

1 BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

2

3 PETITION OF PUGET SOUND POWER) GENERAL RATE CASE
 & LIGHT COMPANY FOR AN ORDER)
 4 REGARDING THE ACCOUNTING) DOCKET NO. UE-920433
 TREATMENT OF RESIDENTIAL)
 5 EXCHANGE BENEFITS)

-----)
 6 WASHINGTON UTILITIES AND)
 TRANSPORTATION COMMISSION,)
 7)
 Complainant,)

8 vs.) DOCKET NO. UE-920499

9)
 PUGET SOUND POWER & LIGHT)
 10 COMPANY,)
)
 11 Respondent.)

-----)
 12 WASHINGTON UTILITIES AND)
 TRANSPORTATION COMMISSION,)
 13)
 Complainant,)

14 vs.) DOCKET NO. UE-921262

15)
 PUGET SOUND POWER & LIGHT) VOLUME XIX
 16 COMPANY,) PAGES 3201 - 3404
)
 17 Respondent.)

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19 A hearing in the above matter was held on
 20 June 10, 1993 at 9:00 a.m., at 1300 South Evergreen
 21 Park Drive Southwest, Olympia, Washington, before
 22 Commissioners RICHARD CASAD, RICHARD HEMSTAD,
 23 Chairman SHARON NELSON, and Administrative Law Judge
 24 ALICE HAENLE.
 25 Cheryl Macdonald, RPR, CSR, Court Reporter

1 The parties were present as follows:

2 WASHINGTON UTILITIES AND TRANSPORTATION
3 COMMISSION STAFF, by DONALD T. TROTTER and SALLY G.
4 BROWN, Assistant Attorneys General, 1300 South
Evergreen Park Drive Southwest, Olympia, Washington
98504.

5 FEDERAL EXECUTIVE AGENCIES, by NORMAN
6 FURUTA, Associate Counselor, Department of Navy,
7 Western Division, 900 Commodore Drive,
Bldg. 107, (Code 09C), San Bruno, California
94066-2402.

8 NORTHWEST CONSERVATION ACT COALITION, by
9 JON WELLINGHOFF, Attorney at Law, 710 South Fourth
Street, Las Vegas, Nevada 89101-6750.

10 PUGET SOUND POWER & LIGHT, by JAMES VAN
11 NOSTRAND and STEVEN C. MARSHALL, Attorneys at Law,
411 - 108th Avenue NE, Bellevue, Washington 98004.

12 WASHINGTON INDUSTRIAL COMMITTEE FOR FAIR
13 UTILITY RATES, by MARK P. TRINCHERO, 2300 First
14 Interstate Tower, 1300 Southwest Fifth Avenue,
Portland, Oregon 97201.

15 PUBLIC INTEREST, by CHARLES F. ADAMS,
16 Attorney at Law, Suite 2000, 900 Fourth Avenue,
Seattle, Washington 98164.

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I N D E X

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WITNESS: DIRECT CROSS REDIRECT RECROSS EXAM

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D. PARCELL 3206 3208 3234

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R. CAVANAGH 3253 3255 3291

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T. POWER 3333 3335 3367 3364

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D. PESEAU 3376 3378 3401

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EXHIBIT MARKED ADMITTED

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T-809 3205 3205

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T-810 3206 3207

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811-819 3206 3207

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820 3211 3212

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T-821 3253

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T-823 3333 3335

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824-825 3335 3335

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T-826 3376 3378

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827-831 3376 3378

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1 P R O C E E D I N G S

2 JUDGE HAENLE: The hearing will come to
3 order. This is a 19th day of hearing in consolidated
4 Puget cases. This is June 10, 1993 and the hearing is
5 taking place before the Commissioners. This is the
6 general rate case phase of the hearing. We have a few
7 different faces this morning, different than we had
8 yesterday. If you would give your name and your
9 client's name beginning with the company.

10 MR. VAN NOSTRAND: For the company James M.
11 Van Nostrand and Steven C. Marshall.

12 MR. TROTTER: Donald T. Trotter and Sally G.
13 Brown for the Commission.

14 MR. FURUTA: Norman G. Furuta for the
15 Federal Executive Agencies.

16 MR. WELLINGHOFF: Jon Wellinghoff for the
17 Northwest Conservation Act Coalition.

18 MR. RICHARDSON: Peter J. Richardson on
19 behalf of WICFUR.

20 JUDGE HAENLE: Any procedural or
21 preliminary matters we need to cover this morning?

22 It's my understanding that we will be
23 taking the NCAC witnesses first, beginning with Mr.
24 Parcell, then Mr. Power, then Mr. Cavanagh and finally

25 the WICFUR witness. We did discuss, though, before we

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1 went on the the record, that the parties had agreed at
2 the request of Ms. Williams that they did not need Mr.
3 Watson for cross-examination. So I have marked the
4 prefiled testimony of Mr. Watson as T-809 and as I
5 understand that testimony will be entered at the
6 request of NCAC by agreement of the parties. Is that
7 your understanding, Mr. Wellinghoff?

8 MR. WELLINGHOFF: Yes, your Honor. At this
9 time we would move for the introduction into evidence
10 of T-809 based upon that agreement.

11 JUDGE HAENLE: Mr. Marshall or Mr. Van
12 Nostrand, which one of you --

13 MR. MARSHALL: That's all right with us.

14 MR. TROTTER: No objection.

15 MR. FURUTA: No objection.

16 MR. RICHARDSON: No objection, your Honor.

17 JUDGE HAENLE: T-809 will be entered into
18 the record.

19 (Marked and Admitted Exhibit T-809.)

20 JUDGE HAENLE: Also, then, during the time
21 we were off the record Mr. Parcell assumed the stand.
22 During the time we were off the record I marked a
23 number of documents for identification as follows:
24 Marked as T-810 for identification is a multi-page

25 document entitled Direct Testimony of David C. Parcell.

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1 In the upper right-hand corner has DCP-1.

2 811 for identification background and
3 experience, DCP-2.

4 Exhibit 812 -- DCP-3 will be 812 for
5 identification.

6 DCP-4 will be 813.

7 DCP-5 will be 814.

8 DCP-6 will be 815.

9 DCP-7, 816.

10 DCP-8, 817.

11 DCP-9, 818.

12 And DCP-10, 819 for identification.

13 (Marked Exhibits T-810, 811 through 819.)

14 Whereupon,

15 DAVID PARCELL,

16 having been first duly sworn, was called as a
17 witness herein and was examined and testified as follows:

18

19 DIRECT EXAMINATION

20 BY MR. WELLINGHOFF:

21 Q. Mr. Parcell, would you please state your
22 name and business address for the record.

23 A. David C. Parcell, 8 North Harrison Street,
24 Richmond, Virginia, 23220.

25 Q. In Exhibits T-810 your direct testimony and
(PARCELL - DIRECT BY WELLINGHOFF) 3207

1 Exhibits No. T-811 through 819, were they prepared by
2 you or under your direction?

3 A. Yes.

4 Q. Do you have any corrections to those?

5 A. Very quick and simple. First on page 2 of
6 line 9 reference is made to DCP-1. That should really
7 be DCP-2.

8 Q. Next one, Mr. Parcell?

9 A. Page 20, line 8 at the very end of that line
10 is the year 1983. That should be 1984.

11 Q. With those corrections, Mr. Parcell, if I
12 were to ask you the questions contained in Exhibit No.
13 T-810 today would your answers be the same?

14 A. They would.

15 MR. WELLINGHOFF: Your Honor, I would move
16 for the introduction of Exhibits T-810 and 811 through
17 819.

18 MR. MARSHALL: No objection.

19 MR. TROTTER: No objection.

20 MR. ADAMS: No objection.

21 MR. FURUTA: No objection.

22 MR. RICHARDSON: No objections, your Honor.

23 JUDGE HAENLE: Exhibits T-810 and 811
24 through 819 will be entered into the record.

25 (Admitted Exhibits T-810, 811 through

(PARCELL - DIRECT BY WELLINGHOFF)

3208

1 819.)

2 MR. WELLINGHOFF: Witness is available for
3 cross-examination.

4

5 CROSS-EXAMINATION

6 BY MR. MARSHALL:

7 Q. Good morning, Mr. Parcell.

8 A. Good morning.

9 Q. As I understand the main thrust of your
10 testimony you've addressed the issue of how the
11 financial aspects of decoupling and demand-side
12 management are viewed by the analyst, investor
13 analysts, rating agencies and so forth; is that
14 correct?

15 A. That is correct.

16 Q. And in doing this you took a look at a lot
17 of the reports that have come out from the various
18 analysts and rating agencies on decoupling, PRAM in
19 general and Puget Power specifically; is that correct?

20 A. That is true.

21 Q. And I take it that one of the things that
22 you looked at beginning at page 8 were the Standard &
23 Poor's report of March 30, 1992 and Credit Week?

24 A. Yes.

25 Q. On demand-side management? You identified

(PARCELL - CROSS BY MARSHALL)

3209

1 that as being the most comprehensive analysis of DSM
2 by a rating agency?

3 A. Of the ones that I have found, that's
4 correct, yes.

5 Q. Do you know who it was in particular who
6 did that analysis at Standard & Poor's?

7 A. I don't know from memory but let me see if
8 the name is stated. Yes. Would you like me to tell
9 you?

10 Q. Yes, please.

11 A. I am on Exhibit 812 on the very last page,
12 which is the Standard & Poor's Credit Week is page 51
13 and the very last thing we see is the name of what
14 appears to be the author. That's Cheryl E. Richer,
15 R I C H E R.

16 Q. Since March 30, 1992, has this author
17 prepared any further analysis of demand side
18 management that you're aware of?

19 A. Well, the same article appeared in an
20 additional Standard & Poor's publication, just give
21 you a brief overview of this. Standard & Poor's Credit
22 Week comes out every week during the year and once or
23 twice during the calendar year Standard & Poor's
24 publishes a special addition on utilities, that is the

25 water, gas and electric utilities. And when they do

(PARCELL - CROSS BY MARSHALL)

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1 that many of the articles that appeared previously in
2 the individual Credit Weeks are reprinted. So this
3 same article appeared again. I am not aware that she
4 has published other articles on DSM since then.

5 Q. At page 13, lines 37 and over to page 14,
6 line 2, you discuss the three stages of the history of
7 PRAM and in summary you said first, when it was first
8 initiated it was viewed with optimism, then it was
9 viewed and described in favorable terms as a mechanism
10 evolved, and then third following the Commission's
11 indicated dissatisfaction in September of 1992 the
12 agencies acted in a negative fashion. Is that a fair
13 summary of the three stages that you were discussing
14 there?

15 A. Yes.

16 Q. Now, the article that you referred to on DSM
17 at page 8 occurred on March 30, 1992 before that
18 September 1992 order that you referred to; is that
19 correct?

20 A. Yes. Although the article we've been
21 referring to is an article on DSM in general as
22 distinguishable from some specific articles on Puget
23 Sound, but technically you're correct, it appeared
24 prior to that.

25 Q. Have you reviewed the May 3, 1993 Credit
(PARCELL - CROSS BY MARSHALL)

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1 Week by Standard & Poor's by any chance?

2 A. In some context I have. I am not familiar
3 of a particular article on DSM, though.

4 MR. MARSHALL: I'm going to hand out the
5 next exhibit to be marked.

6 JUDGE HAENLE: You've handed me a multi-page
7 document. In the bottom it says Standard & Poor's
8 Credit Week, May 3, 1993. I will mark this as Exhibit
9 820 for identification.

10 (Marked Exhibit 820.)

11 Q. If you look at Exhibit 820, can you
12 describe to me what that is?

13 A. Certainly. It's an article from the May 3,
14 1993 Standard & Poor's Credit Week. It begins on page
15 50. The title of the article is Demand Side Management
16 Revisited.

17 Q. Who is the author of that?

18 A. The same Cheryl E. Richer who authored
19 Exhibit 812.

20 MR. MARSHALL: We offer this exhibit into
21 evidence.

22 JUDGE HAENLE: Any objection, Mr.
23 Wellinghoff?

24 MR. WELLINGHOFF: No objection.

25 MR. TROTTER: No objection.

(PARCELL - CROSS BY MARSHALL)

3212

1 MR. ADAMS: No objection.

2 JUDGE HAENLE: Objection from any
3 intervenor?

4 All right. Exhibit 820 will be entered
5 into the record.

6 (Admitted Exhibit 820.)

7 Q. Have you had a chance to review this May 3,
8 1993 article on Demand Side Management Revisited?

9 A. Just the first page.

10 Q. Before I get into -- you were aware of it
11 before I handed it to you; is that correct?

12 A. That is correct.

13 Q. Did you review any of the exhibits to Mr.
14 Elgin's testimony given here in these proceedings this
15 past week, by any chance?

16 A. No.

17 Q. Your indication of what the reaction was of
18 the investment analysts after the September 1992 order
19 came out, what was that based on?

20 A. I'm sorry, I don't follow your question.

21 Q. When you refer to on page 13 and 14 of your
22 testimony about the rating agencies reacting in a
23 negative fashion to the Commission's September 1992
24 order, what did you base that on?

25 A. Two things, actually. Actually even three

(PARCELL - CROSS BY MARSHALL)

3213

1 things. First of all, at the bottom of page 10 of my
2 testimony and the top of page 11 I will just expand on
3 this very briefly before I move on. An October 12
4 Credit Week Puget Sound's outlook was stable by
5 Standard & Poor's. However, two months later, December
6 21, the outlook was negative, on the top of page 11
7 now, and the reason for that -- reading on lines 3
8 through 7 -- "outlook negative, the outlook reflects
9 uncertainty regarding future regulatory treatment
10 including a continuation of experimental rate mechanism
11 which enhances financial stability."

12 The second thing that I was referring to on
13 pages 13 and 14 are the Duff & Phelps articles which I
14 have put in as Exhibit 814, and I have excerpted
15 relevant parts there that talks about the changing
16 attitude, if you will. And also, if you would go
17 through the individual reports on Puget Sound by Value
18 Line, you would get the same reactions. So those are
19 the three things I am referring to on 13 and 14.

20 Q. Did you make a review of the September 1992
21 order? Did you examine that specifically to see what
22 the Commission did?

23 A. I did not review the order. What I reviewed
24 was the financial community's description of it and

25 reaction to it, because I'm a financial analyst as

(PARCELL - CROSS BY MARSHALL)

3214

1 opposed to a policy witness. There are some policy
2 witnesses that are going to follow me so my task was to
3 try to view this through the eyes of the financial
4 community so my focus was on their write-ups of it. So
5 the short answer to your question is no.

6 JUDGE HAENLE: Remember to speak slowly.

7 THE WITNESS: I am from the south but I
8 must have some northern blood in me somewhere.

9 JUDGE HAENLE: Something is causing you to
10 speak quickly.

11 Q. Turn to page 53 of the exhibit that you have
12 -- I know you haven't had a chance to read it.
13 Referring you to the first full paragraph.

14 A. Which column?

15 Q. On the left-hand side where it says "another
16 example." Could you read that just briefly to
17 yourself?

18 A. Okay.

19 Q. Is that consistent with your view of the
20 financial analysts being somewhat skeptical now of
21 what might be the future changes to the PRAM
22 decoupling mechanism?

23 A. I was getting ready to say yes until you
24 used the word skeptical. I am not sure I would agree

25 with the use of that word. I think this paragraph

(PARCELL - CROSS BY MARSHALL)

3215

1 you just asked me to read to myself is consistent with
2 the summary I made on pages, bottom of page 13, top of
3 page 14. I don't know that I agree with the word
4 skeptical but it is consistent with the three phases
5 of the way it's been viewed as it pertains to the PRAM
6 mechanism of Puget Sound.

7 Q. There was testimony, prefiled testimony of
8 Mr. Elgin, in this case Exhibit T-670 where he said,
9 "I agree with the testimony of Messrs. Miller and
10 Olson that uncertainty is what investors abhor. The
11 investment community is seeking some assurance of
12 stability from the Commission regarding PRAM." Do you
13 agree with that general statement?

14 A. Really two general statements there, and I
15 agree strongly with one and fairly strongly with the
16 other. I will elaborate if you will allow me to. I
17 don't want to be an unresponsive witness. The question
18 if the financial community abhors uncertainty, which is
19 why when we have inflation we have high interest rates,
20 for example, that doesn't mean uncertainty is bad but
21 it means that the financial community does not like
22 uncertainty. So when there is more uncertainty there
23 is a tendency for interest rates to go up and stock
24 prices to go down in general terms. As it pertains to

25 the PRAM mechanism the purpose of the PRAM mechanism

(PARCELL - CROSS BY MARSHALL)

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1 was to reduce uncertainty and to the extent that it was
2 perceived as reducing uncertainty that was regarded as
3 a favorable attribute by the investment community.
4 When there was some doubt cast upon the future of the
5 PRAM mechanism, in my view the concern was not so much
6 a direct function of concern over future PRAM but
7 alternatively the fact that that was a risk-reducing
8 factor out there, that is PRAM, that may not be there
9 any longer. So the financial community appeared to be
10 somewhat concerned that this risk-reducing factor may
11 not remain in its current state. So that's my
12 elaboration.

13 Q. This exhibit at page 53 indicates, "another
14 example of reluctance to pass through costs to
15 ratepayers is the difficulty being experienced by some
16 of the electric revenue adjustment mechanism, ERAM
17 experiments, notably Puget Sound Power & Light and
18 Central Maine Power," and it goes on to state,
19 skipping a sentence "Recovery of these balances is
20 being extended or shaved and the mechanisms are being
21 re-examined."

22 Is that the source for some of the negative
23 reaction that you have seen in the financial community,
24 the uncertainty with PRAM decoupling?

