EXHIBIT NO. T- ______(JHS-1)
DOCKET NO. UE-92______
WITNESS: J.H. STORY

BEFORE THE
WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

COMPLAINANT

VS.

PUGET SOUND POWER & LIGHT COMPANY

RESPONDENT

TESTIMONY

UE-921262; -920433; -920499

T-~~55~~556

PUGET SOUND POWER & LIGHT COMPANY
DIRECT TESTIMONY OF JOHN H. STORY

Q. Please state your name, business address, and position with Puget Sound Power & Light Company.

A. My name is John H. Story and I am an Assistant Treasurer with Puget Sound Power & Light Company. My business address is 411 - 108th Avenue N.E., Bellevue, Washington, 98004-5515.

Q. What topics will you be covering in your testimony?

A. I will present an exhibit which, for comparative purposes, shows the balance sheet and income statement for both the test period in our last general rate case and the current test period. I will also explain the various adjustments to the current test period and, after taking into account these adjustments, present the revenue requirement based on the adjusted test year.

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

A. I graduated from the University of Washington in June of 1973 with a Bachelor of Arts degree in Business Administration, majoring in Accounting. I am a member of the American Institute of Certified Public Accountants and the Washington Society of Certified Public Accountants. I started with Puget Sound Power & Light Company in January 1974 and have worked in several areas, including Customer Accounting, Risk and Claims, General Accounting, Major Projects, Internal Auditing, Supervisor of General Books, Assistant Controller and my present position. My responsibilities are to provide professional and technical accounting support to the Vice President of Finance and the various areas within his responsibility.

Q. Would you please explain Exhibit ___ (JHS-2)?

A. Exhibit ___ (JHS-2) is the comparison between the income statements and balance sheets for the year ended September 1988 (the test year in the Company's last general rate case, Docket No. U-89-2688-T (the "1989 rate case")) and the year ended June 1992, the test year in this proceeding.

Page 1 of this exhibit summarizes the assets of the Company for the two test periods. More detail is provided for Utility Plant on pages 1A through 1D.

Page 2 summarizes the capital accounts and liabilities of the Company. Both preferred stock and long term debt are provided in more detail on pages 2A and 2B. Mr. R. E. Olson discusses the changes in both preferred stock and long term debt in his testimony.

The income statements for the two test periods are presented on page 3 of the exhibit. For comparative purposes, the operating and maintenance accounts are presented on pages 3A through 3G.

Page 4 provides some operating statistics for the two test periods.

Q. Please explain your Exhibit ___ (JHS-3).

A. The first page of this exhibit presents the unadjusted rate base for the Company as of June 30, 1992. The rest of the exhibit is composed of two sections.

The first section is the summary schedule of all the pro forma and restating adjustments, pages 2A through 2E. The first column of numbers, on page 2A, is the unadjusted net operating income for the year ended June 30, 1992 and the unadjusted rate base for the same period. Each column to the right of the first column represents a pro forma or restating adjustment to net operating income or rate base. Each of these adjustments has a supporting schedule, which is referenced by the page number shown in each column's title.

The second section of the schedule consists of the supporting schedules for each of the adjustments shown on the summary schedule. Work papers supporting each of these adjustments have been provided to the Commission Staff and have been, or will be, provided to all other parties of record.

The last column, shown on page 2E of the summary schedule, summarizes all the adjustments and is the adjusted test year 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 rate base.

A. I will explain the adjustments in the same order as they are shown on the summary schedule.

General Revenues

This is a restating and pro forma adjustment which removes from operating revenues all rate schedules that are not part of the general rate tariffs, such as residential exchange credits and municipal taxes. The column labeled "Revenue," shown on page 2.01, includes the revenue impact of these schedules. The column labeled "Pro Forma Revenue" is the revenue that would have been collected during the test year if the approved tariffs for the second PRAM period, including the recovery of previously accrued revenues and incentives, had been implemented at the beginning of the test period.

By replacing the actual revenues with these pro forma revenues the test year is adjusted to the rate levels that the customers are paying. Line 15 of this adjustment removes the expense associated with municipal tax receipts that have been removed from operating revenues.

This adjustment, shown on page 2.01, increases net operating income by $44,731,519.

