Q. Please state your name and business address.

A. My name is Kenneth L. Elgin. My business address is Chandler Plaza Building, 1300 South Evergreen Park Drive S.W., Olympia, Washington, 98504-7250.

Q. By whom are you employed and in what capacity?

A. I am employed by the Regulatory Services Division of the Washington Utilities and Transportation Commission as its Case Strategist.

Q. Would you describe your education and relevant employment experience?

A. I received a Bachelor of Arts from the University of Puget Sound in 1974 and a Master of Business Administration from Washington State University in 1980. In January 1985, I was employed as a Utilities Rate Research Specialist for the Utilities Division. In that capacity, I was responsible for many diverse aspects of natural gas regulation including rate design, cost of service, purchased gas costs, and least cost planning. I was also responsible for financial analysis and rate of return issues for all regulated utilities. In December, 1989, I was promoted to the position of Assistant Director for Energy. In that capacity, I was responsible for the policy direction of the Utilities Division's electric and natural gas programs. In 1995, I assumed my present position as Case Strategist for the Division. My current assignment requires me to focus on all aspects of cases presented to the Commission in the context of litigation. I have testified before the Commission on many occasions as outlined in Exhibit ___ (KLE-1). I have testified before the Federal Energy Regulatory Commission on issues related to rate design and risk for interstate pipelines. I have also testified on several occasions in Superior Court regarding the regulation of investor-owned utilities pursuant to Washington's public service laws. I have been the lead analyst for numerous tariff filings, and in this capacity I have presented Staff recommendations to the Commission at its regular open public meeting.

I would also like to describe my role in Docket UE-960195 concerning the merger of Puget Sound Power & Light Company and Washington Energy Company (the "Merger"). This complex docket required a comprehensive analysis of many diverse issues. Although I did not testify, I was responsible for co-ordinating Staff's recommendation to the Commission. Following the evidentiary phase of the case, I also led the Staff effort in negotiating a Stipulation with the Companies and Public Counsel. I testified for Staff in support of the Stipulation. Which was adopted by the Commission. I am knowledgeable of the record in the Merger, and the details of the Stipulation and rate plan currently in effect for PSE's operations.

Q. Are you sponsoring any exhibits?

A. Yes, Exhibits __ (KLE-1) through __ (KLE-5).

Q. Would you please summarize PSE's proposal in this Docket?

A. The Company is proposing to sell its Colstrip generation and transmission facilities to PP&L Global, Inc. These facilities are in PSE's rate base, and they are used by the Company to carry out its obligations as a public service company. The Company, therefore, must obtain an order from the Commission authorizing the transaction. The Company is also requesting authorization to amortize any gain realized from the sale over 5 years, beginning July 1, 1999. Finally, PSE requests that the Commission make the necessary findings in order to allow PP&L Global to obtain exempt wholesale generator (EWG) status under applicable Federal statutes. [15 U.S.C. 79z-5a(c)]

Q. Will you please summarize Staff's recommendation in this Docket?

A. The sale of Colstrip and the proposed accounting treatment are presented by PSE as a complete, unseverable package. PSE's proposed accounting treatment, however, in conjunction with the continued operation of the rate plan approved in the Merger, produces significant benefits for shareholders at a substantial cost to customers. Therefore, Staff recommends that the Commission reject PSE's application in this Docket.

If the Commission chooses to approve the sale, it should ensure that ratepayers capture all of the benefits of the transaction. I will offer two options for the Commission to consider which satisfy this consumer benefits test. The first option would allow PSE to implement its business objective to focus on gas and electric distribution services. This option transfers the Company's power supply operations to a subsidiary by 2001 when the existing rate plan expires. At that time, PSE will be required to offer distribution services to its customers under tariff. PSE's customers would then be able to purchase power supply at market rates, or, alternatively, have access to a portfolio of energy supply options. The second option employs standard accounting procedures which defer the benefits and gain until the rate plan expires, so that customers benefit from the sale of Colstrip. Mr. Martin will testify on this option as well.

STANDARD FOR APPROVAL

Q. What standard should the Commission require of any public service company attempting to sell major generation and transmission facilities?