25 A. Well, the short answer is yes. I think that
 (PARCELL - CROSS BY MARSHALL) 3217

1 is consistent with my perceptions on pages 13 and 14,
2 but I would encourage you to read the very next
3 paragraph after the one you just finished which
4 indicates that -- well, let me just read it. "Yet the
5 write-offs on the scale of those seen in the late 80's
6 and early 90's, are less likely for several reasons."
7 So I think what Standard & Poor's is telling us here
8 is that there is some ongoing concern about the future
9 of these things but the reason there is concern is
10 because when these mechanisms are done to work
11 properly they are recognized and perceived to be risk
12 reducing mechanisms. That's why they're viewed
13 favorably when they are in effect. The concern here
14 is that they will not be in effect and it will go back
15 to the old risk and away from the recent level or
16 level of lower risk. That's the concern.

17 Q. The concern is also that recovery is being
18 extended and some costs are being disallowed? Is that
19 also fair to state?

20 A. Yes, because the mechanism itself is not
21 secured.

22 MR. TROTTER: Not what?

23 THE WITNESS: Secured.

24 Q. At page 24 of your testimony at lines 11

25 through 15, you said that these analysts "focus on

(PARCELL - CROSS BY MARSHALL)

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1 results," and you continue, "as a result of a
2 perception of consistency by regulatory agencies is
3 important since it reduces uncertainty about results";
4 is that correct?

5 A. Yes.

6 Q. I take it that because of that general
7 principle you would agree that making change just for
8 the sake of change in a mechanism that is being
9 examined by investors and investor analysts would not
10 be a wise idea at this point?

11 A. I cannot respond to that question because
12 when you say change for the sake of change I don't
13 know what you mean by that. If you said -- if it's
14 change for the sake of improvement that would be good,
15 but change for the sake of change I don't know what
16 that means so I can't answer that.

17 Q. If investors focus on the end results and
18 there is a perception at the close of this proceeding
19 that costs that would -- were supposed to be recovered
20 in PRAM decoupling are taken back, if you will, in
21 other areas, is that going to send a positive message
22 in your view or a negative one to investors?

23 A. Well, it's a matter of semantics. If you
24 accept the proposition that some revenue stabilizing

25 mechanism is better than none it's a question of a

(PARCELL - CROSS BY MARSHALL)

3219

1 perception there may not be as much good on the one
2 version as there is good on another version. But it's
3 all perceived to be good in the sense that it
4 stabilizes revenue income. If you go from great to
5 just very good, is that a reduction? The answer is
6 yes, I suppose it is a reduction, but it's still
7 better or perceived to be better than the prior system
8 from a risk standpoint.

9 Q. Would you agree that under PRAM decoupling
10 if the company encounters a winter that's unusually
11 cold and the hydro conditions are unusually good the
12 potential that the company had to earn well in that
13 condition would be reduced?

14 A. I would agree with that. It's a two-way
15 street, so to speak.

16 Q. Is that what you would call a symmetrical
17 risk? Have you heard that term used before?

18 JUDGE HAENLE: A symmetrical risk rather
19 than asymmetrical, being all one word, which is the
20 opposite.

21 Q. Is that a risk which is symmetrical?

22 A. Yes. Those were two interpretations of two
23 totally different meanings. The way you meant it the
24 answer is yes.

25 JUDGE HAENLE: I don't mean to be picky but

(PARCELL - CROSS BY MARSHALL)

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1 there's a big difference.

2 Q. In other words, it's fair to say that the
3 customers benefit also from this PRAM decoupling in
4 the situation where you have unusually cold winters
5 with unusually good hydro conditions?

6 A. Yes. My perception is that if it's done
7 properly everyone is better off. It's a term that
8 economists call P A R A D O optimal. Everyone is
9 better off and no one is worse off.

10 Q. And that will hold true, however, only if
11 the risks identified in the article that you have
12 before you, that is, that costs are not disallowed
13 that the mechanism as established as being properly
14 allowed. Isn't that a truism?

15 A. No, that really doesn't follow. Again, and
16 I've said this a couple of times, I will do it quickly
17 this time. The question is, is some good better than
18 no good, and I think the answer to that question is
19 yes. If it's less than what is perceived to be ideal
20 that does not mean it's bad.

21 Q. At the very concluding page of your
22 testimony you indicated that if in fact PRAM does
23 reduce Puget Sound Power & Light's risk, that would be
24 reflected in the cost of a capital because it's

25 virtually an automatic thing that investors then will

(PARCELL - CROSS BY MARSHALL)

3221

1 crank that into their perceptions of risk and price --
2 make their decisions and create the prices accordingly?

3 A. That is correct, and in fact I have seen
4 one or two cost of capital witnesses in this case
5 claim that that has been in fact true for this
6 company. That its cost of equity has gone down in the
7 eyes of investors since PRAM was instituted in 1991.

8 Q. And you've agreed here with Dr. Powers,
9 apparently, that it is difficult for a Commission to
10 "manage the cost of capital," and by that document
11 that it shouldn't try to anticipate the market by
12 pushing the costs of capital down with regard to what
13 might happen with risk?

14 A. I agree in principle. There are some things
15 a Commission could do that have so much impact upon a
16 company's risk that it would be appropriate that when
17 you institute them you would reduce the costs of
18 capital to account for it. In other words, subject is
19 very much of an immediate risk, but I do agree with Dr.
20 Powers that it's hard to manage cost of capital, and
21 on a mechanism like this where it comes up for view
22 every year as I understand it, plus a general rate
23 case every three years, it is possible to let the
24 market tell you what's happened.

25 Q. There's been testimony in this case by a

(PARCELL - CROSS BY MARSHALL)

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1 Dr. Lurito that the Commission ought to set a rate of
2 return on equity 50 basis points lower because of his
3 idea that the cost of capital should take into
4 account, in his view, the reduced risk. Do you agree
5 with that testimony?

6 MR. TROTTER: Your Honor, I am going to
7 object to the question. I believe Dr. Lurito's
8 testimony was that he believed that that would have
9 been a measure of it but his analysis is still based
10 on his DCF regardless of that .5 percent differential.

11 JUDGE HAENLE: I think what he said was he
12 suggested an adjustment of the capital structure rather
13 than an adjustment of the level of equity.

14 MR. TROTTER: No, I don't think that was
15 it. That was I think a different witness, Mr. Hill.

16 JUDGE HAENLE: In any case could you
17 restate the question.

18 Q. Would you agree with any sort of an
19 adjustment in this type of a case to push down the
20 rate of return on equity to anticipate some sort of
21 investor reaction to reduced risk?

22 A. That question sounds so simple but
23 unfortunately the answer is not simple. Let me keep
24 it brief, though. The simple answer is no. There's

25 two reasons for that. First of all, since the PRAM

(PARCELL - CROSS BY MARSHALL)

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1 mechanism has been in effect for two years now it's
2 not a first time implementation of it. The question
3 you asked me would be more appropriately asked when it
4 was implemented in 1991. So today by looking at Puget
5 Sound we can see the market's reaction to what had
6 already happened. That's the first part of it.

7 The second part is, and this is the
8 complicated part, the existence of PRAM permits the
9 company to do things it could not otherwise do. For
10 example, there is testimony which I am going to mention
11 without getting into details, of having a higher deemed
12 common equity ratio because of purchased power or a
13 large amount of purchased power. I do believe that --
14 and I am not proposing this because it's not part of
15 the focus of my testimony but other witnesses have
16 proposed this, that this existence of the PRAM would
17 permit a lower equity ratio given the amount of
18 purchased power insofar as purchased power costs are a
19 part of PRAM. So like I say, it's a fairly complicated
20 answer but the question itself is complicated.

21 Q. In order to get over the issues that you
22 identify at pages 13 and 14 of your testimony about the
23 rating agencies' reaction in a negative fashion, in
24 general terms will you recommend that there be

25 stability, consistency, reduced uncertainty about the

(PARCELL - CROSS BY MARSHALL)

3224

1 future of PRAM decoupling?

2 A. My real concern is that it be done right,
3 and if the act of doing it right requires a change or
4 two in the first few years, I don't think that's bad.
5 I would rather see something done right than keeping
6 something that's not right in effect simply because
7 you don't want to change it.

8 Q. You would not, however, recommend that a
9 company that has done all kind of levels of demand
10 side management that Puget Power has done under this
11 mechanism should be in any fashion disallowed costs
12 because of unusual weather conditions that may have
13 increased the balances of PRAM. Is that fair to say?

14 A. Well, that's beyond the scope of my
15 testimony. If you want me to offer an opinion, I
16 will, but that's a policy question and I am not a
17 policy witness, but if you want to ask it to me again,
18 I would be glad to give you my opinion.

19 Q. I will ask the policy witness. I
20 understand that to be Mr. Cavanagh, yes?

21 A. I personally think that would be more
22 appropriate.

23 MR. MARSHALL: No more questions.

24

1 BY MR. TROTTER:

2 Q. You indicated that the investors had a
3 negative view following the Commission's order last
4 fall of the decoupling experiment?

5 A. Well, the reaction was negative. I
6 wouldn't call it a negative view but something good
7 was possibly being taken away so that was a negative
8 reaction.

9 Q. And so to the extent that the Commission
10 reaffirms the PRAM decoupling process, will there be
11 the opposite? Will we swing back to the optimistic
12 favorable end of the scale? Is there a good chance
13 that could occur?

14 A. The simple answer is yes. If you recall
15 from page 13 I gave you my perception of three stages,
16 optimism, favorablism and negativism. I think when the
17 negativism goes away we probably go back somewhere
18 between optimism and favorablism. Not necessarily
19 back to favorablism.

20 Q. All other things being equal that will
21 reduce Puget's cost of capital?

22 A. Yes. All things equal.

23 Q. Turn to Exhibit 820, page 53 on paragraphs
24 that Mr. Marshall asked you about, and recognizing

25 that neither you nor I may have as much experience

(PARCELL - CROSS BY TROTTER)

3226

1 with shaving as others, the last sentence of the first

2 --

3 A. At least in recent terms that's for sure.

4 Q. -- recovery of these balances is being
5 extended or shaved?

6 A. What page?

7 Q. 53. Recovery of these balances is being
8 extended or shaved and the mechanisms are being
9 re-examined. Mr. Marshall assumed in his questioning
10 that the word shaved meant disallowance. Is that your
11 understanding?

12 A. Yes.

13 Q. And is that how you would interpret that
14 word?

15 A. Yes.

16 Q. And do you know -- and that's --

17 A. Well, reduced is a better word. Reduced as
18 opposed to disallowed.

19 Q. Let's talk about the word extended. You're
20 aware that the PRAM 2 order did allow an extra year, I
21 guess, of an amortization of the deferred amounts?

22 A. That's my understanding.

23 Q. And that would be extending recovery, would
24 that be a fair characterization of that?

25 A. Yes.

(PARCELL - CROSS BY TROTTER)

3227

1 Q. Let's talk about shaving in the context of
2 disallowance, because that's how it was approached to
3 you. Are you aware of any cost under the PRAM that
4 has been disallowed in this jurisdiction?

5 A. Well, my review of the financial
6 community's assessment of it reveals no instances of
7 something being totally disallowed, so the simple
8 answer is no.

9 Q. And assuming that the mechanism itself
10 calls for, in the broad picture, calls for prudence
11 review of purchased power and DSM expenditures in a
12 rate case, would investors understand that those
13 potentially can be reviewed and to the extent they are
14 not shown to be imprudent they can be disallowed, if
15 that was one of the precepts of the PRAM decoupling
16 experiment?

17 A. Well, you've got a narrowly focused question
18 and the answer to that is yes, but even on a broader
19 scale any investor who is familiar with the Bluefield
20 and Hope cases, and not trying to act as a lawyer, the
21 Bluefield case said, assuming efficient economical
22 management there's a long-standing understanding that
23 any utility costs which is not incurred prudently
24 stands the risk of being disallowed just like any

25 industrial company that does something imprudently may

(PARCELL - CROSS BY TROTTER)

3228

1 not recover it.

2 Q. On page 24 of your testimony where you give
3 a summary, you indicate that the PRAM decoupling is
4 generally considered to be a part of the factor from
5 financial integrity standpoint. Is that a fair
6 summarization of your --

7 A. Yes. Even this May 3, 1993 report
8 identified as Exhibit 820, even within that -- on page
9 50 it still says that "S&P maintains that DSM enhances
10 credit strength if it is truly economic compared to
11 other alternatives and uses part of a balanced approach
12 to resource planning." So Standard & Poor's has still
13 given a positive viewpoint of it. They're just saying
14 there is some down side to it from the standpoint of
15 not being maintained and gone the good may not last.

16 Q. The primary focus of your testimony is the
17 DSM side?

18 A. That's the primary focus of my client, but
19 from the standpoint of me evaluating the financial
20 community's assessment of it, a lot of the assessment
21 is for PRAM in general, not just the decoupling
22 component. So I have to evaluate what I see.

23 Q. If you could go to the third page of that
24 exhibit?

25 A. December 23?

(PARCELL - CROSS BY TROTTER)

3229

1 Q. Exhibit 814, the first page is December
2 23, second page is May 6 and the third page is April
3 1992?

4 A. Yes.

5 Q. And this is a Duff & Phelps report, company
6 analysis of Puget Power?

7 A. That's correct. It's called Common Stock
8 Summary.

9 Q. And the major risk category there at the
10 bottom refers to dependency on purchased power and
11 growth in the territory resulting in capacity
12 additions at a higher, much higher marginal costs than
13 current hydrogen rating capacity. Do you see that?

14 MR. TROTTER: May I approach the witness?

15 JUDGE HAENLE: Yes.

16 Q. My exhibit which I received were not
17 apparently in the correct order.

18 A. I have now found it. It's this one right
19 here.

20 Q. Yes. It says April 1992 in the upper left-
21 hand corner.

22 A. Well, actually there are two April 1992s.
23 This one says company analysis at the very top and
24 it's the one that runs several pages on like the prior

25 one which is only a one-page document.

(PARCELL - CROSS BY TROTTER)

3230

1 JUDGE HAENLE: Let's go off the record for
2 a minute so we can identify where we are.

3 (Discussion off the record.)

4 JUDGE HAENLE: Let's be back on the record.
5 During the time we were off the record we made sure we
6 were all on the same page. Go ahead.

7 Q. I was reading from the major risk section
8 at the bottom of this page.

9 A. Yes, I'm with you now.

10 Q. Are all the risks identified there
11 reflected in dollar for dollar recovery through the
12 PRAM mechanism?

13 MR. MARSHALL: I object. I don't
14 understand the question.

15 Q. Isn't it true that purchased power costs of
16 Puget Sound Power and Light Company are recovered
17 dollar for dollar through the PRAM?

18 A. That's my understanding, yes.

19 Q. And to the extent there are future capacity
20 additions at whatever cost, those are recovered dollar
21 for dollar through the PRAM?

22 A. Well, the focus of PRAM is on customer
23 growth and to the extent it's reflected there the
24 answer would be yes, but I am not -- the mechanics of

25 PRAM is not my focus. It's my understanding that

(PARCELL - CROSS BY TROTTER)

3231

1 purchased power is included but I can't tell you
2 mechanically how it works.

3 Q. So you're unfamiliar with the manner in
4 which new purchased power or other power costs are
5 tracked through the PRAM?

6 A. Right. For example, I am a financial
7 analyst, I can tell you the impact of nuclear power on
8 a company's cost of capital but I can't tell you how a
9 nuclear power plant works. And likewise, I can tell
10 you what the financial community reacts to a PRAM
11 mechanism but the mechanics of it is not my focus.

12 MR. TROTTER: Nothing further. Thank you.

13 JUDGE HAENLE: Have you questions, Mr.
14 Richardson?

15 MR. RICHARDSON: No questions, your Honor.

16 JUDGE HAENLE: Mr. Furuta?

17 MR. FURUTA: No questions.

18 MR. ADAMS: I have a few.

19

20 CROSS-EXAMINATION

21 BY MR. ADAMS:

22 Q. Morning.

23 A. Morning.

24 Q. Chuck Adams representing the public. Want

25 to ask you a general term in terms of your question.

(PARCELL - CROSS BY ADAMS)

3232

1 Have you conducted any specific study comparing
2 Puget's market performance with and without PRAM with
3 other utilities which do not have PRAM?

4 A. No.

5 Q. I think you've indicated you reviewed the
6 testimony of some of the other what I will call
7 financial witnesses in this case?

8 A. I have reviewed the cost of capital
9 witness' testimony among others, yes.

10 Q. Then I gather you have looked at the
11 testimony of Steve Hill?

12 A. Yes.

13 Q. Do you recall, he included as part of his
14 exhibits what has been marked Exhibit 797 which is
15 SGH-1, schedule 16, and I will be glad to approach you
16 and show you what I have referred to?

17 A. I have a copy.

18 Q. In his exhibit, not his testimony, would
19 you look at schedule 16 which is a graph depicting the
20 stock performance of Puget versus another group, do
21 you see that?

22 A. (Indicating)?

23 Q. Yes.

24 A. The answer to your question is yes, I see

25 that.

(PARCELL - CROSS BY ADAMS)

3233

1 Q. I want to ask you, doesn't that graph
2 reflect what you have indicated in your testimony and
3 that is a market perception of reduced risk going
4 through phases of optimism -- I think the word was
5 favorablism and negativism in a sense?

6 A. I can't answer your question as you've
7 asked it. If you don't mind me interpolating, I will.
8 What this really shows is the cost of capital has
9 declined because the company's stock price has out-
10 performed the comparison group. One would perceive
11 that the only reason that a company's cost of capital
12 would decline relative to other utility companies in
13 this period so short would be because its risk had
14 decreased.

15 Q. You would agree, would you not, that as you
16 look at the most recent time frame of this table that
17 the differential between Puget and others has narrowed
18 during the time which various analysts have expressed
19 concern about the review of the PRAM mechanism?

20 A. That is correct. In other words what this
21 is showing is that investors agreed with the analysts.
22 The analysts reacted in a negative fashion and
23 investors did as well.