Power Costs

This schedule, shown on page 2.02, adjusts the test year power costs to reflect the power cost resources that will be used during the rate year. The calculation is explained in Mr. Lauckhart's testimony, and is shown in Exhibit ___ (JRL-12).

Net operating income is decreased $123,707,731 by this adjustment.

Sales for Resale--Secondary

This adjustment, shown on page 2.03, increases net operating income by $10,542,113 as determined by Mr. Lauckhart and shown on his power cost schedule, Exhibit ___ (JRL-12).

Temperature Adjustment

This pro forma adjustment, shown on page 2.04, adjusts revenues to a level which would have occurred had the temperatures during the test year been average, or normal. Mr. Lauckhart has provided the actual and temperature adjusted Generated, Purchased and Interchanged (GPI) megawatts for the test period. The difference between the actual GPI and temperature adjusted GPI is adjusted for system losses and then totaled into winter and summer load. To determine the impact on revenues, the winter and summer totals are priced based on the seasonal end block residential rate.

As the test year was warmer than average, the effect of this adjustment is to increase net operating income by $17,929,305.

Conservation Program

Under the PRAM, conservation is calculated in a manner different than that used in previous general rate cases. The calculation for PRAM purposes uses an April 30 cut-off date to determine conservation investment. This pro forma adjustment, shown on page 2.05, is consistent with the method used for PRAM, and uses the estimated balance of conservation expenditures as of April 30, 1993 to determine the rate year amount of conservation amortization and average rate base. This estimated balance will be trued up to actual during the course of this proceeding.

The PRAM methodology calculates the recovery of conservation using the **rate year** load, divided into the rate year conservation revenue requirement. An adjustment has been made to the rate year revenue amount for conservation so that it is adjusted to the **test year** load. This particular adjustment is similar to that used for power cost resources.

The conservation adjustment also includes the deferred taxes, in rate base, associated with the settlement between the Company and the Internal Revenue Service ("IRS") regarding the timing of tax deductions for conservation expenditures. This settlement will be discussed in more detail later in my testimony.

The effect of this adjustment is to decrease net operating income by $7,095,154, and increase rate base by $65,235,885.

Depreciation and Amortization

During the first part of this year, the Company completed a new depreciation study. This study is being used to update our depreciation rates, used since 1985, to current experience. Amortization of the

Commission allowed levels of AFUDC is calculated in conformance with prior Commission orders, and the test year has been adjusted to reflect a full year of the new layer of AFUDC added in 1991.

This restating and pro forma adjustment, shown on page 2.06, increases net operating income by $3,835,761 and increases rate base by $2,792,501.

Property Sales

The purpose of this restating and pro forma adjustment is to provide the customer with the net gains or losses from sales of utility real property since March 1989, the cutoff date used in the 1989 rate case. The amount of the net gain is amortized over a three-year period, with the deferred amounts included in working capital.

The adjustment to rate base shown on line 18 is the additional amount that would have been recorded in rate base if the Company had recorded the full impact of the Commission's decision in the 1989 general rate case to reflect these gains from real property sales in customers' rates. These amounts were not recorded on the Company's books during the test year due to the appeal of the Commission's decision. The appeal was settled May 14, 1992, and this rate base adjustment is calculated in conformity with the provisions of that settlement.

This adjustment, shown on page 2.07, increases net operating income by $170,623 and decreases rate base by $1,025,408.

Storm Damage

This pro forma adjustment, shown on page 2.08, calculates the four-year average expense that the Company has experienced due to storm activity. The average expense amount is used to build the insurance reserve. Actual expenditures, net of insurance recoveries, are charged against the reserve. Due to severe storms in 1990 and 1991, the insurance reserve has a deficit balance. In a previous rate proceeding, the Commission allowed the Company to recover the deficit in the reserve, in addition to the calculated expense, over four years.

Due to the out-of-ordinary costs for the severe storms, the calculated expense amount based on the four-year average is about $6.7 million, even though the ongoing yearly average storm damage amount is estimated to be about $4 million. For purposes of this adjustment, therefore, the amount of the calculated expense amount in excess of $4 million--or $2.7 million--is allocated toward reducing the deficit in the reserve. This "allocation" would leave an additional $5.5 million in the reserve to be collected over the next four years. To reflect the recovery of this additional amount, line 9 of the adjustment adds $1.375 million to the calculated expense amount.

