Ex. T-_____ (KLE-Testimony)
Docket Nos. UE-920433, UE-920499 and UE-921262
Witness: Kenneth L. Elgin

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

PETITION OF PUGET SOUND POWER & LIGHT COMPANY FOR AN ORDER REGARDING THE ACCOUNTING TREATMENT OF RESIDENTIAL EXCHANGE BENEFITS	DOCKET NO. UE-920433
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	DOCKET NO. UE-920499
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	DOCKET NO. UE-921262

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TESTIMONY

KENNETH L. ELGIN

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

MAY 1993

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION
No. UE-920433; -920499; -921262 Ex. T-670

ERRATA SHEET

1. Testimony of Andrea Kelly, Ex. T-___ (ALK-testimony)

Page 7, line 24: insert "of administration and operations" after "control of costs."

Page 9, line 7: insert "clear" before "relationship."

Page 9, line 18: insert "on a per customer basis" after "fixed."

Page 9, line 24: insert "currently" after "statistic."

Page 25, line 23: insert "In the future," before "Employee."

Page 26, line 19: line should read, "benefit to shareholders rather than to ratepayers. Finally"

2. Testimony of Patrick Moast, Ex. T-___ (PJM-testimony)

Page 10, line 11: Change "October," to "October 1,"

Page 11, line 25: Change "($18,215,800 w/.936 adjustment factor)." to "w/.936 adjustment factor."

Page 19, lines 18-19: Place a period after "12/31/91." Delete "which is the period prior to the test year in this case."

Page 31, line 25: After "Point 2," add "and participation in the 3rd AC Intertie,"

3. Exhibit of Patrick Moast, Ex. ___ (PJM-2)

Page 2: Change units on the first line, both columns, from "kwh" to "kw."

Page 2: Change units on the second line, both columns, from "mWh" to "mW."

4. Testimony of Kenneth L. Elgin, Ex. T-___ (KLE-testimony)

Page 11, line 11: The word "one-half" should read "two-thirds."

Page 11, line 19: The word "rate" should read "revenue."

Page 33, line 16: "2.1" should read "2.01."

Page 34, line 10: "588" should be "558."

1 Q. What is your name and business address?
2 A. My name is Kenneth L. Elgin. My business address is
3 Chandler Plaza Building, 1300 South Evergreen Park Drive
4 S.W., P.O. Box 47250, Olympia, Washington, 98504-7250.
5
6 Q. By whom are you employed and in what capacity?
7 A. I am employed by the Washington Utilities and Transportation
8 Commission as the Assistant Director for Energy for the
9 Utilities Division.
10
11 Q. Would you describe your education and relevant employment
12 experience?
13 A. I received a Bachelor of Arts from the University of Puget
14 Sound in 1974 and a Master of Business Administration from
15 Washington State University in 1980. In January, 1985, I
16 was employed as a Utilities Rate Research Specialist for the
17 Utilities Division. In that capacity, I was responsible for
18 many diverse aspects of natural gas regulation and testified
19 before the Commission on issues related to rate design, cost
20 of service, purchased gas costs, and least cost planning.
21 In addition, I have testified before the Commission on rate
22 of return for electric, natural gas and telecommunications
23 companies. In December, 1989, I was promoted to my present
24 position as the Assistant Director for Energy. In that
25 capacity, I am responsible for the policy direction of the

1 Utilities Division's electric and natural gas programs. I
2 am also a member of the National Association of Regulatory
3 Commissioners Staff Subcommittee on Finance and Economics
4 and a member of the National Society of Rate of Return
5 Analysts.
6
7 SUMMARY
8
9 Q. Mr. Elgin, could you please summarize the Staff's
10 presentation in this proceeding and its recommendation?
11 A. Yes. In addition to evaluating the full range of ratemaking
12 issues presented in Puget's rate filing, the Staff is
13 recommending that the Periodic Rate Adjustment Mechanism
14 (PRAM) be continued in a modified form. The recommendation
15 to continue the PRAM is conditioned on the Commission
16 addressing the issue of risk allocation. Puget is
17 requesting continued compensation for risks that have been
18 transferred to ratepayers by the PRAM. The recommendations
19 for classifying revenues (costs) between Base and Resource
20 categories is identical to the presentation Staff made in
21 Docket No. UE-901184-P, Puget's petition creating the PRAM.
22 The Staff is also offering changes to the Simplified
23 Dispatch Model (SDM).
24 The Staff takes exception to the Company's assertions
25 regarding the impacts of purchased power and its financial

1 profile. Staff is also concerned that Puget is not
2 adequately presenting the benefits of the PRAM to the
3 financial community.

4 The Staff is requesting policy direction from the
5 Commission in order to clarify the current least cost
6 planning process. We continue to be troubled by Puget's
7 characterization of the Least Cost Planning process as a
8 "review" by both the Commission and interested parties,
9 implying the process in some fashion gives prior approval to
10 Puget's specific resource acquisition strategy and
11 concomitant costs in this rate proceeding. (Tr. 434) The
12 current least cost planning process, while valid for certain
13 purposes, is too generic and non-specific to accomplish such
14 an objective. The Commission should put Puget on notice
15 that the current least cost planning process is not rigorous
16 enough to be equated with prior approval of its specific
17 resource acquisition decisions. The current process
18 involves nothing more than a Company-sponsored document with
19 an opportunity for the public and Staff to comment on
20 various resource options available to Puget. Furthermore,
21 Puget has not demonstrated exactly how the current resource
22 strategy is least cost.