24 Q. Thank you.

25 MR. ADAMS: That's all I have.

(PARCELL - CROSS BY ADAMS)

3234

1 JUDGE HAENLE: Commissioners, have you
2 questions?

3 COMMISSIONER CASAD: Couple.
4

5 E X A M I N A T I O N

6 BY COMMISSIONER CASAD:

7 Q. Much of your testimony and many of the
8 questions which have been directed to you this morning
9 deal with the Commission's order in reviewing the PRAM,
10 and we've looked at Standard & Poor's considering
11 balances being extended or shaved. Would you agree
12 that the PRAM or decoupling mechanism in PRAM are
13 experimental in nature by the very substance of their
14 character? And that's somewhat difficult for rating
15 agencies. They think they like it because it promises
16 a potential period of rate stability or a mechanism to
17 provide rate stability and recovery of costs, but they
18 really can't be sure, and anything they can't really
19 be sure of they view with a jaundiced eye?

20 A. That's correct. In other words, when
21 something good happens they say that's great, but we
22 hope we don't lose it. So I guess in a sense the
23 financial community is never satisfied in that regard.

24 Q. I think that the order of the Commission

25 has been broadly misinterpreted, and I guess the

(PARCELL - EXAM BY COMMISSIONER CASAD)

3235

1 Commissioners would have to plead to less than artful
2 drafting of that order, but is it your view, and would
3 you affirm that it's your view that it was not the
4 Commission's desire to abandon decoupling conceptually,
5 but the Commission was trying to ameliorate the impact
6 of some very extraordinarily poor weather conditions
7 which resulted in recovery amounts that cried for some
8 kind of a deferral mechanism because of a rate shock?

9 A. Simple answer to that question is yes. As
10 a Commissioner you have the unenviable task of
11 balancing the interests of the ratepayers and the
12 shareholders. Now, if you looked at the shareholders
13 for the first two years that PRAM was in effect, PRAM
14 was very beneficial to the shareholders because of the
15 warm winters, the poor hydro conditions. Puget
16 Sound's shareholders were considerably better off
17 during those first two years due to the existence of
18 the PRAM mechanism. And under that set of
19 circumstances, which is I guess is just the luck of
20 the draw, you try and do something right and the first
21 couple of years rolls around and all of the bad
22 conditions come up -- the ratepayers accepted that
23 risk is what they did, and what you're telling me as I
24 understand it is that from the standpoint of balancing

25 the interests of ratepayers and shareholders you've

(PARCELL - EXAM BY COMMISSIONER CASAD)

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1 got to look back from time to time and say is this
2 what we really want to do and how strict an
3 interpretation of this should we have. That's what I
4 perceived that happened in September. A lot of
5 questions I've been asked today about, well, isn't it
6 negative and the point I've been trying to make and I
7 hope I have made, it's not a question of a negative
8 occurrence. If something is perceived to be very
9 positive is now perceived to be slightly less
10 positive, still positive, still better than before the
11 shareholder's standpoint, just not as completely
12 positive as it was perceived to be when it was an iron
13 clad mechanism that guarantees the company certain
14 cost recovery.

15 Q. Would you agree that from a ratepayers's
16 perspective the experiment probably occurred in about
17 the worst weather conditions imaginable?

18 A. No question that is true. If we had the
19 opposite situation, very cold winters, great hydro
20 conditions, then the ratepayers would have benefited
21 from lower rates. So it's just a question of luck, if
22 you will, or bad luck.

23 Q. And I think that you indicated or testified
24 that it's eminently reasonable for an experimental

25 process like this to be examined during the course of

(PARCELL - EXAM BY COMMISSIONER CASAD)

3237

1 its adoption to make adjustments and changes which
2 improve or make more workable the mechanics of the
3 process?

4 A. Absolutely. I said earlier that in my view
5 the overriding objective should be to get it right and
6 if getting it right requires some changes from time to
7 time so be it. But I wouldn't keep it the same just
8 because it's the same. The objective is to make it as
9 workable and as good as possible. In the long run
10 everyone is better off if it's done right. Even if it
11 has to be changed a couple of times along the way.

12 Q. The character of Puget's resources also are
13 somewhat different than many utilities, are they not?
14 And by that I specifically mean that they are dependent
15 to a large degree, far larger than most utilities, on
16 hydro and purchased power. Would that not be correct?

17 A. That's my understanding, yes.

18 Q. And to view the rating agencies' reaction
19 with horror that accompany the Commission's order, and
20 that's my coining of that phrase, that's no one else,
21 but that rating agencies seem to react as if the
22 bottom had fallen out of the process. Would you
23 compare that with rating agencies' reaction to the
24 other leg of Puget's resources, i.e. purchased power?

25 Rating agencies seem to view purchased power as an

(PARCELL - EXAM BY COMMISSIONER CASAD)

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1 enigma when in point of fact purchased power can be a
2 point of strength for the utility, depending on the
3 nature of the power and can actually contribute
4 significantly to the strength of the resource
5 portfolio, which would cause one to look pretty
6 skeptically at a rating agency that said purchased
7 power is bad across the board, especially when coupled
8 with the fact that national energy legislation now
9 provides an environment in which exempt wholesale
10 generators, independent power producers and others are
11 going to be more the rule than the exception. And I
12 apologize for the long convoluted question --

13 A. My answer is probably just about as long and
14 convoluted.

15 Q. -- but I would be very interested in
16 hearing what it is?

17 A. Let me start by saying you've got to
18 realize what the rating agencies really are. Their
19 job -- they work for the owners, the debt holders, not
20 for the companies. Companies pay a lot of money to
21 get their bonds rated. And the rating agencies report
22 to bond investors. That's who their clients really
23 are. And it's their job to identify anything that
24 investors could perceive to be bad news, and it's my

25 personal perception, and I've been in this business

(PARCELL - EXAM BY COMMISSIONER CASAD)

3239

1 since 1970, which is unfortunately for me a long time,
2 I guess. They are more inclined to focus on bad news
3 than good news. But again, I suppose that's their job.

4 And also, from a standpoint of -- not trying
5 to do a testimonial for any agencies here, but if they
6 perceive the concept of purchased power to be beyond
7 some threshold limit to be having negative influence on
8 risks for utility, if they start making exceptions for
9 one or two companies, other companies try and hop on
10 the bandwagon and get acceptance for them too. So
11 it's easier for a rating agency to say purchased power
12 in excess is bad for everyone than to say it's bad for
13 everyone except for the two companies that I am
14 familiar with are Sierra Pacific Power Company in
15 Nevada and Puget Power here. And in fact both of
16 these two jurisdictions have two strong factors that
17 mitigate the negative impact of purchased power,
18 Sierra Pacific has what's known as resource planning,
19 the Nevada Public Service Commission employs resource
20 planning and the company each year has to go through
21 and have a five year resource plan. Once that plan is
22 approved by the Commission there can be no
23 disallowances for capacity purchases or power
24 purchases. It's updated yearly but that's a

25 risk-reducing factor for Sierra Pacific on its high

(PARCELL - EXAM BY COMMISSIONER CASAD)

3240

1 level purchased power, and likewise the PRAM mechanism
2 insulates Puget Sound. So as long as the regulatory
3 agencies like yourself recognize a potential for risk
4 of something like that and treat it properly such that
5 both the ratepayers and the shareholders are better
6 off, then you can offset that risk.

7 Now, it's hard to get the rating agencies
8 to fully reflect that in writing.

9 Q. I would submit that the quality of the
10 purchased power in itself is important and certainly
11 the quality of Puget's purchased power from a Mid
12 Columbia contract is probably about the most
13 attractive purchased power arrangement that any
14 utility in the United States enjoys. So I would tend
15 to think that perhaps not the PRAM mechanism itself,
16 but the quality of those purchased power contracts,
17 any rational, reasonable rating agency should be able
18 to make the distinction regarding that particular
19 utility.

20 A. Well, you're exactly right. They should.
21 The rating agencies -- since there are more electric
22 utilities in the east they seem to get more attention.
23 If you look at purchased power in the east here's what
24 you've got. You've got a bunch of independent power

25 producers or cogeneration projects where utilities are

(PARCELL - EXAM BY COMMISSIONER CASAD)

3241

1 buying power from a number of relatively small IPPs,
2 they may have a 20-year contract but the contract is
3 set up such that the IPP gets enough money to pay off
4 all of its debt in the first, say, ten years of the
5 contract, and whereas the contract may run for 20, 25
6 years, no one knows yet if these IPP power plants are
7 going to last for 20 years. So, that's how VEPCO,
8 Virginia Electric Power Company, they were probably
9 the first electric utility to have a downgrading that
10 went from a single A to an A-minus, they were the
11 first to be downgraded by Standard & Poor's because of
12 purchased power, and that's exactly the type of
13 purchased power that VEPCO has engaged in the last
14 several years, contracts with IPPs -- and I forget
15 what the other acronym is but it's the small
16 cogeneration unit where you have to pay them a lot up
17 front and they may not last 20 years. I was at a
18 conference a year ago where the vice-president of
19 VEPCO who is in charge of this stated very frankly to
20 the participants of the conference that VEPCO doesn't
21 believe a lot of these plants are going to run for 20
22 years. However, since they are a generating company
23 themselves they fully expect to step into some of
24 these plants that don't operate and pay 15 cents on a

25 dollar and make money on them that way.

(PARCELL - EXAM BY COMMISSIONER CASAD)

3242

1 Q. Well, it's not impossible, is it, as Puget
2 has done to insure that protection of shareholders and
3 ratepayers through structuring those contracts with
4 cogenerators so that if they do head south that
5 there's early and insured recovery by the utility and
6 I would commend your attention that that's actually
7 what Puget has done and structured those contracts and
8 this Commission has reviewed those contracts in a way
9 which protects the ratepayers and shareholders.

10 A. Well, I am not an expert on Puget's
11 purchased power contracts, but I will accept your
12 representation and that fact alone does make a real
13 distinction between the purchased power of a Puget
14 Sound, for example, versus a Virginia Power, no
15 question about it.

16 Q. One final question, and I would hope that
17 in the future we would have -- this is a good
18 opportunity to have a witness like yourself to discuss
19 these issues. It is desirable to perhaps discuss them
20 in a more informal setting at some point to exchange
21 information rather than testimony. I would look
22 forward to that but as a last question, you indicate
23 that you feel that there is substantially less risk for
24 the company because of this mechanism, but you do not

25 recommend a cost of capital reduction or adjustment.

(PARCELL - EXAM BY COMMISSIONER CASAD)

3243

1 Could you expand a little bit on why you do not?

2 A. Yes. It's a timing thing. If I were a
3 witness in a rate case in 1991 where you instituted it
4 I would have look more carefully at it and give
5 consideration to suggestion at that time that the
6 company's cost of equity be reduced to reflect the
7 lower risk of the PRAM mechanism, but the fact that
8 it's been in existence for two years now, insofar as
9 the witnesses giving you cost of capital testimony
10 utilized the market results such as DCF or cap M of
11 Puget Sound in their analyses and insofar as your
12 determinations reflects the company's specific cost of
13 capital, that lower risk should already be reflected in
14 the market price and therefore the cost of capital.

15 Q. Thank you.

16 JUDGE HAENLE: Commissioner.

17

18 E X A M I N A T I O N

19 BY COMMISSIONER HEMSTAD:

20 Q. You stated that the overriding objective is
21 to get it right but you do not have a professional
22 view at this point as to what right is?

23 A. I do not, but I assure you two fellows are
24 going to follow me who have some very strong opinions

25 on that.

(PARCELL - EXAM BY COMMISSIONER HEMSTAD)

3244

1 Q. We've testimony here to the effect that
2 risk has been shifted to the ratepayers away from the
3 company as a result of the decoupling and the PRAM
4 mechanisms. And this may be repeating or your answer,
5 may be repeating some things you've already said here,
6 but if risk has been shifted to the ratepayers and
7 away from the company how does it follow that you can
8 still have a win-win situation or your phrase
9 optimizing effect?

10 A. The shifting of risk from the utility to
11 the ratepayer will lower the the cost of capital to
12 the company so the company can raise capital on
13 cheaper terms and a lower cost of capital can be
14 reflected in rates to ratepayers. So rates should be
15 less as a result of it over time, not necessarily when
16 you first start but over time rates should be lower
17 because of it.

18 Q. But the complaint is asserted that shifting
19 risk to ratepayers is potentially harmful to them.
20 You disagree with that?

21 A. I don't disagree. That's a double negative.
22 I agree with that, unless the shifting of risk has the
23 effect of lowering the cost of capital. If the cost of
24 capital is lowered then ratepayers pay lower rates as a

25 result to accepting more risk.

(PARCELL - EXAM BY COMMISSIONER HEMSTAD)

3245

1 COMMISSIONER HEMSTAD: No further
2 questions.

3 JUDGE HAENLE: Have you any redirect?

4 MR. WELLINGHOFF: No redirect.

5 JUDGE HAENLE: Anything more of the
6 witness?

7 MR. MARSHALL: Just a couple of questions

8

9

CROSS-EXAMINATION

10 BY MR. MARSHALL:

11 Q. Are you aware in this case that the company
12 has proposed a rate moderation plan?

13 A. Is that your complete question?

14 Q. Yes.

15 A. No.

16 Q. Let me just explain briefly that that rate
17 moderation plan is designed to take into account some
18 of these unusual weather conditions and in effect phase
19 in rates over a period of years?

20 A. I had heard that. I don't know any details
21 but I have heard that, I am aware of it, yes.

22 Q. With the hope that the weather conditions
23 won't be quite as unusual as they've been for the past
24 two winters, in fact that they might shift around and

25 become the kind of weather conditions that are more

(PARCELL - CROSS BY MARSHALL)

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1 normally experienced with better hydro, colder
2 weather.

3 JUDGE HAENLE: Is this a question?

4 MR. MARSHALL: Yes, is he aware generally
5 speaking that this is what has been proposed?

6 A. In general only. Not specifically.

7 Q. Now, Mr. Trotter asked you some questions
8 about shaving costs. If you were to do a rate
9 moderation like this and increase deferred amounts but
10 without interest would that in your view be a shaving
11 of costs? In other words, are interests legitimate
12 costs that normally would be allowed?

13 A. That's more of a question that an
14 accounting witness would answer than an economist like
15 myself and it's not terminology that I use in my
16 testimony on a regular basis so I am reluctant to try
17 and give you a yes/no answer to that question.

18 Q. Did you make any calculation on what
19 amounts were not allowed in the September 1992 order
20 of the Commission? Has anybody given you any
21 indication of what costs were shaved, to use Mr.
22 Trotter's question?

23 A. I would have a hard time finding in a
24 second but I have seen references in, I believe, Value

25 Line, that cite the amount of the of I believe PRAM 2

(PARCELL - CROSS BY MARSHALL)

3247

1 costs that were not allowed to be recovered at that
2 time. I can dig a number up if you wish but that's in
3 my testimony in one of these exhibits. Is that
4 responsive to your question?

5 Q. Yes, I believe generally it does. Your
6 opinion or your understanding is that the company has
7 not suggested that these costs shouldn't be extended
8 either in the PRAM 2 or in this general rate case,
9 it's just that the reaction of the investor analysts
10 has been that this induces some or increases some
11 amount of uncertainty about what might happen from
12 this point on? Is that fair to say?

13 A. That's a long question and I didn't know
14 you didn't read it from notes so would you rephrase
15 that for me, please.

16 Q. Sure. You're not saying that the company
17 has opposed efforts to try to moderate rates in any of
18 your testimony? What you're indicating by any kind of
19 a deferral mechanism that makes the company whole, all
20 you're saying is that what has occurred before has
21 engendered some uncertainty among the analysts looking
22 at the situation. Is that fair to say?

23 A. Well, that's fair to say, and I've also
24 reviewed the testimony of Mr. Sonstelie, and I perceive

25 that basically in his testimony that that's the

(PARCELL - CROSS BY MARSHALL)

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1 company's position as well. They are still in favor
2 of PRAM. They are suggesting a couple of changes to
3 it just like other parties are suggesting changes to
4 it and I suppose we're doing the Commission a
5 disservice by trying to do changes like this in a
6 litigated case. I mean, I am not this kind of person.
7 I am a cost of capital witness and I am used to
8 litigation but it just seems to me personally it's my
9 opinion that something like this would be better
10 served by people seeing what they can agree on and
11 what they can't agree on and doing it in that
12 mechanism.

13 Q. One last --

14 A. And I sort of perceive the company feels
15 the same way.

16 Q. One last brief area. You mentioned about
17 risks being shifted to ratepayers. You also testified
18 earlier that the risks were symmetrical, that there
19 were benefits to ratepayers in times when weather was
20 unusually cold or hydro conditions were unusually
21 good. Do you recall that testimony?

22 A. Yes.

23 Q. So in essence if the ratepayers are
24 financially protected against unusually cold winters

25 and the bills that go along with that, haven't

(PARCELL - CROSS BY MARSHALL)

3249

1 ratepayer risks also been reduced?

2 A. In a sense, but what you're implying is
3 that if you did not have a PRAM mechanism, you had a
4 warm winter, all ratepayers are going to put aside the
5 amount of money that they save by a warm winter to
6 spend on their utility bills when it's colder to use
7 later, and I doubt that most ratepayers do that. So in
8 essence there is a risk-reducing mechanism or the
9 phrase you and I used earlier today, there's more
10 certainty that way, and ratepayers are like investors,
11 uncertainty is a bad word.

12 Q. Thank you.

13 MR. MARSHALL: No further questions.

14 JUDGE HAENLE: Anything else, Mr. Trotter?

15 MR. TROTTER: No.

16 JUDGE HAENLE: Mr. Adams?

17 MR. ADAMS: Just a couple of questions

18

19 CROSS-EXAMINATION

20 BY MR. ADAMS:

21 Q. Would you agree that so far under the PRAM
22 mechanism the mechanism has produced earnings
23 stability for Puget but rate instability for
24 customers?

25 A. Well, certainly it has resulted in revenue

(PARCELL - CROSS BY ADAMS)

3250

1 stability for Puget. I don't know if I can answer
2 whether or not it's resulted in rate instability for
3 customers.

4 Q. Have you reviewed the increases allowed
5 under the PRAM so far?

6 A. Yes.

7 Q. And the \$76 million PRAM adjustment that
8 was just filed?

9 A. The latter one, no, but I reviewed the
10 first two PRAM requests and the Commission's response
11 to those.

12 Q. So there have been some substantial
13 increases --

14 A. There have been increases, yes.

15 Q. -- to the rates of customers?

16 A. Yes. If you interpret increases to be
17 instability then I can answer yes to your question. I
18 didn't understand that, sorry.