This adjustment decreases net operating income by $4,247,103.

Self Insurance Reserves

This pro forma adjustment is similar to the adjustment for storm damage and calculates an average expense, based on four years of actual expenditures, for the Company's other insurance reserves.

As with storm damage, the all-risk property reserve has a deficit balance. To eliminate this deficit, the Company is proposing that the deficit amount be amortized over four years. This increases the expense for this reserve by approximately $384,000 a year.

This adjustment, shown on page 2.09, decreases net operating income by $531,460.

Environmental

In April 1992, the Commission issued an Order in Docket No. UE-911476 granting the Company's requested accounting treatment for tracking and recovering costs incurred by the Company in connection with its environmental remediation program. The purpose of this restating and pro forma adjustment, shown on page 2.10, is to implement the provisions of that Order.

Under the Accounting Order, the Company is allowed to defer amounts paid to outside vendors and contractors in connection with specific remediation activities. The Company will expense, as incurred, internal employee expenses and legal costs. When the Company received the Accounting Order and implemented its provisions, it expensed certain costs that had been recorded in various balance sheet accounts. Lines 2 and 3 of the adjustment restate the test period for the costs that would have been recorded if the Order had been in effect since July 1991, the beginning of the test period. Line 7 shows the deferral of third-party costs, which the Company is proposing to recover over three years.

The effect of this adjustment is to decrease net operating income by $374,807. There is no rate base effect shown for this adjustment because the deferred costs are included in working capital under the provisions of the Accounting Order.

Employee Insurance

This pro forma adjustment updates the test year insurance payments to the amount that will be experienced in the rate year. For union employees this rate is known. For salaried employees, an estimate is used, and will be updated to actual during the course of these proceedings.

These costs are allocated to expense, construction and other accounts based on the percentage of payroll charged to these accounts during the test year. The portion of the insurance payments associated with expense during the test year has been determined to be 54%. This adjustment corrects the amounts actually charged to expense to reflect the appropriate 54% allocation.

The effect of this adjustment, shown on page 2.11, is to decrease net operating income by $24,047.

SFAS 106

The purpose of this pro forma adjustment, shown on page 2.12, is to reflect the impact on the Company of the Statement of Financial Accounting Standard 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" (SFAS 106), which becomes effective January 1, 1993. This accounting pronouncement will be discussed in more detail later in my testimony. Mr. Bertko's testimony discusses SFAS 106 and the Company's calculation of the appropriate expense.

Exhibit ___ (JHS-5) is the actuarial report which supports the Company's calculation of SFAS 106 costs. Page 4 of this exhibit shows the expense, $3.568 million, used for calculating the required adjustment to the test year. As noted later in my testimony, this 1992 amount is used as an estimate for the rate year and will be updated during the course of this proceeding. The actual cash payments the Company made during the test year were $1,838,479. As this expense is allocated in the same manner as payroll, only 54% of these amounts are reflected in expense.

On October 22, 1992, the Commission issued its Policy Statement in Docket No. A-921197 regarding the ratemaking and regulatory requirements associated with SFAS 106. One of the requirements addressed in the Policy Statement was that a utility must request recovery in its next rate case of any deferred amounts. We have shown our estimate of the deferred amount on lines 11 through 13 on page 2.12. This amount has not been included in the Company's revenue requirement calculation. It will be updated to actual and included in the Company's rebuttal filing.

The effect of this adjustment is to reduce net operating income by $616,519.

Company Insurance

This pro forma adjustment reflects adjustments to insurance premiums since the test year. As shown on page 2.13, net operating income is reduced by $9,789.

Wage and Salary

This pro forma adjustment, shown on page 2.14, reflects the impact of wage increases and payroll tax changes. For management employees, the adjustment annualizes the average wage increase granted January 1, 1992. For union employees, the adjustment annualizes the wage increase granted in 1992, and to be granted in 1993, as determined in the union contract. The same wage increase percentage used for the union employees in 1993 has been used to annualize the management wages for that year. This estimate will be adjusted to actual during the course of these proceedings.

This adjustment decreases net operating income by $3,506,810.