A. As I will explain in more detail later, in the early years of operation, the cost of a large central generating station is above "market" and in later years below "market", due to the effects of higher early-year capital costs. Any proposal to sell Colstrip must balance the effects of these early year capital costs (which places enormous economic burdens on ratepayers) with benefits that should then be returned at the time of sale. Therefore, before approving the sale of any major electric generation facility like Colstrip, it is necessary for the Commission to find that consumers would benefit explicitly from the transaction, rather than asking only whether customers are no worse off with the transaction.

In this specific case, the Commission must also consider the Company's request to determine that PP&L Global should obtain Exempt Wholesale Generator (EWG) status. In order to comply with federal statutes and obtain EWG status for the purchaser, the Commission must make three specific findings: 1) the proposal is in the public interest; 2) customers benefit from the transaction; and 3) the transaction is consistent with state law. In this regard, PSE has explicitly agreed that customers must benefit from the sale. Otherwise, PP&L Global would not receive EWG status from FERC.

Q. It is your position that all of the benefits of this transaction should accrue to ratepayers?

A. Yes.

Q. Why is this a reasonable position?

A. It is reasonable given the historical rate treatment of the Colstrip facilities and the Commission's use of rate base rate of return regulation for calculating total electric cost of service. As a preliminary matter, I would like to describe the history surrounding the Colstrip facilities. History is an important starting point in evaluating any proposal for the sale of major investments in production and transmission facilities currently in PSE's rate base.

Q. Please describe the historical context of the Colstrip projects?

A. In the 1970's Puget Sound Power & Light Company (Puget) began a massive construction program to develop new thermal generation in order to meet the electrical energy needs of its customers. The Colstrip facilities were an element of that effort.

Q. How did the Commission rule on these expenditures and what rate treatment did it provide to Puget for Colstrip?

A. In Cause No. U-76-01, the Commission included Puget's expenditures for Colstrip 1 & 2 in the Company's rate base. Later, in Cause No. U-83-54 the Commission included Colstrip 3 expenditures in Puget's rate base, and finally in Cause No. U- 85-53 the expenditures for Colstrip 4 were included in rate base. In each of these proceedings, the Commission allowed Puget to include its investment in Colstrip in Puget's rate base.

Q. Why is the Commission's prior rate treatment of these facilities important in this docket?

A. It is critical because these generation and transmission facilities were expected to produce long-term benefits to customers. Since Puget's rates in each of these proceedings were based upon first year capital costs, the costs and benefits to ratepayers of these facilities must be considered over the entire life of the resource. The effect of traditional rate base regulation causes PSE's ratepayers to incur the high cost of these facilities in the early years and the lower costs in later years, as these facilities are depreciated over time. PSE's analysis, Exhibit 7 (WAG-1), corroborates this fact: in the later years, Colstrip produces benefits to ratepayers because the cost of power is less than the market price of secondary power. The fact that Colstrip's capital costs are continuing to decline produces this effect. This levelizing effect of capital facilities creates the impetus for the development of these new higher cost resources. Shareholders are provided benefits by receiving a fair rate of return on and of the investment in these generation and transmission facilities. Therefore, it is very important that the Commission ensure that consumers receive all of the benefits from this transaction, since consumers have paid in the early years of Colstrip the significant portion of the total life-cycle cost of these facilities. Now, and for the remaining life of Colstrip, as these facilities become fully depreciated, the benefits of lower fixed capital costs begin to accrue to ratepayers.

Q. Are there any other factors that should be considered in the decision to provide ratepayers all of the benefits of this transaction?

A. Yes. RCW 80.04.350 requires the Commission to determine the depreciation rates to apply to all utility property used to serve the public. This ensures that shareholders are provided a return of capital over the economic life of facilities. In this specific instance, it is very likely that Colstrip will provide economic benefits after the facilities are fully depreciated. The ability of the Commission to recognize these benefits is difficult at best and can only be part of the rate making process in the future when the facilities become fully depreciated. By capturing the benefits of this transaction now for ratepayers, the Commission ensures that ratepayers receive the full value of the property dedicated to public service up until the sale, and shareholders, conversely, are fairly compensated for the use of these generation and transmission facilities.

Q. Has the Commission ever been faced with similar rate base issues and, if so, how has it determined to treat these properties?