19 Q. If risk and the resulting cost of capital
20 to Puget are reduced by a PRAM mechanism but these
21 benefits are not passed on to ratepayers, this is not
22 a win-win situation for ratepayers, would you agree?

23 A. That is correct. Like I answered the
24 Commissioner a few minutes ago, it needs to be

25 reflected in lower cost of capital, lower rates,

(PARCELL - CROSS BY ADAMS)

3251

1 everybody would be better off.

2 Q. Otherwise it's simply a windfall for the
3 company?

4 A. It's a windfall for the company under the
5 conditions we've had for the last two years. It would
6 not be under the conditions of a cold winter and
7 better hydro conditions.

8 Q. I am focusing on the issue of risk
9 reduction being passed on to customers regardless of
10 whether it's a cold winter or warm winter, the
11 ultimate issues of the risk reductions that Puget
12 experiences in its cost of capital need to be passed
13 on to ratepayers, does it not, or it's not a win-win
14 situation?

15 A. It should be passed to ratepayers through a
16 lower cost of capital, yes.

17 Q. That was the point, thank you.

18 JUDGE HAENLE: Anything more?

19 COMMISSIONER CASAD: Just one thing.

20

21 E X A M I N A T I O N

22 BY COMMISSIONER CASAD:

23 Q. Would you not agree that if one is going to
24 embark on an experiment rather than compound the

25 results of what happens as the experiment goes forward

(PARCELL - EXAM BY COMMISSIONER CASAD)

3252

1 that one needs a base point to evaluate where you're
2 starting from, i.e., a rate case or some method to
3 arrive at a reasonable appreciation of where the
4 company is at the time that the experiment takes
5 place. There have been changes, substantial changes
6 in costs for the company, expenses for the company.
7 Do you believe in just further compounding going down
8 the trail without having some base point to begin with
9 that's measurable and reasonable?

10 A. Well, there's really two questions. The
11 answer is yes and no. I do think that your first
12 question was isn't it reasonable to institute an
13 experiment and then look at it after we've had it for a
14 couple of years to see if it's accomplishing what we
15 wanted it to accomplish, and the answer to that is
16 absolutely correct. I agree with you fully. And the
17 second question was kind of a negative aspect of that
18 was is it proper to continue something that we know is
19 not what we intended simply because it's on the books,
20 and I say no, we should not do that. I agree with you
21 fully. Otherwise what you would in essence be doing
22 would be implicitly saying, this is the way it's going
23 to be, any future Commissioners or future makeup of
24 the Commission or any future Commission staff if we

25 see something we don't like about it, it's fixed in

(PARCELL - EXAM BY COMMISSIONER CASAD)

3253

1 stone, and that's just not the way it should be.

2 COMMISSIONER CASAD: Thank you.

3 JUDGE HAENLE: Anything more of the
4 witness?

5 Thank you, sir, you may step down. Let's go
6 off the record to changes witnesses.

7 (Recess.)

8 JUDGE HAENLE: Let's be back on the record,
9 then, after our morning recess. There's been a change
10 in the order of witnesses I announced earlier. We
11 will be taking Mr. Cavanagh first because of a travel
12 obligation. During the time we were off the record I
13 marked a multi-page document as T-821. It's entitled
14 Direct Testimony of Ralph Cavanagh and has RC-1 in the
15 upper right-hand corner. That's T-821.

16 (Marked Exhibit T-821.)

17 Whereupon,

18 RALPH CAVANAGH,

19 having been first duly sworn, was called as a
20 witness herein and was examined and testified as follows:

21

22 DIRECT EXAMINATION

23 BY MR. WELLINGHOFF:

24 Q. Mr. Cavanagh, could you please state your

25 name and business address?

(CAVANAGH - DIRECT BY WELLINGHOFF)

3254

1 A. My name is Ralph Cavanagh. My business
2 address is 71 Stevenson, San Francisco, California
3 94105.

4 Q. Mr. Cavanagh, Exhibit T-821 which has been
5 marked for identification, was that prepared by you or
6 under your supervision?

7 A. Yes.

8 Q. Do you have any corrections to T-821?

9 A. No.

10 Q. If I were to ask you the questions
11 contained therein today, would your answers be the
12 same as contained therein?

13 A. They would.

14 MR. WELLINGHOFF: Your Honor, move for the
15 introduction of Exhibit T-821.

16 JUDGE HAENLE: I note that that testimony
17 has a couple of attachments to it which the witness
18 has asked just be considered part of that testimony.

19 Any objection?

20 MR. VAN NOSTRAND: No objection.

21 MR. TROTTER: No objection.

22 MR. ADAMS: No objection.

23 JUDGE HAENLE: Objection from any
24 intervenor?

25 All right. T-821 will be entered into the

(CAVANAGH - DIRECT BY WELLINGHOFF)

3255

1 record.

2 (Marked Exhibit T-821.)

3

4 CROSS-EXAMINATION

5 BY MR. MARSHALL:

6 Q. Thank you. Good morning, Mr. Cavanagh.

7 A. Morning, Mr. Marshall.

8 Q. Your testimony has been described as a
9 policy witness on some of the issues relating to the
10 PRAM decoupling issue?

11 A. Correct.

12 Q. And in your testimony you summarize Puget's
13 energy efficiency performance under the mechanism as
14 it's been implemented by the Commission?

15 A. I do.

16 Q. And I was intrigued with a statistic that
17 you had here at page 4, beginning on lines 11 to 13
18 where you said that "Under this energy efficiency
19 mechanism that the Commission has adopted Puget
20 delivered more energy savings in that year" -- meaning
21 1991 -- "than the Idaho Power Company, the Montana
22 Power Company, Pacific Corp, Portland General Electric
23 and Washington Water Power combined." Where did you
24 get that information?

25 A. That information is taken from the regional

(CAVANAGH - CROSS BY MARSHALL)

3256

1 audit of delivered energy efficiency savings that is
2 performed and published by the Northwest Power
3 Planning Council. It is the best available data on
4 those issues that I know of and I regard it as
5 authoritative.

6 Q. And then you add in 1992 Puget did even
7 better and then you compared it to the BPA conservation
8 program. Where did you get the information about the
9 BPA program?

10 A. There again, is footnote 3 indicates the
11 Bonneville data are taken from BPA's own conservation
12 resource energy data. I would note to the Commission
13 that this particular insight that Puget outperformed
14 the entire Bonneville system at half the cost is today
15 on the front page of the Seattle PI's business section.
16 You heard it first, however.

17 Q. What discussion have you drawn from this
18 energy efficiency performance that Puget has been able
19 to achieve under the Commission's guidance and policy
20 direction?

21 A. A critical issue for the Commission going
22 into this experiment was whether it would in fact
23 deliver significantly improved energy efficiency
24 performance to the benefit of Puget's customers. I

25 think that the record unmistakably shows that in that

(CAVANAGH - CROSS BY MARSHALL)

3257

1 respect the experiment was a resounding success. There
2 is no question in my mind based on the record presented
3 in my testimony that Puget is today the most effective
4 and lowest cost energy conservation services delivery
5 mechanism in the Pacific Northwest region.

6 Q. There is some discussion in past testimony
7 about a win-win situation with regard to various
8 financial measures relating to risks and so forth.
9 Just focusing strictly on the benefits of achieving
10 that much energy efficiency, what is your conclusion
11 with regard to whether this energy efficiency has been
12 good for the region, good for the public interest or
13 not?

14 A. There is no doubt in my mind that even
15 viewed strictly in economic terms this was win-win,
16 when you add the environmental benefits the conclusion
17 is even stronger.

18 Q. Are the customers of Puget benefited
19 strictly by the conservation if you could just isolate
20 that alone that has been achieved under the PRAM
21 decoupling mechanism?

22 A. Dr. Blackman's testimony includes the
23 estimate that the net benefits to Puget customers over
24 and above their investments in conservation through

25 Puget, the net benefits for those first year programs

(CAVANAGH - CROSS BY MARSHALL)

3258

1 were on the record of \$40 million. I think if anything
2 that estimate is conservative but it does underscore
3 the point it's viewed strictly in dollar terms. This
4 was win-win. I think it vindicates the Commission's
5 continued insistence on the pursuit of energy
6 efficiency as the lowest cost resource available to
7 Northwest consumers and it vindicates the Commission's
8 decision to try to better align the interests of Puget
9 shareholders with the societal interests in achieving
10 that objective.

11 Q. Are you familiar personally with Puget
12 management? Have you had occasion to discuss things
13 with them, meet with them about what accounted for
14 this performance?

15 A. I have had 14 years of experience with
16 Puget management, which has ranged from the strongly
17 adversarial in an earlier period to, I am delighted to
18 say, a much more productive and cooperative
19 relationship in recent years.

20 Q. Is Puget management responding as you had
21 hoped to the Commission's PRAM decoupling mechanism in
22 achieving energy efficiency?

23 A. Well, I think the numbers speak for
24 themselves, but two of the three Commissioners here

25 heard me testify in a Puget proceeding in 1986 at

(CAVANAGH - CROSS BY MARSHALL)

3259

1 which my basic conclusion was that Puget was bringing
2 up the rear in a slow regional race to deliver energy
3 efficiency. The transformation since that time is to
4 me breathtaking, enormously positive and again
5 attested by the numbers you have before you.

6 Q. You indicated on page 6 at the top few
7 lines that Puget, in your view, is a national leader in
8 energy efficiency?

9 A. Yes.

10 Q. And on what do you base that?

11 A. I base that on my work with utilities
12 nationally on energy efficiency, as I think the
13 Commissioners are aware although I have responsibility
14 at an RDC for Northwest utilities, I also work with the
15 national industry. It's my business to be familiar
16 with the performance of utilities throughout North
17 America and I would join Forbes, the New York Times
18 and other sources, in saying that today Puget would
19 certainly be on my list of the four or five top
20 performing energy efficiency utilities in North
21 America. And the California Public Utilities
22 Commission took that view when it selected Puget as
23 one of the two utilities in North America to come and
24 present as benchmarks for the California utilities to

25 follow in a recent statewide proceeding.

(CAVANAGH - CROSS BY MARSHALL)

3260

1 Q. And at page 6, line 5, you state, "That you
2 credit this to the Commission's decision to marry
3 Puget's shareholders interests consistent with the
4 achievement of the company's least cost planning
5 objectives and that decoupling was a crucial part of
6 that reform."

7 A. Yes.

8 Q. I take it you trace Puget's energy
9 efficiency performance to the Commission's decision to
10 align Puget's interests with that of energy
11 efficiency. Is that a fair general statement?

12 A. Yes.

13 Q. And I take it that you're not trying to
14 separate out decoupling from the other reforms that
15 the Commission has adopted, that they are part of that
16 reform but it is a package of reforms that has
17 produced this energy efficiency performance?

18 A. Well, my testimony identifies, in my
19 opinion, the critical features as being the decision to
20 break the link between Puget's profits and its energy
21 sales and the decision to adopt performance-based
22 incentives to deliver cost effective efficiency, and I
23 think that both of those were critical in, as I put it,
24 aligning shareholder interests with societal interests.

25 Q. You indicated below that the people that you
(CAVANAGH - CROSS BY MARSHALL) 3261

1 have gotten to know in Puget management believe that
2 their ability to "redirect scarce resources toward
3 efficiency objectives depends on assurances that such
4 efforts are consistent with shareholder interests"?

5 A. Yes.

6 Q. And on what do you base that?

7 A. I base that on my familiarity with those
8 individuals and my participation in their
9 deliberations both as an adversary and as a colleague
10 over 14 years.

11 Q. Now, of course PRAM was adopted by order on
12 April 1 of 1991 and put into effect on October 1 of
13 1991. So we've had about 20 months of experience with
14 PRAM decoupling in terms of weather conditions and
15 other conditions that have an influence on that. In
16 your view, if the weather conditions had been either
17 normal or colder than normal, would there be criticism
18 of the PRAM decoupling mechanism as we've seen it here
19 in the last few months?

20 MR. TROTTER: Object to the question. Calls
21 for enormous amount of speculation.

22 JUDGE HAENLE: Mr. Marshall?

23 MR. MARSHALL: I think it's a fair
24 question.

25

JUDGE HAENLE: I will sustain the

(CAVANAGH - CROSS BY MARSHALL)

3262

1 objection.

2 Q. Do you have any opinions based on the way
3 in which PRAM decoupling started out with the weather
4 and hydro conditions as to how it's been perceived?

5 A. There's no doubt that the rate impacts of
6 PRAM have been greater as a consequence of those
7 factors than would otherwise have been the case.

8 Q. Do you agree with Mr. Parcell's observation
9 that the risk is symmetrical between the company and
10 its ratepayers, its customers?

11 A. I am not sure exactly what Mr. Parcell said
12 or intended to convey, so let me simply put it as I
13 would, that I acknowledge as he did that under some
14 circumstances customers will be relatively better off
15 and in some relatively worse off depending on the
16 swings of weather and hydro, and in that sense there's
17 a symmetrical opportunity to either gain or lose in
18 the near term. I think what's important about
19 decoupling mechanisms principally for me is the way
20 that they serve everyone's long term interests in a
21 least cost energy future. And that is for me -- and I
22 hope for the Commission -- one of the critical
23 benchmarks in addition to the short term swings in
24 determining whether this makes sense.

25 Q. In your national perspective how has the

(CAVANAGH - CROSS BY MARSHALL)

3263

1 Commission's role been viewed in this decoupling, PRAM
2 decoupling mechanism?

3 A. Commission is clearly perceived as a leader
4 and there was great concern nationally, but I also
5 think among my constituents in Washington, over the
6 case in the September 1992 order that the Commission
7 might be backing off of decoupling in principle, and I
8 think, Commissioner Casad, you indicated earlier this
9 morning that that wasn't the intention, but I do
10 believe there's been some misinterpretation of the
11 Commission's intention and I think it's critical in
12 this rate case that the policy be made clear.

13 Q. Now, in terms of breaking the link between
14 increased sales of kilowatt hours and company revenues,
15 which is the essence of decoupling, do you believe that
16 the public understands that?

17 A. I think that the public absolutely
18 understands the importance of breaking the link between
19 a company's energy sales volumes and its profits if the
20 public wants the company to promote energy
21 conservation. And the Washington public through every
22 measure of opinion I've seen emphatically wants that,
23 and I think the principle is easy to understand.
24 Obviously, the mechanics of what we've been going

25 through today are going to be as mystifying to the

(CAVANAGH - CROSS BY MARSHALL)

3264

1 typical Washingtonian as the mechanics of any other
2 part of cost of service rate making. I think what's
3 critical is that the principle be clear and defensible
4 and I absolutely believe that here we're on firm
5 ground.

6 Q. Do you believe the public understands the
7 energy efficiency performance that has been achieved
8 under PRAM decoupling?

9 A. I do, and I think that to those of them who
10 read the front page of the business section in today's
11 PI will understand it even better.

12 Q. You had quoted at page 11 of your testimony
13 at lines 5 through 11 a section of the New Energy
14 Policy Act of 1992 indicating that "a utility's
15 investment in energy efficiency should be at least as
16 profitable giving appropriate consideration to income
17 lost from reduced sales due to investments in and
18 expenditures for verification efficiency as in
19 investments and expenditure for construction of new
20 generation."

21 My question is, is that the policy that you
22 believe that the Commission has set on the PRAM
23 decoupling experiment with Puget?

24 A. It's my opinion that the Congress stole

25 this language from the Washington Utilities and

(CAVANAGH - CROSS BY MARSHALL)

3265

1 Transportation Commission.

2 Q. Do you believe, then, if this continues
3 that Puget would be and the Commission would be in
4 compliance with that statement of public interests set
5 forth in your testimony here from the energy policy
6 act?

7 A. No, but I should emphasize, as I'm sure you
8 know, Mr. Marshall, that this language is not
9 mandatory. What the Congress was doing was saying we
10 think that certain states, prominent among them
11 Washington, have set a good example for the rest of
12 the country which the rest of the country should
13 follow, and I do not think it is possible to continue
14 to set or follow that example if decoupling is
15 abandoned.

16 JUDGE HAENLE: You're going to need to
17 remember to slow down, please.

18 Q. Are you familiar with legislation that
19 Puget worked on with others which would provide for
20 conservation bonds for the financing of conservation
21 through what were called conservation bonds?

22 MR. TROTTER: Your Honor, the subject seems
23 to be well beyond the scope of this witness'
24 testimony. I will object.

25

JUDGE HAENLE: Mr. Marshall?

(CAVANAGH - CROSS BY MARSHALL)

3266

1

MR. MARSHALL: I will withdraw the

2

question.

3

Q. In order to make conservation at least as

4

attractive as investing in a coal plant, is one of the

5

considerations the ability of a company to continue to

6

be able to use that investment to finance further

7

company investments? Let me step back. With a coal

8

plant, if Puget were to invest \$200 million in a coal

9

plant that \$200 million could then be used to back its

10

first mortgages and bonds under its first mortgage.

11

Are you familiar in general with that principle?

12

A. No.

13

Q. I won't ask you any further questions then.

14

A. Thank you.

15

Q. I will ask you, however, a general

16

question. Do you believe that it is important to

17

remove various regulatory, unattended regulatory

18

barriers that might tend to not to promote

19

conservation, such as financing barriers?

20

A. I am certainly interested and have made a

21

career in trying to find and remove those barriers.

22

MR. MARSHALL: I don't believe I have any

23

further questions at this time.

24

JUDGE HAENLE: Mr. Trotter?

25

(CAVANAGH - CROSS BY TROTTER)

3267

1 CROSS-EXAMINATION

2 BY MR. TROTTER:

3 Q. Mr. Cavanagh, do I take it correctly that
4 you're here as a policy witness not as an accounting
5 analyst?

6 A. Yes.

7 Q. And am I correct that you have not done an
8 accounting analysis of Puget's conservation programs
9 in terms of -- and done a prudency evaluation of
10 exactly how they've implemented their programs. Is
11 that a fair statement?