23 Q. Mr. Elgin, would you please summarize the Staff's
24 presentation in this proceeding and provide a general
25 description of each witness' testimony?

1 A. The Staff is recommending that Puget be required to decrease
2 its revenues through general rates by $1.633 million. This
3 is a 0.16 percent decrease over current billing rates, which
4 includes approximately $100.1 million in increases from two
5 previous PRAM filings. Due to the small decrease to current
6 rates, Staff is not recommending any rate moderation
7 proposal at this time.

8 I am responsible for the policy direction of the Staff
9 presentation in this proceeding. Mr. Roland Martin presents
10 Staff's results of operations statement. In that effort he
11 is supported by the testimony of Mr. Tho Nguyen and Mr.
12 Thomas Schooley in the evaluation of all accounting
13 adjustments and related issues. Mr. Curtis Winterfeld and
14 Mr. Patrick Moast address all power supply issues. Ms.
15 Dianne Sorrells discusses Puget's investments in
16 conservation and describes Staff's position on the prudence
17 of these expenditures. Ms. Andrea Kelly critiques the
18 Company's presentation on cost controls and efforts to
19 improve organizational effectiveness. Mr. Alan Buckley
20 responds to the Company's request for a price elasticity
21 adjustment. Finally, Dr. Richard Lurito provides an
22 estimate of the fair rate of return and a critique of
23 Puget's presentation on the impacts of purchased power on
24 its financial profile.
25

1 Q. Mr. Elgin, Staff is recommending that the rates be reduced
2 by approximately $1.7 million and Puget has requested an
3 increase of approximately $117 million, would you please
4 explain this significant difference?
5 A. The difference is significant, but I hasten to add that the
6 difference is primarily one of timing the rate recovery to
7 more properly match the on-line date of Puget's new
8 resources. The principle difference between the two
9 presentations is caused by by two factors: rate of return
10 and power supply. The Company is requesting a 10.00 percent
11 return on its rate base. Staff is recommending an 8.91
12 percent return. This alone accounts for approximately $35.7
13 million of the Staff/Company difference. Approximately $48
14 million is accounted for by differences in the timing of the
15 Company's cost recovery for new resources. Puget has
16 requested that a significant amount of its purchased power
17 be recovered from ratepayers now, yet these resources are
18 not on-line to deliver.
19 There are significant differences in the rate base
20 calculation between the Company and Staff. The Staff
21 presentation includes the impacts of new lower depreciation
22 rates which have been agreed to by Staff and Company.
23 The remainder of the Staff/Company difference is due to
24 differences in accounting for various items and the proper
25 recovery of these items for ratemaking purposes.

1 Q. Mr. Elgin, could you please state the purpose of your
2 testimony?
3 A. The purpose of my testimony is to address the following
4 areas:
5 1. The Company's evaluation of the PRAM and its response
6 to the specific areas identified by the Commission for
7 evaluation.
8 2. Staff's evaluation of the PRAM with suggested changes.
9 3. Specific recommendations for clarifying the policy
10 direction of the least cost planning process.
11 4. Specific policy recommendations for addressing the
12 issue of risk allocation and the impact of PRAM on
13 rates to customers.
14 5. Staff's Response to the Company's assertions regarding
15 the risk of purchased power and how its operations are
16 financed.
17 6. Specific recommendations to adjust the test year to
18 adjust costs and revenues to account for the Company's
19 decision to serve a large commercial customer,
20 Nintendo.
21 7. Specific recommendation to remove excessive costs for
22 consultants and attorneys.
23 8. Critique of Puget's proposal for conservation
24 financing.
25

1 PRAM EVALUATION

2

3 Q. The Commission identified specific policy goals in its
4 Notice of Inquiry (Notice), Docket No. UE-900385, in order
5 to evaluate experiments in regulatory reform. Would you
6 please list these goals and briefly describe Staff's
7 perspective on the PRAM in relation to these policy goals?
8 A. Yes. The Commission initially focused on a 1988 policy
9 statement of the National Association of Regulatory
10 Commissioners (NARUC): "Ratemaking practices should align
11 utilities' pursuit of profit with least cost planning."
12 From that statement three specific goals to evaluate
13 experiments in regulatory reform emerged.

14

15 (1) Determining whether our regulatory structure adequately
16 aligns utilities' pursuit of profits with least cost
17 planning;
18 (2) Determining if and how our regulatory structure should
19 recognize utilities' increasing reliance on generating
20 resources not constructed by the regulated utility;
21 and,
22 (3) Complying with the Legislature's mandate, RCW
23 80.28.260, that the Commission consider policies "to
24 improve the efficiency of energy" and "protect a
25 company from a reduction of short-term earnings" due to

1 such increased efficiency.

2

3 There is no question as to whether the PRAM meets the test
4 of the first policy goal. From Staff's perspective, the
5 PRAM also insulates Puget from any variability in earnings.
6 For this reason, the determination of a fair rate of return
7 is of critical importance. With respect to the second
8 policy goal, Puget is provided with timely recovery of the
9 cost of all newly acquired resources plus changes in cost of
10 existing resources. The PRAM is responsive to the third
11 policy goal too. It not only protects Puget from short-term
12 earnings impacts due to efficiency investments, it protects
13 Puget from short-term earnings fluctuations resulting from
14 virtually any cause.