Investment Plan

This pro forma adjustment, shown on page 2.15, adjusts the Company portion of investment plan expense to reflect the additional expense associated with the wage increase.

Net operating income is decreased by $101,581.

Retirement Plan

In the 1989 rate case, the Company proposed, and the Commission adopted, a methodology under which pension expense is reflected in a manner similar to storm damage expense for ratemaking and financial reporting purposes. A four-year average of actual pension contributions is used to determine the amount of expense to be included in rates. The corresponding account for the average expense amount creates a pension reserve. Actual contribution payments are charged to this reserve. The purpose of this reserve is to eliminate the volatility of expense that could have been reported under the accounting pronouncement, SFAS 87, "Employers Accounting for Pensions". This accounting treatment also allows the Company to record the financial impacts of SFAS 87 as offsetting regulatory assets and liabilities on the balance sheet, with no impact on the income statement.

A deficit balance currently exists in the pension reserve, and is projected to increase by September 30, 1993. This pro forma adjustment allocates the estimated amount of the reserve deficit as of September 30, 1993 over the next four years. The effect of this adjustment is to decrease net operating income by $2,226,757.

Bad Debts

This pro forma adjustment calculates the average percentage of bad debt write-offs for the last five years. As in prior general rate cases, this average percentage is used to calculate the expected write-off for bad debts based on the test year revenues.

This adjustment, as shown on page 2.17, decreases net operating income by $307,290.

Interest on Customer Deposits

This pro forma adjustment to operating income is the result of customer deposits being treated as a reduction to rate base. This presentation is consistent with decisions in prior general rate cases and, as shown on page 2.18, reduces net operating income by $373,655.

Creston

As discussed by Mr. Lauckhart, the Creston generating station was being maintained as a possible coal unit site under the Regional Power Planning Council's options strategy. The Regional Power Planning Council has now determined that this site will not be included as a region resource option. The Company is therefore proposing to write off its investment in the project over five years.

The effect of this pro forma adjustment is to decrease net operating income by $786,928 and to increase rate base by $3,541,177.

Stone Creek

Stone Creek is a hydro generating facility that was licensed by the Federal Energy Regulatory Commission (FERC) on September 15, 1989. As discussed by Mr. Lauckhart, this facility will become operational during the first quarter of 1993 and will be added to the Company's accounts as of the date of operation.

The purpose of this adjustment is to reflect the rate base, depreciation and property tax effects associated with this project for the rate year. The depreciation rate used is the composite rate for hydro plant developed in the new depreciation study. This rate will be adjusted to the actual depreciation rate for this project during the course of these proceedings. Property taxes are calculated using the estimated Oregon levy rate for the applicable taxing district. The estimated levy rate will be adjusted to actual during the course of this proceeding.

This pro forma adjustment, shown on page 2.20, decreases net operating income by $739,970 and increases rate base by $21,525,709.

Black Creek

This hydro generating project was licensed by FERC in July 1988 and will become operational during the last quarter of 1993. As with Stone Creek, the rate base adjustment reflects the impact of this project being added after the test year and adjusts rate base to the amount that will be recognized during the rate year. The depreciation rate used is the same as used for

Stone Creek. Property taxes are calculated using the estimated King County rate for the applicable taxing district. The estimated rate will be adjusted to actual during the course of this proceeding.

This pro forma adjustment, shown on page 2.21, decreases net operating income by $293,480 and increases rate base by $9,059,621.

Small Hydro Adjustment

As part of the development of the small hydro licenses, the Company acquired several preliminary permits for potential hydro projects. Upon further study, a number of these projects have been found not to be development quality, as discussed in Mr. Lauckhart's testimony.

The Company is proposing that the costs associated with these sites be amortized over five years. An alternative approach would be to allocate the expenses, or gains, associated with the small hydro program to the projects which are ultimately developed. This allocation would be considered as part of the small hydro construction overheads. This treatment would require Commission approval prior to its use for financial accounting and ratemaking purposes.

The effect of this pro forma adjustment, shown on page 2.22, is to decrease net operating income by $64,091 and increase rate base by $288,412.

Pebble Springs

The amortization of the Company's investment in Pebble Springs will be complete in July 1993. This pro forma adjustment removes the amortization associated with this project during the test year.