12 A. I've looked at the cumulative result, not
13 at the individual programs.

14 Q. And am I also correct that you're taking no
15 position in this case on Puget's -- just to isolate on
16 one particular cost -- Puget's conservation
17 advertising expenditure?

18 A. I am not.

19 Q. I take it you are aware that when Puget
20 filed its rate case late last year it filed it without
21 decoupling?

22 A. I am aware of that.

23 Q. You talked about -- I don't mean to suggest
24 any disrespect, you did refer to Puget as your

25 colleagues. You didn't discuss your testimony that

(CAVANAGH - CROSS BY TROTTER)

3268

1 you filed here with the company before you filed it?

2 A. I did not.

3 Q. I didn't think so.

4 A. And I hope that the -- the reference is
5 intended as conveying the ability of I think all of the
6 parties to work productively together in delivering
7 these conservation results to the citizens of
8 Washington. I have not, nor do I ever anticipate
9 becoming an official part of the Puget Sound Power &
10 Light empire.

11 Q. You talked about --

12 A. They would react with the same horror
13 that you would to that proposition.

14 Q. You talked about other Northwest utilities
15 and did you examine any of the rate increases that
16 have been experienced by the customers of those other
17 companies compared to Puget over the time period 1991
18 to 1992?

19 A. No. I have examined the net benefits
20 associated with their energy efficiency programs and
21 they lag far behind Puget's, and I think that the
22 impact on bills in terms of the public interest that
23 we're addressing here may be more significant than the
24 one you just put forward.

25 Q. And that significance I guess we're talking

(CAVANAGH - CROSS BY TROTTER)

3269

1 about in the long run?

2 A. Well, over the life cycle of the
3 investments involved, yes, which varies between
4 relatively short run and much longer run.

5 Q. Are you focusing on purely DSM?

6 A. Yes.

7 Q. You're not focusing on the power supply
8 aspect?

9 A. No.

10 Q. Do you agree with Dr. Power -- he hasn't
11 testified yet, but in his predescribed testimony that
12 8 percent of the PRAM 2 increase was due to
13 decoupling?

14 A. I wouldn't venture an opinion on the
15 particular percentage. I believe that a very small
16 fraction, probably on the order of -- the numbers I
17 have seen suggest that something like 2 percent of the
18 total rate impact experienced by Washington customers
19 was attributable to the decoupling mechanism itself,
20 that is two percentage points of a total on the order
21 of 9 or 10 percent.

22 Q. Do you agree with Dr. Parcell that it's
23 important for the Commission to get this mechanism
24 right, recognizing some stability but that some

25 changes may be necessary?

(CAVANAGH - CROSS BY TROTTER)

3270

1 A. Yes, and I go on to urge the Commission to
2 basically direct the parties to assist in that
3 process. I think we can develop together an even
4 better mechanism than the one we have now and one of
5 the purposes of my testimony is to urge the process be
6 initiated to do that.

7 Q. You talked about the collaborative process
8 in your testimony and you specifically addressed the
9 issue of scarce staff resources?

10 A. Yes.

11 Q. I take it that you would agree that having
12 collaborations while staff is preparing its rate case
13 may be not be the best timing for such collaboration.
14 Would that be a fair statement?

15 A. I wouldn't presume to micro manage the
16 Commission's resources. Obviously it would be better
17 if you weren't trying to do both at once and I do think
18 staff is once.

19 Q. So the timing of that when the staff is not
20 committed to dealing with a sizable rate case -- that
21 the timing is important?

22 A. I think this is important and I think this
23 is a high priority of staff resources. Obviously the
24 Commission has to make a decision -- my experience has

25 been that there's never a good time to ask of staff or

(CAVANAGH - CROSS BY TROTTER)

3271

1 any of the other participants to do something like
2 this. The work seems to more or less expand to more
3 than fill the time we have available. The real
4 question is is this one of most important things we
5 could be doing and I think it is.

6 Q. But to the extent that a utility is able to
7 initiate or the parties are able to initiate a
8 collaborative process outside the time period of a
9 pending rate case, is that going to be preferable
10 to --

11 A. Sure, if you can, but you don't always have
12 that luxury.

13 MR. TROTTER: Nothing further.

14 JUDGE HAENLE: Do you have questions, Mr.
15 Richardson?

16 MR. RICHARDSON: I do, your Honor.

17

18 CROSS-EXAMINATION

19 BY MR. RICHARDSON:

20 Q. Mr. Cavanagh, at page 1 of your testimony,
21 line 7 you state you're testifying as an expert. In
22 what manner are you testifying as an expert here today?

23 A. I am afraid I don't understand the
24 question.

25 Q. You responded to Mr. Trotter that you're

(CAVANAGH - CROSS BY RICHARDSON)

3272

1 not testifying as an expert accountant. Are you
2 testifying as an attorney or as a general policy
3 witness for the NCAC?

4 A. I think it would be most appropriate to
5 characterize me as a general policy witness. I almost
6 never testify as an attorney.

7 Q. Turn to page 11 of your prepared testimony.
8 On this page are you then not giving your legal
9 opinion relative to the implementation of the Energy
10 Policy Act?

11 A. Oh, I'm happy -- on that page I am
12 delighted to give you my legal opinion.

13 Q. That is your legal opinion?

14 A. Absolutely is. I hope it's possible
15 occasionally to testify both as a general policy
16 expert and as an attorney.

17 Q. And so you are testifying as an attorney on
18 page 11?

19 A. I certainly am.

20 Q. Is it your legal opinion then that
21 decoupling is the only regulatory mechanism available
22 for compliance with the Energy Policy Act?

23 A. That is my opinion, yes.

24 Q. So it's your opinion that those Commissions

25 that do not institute decoupling will be in

(CAVANAGH - CROSS BY RICHARDSON)

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1 noncompliance with the Energy Policy Act?

2 A. Yes, although as I explained to Mr.
3 Marshall no consequences flow from that. This is an
4 advisory provision like the other advisory provisions
5 at PURPA which tell the states that they ought to
6 consider a particular course of action but do not
7 mandate it.

8 Q. You spoke with Mr. Marshall about how the
9 Commission is viewed relative to DSM and you implied
10 that your constituents in Washington are concerned
11 about the lack of Commission commitment. Who were you
12 referring to when you referred to your constituents?

13 A. I refer both to the Washington members of
14 the Northwest Conservation Act Coalition, of whom
15 there are many, and to NRDC's members in Washington
16 of whom there are some 5,000.

17 Q. Referencing page 6 of your prefiled
18 testimony, you were questioned by Mr. Marshall
19 relative to Puget's perception as a national leader in
20 energy efficiency. Do you recall that testimony?

21 A. Yes.

22 Q. You testified that you joined Forbes and
23 the New York Times as listing Puget as one of the top
24 producers in energy efficiency, correct?

25 A. I also listed the California Public

(CAVANAGH - CROSS BY RICHARDSON)

3274

1 Utilities Commission, yes.

2 Q. In fact you testified that Forbes and the
3 New York Times list Puget as one of the top four or
4 five energy efficiency producers, correct?

5 A. No. I said I would. Let's be clear. I
6 said I would. I said that based on my experience over
7 14 years working with utilities throughout North
8 America and rating their energy efficiency performance
9 that I would rank Puget as one of the four or five top
10 performers in the country.

11 Q. You didn't testify that you would join the
12 New York Times and Forbes in ranking them as one of the
13 four or five top?

14 A. What I intended to say is that I would join
15 Forbes and New York Times as ranking them among the
16 leaders and I believe you will find Puget listed in
17 both of the articles attached to my testimony.

18 Q. Let's turn to the New York Times article
19 attached to your testimony?

20 A. Sure.

21 Q. Where in the text of that article is Puget
22 Sound Power & Light referred to?

23 A. Puget is referred to -- there is an inset
24 table which you will see to the right of the text

25 which lists the utilities that have made the largest

(CAVANAGH - CROSS BY RICHARDSON)

3275

1 relative investments in energy efficiency and you will
2 find Puget in sixth position.

3 Q. And what's the source of that table of the
4 New York Times included in its article?

5 A. The Natural Resources Defense Council.

6 Q. And that's the organization you're here
7 testifying on behalf of?

8 A. It is and for this purpose the Times
9 accepted that table as authoritative.

10 Q. I assume you would continue to believe it
11 is authoritative?

12 A. I believe I would.

13 Q. But Puget is not referenced anywhere in the
14 text of that article, is it, other than that one
15 table?

16 A. Well, the article is about how utilities
17 nationally are getting --

18 Q. Can we get a yes or no first and then
19 explanation?

20 A. I think Puget is referenced indirectly in
21 that the article is about utilities that are moving
22 forward into national leadership on energy efficiency.
23 It isn't mentioned by name in the article which is
24 principally about Sacramento Public Utility District

25 which appears first on that list but Puget, as I've

(CAVANAGH - CROSS BY RICHARDSON)

3276

1 said on the table, which the Times has reprinted and
2 we don't normally get editorial control over the Times
3 graphics or the material that it includes to makes its
4 points. So I think you can reflect this as the Times'
5 view.

6 Q. So, if you will, we have to read between the
7 lines to find Puget in the text of that article, don't
8 we?

9 A. You will find it -- most newspapers and
10 most readers view graphics as equally part of an
11 article and you will find it squarely in the graphic.

12 Q. Look at the Forbes article you reference
13 in your testimony. Would you agree that generally
14 Forbes is an article aimed at investors?

15 JUDGE HAENLE: An article?

16 Q. A news magazine aimed primarily for
17 investors?

18 A. I don't know.

19 Q. You have no idea?

20 A. No idea.

21 Q. You have no idea what Forbes' general
22 purpose is?

23 A. The Forbes editorial board does not consult
24 regularly with me.

25 Q. Do you read Forbes regularly?

(CAVANAGH - CROSS BY RICHARDSON)

3277

1 A. Occasionally.

2 Q. I suppose you read the article attached to
3 your testimony then?

4 A. I did.

5 Q. And ask you the same question. Where in
6 this article other than the table do we find a
7 reference to Puget Sound Power & Light?

8 A. Again, only in the table showing the
9 national leaders in energy efficiency do you find
10 Puget listed.

11 Q. Would you agree that that table shows Puget
12 as a national leader in energy efficiency? Would you
13 read the caption under the table in its entirety,
14 please.

15 A. The caption under the table states that
16 "Utilities are allowed to raise rates to cover the cost
17 of demand side programs to compensate for lost sales
18 and to earn an incentive pre-tax profit. The profit
19 incentive lost sales compensation often results in a
20 large margin on the program. All utilities have
21 different rules but for many DSM programs add
22 significantly to overall profitability."

23 Q. It's your testimony that this article is
24 about Puget as a leader in DSM or would you agree that

25 it's more about Puget as a profitable entity to invest

(CAVANAGH - CROSS BY RICHARDSON)

3278

1 in?

2 A. Obviously, the Commissioners can read the
3 articles for themselves. I believe that the article is
4 about the emergence of DSM as a major national
5 opportunity for utilities and their customers and I
6 believe that by including Puget as one of the utilities
7 cited that is moving ahead the article identifies Puget
8 as a leader.

9 Q. At page 8 of your prefiled testimony
10 beginning of that page you testify that there is no
11 precedent in the United States for a Commission
12 abandoning decoupling once it has instituted such a
13 mechanism. That was the question and your answer is
14 no?

15 A. That's right.

16 Q. Then at page 10 you're asked if but didn't
17 the Maine Commission reject decoupling recently, and
18 you begin the answer with an explanation but is there
19 a yes or no answer to that question?

20 A. The answer is no.

21 Q. The answer is no, that the Maine Commission
22 did not reject decoupling recently?

23 A. That is correct.

24 MR. RICHARDSON: That's all I have, your

25 Honor.

(CAVANAGH - CROSS BY RICHARDSON)

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1 JUDGE HAENLE: Have you questions, Mr.
2 Furuta?

3 MR. FURUTA: No, your Honor.

4 JUDGE HAENLE: Mr. Adams?

5 MR. ADAMS: Yes, I have a few.

6

7 CROSS-EXAMINATION

8 BY MR. ADAMS:

9 Q. First off, Mr. Cavanagh, you've used the
10 term decoupling consistently throughout your testimony
11 and yet I am not sure I have seen a definition or how
12 you would define decoupling since often decoupling is
13 used as a term or at least I think in this
14 jurisdiction sometimes includes PRAM, other
15 jurisdictions it does not include something of
16 resource recovery mechanism. How are you using it in
17 your testimony?

18 A. Strictly to identify the decision to break
19 the link between utility's energy sales and its
20 profits.

21 Q. And so any resource recovery mechanism is
22 something different?

23 A. Yes, it is.

24 Q. Turning to your testimony, I think it's

25 about page 9 but referring to the Oregon recent

(CAVANAGH - CROSS BY ADAMS)

3280

1 experience. Am I correct that both Pacific Corp and
2 Portland General Electric have now submitted
3 decoupling proposals to the Oregon Commission?

4 A. You are.

5 Q. And am I correct that both of these
6 proposals were developed by collaborative groups that
7 included representatives of the utility, its
8 customers, regulators and environmental public
9 interest groups?

10 A. That's right.

11 Q. Did you serve on the collaborative of both
12 of those groups?

13 A. I served on both. I was most active in the
14 Pacific decoupling proceeding.

15 Q. You are generally familiar, at least with
16 the provisions or mechanisms involved in both?

17 A. Yes, I signed both agreements.

18 MR. ADAMS: Your Honor, could I have marked
19 as the next identification in line a multi-page
20 document with a cover letter from Pacific Corp to the
21 Oregon Commission.

22 JUDGE HAENLE: Yes. A multi-page document
23 dated May 19, 1993 on Pacific Corp letterhead will be
24 marked as Exhibit 822 for identification.

25

(Marked Exhibit 822.)

(CAVANAGH - CROSS BY ADAMS)

3281

1 Q. Mr. Cavanagh, have you had a chance to
2 review the document that has just been marked as
3 Exhibit 822?

4 A. I have.

5 Q. And I believe, am I correct that your
6 signature is one of the signing parties on the second
7 to the last page?

8 A. Yes.

9 Q. And this is the decoupling proposal as it
10 relates to Pacific Corp presented to the Commission?

11 A. Yes.

12 Q. And briefly, where is that in the process?
13 Has the Commission instituted any hearings to consider
14 this proposal?

15 A. No. The proposal includes a commitment by
16 Pacific to initiate a proceeding within a date certain
17 and that hasn't happened yet.

18 Q. Am I correct that a similar type of a
19 document -- and I don't mean identical terms but has
20 been submitted to the Commission as far as PGE is
21 concerned?

22 A. Yes.

23 Q. And you say you signed that document as
24 well?

25 A. Yes.

(CAVANAGH - CROSS BY ADAMS)

3282

1 Q. In your experience, did the Pacific Corp
2 collaborative group benefit or learn from the
3 experience of Puget Power and the Commission with
4 decoupling here?

5 A. Absolutely.

6 Q. In what sense?

7 A. In the sense that some of the participants
8 in the collaborative had learned a good deal about the
9 issues by working through the Puget experience. In
10 the sense that the Puget system was a benchmark from
11 which discussion could begin, and in the sense that I
12 think the Washington Commission's earlier action gave
13 the Commission a sense that this was a good move to
14 take.

15 Q. In general do you believe that the two
16 proposals that Pacific Corp and PGE have proposed
17 would remove the incentives of these utilities to
18 increase sales and the disincentive of utilities to
19 acquire conservation?

20 A. Both mechanisms break the link between
21 profits and sales volumes, yes. They do it in
22 different ways.

23 Q. Does either the PGE mechanism or the Pacific
24 Corp mechanism -- start over.

25

Does either the PGE mechanism or the Pacific

(CAVANAGH - CROSS BY ADAMS)

3283

1 Corp mechanism shift the risk of weather-related
2 changes in revenues or costs from the utility to its
3 customers?

4 A. No.

5 Q. Is it true that both mechanisms would be
6 implemented using weather adjusted actual sales rather
7 than actual sales without adjustment for weather?

8 A. Yes.

9 Q. Is it correct that both mechanisms use a
10 projection of power supply costs?

11 A. That is basically right, but there are -- I
12 think both mechanisms also incorporate the possibility
13 of adjustment over time to reflect actual experience.

14 Q. Well, they don't have a true-up mechanism,
15 however, do they?

16 A. I think what's important for me to
17 emphasize was that we did not have as part of our
18 charge in the decoupling collaboratives dealing with
19 resource costs and power costs in the way that the
20 Washington Commission had for Puget. So the reason I
21 am hesitating is that this was not an issue that was
22 squarely part of our charge. Decoupling mechanisms
23 have to have ways of dealing with variable costs of
24 power over time but we were not attempting to create --

25 we're not attempting to create the equivalent of a fuel

(CAVANAGH - CROSS BY ADAMS)

3284

1 cost adjustment mechanism and in fact the Commission
2 specifically told us they didn't want us to look into
3 that issue.

4 Q. Looking at page 2 of the document, I see
5 under design criteria B it states there should not be a
6 power cost adjustment.

7 A. But to be clear, that's what the Commission
8 was saying here and what we were reflecting is that
9 that issue was outside of our purview. It was not a
10 policy judgment that we were making.

11 JUDGE HAENLE: Did you move to enter the
12 document?

13 MR. ADAMS: I haven't but I should. Move
14 the admission of Exhibit 822, your Honor.

15 JUDGE HAENLE: Any objection, Mr. Marshall?

16 MR. MARSHALL: No objection.

17 MR. TROTTER: No objection.

18 JUDGE HAENLE: Objection from an
19 intervenor? I should have asked you specifically any
20 objection, Mr. Wellinghoff?

21 MR. WELLINGHOFF: No objection.

22 JUDGE HAENLE: Exhibit 822 will be entered
23 into the record.

24 (Admitted Exhibit 822.)