15

16 Q. Throughout the Commission's inquiry process regarding
17 regulatory reform, it has consistently stated that it will
18 rely on four separate elements to evaluate any new
19 regulatory reform mechanism. What are these criteria?
20 A. The four criteria are: 1) the mechanism must be measurable;
21 2) it must be simple to administer; 3) it must be intuitive
22 to customers; and 4) it must be an improvement on balance
23 over current rate base, rate of return regulation.

24

25 Q. Does the PRAM meet these evaluation standards?

1 A. No. The current mechanism fails to meet these standards in
2 all but one category. However, the Staff is not
3 recommending that the mechanism be abandoned. As I will
4 discuss later, even though the mechanism fails to meet these
5 criteria, the mechanism offers other benefits that are in
6 the public interest. The issue is weighing these benefits
7 against the "costs" of the PRAM.
8
9 Q. Would you explain how the PRAM satisfies the first
10 criterion, but fails to satisfy the other three?
11 A. The first criteria is that the PRAM must be measurable. I
12 interpret this criterion to mean that the focus should be on
13 specific Company behavior under the mechanism. In that
14 sense, this is the only criteria which the PRAM passes. The
15 Company has become aggressive in its pursuit of conservation
16 resources and related efforts to determine the appropriate
17 means to verify savings from efficiency investments. The
18 Company asserts that without the mechanism it could not have
19 ramped up its conservation programs to the degree it has
20 done so.
21 While I accept this assertion as Puget's position, it
22 must be emphasized that conservation resources are both low
23 cost and low risk. A prudent management should take
24 advantage of all available low cost, low risk resources.
25 Exhibit ____ (KLE-1) is a June 1991 article from the

1 *Electricity Journal* entitled, "Why Stockholders Don't Need
2 Financial Incentives to Support Demand-Side Management" for
3 the Commission's review. It supports the proposition that
4 those companies pursuing sales growth may not be the most
5 profitable to shareholders. Active pursuit of conservation
6 is, in fact, in the best interest of shareholders.
7 Acquiring conservation may not be in the best interest of
8 utility managers.
9
10 Q. Turning to the second criterion, is the PRAM simple to
11 administer?
12 A. In concept the PRAM should be simple to administer.
13 However, anytime a mechanism is developed to "automatically"
14 adjust rates, it is prone to implementation problems.
15 Automatic adjustment mechanisms lack the ability to apply
16 sound reason and judgment to the inputs and at times produce
17 undesirable results. A ten percent rate increase, such as
18 that generated by the PRAM 2 filing, is difficult even under
19 the best of circumstances. The mechanism may have "worked",
20 but the results were problematic.
21
22 Q. Is the PRAM understandable to customers?
23 A. The PRAM and its workings are very difficult to explain to
24 customers and are not likely understood by customers. In
25 fact, based on my assessment of the hearings, very few

1 parties fully understand the workings of the mechanism, its
2 complexities and its ultimate impact on the rates customers
3 pay for service. I also take exception to Mr. Sonstelie's
4 testimony that traditional ratemaking is difficult for
5 customers to understand. (Ex. T-502, p.12) Customers
6 readily understand the concept that rates should be based on
7 prudent costs. However, when customers are asked to begin
8 to think about their rates in terms of prior period under-
9 collections, for whatever reason, this complicates the
10 process. If one considers that the rates for the PRAM 3
11 alh cycle will include ~~one-half~~ two-thirds of the amounts from under-
12 collections during the first seven months of PRAM 1, the
13 remaining five months under-collection from PRAM 1, under-
14 collections from the first seven months of PRAM 2, true-ups
15 from these prior period under-collections, a general rate
16 increase and the PRAM 3 increase, one must agree that no
17 customer can be expected to comprehend this. I should add
18 that Puget's rate moderation proposal further complicates an
19 alh already complex ~~rate~~ revenue collection scheme.
20
21 Q. Is PRAM an improvement over the traditional ratemaking
22 process?
23 A. No. However, the evaluation of the PRAM in this context
24 must be considered in light of what one is measuring. The
25 Staff continues to be concerned that the Company is given

1 rate increases and additional revenues without an
2 examination of underlying costs. The mechanism itself may
3 produce unexpected results; this is particularly troubling
4 when the rates are not tied to a review of all costs.
5 The Staff continues to be concerned about the issue of
6 risk allocation. The PRAM mechanism shifts significant
7 risks to ratepayers without sufficient compensation.
8 However, all of these elements must be weighed against the
9 Company's assertion that the mechanism was a necessary
10 condition to Puget's pursuit of the resource strategy
11 identified in its least cost plan. I discuss and develop
12 these issues later in my testimony.
13 Q. Are there any other issues related to the evaluation of the
14 PRAM that the Commission should consider?
15 A. Yes. It is very important to recognize that PRAM is both a
16 decoupling and a resource recovery mechanism. Puget in its
17 initial direct case made that distinction clear since it
18 filed for new rates on the basis of no decoupling, but it
19 did file a resource recovery mechanism. Decoupling and
20 resource recovery mechanisms are separable. The critical
21 issue is whether each element is needed to pursue the goals
22 of least cost planning. From the Staff's perspective the
23 decoupling proposal was accepted by the Commission to solve
24 the lost revenue issue associated with acquiring
25 conservation. The resource recovery element was accepted to

1 provide recovery of new resources, principally purchased
2 power, and to remove the impacts of hydro variations on the
3 Company.
4
5 Q. Are there any other issues the Commission determined should
6 be addressed by the Company and other parties in this
7 proceeding?
8 A. Yes, in Docket No. UE-920630 the Commission identified the
9 following issues that should be addressed:
10 1) Theoretical inconsistencies between historical test
11 year with pro forma results of operations and PRAM
12 projections.
13 2) Logistics of the PRAM 3 cycle and general rate case
14 filing; (This area has been further complicated by the
15 Company's rate moderation proposal.)
16 3) Resource acquisition; thermal plant availability and
17 the prudence of recent power purchases.
18 4) Conservation; amortization period, tax benefits and the
19 IRS settlement, advertising expenses and an examination
20 of the link between PRAM and conservation.
21 5) Re-examination of the Base and Resource categories.
22
23 Other Staff witnesses will evaluate these issues in
24 depth. I would like to comment on the last item here since
25 it relates to my previous discussion concerning the criteria

1 for evaluating the PRAM.