The effect of this adjustment, shown on page 2.23, is to increase net operating income by $4,856,240.

Working Capital

The purpose of this calculation is to provide a return for the funds the shareholder has invested in the Company, for utility purposes, over and above the investment in plant and other specifically identified rate base items already earning a rate of return.

This adjustment corrects the June 30, 1992 calculation for some new accounts that were treated improperly in the original June calculation and adjusts the calculation for the treatment of residential exchange credits and dividends declared.

As part of this filing, we are proposing to change the accounting treatment for residential exchange benefits which the Company receives from the Bonneville Power Administration ("BPA"). In the Company's previous general rate cases, the Company's customers benefited from a credit balance in the residential exchange account through a reduction to working capital. BPA took exception to this treatment in a compliance audit, and urged an alternative treatment under which the Company would accrue interest on any balance in the residential exchange account. This treatment would allow any interest associated with balances in the residential exchange account to be shared among, or recovered from, only those of the Company's customers who are eligible to participate in the residential exchange program. The Company agreed to implement this treatment on a prospective basis, and submitted a Petition for an Accounting Order in Docket No. UE-920433-P that would have allowed implementation prior to a general rate filing.

In this filing, the Company proposes to calculate working capital in a manner that removes the impact of any balance in the residential exchange account. In order to effect this change, the residential exchange balance has been treated as short term debt and has been added to the capital structure and the short term debt component of this adjustment. Upon acceptance of this treatment by the Commission, the Company will accrue interest on balances in the residential exchange account at a rate equal to the Company's short term debt rate.

In the 1989 rate case, the Commission agreed with Staff that dividends declared should not be part of working capital. The Commission indicated in its order in Cause No. U-79-66 that dividends declared are available to the company as zero-cost capital and it is not proper that a return be allowed. Reviewing the cited order, it appears there may be some confusion as to how the Company records dividends declared. When a declaration of dividends is announced, in the month before the actual payment is made, the Company must record this liability. The entry made is to charge retained earnings, a component of working capital, and credit dividends declared, a payable to the shareholders. Nothing else has occurred. No change has been made in the invested capital by shareholders; they still have their money invested in the business. It is in the month of payment that the invested capital will change and that effect is captured in the working capital account balances at that time. As these funds are provided by the investor and are not earning a return elsewhere, they are properly included in the working capital calculation.

This restating and pro forma adjustment, shown on page 2.24, increases rate base by $15,700,309.

OBC Lease Income

This restating adjustment, shown on page 2.25, increases operating income for the revenues to be received on the land leased to One Bellevue Center. Although this land is recorded in non utility property, the Company is leasing space in the building built on the site. As the land lease payments contribute to the payment of the lease for the building space, this adjustment provides the benefit of the land lease income to the customer. This adjustment increases net operating income by $292,937 and rate base by $48,673.

Rate Case Expenses

As in prior general rate cases, this pro forma adjustment, shown on page 2.26, calculates the expected costs for this case and amortizes them over two years. This adjustment will be updated during the course of this proceeding.

The effect of this adjustment is to decrease net operating income by $131,380.

Non-Recurring & Operating Expenses

This restating adjustment, shown on page 2.27, adjusts the test year for various items which relate to periods outside the test year and for known expenses and savings which do not reflect an annual amount during the test year.

The effect of this adjustment is to increase net operating income by $1,155,401.

Production Adjustment

This pro forma adjustment, shown on page 2.28, reduces production related rate base and certain production expenses by the same production factor which was used by Power Planning for calculating power costs.

Net operating income is increased by $1,937,539 and rate base is reduced by $41,950,775.

Washington Excise Tax

This restating adjustment, shown on page 3.01, adjusts the test year estimates to actual expense for the Washington Utility Tax and filing fee. The effect of this adjustment is to decrease net operating income by $457,571.

Property Taxes

This pro forma adjustment, shown on page 3.02, reflects the estimated property tax levy rates to be paid in 1993 based upon 1992 value. These rates will be adjusted to actual during the course of this proceeding. The effect of this adjustment is to lower net operating income by $1,655,052.