25 Q. Is it the case with both decoupling

(CAVANAGH - CROSS BY ADAMS)

3285

1 mechanisms developed in Oregon that they would place
2 an annual cap on the decoupling related rate increases
3 that are allowed?

4 A. Or decreases, yes.

5 Q. And what is that cap?

6 A. 3 percent.

7 Q. In either direction?

8 A. Yes.

9 Q. Am I correct that one of the design
10 criterias of both mechanisms was that it should avoid
11 significant rate increases and fluctuations?

12 A. Yes.

13 Q. I gather that was part of the charge from
14 the Oregon Commission?

15 A. No. That actually was a criterion
16 developed by the parties themselves.

17 Q. So actually then just so I understand page 2
18 and 3 of the document under Design Criteria that
19 incorporates both, if you will, directives from the
20 Commission and agreed upon criteria by the
21 collaborative?

22 A. That's right. I should emphasize all of the
23 Commission's direction can be found in the order which
24 is cited at length in my testimony.

25 Q. Dealing with the collaborative process in

(CAVANAGH - CROSS BY ADAMS)

3286

1 general, you've indicated at page 15 of your testimony,
2 generally you're discussing the value of collaborative
3 approaches and at line 17 you state "Collaborative
4 processes are almost never successful in resolving
5 broad policy differences over," and then you go on
6 "issues likely to institute decoupling mechanisms or
7 issues on performance-based incentives." Would you
8 also agree that collaborative processes probably would
9 not be as successful in resolving cost of capital
10 issues?

11 A. I would, and I should make clear.

12 Collaborative processes of course don't resolve any
13 issues. Commissions resolve issues. The question is
14 whether there are circumstances under which the
15 Commission can benefit from sending the parties off to
16 try to develop joint recommendations, and I think that
17 that's most productively done, as I said, where the
18 broad policy is clear that the Commission wants to
19 follow and the issue is essentially how do we fell in
20 the details. In my experience fights over cost of
21 capital seldom fall in that category.

22 Q. Looking at page 11 of your testimony, the
23 quote from the Energy Policy Act of 1992 between lines
24 5 to 11. Would I be correct that you and NRDC were

25 influential players in getting that language inserted

(CAVANAGH - CROSS BY ADAMS)

3287

1 before the Congress?

2 A. We were part of the process, but this
3 language had very broad support.

4 Q. Turning to your discussion on the
5 incentives, the conservation incentive, at page 3,
6 line 18 you describe and say that you will, and I
7 quote "will urge restoration of the performance based
8 system of energy efficiency incentives the Commission
9 instituted for Puget in 1991." Do you see that
10 language?

11 A. Yes.

12 Q. In reading that section I could not really
13 tell what you were asking the Commission to do. Are
14 you asking the Commission to restore the precise
15 mechanism that was in place for Puget's 1991
16 conservation performances?

17 A. No. I am asking the Commission to include
18 this as part of its charge to a collaborative process.

19 Q. Have you performed any specific analysis of
20 the results of the incentive mechanism other than
21 looking at, if you will, the performance achieved in a
22 general sense?

23 A. Not beyond the aggregate impact.

24 Q. When you prepared your testimony, had you

25 reviewed the testimony of Dr. Blackman in Puget's last

(CAVANAGH - CROSS BY ADAMS)

3288

1 PRAM implementation filing where he addresses some of
2 the specifics of the incentive mechanism?

3 A. No.

4 Q. Have you seen that subsequent to your
5 preparation of the testimony?

6 A. Well, I've seen Dr. Blackman's
7 recommendations, I believe, in this proceeding where
8 he has indicated some concerns with the incentive
9 mechanism and let me be clear. I think Dr. Blackman
10 and others have raised some good questions about the
11 previous incentive mechanism. My hope would be that
12 the parties would work together on what I would
13 characterize as an even better system. We can almost
14 always do something better once it's in operation.
15 What I think is crucial for the Commission to do at
16 this point is indicate its commitment to the concept
17 of performance based incentives that again reward
18 achievement as opposed to simply tonnage of dollars
19 invested, and that again was an area where this
20 Commission pioneered, which because of the failure to
21 renew the Puget mechanism we're now in need of some
22 renewal.

23 Q. Do you have any reason to believe at this
24 point that the company has reduced its efforts to

25 acquire cost effective DSM?

(CAVANAGH - CROSS BY ADAMS)

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1 A. No, but this is an issue I address in my
2 testimony. There clearly is still strong momentum
3 from the initial decoupling and the initial incentive
4 system, but my experience in a number of other
5 jurisdictions and in the Northwest indicates that it
6 is difficult to sustain that kind of momentum
7 over time, unless the company has a performance based
8 incentive system in place. And my concern is that, as
9 we've all seen happen several times I think over the
10 last 15 years, this momentum could be lost if we don't
11 have a system of incentives in place to sustain it.
12 But I don't suggest that we're on the brink of a crisis
13 today.

14 Q. I think you are specifically addressing in
15 your testimony the acquisition of DSM resources as
16 opposed to power supply resources of a broader type?

17 A. That's right.

18 Q. Would you agree that or accept subject to
19 check, I think you've indicated that Puget's first
20 savings for conservation in its first two years were
21 17.6 average megawatts and 27.9 average megawatts?

22 A. Yes.

23 Q. Totally 45.5 average megawatts. Would you
24 agree or accept subject to check that in this

25 proceeding Puget is reflecting new purchased power

(CAVANAGH - CROSS BY ADAMS)

3290

1 contract resources of 684 average megawatts?

2 A. I have no knowledge. But if you remember
3 telling me it must be true.

4 Q. I wish I could get away with that all the
5 time.

6 A. Mr. Adams, obviously I want to be clear
7 that my aspirations for Puget's efficiency programs go
8 well beyond the current levels of achievement and I
9 know yours do also. I think it is important, however,
10 to look at the relative record around the region in
11 assessing how well Puget is doing and that's the
12 principal thrust of my testimony but let's not be
13 complacent for an instant.

14 Q. Nor would you dispute that at least in the
15 last couple of years the company has acquired far more
16 resources through, if you will, more conventional means
17 than through DSM resources?

18 A. Yes. I think Mr. Watson's testimony for
19 the coalition suggests that at the moment Puget has
20 acquired about a third of its load growth from
21 efficiency and the rest through new resources, so
22 you're right about the new direction of the
23 relationship.

24 MR. ADAMS: Thank you.

25

JUDGE HAENLE: Commissioners.

(CAVANAGH - CROSS BY ADAMS)

3291

1

2

E X A M I N A T I O N

3

BY CHAIRMAN NELSON:

4

Q. Mr. Cavanagh, at page 7 of your testimony

5

you address the problems of simplicity and

6

intelligibility, and I have to tell you during the last

7

PRAM proceeding public hearings I wish we had had both

8

you and David Moskovitz with us to explain to the

9

public why their bills were going the direction they

10

were going. And I don't know if I agree with you. It

11

seems to me that when asked by pollsters how green they

12

are and how conservative they are Washingtonians

13

will readily say they are, but when asked to pay the

14

bills or at least the people turn up at our hearings

15

they're not so sure, and it's almost as if the dean of

16

public utility regulators who is now at NERA, Kahn,

17

has got the public's pulse read better than you or me.

18

We did hear from the public saying why should I pay for

19

this stuff that just benefits other people. Do you

20

have a ready answer for us when we're out there facing

21

these bill payers?

22

A. A couple of things are important. It is

23

first of all crucial to remember that the rate impact

24

of decoupling in Washington has not been substantial.

25 We need to distinguish decoupling from the other

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3292

1 elements of the PRAM mechanism. The rate impact of
2 decoupling in the last proceeding was on the order of
3 2 percent and of course there is a mechanism that by
4 its very nature goes up and down. So on the issue of
5 decoupling -- I think the issue of decoupling,
6 Commissioner Nelson, is different from the question of
7 whether people are willing to pay more to be green.
8 The nature of a decoupling mechanism is that rates
9 fluctuate up and down around a band, around a
10 reference point. The overall impact of a decoupling
11 mechanism over any extended period of time, say on the
12 order of six years to a decade is going to be neutral.
13 The purpose of the mechanism is again to adjust around
14 a reference point.

15 The issue of whether people -- now, there's
16 a separate issue which you are also right to raise
17 about whether it is reasonable to invest in energy
18 conservation as an alternative to new power supply and
19 that's the context in which people begin to say why
20 should I pay for conservation in someone else's
21 building. My response to them is when a power plant
22 is built in someone else's county you pay part of the
23 cost of that. The reason you pay part of the cost of
24 the conservation is the same as the reason you pay

25 part of the cost of the power plant. This is part of

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 the resource base that the system has to acquire to
2 keep the lights on. It is the nature of an integrated
3 power system that all of us pay part of the cost of
4 power resources that are not installed in our own
5 home, in our own county because we have a joint
6 interest in minimizing the systemwide costs of power
7 supply.

8 I think that the notion that there are
9 nonparticipants in a cost effective conservation
10 program is one that I reject. If that program is part
11 of an integrated least cost resource plan as this
12 Commission has insisted then it is part of the
13 resource base that quite literally keeps the lights on
14 for everybody in Washington state. And I think that
15 case can be won and I think, Commissioner Nelson, that
16 you have the better of your argument with Mr. Kahn.

17 Q. Well, thank you, Mr. Cavanagh, but you just
18 took a lot longer than I did in trying to respond to
19 those bill payers out there. I lamely try to say
20 well, wouldn't you rather pay a little bit more with
21 this resource now than a lot more for a coal plant and
22 they just didn't seem to think that was much of an
23 argument, but this public education process will
24 continue. I think you're right and we do try to

25 distinguish between the decoupling principle and a

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3294

1 resource acquisition principle and there's been
2 suggestions in this case already to try to separate
3 either in time or in procedure those two.

4 I guess I would ask you if you have any
5 general comments on any of the reforms that have been
6 suggested here or is your recommendation to the
7 Commission to kick all this over to reaffirm the
8 decoupling principle and kick the details into the
9 collaborative.

10 A. I would kick the details of decoupling and
11 the details of performance based incentive into the
12 collaborative. Obviously there are many other issues
13 before this Commission. I am not saying send the
14 whole rate case over to a collaborative. The reason I
15 am urging you to do that is that I think frankly the
16 principal problem we've had with both decoupling and
17 performance based incentives in Washington, and the
18 reason they've been lumped so readily with the much
19 stronger determinants of rate pressure, is that we
20 don't yet have the full buy-in of all of the stake
21 holders and I think it's worth making an effort to get
22 that. That one could, I suppose, assemble from all of
23 the testimony in this proceeding any number of
24 different decoupling alternatives that would serve the

25 objective of breaking the link between profits and

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3295

1 sales, but what you wouldn't get if you did that was
2 the kind of buy-in that would give this mechanism the
3 sustained life that I think all of us believe it must
4 have if we're really to change the way that utilities
5 do resource planning and resource acquisition in
6 Washington state.

7 And it's the opportunity to get that buy-in
8 that very strongly motivates our recommendation to you
9 that you send these issues over to that kind of a
10 process.

11 Q. Then that's anticipating my next questions
12 which I've been waiting to ask you about Oregon and
13 New York. I note that on Exhibit 822, Mr. Tanner's
14 signature is affixed.

15 A. Glad to have it.

16 Q. And that may be one of the stake holders
17 that you were just referencing, the industrial users?

18 A. Absolutely.

19 Q. And as I understand Pacific's proposal from
20 reading Trade Press, and correct me if I'm wrong, is
21 that it applies only to the residential class?

22 A. That is wrong. But you're right that the
23 Trade Press I think got it widely wrong. Let me be
24 very clear on what happened. The proposal itself

25 covers all customer classes. The proposal also

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 indicates that Pacific volunteers at this time only to
2 apply the mechanism to the residential class. The
3 report is accompanied by a letter that Mr. Adams
4 didn't introduce into evidence, probably because he
5 doesn't have it but I should alert you to its
6 existence. It is signed by seven of the participants
7 including the Northwest Power Planning Council, NRDC,
8 NCAC and some of the consumers groups. And the
9 addendum letter indicates that in their view the
10 mechanism should be applied to all customer classes.
11 What the report does is to identify a mechanism that
12 could be applied to all customer classes. There is a
13 difference of view among the parties as to how many
14 classes it should initially be attached to but the
15 other simply sets out a mechanism for incorporating
16 the industrial class in the mechanism that Pacific
17 ultimately adopt, if in the Commission's judgment all
18 customer classes should be included.

19 Q. Mr. Tanner didn't sign this latest letter?

20 A. No, Mr. Tanner did not sign the letter, but
21 Mr. Tanner did participate in the development of the
22 default option, that is the way to apply the mechanism
23 to the industrial class, and what you will see if you
24 look at the agreement, for example, is that Mr.

25 Tanner's constituents are exposed to somewhat lower

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3297

1 fluctuations up and down than other classes.

2 Q. Could you then inform me of what's going on
3 with Niagara Mohawk's program? I understand there's
4 special treatment for industrial customers there as
5 well?

6 A. There is, but that proceeding had nothing
7 to do with decoupling. The issue in that proceeding
8 was whether to allow industrial customers to opt out
9 of sharing in the cost of rebates for industrial
10 energy efficiency. If instead they pursued an
11 alternative course of action which in the Commission's
12 mind might yield even more energy efficiency, which
13 involved opting into a program in which the utility
14 used its own funds to basically create loans to
15 industrials to do energy efficiency that the
16 industrials then repaid. The Commission has
17 characterized this as an experiment to see if this
18 loan mechanism for promoting energy efficiency will
19 work better for industrials than the traditional
20 system of rebates. There's a three-year evaluation
21 procedure provided for, and I commend to the
22 Commission and anyone interested in a further analysis
23 of that opinion the March 1993 issue of the
24 Electricity Journal which contains chairman Peter

25 Bradford's detailed assessment of what the Commission

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3298

1 was doing there and why.

2 I think it's important, though, for me to
3 emphasize that the Commission viewed this move as one
4 that would deliver more energy efficiency rather than
5 less and part of the Niagara Mohawk decision is a
6 Commission order that increases the savings targets
7 from the very industrial sector to which this
8 experiment is being applied. And I want to repeat
9 once again, decoupling wasn't on the table in the New
10 York proceeding in terms of the final decision. It
11 has been retained in force.

12 Q. Thank you. That was anticipating my
13 question. Is then the new Niagara Mohawk loan program
14 for industrials something like Pacific's financier?

15 A. It is, and in fact it was modeled on
16 Pacific's financier.

17 Q. Thank you. Also with respect to Oregon, is
18 it true that Oregon uses a future test year or will
19 adopt a future test year?

20 A. Yes. Both mechanisms anticipate a future
21 test year.

22 Q. At page 15 of your testimony you talk about
23 the measurement evaluation problem, and you applaud
24 Puget's system. I am not sure where we are with

25 respect to measurement and evaluation, especially with

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3299

1 respect to the longevity of efficiency mechanisms. I
2 also am not sure where we are. A year or two ago the
3 Commissions of the region met with the Northwest Power
4 Planning Council and agreed that the counsel staff
5 should help us with measurement and evaluation. Can
6 you just give me a little update on what you know about
7 any of those developments?

8 A. I know that the Puget system is still in
9 place and in the judgment of -- it's a collaborative
10 system. It was one of the really productive outgrowths
11 of the initial collaborative that you set up to work on
12 performance based incentives, and in the judgment of
13 the participants in the power council it's still
14 working well. Remember also that the initial
15 performance based system you approved for Puget
16 included specifically, and you were the first
17 Commission in the country to do this, a reward for
18 persistence of savings demonstrated over time.

19 So, the Puget system remains in place. I
20 think the rest of the region has an enormous amount of
21 work to do to catch up to the Puget system, and one of
22 the reasons that the rest of the region has lagged
23 behind is because we haven't had performance based
24 incentives for energy efficiency in the rest of the

25 region. People's rewards have essentially been based

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3300

1 on tonnage of money invested and that's a real
2 problem. In Oregon because the Commission even as it
3 sets up decoupling is also instituting performance
4 based incentive, as my testimony notes, there is now a
5 great deal of effort underway to get a workable merit
6 and evaluation system in place. And the Commission
7 staff remains active on the issue. But we don't yet
8 have, for example, something which I think we need as
9 a region, an independent certification agency that
10 could be brought in to work on these issues.

11 Q. So is the council staff working on this as
12 well?

13 A. Yes.

14 Q. And will we be able to learn from them or
15 from Oregon, do you think, in the near future?

16 A. I think that no one is close to being
17 caught up -- Puget remains the regional leader in
18 measurement and evaluation. But Dick Watson, a person
19 of some familiarity to this Commission, has I know
20 taken this issue on as a particular item of interest
21 and is determined to push ahead in Oregon. Because the
22 Oregon Commission has made a commitment to get
23 performance based incentives in place this year if
24 possible, I think we will be in a position to learn

25 from them, and if I could broach an even less

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3301

1 plausible source of enlightenment, I might note that
2 the California Commission has just adopted a major
3 order on measurement and evaluation which I would
4 commend to this Commission. That was finalized within
5 the last month.

6 Q. With respect to your recommendations on
7 collaboration?

8 A. Cooperation.

9 Q. I went over this ground with Mr. -

10 A. Mr. Bell?

11 Q. Yes. And I am trying to understand your
12 recommendation at page 17 where you say at line 6, "by
13 setting priorities and limiting the total number of
14 initiatives." As I understand it, Puget at least has
15 a policy collaborative, a so-called technical
16 collaborative and it had a rate design collaborative
17 and it may have had a small collaborative to deal with
18 the total resource test. I asked Mr. Bell why they
19 were so hot on collaboration when we got into a
20 discussion of World War II as we went along. But his
21 answer seemed to be that he thought it was cheaper for
22 groups like his to participate in collaboratives than
23 to participate in full blown rate cases. Your
24 reasons, I think, are even more compelling. That was

25 outside the adversary process technicians can really

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 work together to hammer out a decent system. I guess
2 my question is, the thing I worry about is the
3 openness problem. And that trying to explain to the
4 public who, after all, we took an oath to protect the
5 public's interest that the processes are really not
6 places where people get coopted or that sort of thing.
7 How do you deal with that with making sure that the
8 scrutiny that the Commissioners need to satisfy
9 themselves that the results achieved in the
10 collaborative are fair to the whole public?