2

3 Q. What comments do you have regarding the issue of
4 classification of revenues (costs) between Base and Resource
5 categories?

6 A. First, and most important, the current classification of
7 costs between base and resource categories is highly
8 favorable to Puget. Resource costs are permitted full
9 recovery through the Simplified Dispatch Model (SDM). These
10 costs are increasing faster than inflation, energy sales,
11 customers or any other comparable index. On the other
12 hand, costs classified in the base category are either
13 declining, stable, or increasing moderately but they are
14 decoupled, providing Puget with an opportunity to increase
15 rates and revenues on the basis of customer growth. It was
16 clearly established in the direct testimony of Mr. O'Meara
17 of WICFUR in Docket No. UE-901184-P that there is <u>no</u>
18 relationship between the rate of growth in customers to the
19 rate of growth in base costs. It is Staff's view that the
20 base cost category, as constructed, is simply an attrition
21 adjustment without justification. Staff's proposal is to
22 classify revenues (cost) between the two categories in a
23 principled manner.

24 An additional problem with the PRAM is that the
25 mechanism provides for additional revenues to Puget through

1 higher rates for service without an evaluation of Puget's
2 underlying costs. The Company's assertion that PRAM is
3 cost-based is incorrect. Even though it is true that the
4 rate per customer remains constant between general rate
5 proceedings (Ex. T-502, p. 14), the application of the rate
6 to customer counts to determine a portion of Puget's revenue
7 requirement fails the cost test. Between rate proceedings,
8 we do not measure whether in fact these test period
9 relationships between revenues and costs remain valid, yet
10 we increase rates as if they do.
11
12 Q. Are there any other issues related to the classification of
13 revenues (costs) between the two categories that should be
14 addressed by the Commission?
15 A. Yes. Another element of the decoupling proposal that is
16 highly favorable to Puget is the failure to distinguish the
17 different cost characteristics between customer classes for
18 the Base category. As it is currently structured, the
19 revenue per customer (RPC) calculation does not
20 differentiate between customer classes. The RPC should be
21 differentiated between the major customer classes for Puget:
22 residential; primary, secondary and high voltage; and firm
23 resale.
24
25 Q. Why is it important to differentiate the Base category

1 between the various customer classes?

2 A. The decoupling element of PRAM provides growth in revenue
3 based upon the total number of customers served. If during
4 a general rate proceeding the RPC is calculated as an
5 aggregate number for all customers, and the rate of growth
6 in customers during subsequent PRAM cycles is not
7 proportional to the test period customer mix that
8 established the undifferentiated RPC, Puget could either
9 over- or under-collect its Base revenues. As it stands now,
10 Puget receives favorable treatment because customer growth
11 patterns are not proportional and are skewed to the smaller
12 sized customer classes.
13
14 Q. Has this issue been raised in previous proceedings?

15 A. Yes. Both Staff and Public Counsel discussed the potential
16 for this bias in Docket No. UE-901184-P. The Commission
17 directed the Company to modify its cost-of-service model to
18 compute RPC on a class-specific basis. In Docket No. UE-
19 910689 Staff raised the issue again. Staff estimates Puget
20 has over-collected $3.6 million during the PRAM 2 cycle due
21 to this factor in the decoupling calculation.
22
23 Q. How should this issue be resolved?

24 A. If the Commission chooses to continue decoupling along
25 Base/Resource categories, it should order Puget to file

1 class-specific cost calculations in future PRAM proceedings.
2 Docket No. UE-920499 contains evidence of the basis for cost
3 allocation between each customer class. Each customer class
4 can then be allocated appropriate Base costs, which will
5 provide a class-specific RPC.
6
7 Q. The Company, in its evaluation of the PRAM through
8 supplemental testimony, analyzed the issues identified by
9 the Commission in its Notice. What other issues regarding
10 the PRAM evaluation did Puget address in its supplemental
11 testimony?
12 A. The Company argued several points. First, it claimed that
13 rates continue to be cost-based under PRAM. It discussed
14 attempts by several parties to re-litigate issues in the
15 context of a PRAM proceeding, which should automatically
16 calculate a new revenue requirement and adjust rates
17 accordingly. It argued that under PRAM its revenues are
18 lower than they would be if the Company were under
19 traditional regulation. Puget argued that poor hydro and
20 temperature are transitory in their effect on rates.
21 Finally, with respect to lost revenue, Mr. Sonstelie argues
22 that absent PRAM, Puget would have lost $4.6 million in
23 1991, and $9 million in 1992 due to Puget's investment in
24 conservation resources during those two years. (Ex. T-502,
25 p.16)