A. The issue has been before the Commission in similar circumstances. The issue was first addressed by the Commission in Cause U-85-53, involving Puget Sound Power & Light Company. In that case, the issue was the transfer of property previously included in the Company's rate base to an unregulated subsidiary. The transfer was recorded at book value and subsequently sold by the subsidiary at a profit. All the profits were booked by the subsidiary "below the line". Public Counsel proposed adjustments to provide ratepayers the benefits of the transactions. The Commission accepted the arguments of Public Counsel that consumers bear the risks of ownership and should receive the gains on property transactions. The Order states:

> "We are convinced that the recognition of gain on sale of these assets is fair both to the utility and to the ratepayers, that it reflects sound rate making policy and that it is proper under regulation, land and constitution." (Fourth Supplemental Order, Cause No. U-85-53, pp. 33-34)

In Docket No. UE-87-1533-AT the Commission was faced with an issue almost identical to the sale of Colstrip. The Washington Water Power Company requested approval to sell its Othello combustion turbine facility. The Commission approved the sale, but rejected the Company's proposed treatment that would pass the gain to shareholders. The Commission required deferred accounting of the gain for later rate making treatment. The Order Granting Application is very clear on the treatment:

> "The authorization herein is based upon the premise that 100 percent of the after tax gain on the turbine sale is returned to the ratepayers....The Commission will make no final determination in this proceeding as to the accounting entries to record the proposed sale of the Othello Turbine. Such determination will be deferred and considered during the next general rate filing by Water Power."

The same analysis is compelling for Colstrip. Ratepayers do bear the risks of ownership, and as I've already explained, Colstrip is a long-lived asset necessary and useful to the public. The public has already shouldered the tremendous burden of Colstrip's early year capital costs, and we are at a point in time when the real benefits of these facilities begin to materialize for consumers. Therefore, a consumer benefit test should be applied in this case.

Q. What evidence is the Company offering to support a finding that the transaction will further the public interest?

A. Mr. Gaines asserts that the transaction furthers the public interest for the following reasons: 1) it is consistent with PSE's merger commitment to pursue cost savings and the savings will produce significant financial benefits; 2) it eliminates significant risks associated with coal-fired generation; 3) it will permit PSE to pursue a more diverse power supply portfolio; 4) it will limit PSE's exposure to future environmental liabilities that might arise from continue ownership of the resource; 5) it will eliminate operational problems associated with PSE's minority ownership; and 6) PSE serves a significant load with market based power supply and it will be in a better position to match these customers needs with secondary power purchases.

Mr. Gaines also provides additional factors which contribute to a finding that the transaction is in the public interest. First, the buyer will obtain a controlling interest in the resource, and a diversified package of generation throughout Montana. As a result, PSE claims that it is obtaining an exceptional price for these assets. Finally, the Company states in its application that Colstrip is an above market resource and this transaction eliminates future stranded cost problems.

Q. You have described the Company's testimony with respect to the issues surrounding a public interest finding. What about the issue as to whether the transaction produces consumer benefits?

A. The Company's presentation did not explicitly discuss how consumers benefit under their proposal through lower rates or cost of service, now or in the future. As I've already stated, any decision to sell a major generation asset like Colstrip should require a specific finding that consumers benefit from the sale. An explicit analysis of rate impacts is necessary in order to determine whether consumers benefit.

Q. Do you have any opinion about the other factors included in Mr. Gaines' testimony as support for a pubic interest finding for the sale of Colstrip?

A. I agree with Mr. Gaines regarding many of the qualitative factors that went into the decision to sell Colstrip and will not comment upon them any further. These factors, while necessary, are insufficient to approve the application unless it can be clearly demonstrated that consumers benefit from the sale.

<u>PSE's ACCOUNTING AND RATE MAKING PROPOSAL</u>

Q. How is the Company proposing to account for any gain realized from the sale of Colstrip?

A. It proposes to amortize any gain over a five year period beginning on July 1, 1999. The Company further states that its decision to proceed with the transaction is conditioned upon acceptable regulatory treatment of the sale. [Exhibit 8 (WAG-2), p. 28 § 4.01; 1998 Report to Shareholders, p. 54]

Q. Please summarize your perspective of the Company's proposed accounting treatment?

A. The Company's proposal provides a windfall to shareholders at the expense of consumers. It should be rejected by the Commission.