11 A. I think you do that by providing that
12 scrutiny in a public forum, that is the agreement has
13 to be brought back to you, it has to be defended
14 before you, it has to be responsible to the kind of
15 searching questions that you are asking me right now,
16 and it has to have built into it regular opportunities
17 to step back and make mid course corrections, a point
18 that could be overstated. No collaborative, even if
19 you accept it in full, is going to be setting
20 Commission policy indefinitely. You always are going
21 to want the opportunity to step back and reevaluate,
22 but what I think you can now say based on the better
23 part of a decade of experience with this particular
24 tool for improving decisions and reaching agreements

25 is that there is certainly no evidence of a problem of

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3303

1 the kind of almost corruption of the decision-making
2 process that you've identified. You've got to look
3 out at these participants and recognize the kind of
4 record they have, the kind of longevity they have, the
5 kind of commitment to their interests that you all
6 know they have, and you've got to basically trust them
7 in that forum as in this one to ably represent those
8 interests.

9 What I think you principally get in a
10 collaborative context is they spend more time and
11 effort trying to see if there is a common base of
12 interests in a joint proposal to you than they point
13 into the kind of adversarial gamesmanship that you
14 all and I know all too well. And the real issue is
15 are we going to get better decisions if we redirect
16 some of our understanding that way. We're not giving
17 up the process, we're not giving up Commission
18 scrutiny and we're emphatically not giving up the
19 independence of Commission decisions.

20 There will be collaborative agreements
21 come back to you which you send back again or reject
22 out of hand. Everyone should know that, and I
23 certainly accept and understand it. But I hope also
24 that you will, as the Commission that really got this

25 started and as your experience grows, find that on

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3304

1 balance you get better decisions by incorporating some
2 of these proposals and by letting the parties get more
3 of a chance to assume joint ownership of initiatives
4 that after all are sweeping in the terms of their
5 potential for the reform of the industry.

6 You're absolutely right to take very
7 seriously the reform dimension implicit here. These
8 are not small decisions. These are not small changes.
9 They are shifting the nature of the industry, I think
10 in a very positive direction, but in the end the
11 responsibility remains the Commission's.

12 Q. In Colorado before Ron Layer left who
13 worked with many forms of dispute resolution is
14 essentially what he recommended is what I think what I
15 just heard you say is fairly frequent reporting to the
16 Commission so the Commission can offer feedback when
17 it hears of progress in the collaborative?

18 A. And in Oregon, by the way, that actually
19 was done in part because of a concern about a
20 perceived disconnect with the Washington Commission.
21 I think that was one of the useful lessons from the
22 Washington experience. The Oregon Commissioners asked
23 for monthly briefings and questioned the parties about
24 where things were going and had a chance to talk

25 through and get some sense of ownership in the process

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 themselves and I do think that's valuable.

2 Q. One last question. With the new Energy
3 Policy Act we now have Congress setting in motion new
4 competitive forces for the electric utility industry.
5 And I think I've heard through the trade press or
6 others that you worry about the durability of these
7 mechanisms with the advent of competitive forces. I do
8 also.

9 A. Well, let me correct the trade press in
10 this regard. I think that, and the place I've written
11 about this most recently is the April 1991 Electricity
12 Journal, an article that I think would like to get
13 into this proceeding if we can because it squarely
14 addresses that issue. I think that competitive forces
15 in wholesale markets, Commissioner Nelson, are
16 entirely compatible with what we're doing here.

17 Q. I'm talking retail market.

18 A. I think that if retail wheeling made a
19 serious -- came into a serious prominence in the
20 country we would have a problem, and that by the way
21 is principally what the new Standard & Poor's analysis
22 is taking off of. That basically the exhibit from
23 Puget, from the May 1993 Credit Week might better be
24 retitled Standard & Poor's discover retail wheeling.

25 The emphasis that I want to make, when I am going

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 around the country saying about that now is that I
2 emphatically deny both the inevitability and the
3 merits of the particular fix that I think retail
4 wheeling represents.

5 I remind the Commissioners that the
6 National Energy Act prohibits the Federal Energy
7 Regulatory Commission from ordering directly or
8 indirectly the institution of retail wheeling. That
9 is now a policy issue that has been confined to the
10 three of you. And it is my judgment that when you
11 take a hard look at that issue, and this proceeding
12 may not be the place to do it, you will say absolutely
13 emphatically no even as you say yes to encouraging the
14 wholesale market competition that the National Energy
15 Policy Act was designed to promote. And I repeat I
16 very strongly feel that there is nothing at all
17 inconsistent between aggressive competitive wholesale
18 power markets and the kind of least cost retail market
19 orientation also based on competitive forces that this
20 Commission is encouraging when it sends Puget out with
21 the right market signals and the right market
22 incentives to promote the best results for its
23 customers. No incompatibility at all between those
24 two developments in my view.

25 Q. Well, that's encouraging. I will encourage

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

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1 you to get hold of the notice we issued yesterday on
2 implementing our responsibilities under the Energy
3 Policy Act. Thank you, that's all I have for now.

4 JUDGE HAENLE: Commissioner.

5

6 E X A M I N A T I O N

7 BY COMMISSIONER CASAD:

8 Q. Always a pleasure to welcome you, Mr.
9 Cavanagh. I suspect there are a significant number of
10 people to welcome you more often to rebuild the fires
11 in the bellies of a lot of people who have been
12 engaged in the process and for one reason or another
13 have had the fire dampened a little bit. Maybe it's
14 your red hair but you always seem to bring that
15 characteristic to whatever presentation you might
16 make.

17 I would like to explore a few areas with
18 you and get your views and this is policy morning. We
19 have a series of witnesses who are really broader in
20 scope from the particular perspective they represent
21 than detailed kind of testimony. First I would like
22 to discuss with you a little bit a little known feature
23 of the Energy Policy Act and that is the optional
24 credits that are available -- I'm sorry -- Clean Air

25 Act -- the optional credits that are available for

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

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1 essentially early adoption post 1991 energy efficiency
2 investments.

3 A. Yes.

4 Q. The last I heard, and this has certainly
5 been a consideration regarding Puget, the last I heard
6 these credits were going to be awarded on a kind of a
7 telephone auction first come first serve basis. Is
8 that still true?

9 A. Yes, that is still true.

10 Q. To your knowledge, does Puget have its oar
11 in the water early?

12 A. I am confident that it does, Commissioner.
13 I should note that the teller's window is opening a
14 little late. The EPA took longer than expected to
15 issue the implementing regulations. They are cited in
16 my testimony, and I am confident, although I haven't
17 discussed this with Puget management, that they will
18 be aggressively trying to insure that California does
19 not succeed in locking up all the allowances in the
20 first hour and a half. And the good news that I think
21 Puget is one of the few utilities in the country that
22 unambiguously qualifies from the first moment of
23 eligibility under the Clean Air Act for these credits,
24 and of course part of the reason I am testifying here

25 today is to make sure that that eligibility is

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

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1 continued because I think it's at risk if decoupling
2 goes away.

3 Q. Now, the fair distribution of those
4 benefits has always been a concern to many, and the
5 earlier telephone call auction didn't seem to be the
6 fairest process to accomplish that, and one would hope
7 that those who are attempting to influence policy
8 would continue to bang at the door of the rule makers
9 to insure that there is a fair distribution and the
10 intent of the legislation is actually carried out?

11 A. In fact Commissioner Casad, I would go
12 further. To some a fair distribution means that every
13 state gets a percentage reflecting its population. I
14 think a fair distribution is that Washington state
15 gets substantially more than that, given its
16 substantially greater contribution on these issues.
17 So with that understanding of a fair distribution I
18 think we have a common agenda and I assure you we will
19 pursue it.

20 Q. Thank you very much. In the area of
21 incentives you urge the reinstatement of incentives in
22 the program that was originally adopted for Puget and
23 you apparently strongly believe in the benefits that
24 are achieved through offering incentives to

25 ratepayers?

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3310

1 A. Performance-based incentives to utilities,
2 yes, Commissioner.

3 JUDGE HAENLE: Slowly, please.

4 Q. What do you think about incentives for
5 other than conservation? What would be your view
6 toward offering incentives to a utility for other
7 resource acquisitions which were extraordinarily
8 beneficial in nature?

9 A. Let's recognize now that I am going outside
10 the scope of my testimony but I will happily answer
11 the question. I think that --

12 Q. I bet we can get away with it.

13 A. Okay. I think we have the following
14 problem now if we look at utilities collectively in
15 Washington. There is a very substantial earnings
16 opportunity for the company's own power plant
17 distribution transmission investments. There is an
18 earnings opportunity for energy efficiency that's in
19 some question but at least implicitly there. For
20 purchased power, the subject of this morning's
21 colloquies, there's no earnings opportunity at all and
22 no corresponding symmetrical opportunity of loss for
23 poor performance. I in general think that the
24 objective ought to be, and this Commission was the

25 first in the country to adopt it, that a company's

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3311

1 least cost procurement least cost plan ought to be its
2 most profitable course of action. I think the
3 question you ought to be constantly asking as a
4 Commissioner is are we there yet and I agree with
5 you that getting there requires more than just
6 attention to DSM.

7 Q. I find your observation interesting that
8 there are no opportunities in the purchased power
9 arena for a utility to exceed the performance of
10 others and therefore -- you do not believe that
11 opportunity exists?

12 A. I do not believe that there is -- let me be
13 very careful on this because there are some
14 opportunities to make or lose money in purchased power
15 markets but I don't believe that from the perspective
16 of a utility's overall balance sheet that the
17 opportunity either to earn or lose, based on good or
18 poor performance, is in any sense symmetrical on the
19 purchased power side with what they have on their own
20 generation, their own transmission, their own
21 distribution equipment. I think that that is a
22 problem if one is moving into a world in which utility
23 owned generation and transmission and distribution
24 isn't the only option available. And I do think that

25 that is a reasonable issue for this Commission to

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3312

1 begin to engage, and energy efficiency is going to be
2 part of it because the energy efficiency investment is
3 part of the overall profitability of the company also.

4 Q. Are you saying that the incentives are
5 contained in the product, i.e., that the incentive to
6 perform extraordinarily well in the purchased power
7 arena is the reward that a utility achieves through
8 either cutting costs and therefore get some kind of a
9 return to the regulatory process which some would
10 question perhaps, or in its ability to market or
11 perform other things where there's some revenue return
12 to the company?

13 A. Those opportunities may be there, but in
14 general -- and I want to emphasize I have not looked
15 at Puget in particular in reaching this conclusion --
16 I would say in general U.S. utilities do not at this
17 time have a substantial performance-based incentive
18 either to succeed or fail in the purchased power
19 markets and I think that's a problem.

20 Q. What is your view regarding that
21 circumstance and other issues, retail wheeling which
22 you've chosen to discuss a little bit, in view or in
23 relation to the power legislation which has just been
24 passed by the Congress?

25 A. The power legislation just passed by the
 (CAVANAGH - EXAM BY COMMISSIONER CASAD) 3313

1 Congress will encourage competitive wholesale markets
2 and discourage retail wheeling. In fact, it prohibits
3 retail wheeling orders by the Federal Energy
4 Regulatory Commission which was the body everyone
5 expected to drive that trend, if indeed that trend was
6 going to be driven. At the state level there has been
7 over the eight months since the national act was
8 passed no discernible move toward retail wheeling.
9 New Mexico has said no, California has tabled
10 legislation, Minnesota has tabled legislation, Rhode
11 Island has said no. Michigan is still deliberating
12 but the deliberations have now dragged out months
13 beyond the initial deadline. I don't think it's going
14 to move, and I think if a few jurisdictions do it they
15 will discover they don't like it. It will not take
16 hold.

17 Q. The act does, however, provide for a
18 totally changed energy marketing environment in the
19 country with the exempt wholesale generators,
20 independent power producers, access to the
21 transmission grid, the entire context is changed and
22 therefore one would think that there would be pretty
23 substantial follow-on impacts on utilities at the
24 local level, i.e., 636 and the LDC's?

25 A. Well, no. There -- I go almost as far as
 (CAVANAGH - EXAM BY COMMISSIONER CASAD) 3314

1 as you took me and then I stop because order No. 636,
2 which some might say is the gas equivalent of retail
3 wheeling came, remember, from FERC, the agency that's
4 now out of the gate on the electric side. I think
5 that what will happen, you're absolutely right, there
6 will be a transformative impact on wholesale markets
7 and what that means is when a Puget Power or a Pacific
8 Corp needs new power supply they are going to go into
9 a competitive market price with a lot of exciting
10 options, but you know, for you western regulators this
11 isn't as dramatic a change as it is for the rest of
12 the country because you've been moving toward a
13 competitive acquisition market with nonutility
14 suppliers for years now. And in that sense I think
15 that what you are describing was a trend that Congress
16 absolutely picked up but they got it from you, they
17 didn't invent it.

18 Q. I would like to very briefly discuss
19 collaboratives which has received a lot of attention
20 this morning. And I would premise my question with
21 my personal view that collaboratives, at least in the
22 context of this Commission and the experiences we've
23 had, I believe have made a significant contribution to
24 the effectiveness of regulation and dealing with the

25 problems that we have. And not the least of which

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3315

1 values is the buy-in concept that you mentioned, and I
2 think it's a simple postulation that you can get a lot
3 farther with cooperation than you can through
4 opposition to each other's position. And you
5 eliminate litigious or potentially litigious matters
6 as a result of the communication and the inter-
7 communication that you have and the resolution of
8 these issues before they're brought to the Commission.
9 They never get to the Commission because they aren't
10 of sufficient policy importance that they need to get
11 that far. And therefore are resolved at the
12 collaborative level. That's a value. I think this
13 Commission's experience has been that the
14 collaborative process, I think has generally been
15 recognized as a very good one.

16 The problem has been that with the
17 participation of our staff our usual repository of
18 expertise that we depend upon when they become
19 participants in the collaborative process then we have
20 no independent mechanism to evaluate the
21 worthwhileness of the collaborative process. We
22 ourselves are not participants. Our staff, which
23 ordinarily does provide us with this quality of
24 independent analysis is also a participant and has to

25 buy off on the product with everyone else. We have

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3316

1 felt -- and that was one of our gravest concerns was
2 the effectiveness of the process was that lack. What
3 views do you have concerning this, if any?

4 A. Well, again, I will assume for a moment
5 that there's no way of dividing the staff so some of
6 them can continue to advise you and some of them can
7 participate in the collaborative which is obviously
8 one way of responding to that. Assuming that option
9 is not available, then to me the continuing -- then I
10 think what you should do is insist that the
11 collaborative allows for a mid course review. If you
12 adopt a decision that's brought to you by a
13 collaborative process there ought to be a mid course
14 review in which your staff breaks free, if you will,
15 and participates as an independent adjunct to your mid
16 course review. I don't think that the staff -- it
17 ought to be clear from the beginning to everybody that
18 by signing off on an initial agreement the staff is
19 not taking a position that that is forever more the
20 right way to go. The staff is retaining the
21 obligation and the intention of critically evaluating
22 the proposal, as everyone else is, at mid course.

23 And I think that ought to give you some
24 reassurance at least in a context that allow for

25 mid-course corrections that you will not be led down

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3317

1 some fundamentally wrong path based on the fact that
2 you didn't have the same level of independent analysis
3 that you would have had without the collaborative.

4 You are identifying a real trade off. I
5 don't want to suggest that collaboratives are a
6 panacea. I do think on balance that they're a plus in
7 areas -- again, let's be clear where you should do it.
8 You should do it where you have made the policy
9 decision, Commissioner Casad, where you have made the
10 determination and with the independent assistance of
11 your staff. That is the right way to go. What you're
12 sending the staff off to go with the other
13 participants is to work out a detailed mechanism that
14 you can deliver the policy you have already decided is
15 right, and I think the dangers of the somewhat
16 diminished independent review are less there than if
17 you were sending us all off to initiate the policy.
18 If you were sending us all off to decide whether to
19 decouple, then the lack of independent review would
20 weigh much more heavily with me than if all you're
21 doing is telling us to go off and fill in the details
22 of a policy that you've adopted based on the kind of
23 adversarial review and independent assessment that
24 you're talking about.

25 Q. There are other alternative proposals I was

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3318

1 interested in your view. Regarding conservation in
2 the industrial area, would you agree that perhaps the
3 greatest amount of cost effective conservation is
4 available in the industrial area?

5 A. I would.

6 Q. What would you propose as a methodology to
7 capture that cost effective conservation?

8 A. Well, the good news that I think I would
9 push Puget very hard to continue down the path it's
10 already pursuing, Puget aggressively attacks
11 industrial conservation opportunities and I think that
12 the basic notion that Puget has to invest in
13 conservation, has to create financial incentives, has
14 to try and enroll the industrial community as a full
15 participant in these programs, and that Puget's
16 earnings reflect to some extent its success in
17 enlisting that constituency.

18 But the good news, the industrial
19 constituency of the Northwest, in my experience, is
20 eager to take advantage of these opportunities and the
21 problem isn't an unwillingness to explore the
22 opportunity, it is a historical skewing of
23 conservation investment in this region toward some of
24 the less cost effective options in residential and

25 commercial sector applications. I think all of those

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3319

1 programs, by the way, are still on balance good
2 investments for utilities. But I think in this region
3 what we need over the next half decade or so is an
4 aftermath of renewed emphasis on preparation. A
5 proportional shifting of resources more towards the
6 industrial sector precisely because I agree with you
7 that that right now is where some of the largest and
8 least expensive opportunities are. I think you should
9 unleash Puget -- Puget has shown that, given the right
10 incentives, it can achieve great results and it isn't
11 probably for you or I to tell them how to do it, it's
12 for you and I to try to make sure they have the
13 incentives to suggest and get out of the way and watch
14 them perform.