1 Q. Are the rates that result from a PRAM proceeding cost-based?
2 A. No, for the reasons I gave previously.
3
4 Q. Is it fair for Puget to criticize other parties' efforts to
5 re-litigate certain issues?
6 A. No. Since the Commission accepted Puget's proposal in its
7 entirety, the parties were merely trying to cope with
8 elements of the PRAM that provided favorable treatment to
9 the Company in light of a substantial rate increase.
10 Moreover, the "shaping" and customer count issues raised by
11 the parties were not specifically resolved in the
12 Commission's Order establishing the PRAM. These items
13 should have been addressed.
14
15 Q. Is the Company's claim that revenues are lower under the
16 PRAM substantiated?
17 A. No, for two reasons. First, the Company is attempting to
18 confuse revenues with rates implying that under traditional
19 ratemaking <u>rates</u> would be higher. This is simply improper.
20 Admittedly, we will never know "what would have been"
21 during this experimental period under traditional
22 ratemaking. However, there are several things we do know
23 about the mechanism and its impact on the Company. Puget
24 would have been in the same position as all jurisdictional
25 energy companies in coping with the unusually warm winter of

1 1991/1992: its earnings would have been severely impacted.
2 The PRAM insulated Puget from weather's impact on its
3 earnings. Therefore, <u>both</u> Puget's rates and revenues are
4 higher than they would be under traditional ratemaking.
5 Second, Staff takes exception to the assumptions
6 underlying Puget's claim. Puget assumes that its proposed
7 Energy Adjustment Mechanism guarantees full recovery of all
8 resource costs. (Ex. T-533, p.5) Once that assumption is
9 made, Puget's conclusion becomes true since it is further
10 assumed that energy sales grow at a faster rate than do
11 customers.
12
13 Q. Is the Company's analysis concerning lost revenue due to
14 conservation investment valid?
15 A. No. It is not correct because the Company failed to take
16 into account the costs avoided in selling that energy. It
17 could be argued that for every kilowatt hour conserved,
18 Puget gains profit margin. That calculation depends on what
19 one considers as the incremental resource cost to Puget in
20 making any incremental energy sale. For example, if one
21 were to assume that for each kilowatt hour Puget conserves
22 and the value of the saved energy would be equal to Puget's
23 avoided cost, then Puget would gain margin from conserving
24 energy.
25

1 Q. What other issues remain with the PRAM?

2 A. There is no quantitative evidence provided by Puget to
3 demonstrate that the Company's experiment with decoupling
4 has been a success in achieving a least cost mix of
5 resources. The Company has not demonstrated that its
6 current resource strategy will in fact produce the lowest
7 overall long term revenue requirement. The Company's
8 presentation points to conservation investments, purchases
9 of new power and other resource acquisition strategies, but
10 the fact remains that the Staff is unable to tell whether
11 these new resources and the associated cost increases truly
12 reflect a least cost resource strategy.

13 This point deserves emphasis. Clearly, if the existing
14 resource strategy were least cost, there should be an
15 analysis of an alternate "resource stack" with which to
16 compare Puget's selected alternative. For example, Puget
17 did not compare its current resource strategy with resources
18 purchased from BPA under the New Resource Rate Schedule, nor
19 did Puget compare its resource strategy of company ownership
20 of the resources, primarily large thermal cogeneration
21 projects. There is no comparison of the existing resource
22 stack and its revenue requirements with any other
23 alternatives.

24

25

1 LEAST COST PLANNING

2

3 Q. You've stated that the Company's evaluation of its resource
4 strategy is not quantitative. Isn't it true that the
5 resources included in this general rate case are the types
6 of resources identified by Puget in its least cost plan?
7 A. Yes, they are, but only in the most general terms. This is
8 precisely why the current least cost planning process cannot
9 be used to prove that Puget's resource acquisitions are
10 least cost from a revenue requirements perspective. There
11 is no quantitative evidence and explicit cost analysis
12 linking the planning process and the rate-setting process.
13 The Company's current least cost plan is a perfect
14 example of this phenomena. While reference is made to a
15 particular resource strategy in the action plan for the
16 upcoming two year period, there is no statement with respect
17 to the impact this strategy will have on rates or long-term
18 revenue requirements. There also is no specific standard
19 for measuring the particular strategy against any other
20 viable alternate resource strategy. The only reference to
21 any such "standard" I can find is Puget's reference to
22 avoided cost. It is presumed that if the utility's actions
23 to acquire new resources meet this "standard", that strategy
24 is least cost.
25 If during the 1989 planning cycle the Company had

1 informed us that the rates resulting from the plan would
2 result in multiple requests for significant rate increases,
3 I believe parties would have been asking for an evaluation
4 of the long-term revenue requirements and rate impact of
5 alternative resource scenarios for comparison purposes.
6 I would like to make an additional observation about
7 the least cost planning process. In this proceeding, Puget
8 has for the very first time quantified what it views to be
9 the impact of purchased power on its capitalization ratios.
10 Also, this is the first time Puget has ever asserted that
11 conservation investments are 100 percent equity financed.
12 Indeed, a 45 percent equity ratio for Puget has tremendous
13 effect on its overall revenue requirements. Furthermore, if
14 conservation can only be financed with equity, the cost-
15 effectiveness of this resource must be seriously questioned.
16 Puget's 1989 and 1991 Least Cost Plan fails to include any
17 quantification of these items. If the 1991 Plan included
18 these numbers, an entirely different resource stack may have
19 emerged.
20
21 Q. What specific changes to the least cost planning process
22 would you recommend to solve this problem?
23 A. The Staff is not recommending any specific changes to the
24 rule at this time. Staff is recommending that the
25 Commission provide policy direction on both the intent and