Q. What is the Company's justification for its proposed accounting treatment?

A. Mr. Gaines testifies that Commission's Order in the Merger provides for PSE to realize the gain immediately, but the Company is requesting a five year amortization period so that half the gain is realized after the rate plan expires. Mr. Gaines on page 27 line 19 testifies that 50 percent of the gain will be amortized after the rate plan expires. While not explicit, the testimony implies that is a reasonable sharing of the gain between shareholders and ratepayers. This proposal is unacceptable. There is no basis for shareholders to share in the gain on the transaction. To date, the rate setting process has treated shareholders fairly with respect to the Colstrip facilities. Ratepayers are now entitled to receive all of the gains associated with the sale.

Q. What is the Company's proposed rate making treatment for recognizing the benefits of the transaction?

A. The Company's presentation does not explicitly include a rate making proposal, although Mr. Story in his testimony mixes the proposed accounting treatment with rate making treatment. (Exhibit 1 JHS-T p. 10, ln. 6) However, the continued operation of the rate stability plan approved by the Commission for PSE in the Merger, which includes additional programmed rate increases in 2000 and 2001, creates a very specific rate making result from this transaction. The continued operation of the rate plan following the sale of Colstrip is adverse to ratepayer interests.

Q. Could you briefly explain the rate plan approved by the Commission in the merger?

A. Yes. The rate plan resulted from a Stipulation between Staff, Public Counsel, and the applicants. It is designed to provide the new PSE management team an opportunity to achieve savings from best operating practices and power stretch savings, while recognizing the future rate impacts from increases in purchased power and the expected changes in benefits offered under Bonneville's residential exchange program. The rate plan reflects a balance of ratepayer and shareholder interests through 2001 by providing customers with predictable price increases and PSE the opportunity to manage its cost pressures within the five year window.

The underlying analysis of Merger benefits and increasing costs recognized by the Stipulation, however, did not contemplate the sale of Colstrip, nor did the analysis consider amortizing gains associated with the sale of any major asset. In fact, the Stipulation and Commission order protects against such a result: property transfers not directly related to the merger are to be treated separately. Colstrip clearly falls within this category. (Stipulation, p. 9 and Fourteenth Supplemental Order p. 22)

Q. Please continue your explanation as to why the proposed accounting treatment and the continuation of the rate plan is adverse to ratepayer interests?

A. The rate plan enables the Company to transfer to its bottom line virtually all of the expected savings and the gain on the sale for the benefit of shareholders. The mechanics of the rate plan precludes the Commission from recognizing in rates any of the short-term benefits of the transaction.

Q. Please describe the analysis which supports your testimony that the proposed accounting for the transaction is adverse to consumers?

A. I started with the analysis provided by Mr. Gaines in Exhibit 7 (WAG-1). This exhibit provides a range of potential values for the Colstrip facilities. It contains a series of power cost forecasts which provide the foundation for calculating the "benefits" of the transaction. On page 4 of his direct testimony, Mr. Gaines provides the summary of this analysis. He states that applying reasonable assumptions to a range of long-term power cost forecasts produces a positive ten-year net present value (NPV) of some $128 million. Based upon this analysis, Mr. Gaines concludes that there are significant financial benefits from the proposed sale.

Q. Is the Company's NPV analysis sufficient to show that there are significant financial benefits from the transaction?

A. No. The Company fails to describe the interaction of three distinct elements from its proposal: the rate plan from the Merger, the tangible benefits of replacing a high cost resource with lower cost secondary energy, and PSE's proposed accounting treatment of the gain. However, there is one item from the analysis that is absolutely clear: all of the benefits from the transaction occur over a very narrow time horizon, 1999 through 2004. Since the benefits are realized primarily over the same period as the rate plan, the result is to transfer the economic benefits of the transaction to shareholders. Consumer's are unable to realize these short-term power supply benefits because the rate plan caps rates as if this transaction never occurred. Even more troublesome is the fact that PSE's analysis shows consumer's exposure to higher power supply costs in later years when PSE is able to file a rate case and pass on these higher costs to customers. I have provided Exhibit___ (KLE-2) summarizing the timing of the expected nominal benefits from the transaction.

In summary, PSE's entire NPV analysis treats all costs and benefits in 1999 dollars as equal and assumes a regulatory process that can equally capture the benefits and the costs of the transaction in 1999 dollars. Unfortunately, this premise, under the rate plan, is faulty.

Q. Due to the rate plan and the timing of the benefits, what does PSE's analysis show for the magnitude of benefits to shareholders?