Montana Corporate License Tax

This pro forma adjustment, shown on page 3.03, adjusts this tax to the current taxable income computed in the pro forma income tax adjustment. This Corporate License Tax is based upon Federal taxable income. The effect of this adjustment is to decrease net operating income by $113,818.

Tax Benefit on Pro Forma Interest

This restating adjustment, shown on page 3.04, uses a rate base method for calculating the tax benefit of pro forma interest. As adopted by this Commission in prior rate cases, the customers receive the tax benefit associated with the interest on debt used to support rate base and construction work in progress that has associated tax deductible interest.

The effect of this adjustment is to decrease net operating income by $7,297,118.

Montana Energy Tax

This restating adjustment, shown on page 3.05, adjusts the test year amount of this tax to the amount that would be incurred based on the power cost adjustment.

The effect of this adjustment is to increase net operating income $76,215.

Federal Income Taxes

This schedule adjusts actual Federal Tax expense to the restated level based on the test year for this case. As our normal tax year is December ended, this adjustment recalculates the test year using the expenses and tax adjustments for the twelve months ended June 30, 1992, and removes the current tax year estimates from the test period. The effect of this adjustment, shown on page 3.06, is to decrease net operating income by $10,916,541.

Q. You mentioned earlier that you would discuss the settlement reached between the Company and the IRS on the treatment of deductions related to conservation expenditures. Would you please explain the settlement?

A. Yes. This settlement is one of the reasons that the Company's Federal income tax expense in this case has increased. The settlement affects the timing for deductions taken by the Company for conservation expenditures. Historically, the Company has taken conservation expenditures as a current tax deduction since the beginning of the conservation program and has been providing the tax benefit to the customer. The IRS has continually challenged this treatment, contending that the proper method of deducting these costs is the same as that used for book and ratemaking purposes, i.e., the deduction should be taken over a ten-year period. The IRS took the position that the Company was required to recalculate its prior tax returns taking as a current deduction only the amount of book conservation amortized in a given year. This treatment would have required the Company to pay taxes on the difference between the amount actually deducted and the amortization taken in a particular year. In addition, the IRS claimed the Company would have to pay interest on all the taxes from the date they would have originally been paid. The interest alone would have been in excess of $40 million and would have been due immediately.

Q. Did the Company ever try to get this issue resolved through the National Office of the IRS?

A. Yes. The Company requested and received a technical advice memorandum that agreed with the Company's position. The effect of this ruling, however, was limited to the years 1979 and 1980. The memorandum left the issue open for a different conclusion if the local

IRS office could prove that the conservation program produced a future benefit that is more than merely incidental. This relatively new criteria for determining the non deductibility of an expenditure was adopted by the Tax Court during 1991. Ultimately the issue was decided in favor of the IRS when the United States Supreme Court ruled on this issue in early 1992 (INDOPCO v. Commissioner of Internal Revenue).

Q. What effect would the Supreme Court's decision in INDOPCO have had on the Company's position?

A. We were advised by legal counsel that the INDOPCO decision would have made it very difficult for the Company to prevail on this issue without Congressional action to change the tax laws.

Q. When were the terms of the final settlement agreed upon?

A. Mr. Moreton, Puget's Manager of Taxes, met with the local appeals officer and the Examination Branch of the IRS in the early part of 1992. The terms of the settlement were agreed upon in the last part of February 1992, about the same time the U.S. Supreme Court ruled in favor of the IRS in the INDOPCO case. The settlement was finalized in April 1992 after the Commission issued its Order in

Docket No. UE-920349 approving the Company's proposed accounting treatment.

Q. What benefits do the Company and its customers receive under the settlement?

A. The settlement provides the following benefits for the Company and its customers:

- **No interest charges for pre-1991 deductions.** The IRS did not disturb the deductions for conservation expenditures as claimed on the income tax returns for years prior to 1991. As a result, the Company and its customers avoided exposure to interest charges in excess of $40 million. By avoiding these interest charges, customers had free use of these tax benefits for years prior to 1991.

- **Repayment of prior taxes over six-year period.** The Company was required to return to taxable income a tax adjustment based on computing the deductions for conservation expenditures since 1984 in the manner proposed by the IRS. The amount to be returned to income is about $118.6 million. Rather than being required to pay tax on this amount immediately, the Company was allowed to spread the tax payment over a six-year period starting in 1991. The Company was not required to pay interest on the unpaid balance, thereby providing customers with an additional benefit from the free use of these tax benefits.