1 spirit of WAC 480-100-251. As the rule is currently
2 crafted, there is no quantitative rigor underlying the rate
3 consequences of specific resource decisions. The rule does
4 serve a valid and useful purpose. It provides an
5 opportunity for companies to inform the public about their
6 resource planning process, discuss various resource options,
7 evaluate both demand and supply side resources, and receive
8 public comment on various options. However, the current
9 rule is not rigorous enough to warrant the elimination of
10 Puget's obligation to demonstrate in a rate proceeding that
11 its specific resource decisions are in fact least cost.
12 Puget's effort to liken the current planning process to a
13 prudence review process is disturbing.
14 If the Commission were desirous of further refinements,
15 the current rule could be expanded to include more
16 quantitative rigor, e.g. the requirement that a company
17 demonstrate the long-term revenue requirement of various
18 resource scenarios. This change would require considerable
19 resources by all parties involved. It would also require
20 more involvement by the Commission. The end result could be
21 closer to Commission approval of a specific resource
22 strategy. Even though such a change would move the
23 Commission into relatively uncharted waters, it may be
24 preferable to the current process where there is no direct
25 link between the planning process and the rate-setting

1 process.

2

3 ALLOCATION OF RISK

4

5 Q. Mr. Elgin, you have described several technical problems
6 with the mechanism. Are there any significant policy issues
7 that have not been addressed at all by the Company?
8 A. Yes, the most important issue which must be resolved in this
9 proceeding is the allocation of risk between shareholders
10 and ratepayers. The PRAM has shifted significant elements
11 of Puget's business risk from shareholders to ratepayers (TR
12 708, 727, 760). One of the most troubling aspects of this
13 proceeding is Puget's failure to adequately address this
14 development. Staff is further troubled by Puget's message
15 in its direct case: PRAM and its underlying resource
16 strategy imposes additional risks to the Company, and the
17 Company therefore requires additional compensation for these
18 new risks. What the Company has asked for in its rate of
19 return on common equity and its capital structure is
20 excessive. The request is inconsistent with the risk
21 transfer characteristics of the mechanism. In summary, the
22 Commission must make a policy determination regarding what
23 Puget should earn in a decoupled environment where earnings
24 variability due to hydro, temperature, and economic
25 conditions have been transferred to ratepayers. Puget

1 shareholders should no longer be compensated for risks they
2 are not facing.
3
4 Q. You have discussed both technical and policy issues
5 surrounding the PRAM. Is decoupling necessary?
6 A. No, it is not necessary. First, the demand for electricity
7 is derived. In other words, Puget has little, if any,
8 influence on the demand for its service. The demand is a
9 function of general economic and demographic factors rather
10 than a function of any utility marketing effort. Second,
11 and most critically, no prudent utility would proceed on a
12 course of promoting electricity sales. Unless it can be
13 demonstrated that there is a new "golden era" for electric
14 utilities where increased growth results in declining costs
15 (a highly unlikely scenario for the foreseeable future), a
16 rational utility, particularly a utility faced with
17 significant growth, responds by pursuing least cost
18 resources. As a part of that strategy, a prudent utility
19 should do everything in its power to effectively manage
20 demand, and control costs. This includes the aggressive
21 acquisition of low-cost efficiency investments. In such an
22 environment, decoupling should not be necessary.
23
24 Q. Is it Staff's recommendation to abandon the PRAM at this
25 time?

1 A. No. I agree with the testimony of Messrs. Miller and Olsen
2 that uncertainty is what investors abhor. (Tr. 722,763) The
3 investment community is seeking some assurance of stability
4 from the Commission regarding the PRAM. The Staff is
5 therefore recommending modifications to the PRAM, and is
6 asking for policy direction concerning the level at which
7 Puget should earn, in light of the fact that Puget is no
8 longer facing the earnings variation endemic to the
9 traditional regulatory structure. This risk issue must be
10 resolved by any utility embarking on a path of regulatory
11 reform, which includes a resource recovery mechanism and
12 decoupling. The financial community must also recognize
13 this fact. In such an environment investors should no
14 longer be compensated for risks that have been transferred
15 to the ratepayer.

16 Staff cannot say that the technical modifications it is
17 proposing remedy the problems identified above since 1) the
18 mechanism continues to adjust rates without a review of
19 costs, 2) it continues to pose implementation problems, and
20 3) deferred accounting will continue to add complexity to
21 consumers' understanding of the rate-setting process for
22 Puget.

23 The PRAM and the decoupling aspect of the mechanism
24 offer significant benefits, however. The Company has
25 aggressively pursued conservation resources, which have been

1 declared a high priority resource under both Washington and
2 federal law. The Company can pursue more rational rate
3 designs since the Company is no longer concerned with
4 recovering its revenue requirement under various energy
5 sales scenarios. There is substantially less variabliity in
6 Puget's earnings. This should provide a benefit to
7 ratepayers through lower cost of money, and stability to
8 shareholders because Puget's earnings are more predictable.
9
10 PURCHASED POWER AND ASSOCIATED RISKS
11
12 Q. The Company has presented several witnesses who assert that
13 certain elements of its least cost resource strategy impose
14 additional risks on the Company. Do you have any general
15 comments regarding this issue?
16 A. Yes, I do. Staff continues to be concerned about Puget's
17 apparent inability to convince both Wall Street analysts and
18 Puget's shareholders of PRAM's benefits. Instead, Puget
19 presented two consultants to tell the Commission how much
20 additional risk purchased power imposes on the utility.
21
22 Q. Please describe Staff's concerns regarding the purchased
23 power issue?
24 A. While Dr. Lurito responds in greater detail to this issue,
25 Staff is concerned with Puget's inability to adequately