A. The analysis shows that shareholders gain over $150 million in nominal dollars through 2002.

Q. What does this same analysis show as the harm to ratepayers from the proposal?

A. The <u>cost</u> to ratepayers is $355 million nominal after 2002.

Q. Do you agree with Mr. Gaines' testimony on page 4 lines 3-4 that the sale is consistent with PSE's commitment to pursue power cost savings in the Merger, and that it will produce significant financial benefits?

A. No. The rate plan and associated annual increases in rates dealt with PSE's cost pressures from increases in purchased power and its commitment to achieve "power stretch savings". The cost pressures surrounding power stretch savings were tied to many of the purchased power resources Puget acquired and were earlier found to be imprudent in Docket UE-921262. Colstrip was <u>never</u> factored into the analysis of any power stretch savings. In fact, when Staff attempted in the Merger to include power stretch savings in its analysis of the benefits from the Merger, the Company argued that Staff's analysis was improper because power stretch savings were not known and measurable and, therefore, could not be considered in evaluating the impact on future rates.

Q. Is there anything that explicitly references what is included in power costs for the rate plan period.

A. Yes. I have included in Exhibit ____ (KLE-3) a copy of Exhibit D to the Stipulation which shows the power cost increases. Turn to Table 2 of the Exhibit. First, note that fuel costs are escalated at 3% from a base of $105 million. If Colstrip were included in this analysis, fuel costs would be significantly lower. Likewise, replacing Colstrip with secondary power purchases would dramatically change the Purchase & Interchange component. Finally, the sale of Colstrip would have required the addition of a new component to recognize the impact of removing Colstrip from rate base. There is no reasonable basis to conclude that the sale of Colstrip is part of PSE's "power stretch" goals and Merger commitments to reduce power costs.

Q. Are there any other potential benefits to shareholders from the sale of these facilities after the rate plan period?

A. Yes. The current structure of the transaction provides an incentive for PSE to stay out of the rate setting process after the rate plan period. Therefore, the power cost benefits would continue to accrue to shareholders as a result of the transaction.

Q. What is the total potential benefit to shareholders from the continued operation of the rate plan and PSE's proposed accounting treatment?

A. The rate plan and PSE's accounting proposal provide shareholders a potential gain of $190 million nominal through 2004.

Q. What is the potential harm to ratepayers from PSE's proposal in this Docket?

A. Over $390 million in higher costs after 2004.

Q. Please summarize your conclusion regarding PSE's proposed sale and accounting treatment for Colstrip?

A. I agree that there is a potential for significant financial benefits of the transaction, but the rate plan and the timing of the benefits prohibit them from being realized entirely by ratepayers. Therefore, the Commission should reject the sale of Colstrip as presented with the proposed accounting treatment.

<u>STAFF OPTIONS TO CAPTURE BENEFITS FOR RATEPAYERS</u>

Q. You have testified to Staff's recommendation that the Commission deny PSE's application. Are there any options for the Commission to ensure that customers will benefit so that the sale could proceed?

A. I have two options for the Commission to consider as conditions to approval of the sale that would satisfy the consumer benefit test.

Q. What is your preferred option should the Commission examine methods to approve the sale?

A. My preferred option allows PSE to pursue its business strategy of becoming a utility focusing on distribution service. It would require the transfer of all of the Company's production supply below the line at the end of the rate plan period. This option allows the Company to keep all benefits of the transaction consistent with its proposed accounting treatment. In exchange, at the end of the rate plan period PSE would file unbundled transmission and distribution services for its customers. At that time, the Company's power supply would be moved to a sister company within PSE's newly created utility holding company.

Q. What is the basis for this particular option to move PSE's electric supply costs to market?

A. The Commission's Order approving the Merger is the starting point. It is reasonable to consider the Commission's approval of the Merger and the rate plan as a transition mechanism providing PSE the opportunity to realize the synergies from the Merger, manage its resource costs through the rate stability period, and, at the end of the five year rate plan, become a distribution company. Its customers, at that time, would then take distribution services from PSE and a choice of power supplies at market prices.

