASSIGNMENT OF UTILITY PLANT?

A. The Company's proposal to implement the allocation results on December 1, 2000 should be rejected. It is unreasonable to shift $3 million in costs to the Washington system (by itself is a 10 percent increase to Washington customers) to comply with a request from the Oregon Staff. Staff is prepared to support the allocation methodology, however, if it is phased-in over a three year period ending December 1, 2002. This would amount to approximately a 3 percent increase per year and is more reasonable than the flash-cut proposal of the Company.

Q. PLEASE DESCRIBE THE PROPOSED ADJUSTMENT TO STAFF'S CALCULATED REVENUE REQUIREMENT RELATED TO YOUR PROPOSED PHASE-IN OF THE NEW ALLOCATION FACTORS.

A. Staff's analysis as presented by Mr. Russell is based on state allocated results. There are no calculations of what the revenue requirement would be if calculated on a system basis as there has been in the past. Thus, in order to determine the impact of the revised state allocation, Staff relied on analysis from earlier worksheets provided by the Company during discussions last winter. Those worksheets indicate a revenue shortfall directly related to the change in state allocations of approximately $3 million. It is our recommendation that this $3 million of additional costs be phased in over a three year period. Thus, for this proceeding, the revenue requirements based on fully allocated results should be reduced by $2 million, two-thirds of the total impact. Mr. Russell provides the calculation of total revenue requirement.

Q. HOW SHOULD THE COMPANY FILE FOR THE SECOND AND THIRD PIECES OF THE COST PHASE-IN?

A. The Company should be allowed to file tariffs which implement the additional $2 million in revenue requirement based on this test period. The first additional $1 million should be filed to become effective December 1, 2001. The remaining $1 million should be filed to become effective December 1, 2002.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.