- **No tax adjustment for pre-1984 deductions.** For amounts prior to 1984, no tax adjustment was made.

- **Retention of benefits from reduction in tax rate.** The Company and its customers retained the benefit from the reduction in the Federal tax rate that occurred since some of these deductions were taken. Although some of the deductions were taken at the 46% tax rate, the effect of this settlement is to "return" them to income at a 34% rate.

As the Commission will recall, the Washington Water Power Company ("Water Power") had a similar dispute with the IRS over this issue regarding its weatherization program for the years 1982-87. In late 1988, Water Power reached a settlement with the IRS which involved paying the back taxes, plus interest. The Commission approved this settlement in Docket No. 88-2560-P. As discussed earlier, this type of settlement would have cost our customers an additional $40 million.

Q. **Is the Company precluded from taking a current deduction for conservation expenditures if the tax laws are changed?**

A. No. If the tax laws are changed or clarified to allow current deductions for conservation, the Company can change back to this method. The settlement does preclude the Company from changing its tax treatment of conservation expenditures for years prior to 1991, however. With the support of the Commission, the Company is still actively pursuing a change to the tax laws that will permit a current deduction for conservation expenditures.

SFAS 106

Q. What does SFAS 106 require?

A. As discussed in more detail in Mr. Bertko's testimony, SFAS 106 requires a change in accounting for post-retirement benefits other than pensions, or PBOPs, from a cash or pay-as-you-go basis to an accrual basis. SFAS 106 prescribes how the level of accrued expense is to be determined.

Q. How was the expense amount associated with SFAS 106 calculated in this proceeding?

A. The SFAS expense for 1992 was calculated using 1991 data. As the Company has not begun funding this liability, this 1992 SFAS 106 expense amount was used as an estimate for purposes of the expense level in this proceeding. This amount will be updated to more current data during the course of this proceeding. As I stated earlier, Mr. Bertko discusses the actuarial assumptions and methodology used to determine the liability associated with these benefits.

Q. Why is the Company proposing to use the level of PBOP expense required under SFAS 106 for ratemaking purposes?

A. Calculating PBOP expense for ratemaking purposes in accordance with SFAS 106 would provide the following benefits:

- It would enable the Company to begin funding its post-retirement benefits liability. Prefunding this liability will benefit the Company's customers inasmuch as earnings on the funded assets will help offset the liability growth, thereby reducing the cost of post-retirement benefits.
- It would provide similar ratemaking treatment for post-retirement benefits as is used for pension costs.
- It would allow utility rates to reflect the true costs of service provided by the Company's workforce. Inasmuch as today's customers receive the benefits of services currently provided by employees, today's customers should pay for the cost of the employees' compensation--including deferred compensation, such as retirement benefits--at the time service is rendered.
- It would allow accounting for ratemaking purposes to follow the required treatment for financial reporting purposes, and thereby avoid any negative financial impact associated with implementation of SFAS 106.

Q. What is the Company required to demonstrate before it can reflect the higher SFAS 106 level of PBOP expense in rates?

A. Under the Policy Statement issued by the Commission in Docket No. A-921197, the Company must show that: (1) the expense under SFAS 106 is reasonable, prudently incurred, and determined under conservative assumptions; and (2) the level of PBOP expense requested reflects prudent and safe funding of the entire amount based on tax-free asset transfer and fund income. Mr. Bertko's testimony describes the assumptions used in determining the Company's SFAS 106 expense. The remaining requirements are discussed in my testimony below.

Q. **Has the Company done any studies which show that its PBOP expense levels are reasonable as compared to the expense levels of other utilities?**

A. The Company has not performed any formal studies. The Commission Staff did a study in its "White Paper" in Docket No. UG-911253 which showed that the Company's expense for these benefits is less than one-half as much, per employee, than that of any of the other nine utilities included in the study.