Q. Is there any other evidence that supports this option?

A. Yes. During the Merger proceeding Puget presented Schedule 48 as a transition plan for its largest industrial customers. Included in the Company's presentation of Schedule 48 was the assertion that it would manage its resource costs during the rate stability period. Puget's president and CEO, Richard Sonstelie stated , "... (Schedule 48) would allow its largest customers to access electric energy at current market cost and lead to choice of energy supplier for all its customers within five years... We intend to provide our customers the option to purchase their energy from any supplier--us, or another company."

My first option holds PSE accountable to its assertions in the Schedule 48 and Merger proceedings. Its shareholders realize the benefit of management's pursuit of Merger synergies and power supply savings during the rate plan period. It also provides shareholders all future benefits from PSE's ability to sell electric power supply in an unregulated competitive market.

Q. Are there any other factors you believe should be considered in support of this particular option?

A. Yes. PSE has on several occasions indicated to Staff and the Commission that its long term business strategy is to focus on energy distribution services. In PSE's 1998 Report to Shareholders is entitled <u>Redefining Energy Distribution</u>. In that report the first statement to shareholders says, "...Puget Sound Energy intends to emphasize the distribution of energy, rather than production....The company's goal is to be the best energy distribution company anywhere, bar none."

Consistent with implementing this business strategy, is the recent decision of PSE's Board of Directors to form a public utility holding company. The Company issued its prospectus on April 30, 1999 seeking shareholder approval of a public utility holding company structure for PSE. I have included relevant pages of the prospectus in Exhibit____ (KLE-4). On June 23, 1999 shareholders will vote on the proposal. The sale of Colstrip conditioned on my first option empowers PSE to implement its business strategy to become a distribution company. In the future, with the formation of a holding company, the Commission will be able to focus its regulatory oversight on electric distribution services offered by PSE to it customers in Washington. PSE will be regulated as a distribution company for the electric and natural gas services it offers under tariff.

Q. How does this option benefit ratepayers?

A. The benefit to consumers is that PSE's resource portfolio is priced at market at the end of the rate plan and customers may then choose alternate power supply providers or from a portfolio of resources. Consumers also benefit by recognizing the expected reductions in cost of service from a distribution company that is properly financed and with returns that are a function of the low business risk associated with a distribution utility.

Q. What happens to issues related to stranded costs under this option?

A. The stranded cost issue becomes moot. PSE's power supply portfolio is transferred to another company within the holding company structure. The rate plan provided a five year window for PSE to manage the cost of its electric supply portfolio, which included all efforts to reduce the cost of those resources the Commission determined to be imprudently incurred in Docket UE-921262. After the rate plan, PSE must compete to recover these costs of power supply. Shareholders capture the rewards of management actions to reduce power supply costs, including the sale of its generation rate base, to align resource decisions with the market, and to position itself as a distribution utility during the rate plan. Shareholders similarly capture the benefits of management's ability after the rate plan to effectively market its power supply portfolio.

Q. Doesn't this recommendation effectively limit shareholders opportunity to recover these costs?

A. No. It provides shareholders with a symmetrical balance of the risks and rewards for decisions related to power supply decisions related to the ability of PSE to realize all categories of savings associated with the merger, and the rate stability provided by customers in order for PSE to accomplish these objectives.

I would also note that in Schedule 48, as part of the rate design, the Company proposed transition charges for its largest industrial customers as an element of its market transition plan. These charges were designed to reflect the difference between Puget's embedded cost of power and market rates. The rate design moves these charges to zero at the end of the rate plan period. PSE, in advocating for Schedule 48 approval, made commitments to manage its resource costs over this same five year period. While the parties fully recognized these charges were not for stranded cost recovery, it was an explicit acknowledgment by PSE that it must manage its resource portfolio within the five year plan period.

Q. Does your first option provide any benefit to shareholders from the Merger?

A. Absolutely. Exhibit____ (KLE-2) shows that shareholders receive a huge benefit from the transaction: earnings immediately reflect the benefits of accelerated amortization of the gain and the ability to swap a high cost resource for secondary power purchases. It would not be unreasonable for the Commission to considering carrying these benefits at a shareholder rate of return over the remaining life of PSE's entire resource portfolio. This option also provides for similar benefits for PSE in selling other generation and related transmission facilities during the rate plan.

Q. You stated that there was another option for the Commission to consider should it approve the sale. Please describe this option?