1 distinguish to investors the unique operating
2 characteristics of its low cost hydro system with those of
3 other utility systems. Many of its purchased power
4 contracts are for extremely low cost hydro.
5
6 Q. Is purchased power a debt equivalent?
7 A. No. The "debt equivalent" arguments Puget advances are also
8 inconsistent with the type of electric industry contemplated
9 by recently enacted federal legislation. The policy
10 direction is designed to introduce competition into the
11 wholesale generation market. Purchased power, particularly
12 any contract for low cost hydro, is not a debt equivalent.
13 Rather, it is a contract to purchase a commodity and, like
14 any commodity contract, it has intrinsic market value. It
15 cannot be compared to the Company's investment in
16 distribution and transmission facilities. Puget's
17 commitment to purchased power will always be tied to the
18 general market for electric supply. With the region
19 currently in a deficit position, with no large thermal
20 resources being planned, those contracts are more of an
21 asset than a liability. Mr. Weaver testified the Mid-
22 Columbia contracts are more of an asset since these
23 resources are so inexpensive compared to other power.
24 (Deposition of Mr. Weaver, Ex. 579, p. 59-60) In view of
25 the region's deficit, Puget's other purchased power

1 contracts should be viewed as more of an asset as well. The
2 risk analyses offered by Puget and its consultants ignore
3 these facts.

4 Furthermore, the analysis offered by Puget's
5 consultants is too generic. Its broad-based approach
6 clearly does not differentiate among utilities and the
7 unique operating characteristics of each utility. It fails
8 to quantify regulatory support for purchased power as an
9 effort to pursue the goals of least cost planning. Puget's
10 cost of purchased power under the PRAM is guaranteed
11 recovery through rates. The impact of earnings stability is
12 highly significant. I have not seen any quantitative
13 analysis by Puget addressing this aspect of Puget's
14 financial profile, nor do I see any explicit statement in
15 Puget's annual report to shareholders to that effect.

16 I also want to point out what appears to be differing
17 treatment between electric and gas utilities. I do not know
18 of any similar debt equivalent analysis performed by rating
19 agencies for purchased gas costs for gas distribution
20 companies. As the electric industry adapts to the federal
21 policy direction designed to create a competitive market
22 place for wholesale electric generation, electric utilities
23 will begin to look more like gas distribution utilities.
24 The critical issue in the gas industry is the purchased gas
25 cost adjustment mechanisms that track the cost of gas.

1 Something similar may well become necessary for electric
2 utilities. The PRAM accomplishes this, <u>now</u>.
3 Exhibit____ (KLE-2) is an April 1991 article from <u>The</u>
4 <u>Electricity Journal</u> entitled, "Risky Business? The Case for
5 Independents" for Commission consideration on the issue of
6 purchased power risk. It puts forth the proposition that
7 purchased power actually reduces the risk of a utility
8 seeking new generation. The article indicates that the only
9 risk that the decision to purchase rather than build cannot
10 alleviate to some degree is the demand risk - i.e. will the
11 load grow sufficiently to absorb the new power production?
12 As Mr. Sonstelie points out, the region is moving into a
13 deficit position, therefore the demand risk is minimal.
14
15 <u>TANNER/PUGET/NINTENDO</u>
16
17 Q. One of the issues discussed by the Commissioners during the
18 hearings for the second PRAM was related to the decision by
19 Puget to serve a large commercial customer, Nintendo. Is
20 the Staff proposing any adjustment in this case to the
21 results of operations to account for the Company's decision
22 to serve this customer?
23 A. Yes. The Staff is proposing to remove all test period
24 expenses associated with the litigation, as non-recurring.
25 Receipts from energy sales to Nintendo remain since Puget is

1 decoupled. In subsequent PRAM filings the customer count
2 will be adjusted to remove Nintendo from the count. The
3 last adjustment Staff will propose is a permanent adjustment
4 to the SDM to remove the highest cost resource Puget
5 acquires at any future point in time by the actual kilowatt
6 hour load placed upon Puget by Nintendo. Mr. Martin
7 provides the calculation to remove the litigation expense,
8 and Mr. Moast provides the change to the SDM to incorporate
9 the adjustment for resource costs.
10
11 Q. Please explain your understanding of the Tanner
12 Electric/Puget Power dispute.
13 A. Nintendo of America, Inc. built its distribution facility in
14 North Bend, Washington. The facility was located in
15 Tanner's serving area as described in the service area
16 agreement (Agreement) approved by the Commission in 1974,
17 Cause U 73-44. A portion of the land was also located in
18 Puget's serving area under that Agreement.
19 Tanner provided electricity to the site during the
20 construction phase, but Puget, upon request by Nintendo,
21 began serving the facility on January 17, 1991. At that
22 time Puget took the position that it was obligated to honor
23 that request for service under RCW 80.28.110. Pursuant to
24 the terms of the original service area agreement, Puget
25 terminated the contract effective September 27, 1991.