Q. **Why is the Company's expense so much less than that of the other utilities?**

A. In 1988 and early 1989, the Company did an analysis of its current retiree health and life insurance programs. That study concluded that with projected large increases in medical insurance premiums, the Company was facing a substantial future liability under its defined benefit plan. To limit this exposure and still provide a competitive retirement benefit, the Company changed to a defined dollar plan. This plan provides a set amount per year of service that will be used to purchase retiree medical insurance. As discussed by Mr. Bertko, this plan became effective for employees retiring after December 31, 1991 and is not subject to medical inflation rates.

Q. Does the Company compensate for the low cost of post retirement benefits by providing other employee benefits at a rate considered to be higher than market?

A. No. The Company has controlled its costs on other employee benefits by changing to a "cafeteria" plan for active employees. The purpose of this plan is to provide employees with the opportunity to buy cost-effective medical, dental, life insurance and other benefits based on their individual needs. The Company provides an amount for each employee, and the employee determines the level of desired benefits in each category. Each employee is required to purchase a minimum amount of insurance in categories such as medical, disability, dental and life insurance, and can also contribute their own pretax dollars to purchase additional benefits, if desired. The advantage this plan provides for both the employee and the Company is that employees can purchase the benefits that are needed according to individual circumstances, and the Company's costs are fixed and not based on the level of benefits selected.

Q. Is the Company able to fund its SFAS 106 obligation using tax deductible contributions?

A. Yes. At this time, the Company would be able to fully pre-fund its SFAS 106 accrual expense using a collectively bargained Voluntary Employees' Beneficiary Association, or VEBA, for union-represented employees and a 401(h) account for salaried employees.

Q. Would you please explain these funds?

A. Yes. A VEBA is a tax exempt trust under Internal Revenue Code (IRC) 501(c)(9). To establish a VEBA, the employer must adopt a formal trust document which provides that no assets of the VEBA may revert to the employer. All assets in the VEBA are to be invested and held for the exclusive benefit of participants and beneficiaries. A collectively bargained VEBA, established pursuant to arms-length collective bargaining, is not subject to contribution limits. The maximum amount that can be contributed for a year is based on the year's actuarially determined service cost for retiree medical benefits. Although a VEBA's earnings typically are subject to Unrelated Business Income Tax, this tax does not apply to a collectively bargained VEBA.

An IRC 401(h) fund is a separate fund established within a defined benefit pension plan to pay "incidental" retiree medical benefits. This fund requires IRS approval, which the Company applied for on July 24, 1992. The fund accumulates tax-free and retirees are not taxed on medical benefits received through the fund. The fund is built by employer contributions, which cannot exceed 25% of the current cost for pension benefits. If the Company is not currently making pension contributions, then contributions to this fund cannot be made and an alternative source of funding would be required.

Wage and Salary

Q. In the 1989 rate case, the Commission ordered the Company to complete a study of "slippage" as part of the management salary adjustment in its next general rate case. Has this been done?

A. Yes. This study was completed recently and the results have not been completely analyzed. Based on a preliminary review, we are not proposing any change to the method we have used to adjust wages.

Revenue Requirement

Q. Has the Company completed an attrition study?

A. Yes. The study shows that there is positive attrition of approximately $16 million between the adjusted test year and the rate year. Mr. Sonstelie discusses the use of this study in his testimony.

Q. What is the revenue deficiency taking into consideration these restating and pro forma adjustments?

A. Exhibit ___ (JHS-4) computes a general rate deficiency of $117,772,940 for all customers. Of this amount, $999,385 is allocated to wholesale customers, resulting in a retail rate increase of $116,773,555.

Q. Have you calculated the revenue requirement under the rate moderation proposal discussed in Mr. Sonstelie's testimony?

A. Yes. If the Company were to defer $46 million in power costs, the revenue requirement for all customers would be $69,688,136. The increase for retail customers would be $68,936,180. To recover this deferred amount over the three years following the rate year will require that the Company increase rates in each of those years by approximately $34 million, ~~before~~ AFTER adjusting for revenue-sensitive fees and taxes. This levelized recovery of $34 million each year will satisfy accounting requirements by achieving recovery of deferred amounts within two years of the year in which the deferral occurred. The calculation of the levelized amount assumes that the Company will be allowed to earn an interest rate equivalent to its net of tax rate of return, or 8.74%. ah

Q. Does this conclude your testimony?

A. Yes.