A. The second option is quite different from the one I've just described. Mr. Martin explains the details of this alternative which, generally speaking, "carves out" Colstrip from PSE's electric operation. It creates deferred accounting mechanisms for both the gain and power supply benefits associated with the transaction for future rate treatment. This option is also consistent with the Merger rate plan because it provides PSE the continued opportunity to capture synergy and power stretch savings. Finally, this approach corrects PSE's piecemeal approach to stranded costs.

Q. What do you mean by the phrase "piecemeal approach to stranded costs"?

A. PSE, in this application, considers Colstrip in isolation to its entire resource portfolio. If there is a need for the Commission to address the stranded cost issue at all, it must be in the context of examining <u>all</u> prudently incurred resource costs. The portfolio approach to stranded costs, which both options incorporate, is the only reasonable course of action for the Commission. It considers PSE's entire resource portfolio and provides stranded cost recovery for all prudently incurred costs within PSE's entire portfolio.

Q. Do you have any other information that shows that PSE is taking a piecemeal approach to the resolution of stranded cost issues?

A. Yes. I am deeply disturbed, as well the Commission should, by recent statements in footnotes to PSE's shareholders regarding stranded costs. According to the 1998 annual report to shareholders PSE states that it has significant cost exposure under several contracts for purchased power with non-utility generators. It goes on to state that in the event of open access, PSE's intent is to seek stranded cost recovery for these purchased power commitments. I have included the applicable pages of

Footnote 17 from the 1998 Annual Report to Shareholders in Exhibit____ (KLE-5). The text is on page 2 of the Exhibit.

PSE's "piecemeal" approach to the stranded cost issue is unreasonable. If the Company believes that it has a stranded cost liability and is entitled to recovery under a traditional rate setting structure, it is reasonable to defer all benefits of this transaction to offset any potential liabilities. It is unreasonable to consider a piecemeal approach to the liquidation of an electric utility's resource portfolio, where the profits are privatized and the losses socialized.

Q. Is there any other evidence that the "piecemeal approach" to the stranded cost issue is an unreasonable proposal?

A. Yes. The Commission, in response to a legislative inquiry on the stranded cost issues stated:

> Studies we have recently reviewed conclude that significant stranded cost issues are unlikely to arise in the Washington and the Northwest. However, if the recovery of stranded costs is deemed by the Legislature to be an important transition issue, the WUTC should set the magnitude of stranded costs eligible for recovery for the investor-owned utilities, as well as the standards to apply for mitigation of such costs, and the recovery mechanism and rate design to be used for recovery. The WUTC should approve charges payable by customers to accomplish recovery of approved costs and be directed to establish mitigation requirements and incentives (including less than 100% recovery) to ensure that transition costs are managed effectively.
>
> Stranded costs should be based on the amount by which the costs of the entire generation portfolio of the utility exceed likely market valuation, rather than be based on individual resources or individual power purchase contracts. Only prudently incurred costs should be eligible for stranded cost recovery. The recovery period should be of limited duration.

> If our recommendations concerning a staged approach to opening direct market access is implemented, it will be important to evaluate the magnitude of stranded assets and establish the mechanism for collection of stranded costs before customers in the first stage are granted access. If any stranded costs are found to exist, these customers must be expected to pay their fair share. (Letter dated September 9, 1997 to Senator Bill Finkbeiner, Chairman Senate Energy and Utilities Committee)

The Commission is explicit in its recommendation: a portfolio approach for all prudently incurred costs with proper mitigation should be required.

I would also note that the Commission briefly touch on the issue of stranded costs in its POLICY STATEMENT, <u>Guiding Principles of Regulation in an Evolving Electric Industry</u>, Docket No. UE-940932. Principle No. 8 stands for the proposition that PSE might not be entitled to 100 recovery of its stranded costs. I do not see any reference to the Commission's policy statement in the footnote to PSE's 1998 annual report to stockholders.

Q. Are there any other factors the Commission might consider in the second option and the accounting and rate treatment for this sale?

A. Yes. The Commission may want to condition approval of the sale and defer the increases programmed for the next two years under the rate plan as offsets to the power supply benefits and gain from the sale. Mr. Martin provides the details of this option.

Q. Please summarize your testimony.

A. The Commission should reject the Company's application because the proposed accounting treatment harms ratepayers. Should the Commission choose to approve the sale, it should ensure that consumers benefit from the transaction. I presented two options as conditions for approval which satisfy that test.

Q. Does that conclude your direct testimony?

A. Yes.