1 Tanner sued Puget for breach of the service area
2 agreement, tortious interference with Tanner's valid
3 business expectancy, and violation of the Consumer
4 Protection Act.
5 On March 14, 1993, the jury found for Tanner on each of
6 these counts and awarded Tanner damages in the amount of
7 $2.5 million. Counsel has advised me that Tanner's damages
8 case was predicated on the theory that had Puget not
9 breached the agreement or interfered with Tanner's valid
10 business expectancy, Nintendo would have had no objective
11 reason to leave Tanner.
12
13 Q. Did Tanner come to the Commission when the dispute first
14 arose?
15 A. Yes. On December 27, 1990 Tanner filed a Petition for a
16 Declaratory Order with the Commission in Docket No. UE-
17 901596, asking whether Puget was obligated to serve
18 Nintendo, and whether the Commission could enforce the terms
19 of the Agreement. Puget was a party to that proceeding.
20
21 Q. Did the Commission issue an order in that case?
22 A. Yes. On March 24, 1991 the Commission issued its
23 Declaratory Order, and on April 22, 1992 its Order on
24 Reconsideration pursuant to Puget's request for rehearing.
25 Copies of these orders are attached as my Exhibits ______

1 and _____ (KLE-3, KLE-4) respectively.

2

3 Q. Did the Commission find that Puget breached the Agreement?

4 A. No. The Commission deferred interpretation and enforcement

5 of the Agreement to Superior Court. It did reason, however,

6 that Puget did not have an obligation under RCW 80.28.110 to

7 serve Nintendo under the assumed facts.

8

9 Q. Did your counsel provide you with copies of the jury's

10 verdict and the court's instructions to the jury in the

11 Tanner/Puget litigation?

12 A. Yes. They are included as my Exhibit _____, (KLE-5).

13

14 Q. Did the court instruct the jury on Tanner's ability to

15 provide service?

16 A. Yes. I have been advised by counsel that Instruction ~~2.1~~ 2.01 alh is

17 that instruction.

18

19 Q. In your opinion, was Puget prudent in serving Nintendo's

20 facility at North Bend?

21 A. No. Puget should have declined to serve. The Staff

22 repeatedly indicated to Puget that it did not have an

23 obligation to serve that customer.

24

25 Q. Should Puget have declined to serve after the service area

1 agreement was terminated?

2 A. Yes. From my perspective, the obligation to serve a
3 customer that has adequate electric service available from
4 another electric utility is not absolute. At a minimum,
5 Puget should have come to the Commission to resolve this
6 issue prior to serving Nintendo.

7

8 CONSULTANT COSTS AND RATE CASE EXPENSE

9

10 Q. As shown in Exhibit ~~588~~ 558, p. 2.26, the Company is proposing
11 some $715,000 in rate case expenses to be amortized over two
12 years. Is the Staff proposing any adjustment to that level
13 of expense?

14 A. Yes. Of the $715,000 proposed rate case expense, $200,000
15 is for the cost of consultants. Those expenses should be
16 adjusted. Puget has, or should have, sufficient staff
17 expertise to present its position regarding rate of return
18 and financial risks of purchased power before the
19 Commission. The exception to this is the need for an
20 independent evaluation of Puget's recording of the liability
21 created by SFAS 106. The reasonable expenses associated
22 with the verification of compliance with SFAS 106 should be
23 included in rates.

24 This adjustment also goes to the very heart of Staff's
25 concerns about Puget's presentation. Puget should be more

1 effective in its communications with the financial community
2 in explaining the significant investor benefits of the
3 Commission's experiment with decoupling and regulatory
4 reform. From the Staff's perspective, the only beneficiary
5 of these consultants is the shareholder who, therefore,
6 should pay the costs.
7 The remaining $515,000 for legal fees is also
8 excessive. Puget is entitled to representation in the rate
9 setting process, but there must be limits. Full recovery of
10 such excessive litigation costs sends the message that
11 complicated rate hearings serve ratepayer interests. In her
12 testimony, Ms. Kelly, notes that the efficiency report from
13 the consulting firm, Towers Perrin, registered concern over
14 Puget's apparent inability to control its legal costs.
15 Staff recommends that only half of the legal fees be
16 included with a three year amortization.
17
18 CONSERVATION FINANCING
19
20 Q. You indicated earlier in your testimony that you planned to
21 discuss the issue of conservation financing. What is the
22 basis for this discussion?
23 A. Mr. Weaver in his supplemental testimony Ex. T-504,
24 discussed the need to convert Puget's investment in
25 conservation from a regulatory asset to a statutory asset.

1 As the Commission is well aware, Puget attempted significant
2 changes to Title 80 RCW to effectively guarantee its
3 recovery of investments in conservation. During this
4 proceeding I worked on the Company's specific legislative
5 proposal to accomplish this objective. While the proposal
6 was put on hold for the 1993 legislative session, it will be
7 considered again next session and the Commission will need
8 to respond at that time.
9
10 Q. What is the specific policy issue Staff sees regarding the
11 financing and acquisition of conservation resources?
12 A. The issue is this: who pays for the resource? Puget's
13 approach is to have all ratepayers pay for the resource with
14 the participating customer contributing a portion of the
15 cost. This is in direct contrast with Pacific Power & Light
16 Company's energy service charge (ESC) concept where the
17 participating customer pays for the entire measure through
18 lower electric bills. Pacific provides for the financing
19 and the customer pays for the measure through the electric
20 bill. The customer's total bill is lower and other
21 customers who do not participate do not have the rate
22 pressure associated with conservation acquisition.
23 As the Commission evaluates various programs for
24 acquiring conservation it should keep in mind how this
25 resource is to be financed. Staff recommends that any

1 discussion concerning financing be delayed until the
2 Commission has sufficient information to determine the most
3 cost-effective method for acquiring this resource. At that
4 time, the issue of financing will be ripe for consideration.
5
6 Q Does that conclude your testimony?
7 A. Yes.
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