15 Q. One of the problems, as you well know, is
16 that in order to capture the benefits of conservation
17 that one has to make a substantial upfront investment
18 which is returned over time cost effectively but is
19 very painful or can be very painful as far as rate
20 shock and rate impact when you initiate the program.
21 Now, are there alternatives for industrial and
22 commercial conservation that would tend to minimize
23 this rate impact across the whole spectrum of
24 residential customers?

25 A. Certainly Puget I think has been aggressive

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3320

1 and effective at finding ways to minimize the rate
2 impact of its programs. It's important to remember
3 that Puget, with the most aggressive conservation
4 program in the region, has a rate impact related to
5 conservation on the order of 6 percent at the present
6 time if you look at the total resource investment.
7 What does that represent in terms of the system's
8 total outlays. That would be the maximum, that's the
9 highest investment that I've seen. The New York Times
10 estimate attached to my testimony suggests that it's,
11 in fact, less than 4 percent. In that range I don't
12 think we're talking about rate shock. The critical
13 question is, are we getting a return that is
14 comparable to or significantly better than the other
15 returns that are available in industrial settings.
16 That's a fair question, we ought to answer it. We
17 also ought to be trying to enlist contributions from
18 participating customers and we do that. Puget does
19 not give conservation away. Every Puget program, as
20 far as I know, requires a contribution by the
21 participating customer, and certainly in the
22 industrial side that could be pursued. There are also
23 innovative program techniques involving putting
24 capital up front and having it repeat over time as an

25 alternative to the rebate mechanism.

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3321

1 Commissioner, absolutely, there are
2 innovative conservation mechanisms available to help
3 reduce the impact of conservation but I do want to
4 dispute the premises of the question that conservation
5 has in some sense been responsible for rate shock in
6 Washington or elsewhere up to the present time, don't
7 think the record bears that out. The rate shock
8 problems the region is having have a very different
9 origin.

10 Q. But you would agree as a matter of accepted
11 understanding that investments in conservation do have
12 an upfront cost which are amortized over time and
13 therefore are somewhat front loaded as far as --

14 A. Yes, like most other utility investments in
15 capital.

16 Q. Then the final question I would like to ask
17 you is with your national perspective and work in this
18 area. This Commission has embarked on a number of
19 unique approaches to regulation, in my view, and
20 school is not out yet. We are in the midst of them.
21 We are, I think, amongst the first to embark on
22 integrated resource planning, least cost planning as
23 we called it at that time, competitive bidding, which
24 by rule both of those I think we have had in existence

25 now for a substantial period of time. The decoupling

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3322

1 experiment with Puget, which was the result of a
2 notice of inquiry issued by this Commission regarding
3 incentives, and I guess there are two questions. From
4 your experience nationally, is there doubt zone in the
5 financial community and amongst the responsible
6 reviewers of regulatory activity that instead of being
7 on the cutting edge of regulation we might be running
8 around with an ax and cutting off all the chickens'
9 heads?

10 A. Absolutely not. And I think the testimony
11 this morning brought it out. The only thing this
12 Commission did recently that gave pause to the
13 financial markets was the appearance of retreat from
14 decoupling in the September 1992 order in the single
15 paragraph that is quoted in my testimony at page 7
16 which is a paragraph that I would love to obliterate
17 from the records of this Commission, and this
18 proceeding is a marvelous opportunity to do it. I
19 think that, on the contrary, this Commission has set
20 the direction and the precedence that are guiding the
21 policies of utilities in the rest of the country
22 and it is only the moments when this Commission
23 appears to be stepping back and expressing
24 indecisiveness that the markets tremble.

25 Q. Along that line as I tried to express this

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

3323

1 morning we don't claim credit for authoring of the
2 order drafting, the Commissioners themselves, but I
3 think that has been broadly -- that order has been
4 broadly misinterpreted. That was not the intent of
5 the order, there was no abandonment of decoupling as
6 an experimental concept. We wanted to stay the course
7 but if those words have any impact on the desired
8 result, why, fine, and so be it. What do you think --
9 the other question regarding these innovative kind of
10 approaches is what do you think of them as a package?
11 Do you see a benefit or a lack of benefit?

12 A. I think that these reforms as a package
13 have transformed the utility industry. They have
14 transformed it from a commodity supplier trying to
15 maximize sales into a service industry that is
16 attempting to deliver the energy services which none
17 of us values kilowatt hours or therms for themselves.
18 We value the services they provide. What you have
19 done is to refocus the industry on minimizing the
20 cost and maximizing the value of those services which
21 go to the heart of what it means to have a competitive
22 economy and a sustainable energy future. And without
23 those reforms I don't think we would have any hope of
24 delivering that result, and I think you have helped

25 set in motion a process that I believe will, in a very

(CAVANAGH - EXAM BY COMMISSIONER CASAD)

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1 positive way, transform the face of the industry. And
2 the good news is that the financial markets are
3 applauding you as you go and only responding nervously
4 when you appear to be losing your momentum.

5 Q. Thank you. We've ranged from fire in the
6 belly to warm and fuzzy, so thank you very much.

7 JUDGE HAENLE: Commissioner?

8 COMMISSIONER HEMSTAD: Try to make my
9 questions brief here.

10

11 E X A M I N A T I O N

12 BY COMMISSIONER HEMSTAD:

13 Q. In Oregon you referenced both Pacific Corp
14 and PGE as having now adopted decoupling?

15 A. Proposals, Commissioner. Hasn't happened
16 yet.

17 Q. I believe you said they were different or
18 they were similar objectives but structured
19 differently. Are those differences the result of
20 uniqueness of each company or is it a difference
21 resulting from the participants in the process?

22 A. I think it's a little of both that you can
23 find in the agreements differences that are partly a
24 reflection of corporate culture. This Commission was

25 the first to say, and I think that it was right, that

(CAVANAGH - EXAM BY COMMISSIONER HEMSTAD)

3325

1 incentives are most effective if the recipient
2 perceives them as such, and there are different
3 corporate cultures and it is necessary to respond to
4 that, and there were somewhat different participants
5 as well. Each of these was an agreement hammered out
6 by informed and consenting adults that achieved the
7 objective of breaking the link between profits and
8 sales, and what I want to emphasize to you,
9 Commissioner, is there's no single cookie cutter way
10 of doing that. There are a number of different
11 approaches, any one of which could work well.

12 Q. Does it follow that for example in this
13 jurisdiction that each company will ultimately then
14 have to adopt aggressively and pursue this set of
15 arrangements will have a unique set of circumstances
16 that will have to be addressed, is that inherent in
17 the process?

18 A. I think it's a policy judgment for the
19 Commission. You should certainly choose to adopt
20 one approach for all utilities. California has done
21 that. California has a decoupling system that is
22 uniformly applied to all of its utilities. Oregon
23 has chosen to let each utility come forward and help
24 design its own mechanism. In my own sense looking

25 back at it at this point is that the best way to get

(CAVANAGH - EXAM BY COMMISSIONER HEMSTAD)

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1 decoupling done in Washington is probably to have each
2 utility bring forward its own proposal and to create
3 the opportunity for ownership investing that gives
4 some assurance that that will be sustained over time.
5 But it's a policy call for you and there are states
6 that have gone both ways.

7 Q. Then a couple of questions back on the
8 collaborative process again. You've been involved in
9 that process in this state. Is that true?

10 A. Yes, although my involvement in the Puget
11 process was less than my involvement in Oregon.

12 Q. And in the Puget process as it pertains to
13 this particular hearing now?

14 A. Well, there was no collaborative process
15 for this particular hearing, Commissioner. There was
16 a collaborative process that developed both -- it
17 attempted to get a consensus on the decoupling
18 mechanism ultimately failed and then did develop a
19 consensus on performance based incentives and I was
20 part of that.

21 Q. In earlier testimony there were apparently
22 proposals to have a collaborative process and after
23 the filing of the company's initial case. My question
24 goes to what is the appropriate time for this kind of

25 a process to work, and I approach this from the

(CAVANAGH - EXAM BY COMMISSIONER HEMSTAD)

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1 perspective of my background as a lawyer and I suppose
2 there are at least three different points. There's a
3 period prior to the company filing a case at all, the
4 period after the company has filed its case and then
5 following something of interim order from this
6 Commission. And that poses different kinds of
7 tactical and substantive issues I suppose on each of
8 those filings. What is your sense of when the
9 collaborative process should be applied, prior to the
10 start of hearings or in the middle or after?

11 A. At the present moment I think the clear
12 answer is after, because the difficulty at the moment
13 is we don't have the clear direction from the
14 Commission that I think is needed to make the thing
15 work here and we also, the last time the Commission
16 spoke on collaboratives in its January 1992 order it
17 did so without the fire in the belly, Commissioner
18 Casad, that might be helpful in convincing
19 participants that this was a useful thing to do.
20 Collaboratives shouldn't form unless Commissions want
21 them, and I think that this Commission, if it wants
22 this to happen, needs to set the thing in motion,
23 needs to create a clear deadline and needs to make the
24 policy calls without which the collaborative can't

25 proceed. In the future, Commissioner, there may well

(CAVANAGH - EXAM BY COMMISSIONER HEMSTAD)

3328

1 be occasions when it will be productive to use these
2 sorts of approaches to help frame a utility's filing
3 or to help settle disputed issues.

4 Q. Before it's presented?

5 A. Right.

6 Q. I analogize as a lawyer to the requirements
7 for negotiation conferences or prefiled orders and the
8 like that are different, I realize, but to narrow the
9 issues, the issues that would be presented in open
10 hearings or in contested hearings could be much more
11 narrow, for example?

12 A. I agree, and I think that this is a tool
13 that could work at different levels of the regulatory
14 process and my recommendation here is limited to these
15 particular issues at this particular moment.

16 COMMISSIONER HEMSTAD: No further
17 questions.

18 JUDGE HAENLE: Let's go off the record to
19 discussing scheduling.

20 (Discussion off the record.)

21 JUDGE HAENLE: Let's be back on the record.

22 We determined we will finish the questions before we
23 break for lunch. Madam Chairman, you had something
24 else?

25

CHAIRMAN NELSON: Just one.

(CAVANAGH - EXAM BY COMMISSIONER HEMSTAD)

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EXAMINATION

3

BY CHAIRMAN NELSON:

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Q. Mr. Cavanagh, in answer to Mr. Marshall, I think you said something like Puget has the most effective and the lowest cost conservation programs of any company in the country?

A. No. Again, I want to clarify that, but continue.

Q. My question is, how do you know they're the lowest cost?

A. On cost my reference was to the Northwest region and I am relying there on the power council's recent analysis described in my testimony about the relationship between the Puget costs and the region wide averages generated by the Bonneville Power Administration. I am also relying on my knowledge of the state of the other utilities' programs. So I can make that statement confidently for the Northwest region. Making cost comparisons between regions is more difficult because the retail costs, as you know, are so different and that has a profound effect on the cost of utility programs. But I do make the statement, that is my opinion in terms of the

25 Northwest region, most effective lowest cost.

(CAVANAGH - EXAM BY CHAIRMAN NELSON)

3330

1 CHAIRMAN NELSON: Is the power council
2 document in the public domain?

3 THE WITNESS: Absolutely. The power
4 council document is the -- well, the document on the
5 total savings is in the public domain and the
6 comparison between Puget's conservation and Puget
7 savings and Bonneville's verification budget and
8 savings is documented in my testimony. And again the
9 PI has it on the front page of the business section,
10 today, so it's sure in the public domain.

11 JUDGE HAENLE: Commissioners, anything
12 else?

13 COMMISSIONER CASAD: No.

14 JUDGE HAENLE: Redirect, Mr. Wellinghoff?

15 MR. WELLINGHOFF: No.

16 JUDGE HAENLE: I think you had some more
17 cross?

18 MR. RICHARDSON: I do, your Honor, thank
19 you.

20

21 CROSS-EXAMINATION

22 BY MR. RICHARDSON:

23 Q. Mr. Cavanagh, referring to what's been
24 identified as Exhibit 822 which is the Pacific Corp

25 decoupling report which you were requested by the

(CAVANAGH - CROSS BY RICHARDSON)

3331

1 chairman concerning the import of signatures on that
2 document, weren't you?

3 A. Yes.

4 Q. Isn't it true that by signing that document
5 the signator is not agreeing that decoupling is a
6 desirable method for or a desirable rate making tool?

7 A. This is an important thing to be very
8 clear on. All that the signature means, and the
9 exhibit fortunately makes this very clear, is that the
10 parties agree that this is the best decoupling
11 mechanism for meeting the objectives of the
12 Commission's order. You are correct to say that the
13 participants in this process do not take a position on
14 the intrinsic merits of decoupling, and that reflects
15 again, I think, the recommendation I made earlier that
16 the policy judgment must be made by the Commission.
17 In Oregon, the policy judgment was made by the
18 Commission. And the parties were sent off to come up
19 with the best mechanism they could. All that these
20 signatures mean is that all of us agree that this is
21 the best mechanism we can come up with.

22 Q. It's true that the Oregon Commission
23 prohibited the parties from discussing the relative
24 merits or demerits of decoupling as a rate making

25 tool?

(CAVANAGH - CROSS BY RICHARDSON)

3332

1 A. Didn't stop Grant from bringing it up
2 occasionally, but absolutely right. The Commission
3 said, This is our policy call. Don't you folks
4 revisit it.

5 MR. RICHARDSON: That's all I have.

6 JUDGE HAENLE: Anything more of the
7 witness?

8 All right. Thank you, sir, you may step
9 down. Let's recess at this time. We'll be back at
10 1:40 for the next witness.

11 (Luncheon recess at 12:15 p.m.)

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(POWER - DIRECT BY WELLINGHOFF)

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AFTERNOON SESSION

2

1:50 p.m.

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(Marked Exhibits T-823, 824 and 825.)

4

JUDGE HAENLE: Let's be back on the record

5

after our lunch break. We are now going to take the

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last of the NCAC witnesses. While we were off the

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record I marked for identification three documents as

8

follows: Marked as Exhibit T-823 for identification

9

is a 33-page document. In the upper right-hand corner

10

TMP-1, the prefiled testimony.

11

TMP-2 in three pages, qualifications will

12

be 824.

13

And TMP-3 in 19 pages will be 825.

14

Whereupon,

15

THOMAS POWER,

16

having been first duly sworn, was called as a witness

17

herein and was examined and testified as follows:

18

19

DIRECT EXAMINATION

20

BY MR. WELLINGHOFF:

21

Q. Dr. Power, could you please state your name

22

and business address for the record.

23

A. Yes. My name is Thomas Michael Power. My

24

business address is Economics Department, University

25 of Montana, Missoula, Montana 59812.

(POWER - DIRECT BY WELLINGHOFF)

3334

1 Q. What has been marked for identification as
2 Exhibits No. 823 through 825, were they prepared by
3 you or under your direction?

4 A. Yes.

5 Q. Do you have any corrections to those
6 exhibits?

7 A. Yes. There's three or four corrections
8 that have been pointed out to me that would be helpful
9 to make. On page 4, lines 23 and 24 was not intended
10 to discuss the utility's bottom. It was the utility's
11 bottom line that was of interest to me.

12 And on the next line it should read the
13 utility's bottom line is unavoidably damaged.

14 On page 9 line 11, starting on line 10, it
15 should read "rates are temporarily reduced." Instead
16 of "reduce" it should be "reduced."

17 On page 15, line 8 before the beginning of
18 the new sentence that starts with the word "accurate,"
19 I want to change that to "completely accurate" so it
20 should read, "completely accurate economic data on a
21 utility's service area is not available."

22 And finally on page 18, line 4, it should
23 read "there is no relationship" rather than "there
24 in." There are some other typographical errors that I

25 don't think will confuse the meaning that I will leave

(POWER - DIRECT BY WELLINGHOFF)

3335

1 unchanged.

2 Q. Dr. Power, if I were to then ask you with
3 those corrections the questions that are contained on
4 Exhibit 823, T-823 would your answers be the same
5 today?

6 A. Yes, they would.

7 MR. WELLINGHOFF: I would offer for
8 introduction into evidence Exhibits T-823 through 825.

9 MR. MARSHALL: No objection.

10 MR. TROTTER: No objection.

11 MR. ADAMS: No objection.

12 JUDGE HAENLE: Objection from any
13 intervenor?

14 All right T-823, 824 and 825 will be
15 entered.

16 (Admitted Exhibits T-823, 824 and 825.)

17

18 CROSS-EXAMINATION

19 BY MR. MARSHALL:

20 Q. First I would like you to turn to page 9 to
21 one of those same sentences that you just corrected.
22 At lines 9 through 11 you said there that the kilowatt
23 hour index -- if the kilowatt hour index has grown
24 more than the decoupling index allows, rates are

25 temporarily reduced to "confiscate" those over

(POWER - CROSS BY MARSHALL)

1 earnings. Do you see that?

2 A. Yes.

3 Q. What did you mean by that?

4 A. Simply that the utility's revenues are
5 reduced so that the revenues that the utility actually
6 receives match the revenues that are indicated
7 appropriate by the decoupling index. So that if there
8 is significant growth, for instance, beyond what the
9 decoupling index indicates is appropriate, revenues
10 are reduced.

11 Q. We've talked earlier this morning about the
12 situation where there might be a severe winter with
13 ample hydro, severely cold winter with ample hydro?

14 A. Yes.

15 Q. Is that where you mean that the kilowatt
16 hour index is growing more than the customer index or
17 some other index would grow?

18 A. No. If the decoupling mechanism were
19 intended to take into account variations in weather
20 and variations in kilowatt hour sales associated with
21 weather, then that would be the case. What I had in
22 mind here as in my testimony as a whole was what I've
23 labeled pure decoupling where I've tried to separate
24 out fluctuations due to weather or due to economic

25 conditions or a variety of other fluctuations in

(POWER - CROSS BY MARSHALL)

1 revenues. And I am simply focused on what I see as
2 the point of decoupling and that's that you're trying
3 to break the connection between the utility's revenues
4 or profits and its kilowatt hour sales. Between rate
5 cases now as kilowatt hour sales grow the utility's
6 revenues grow. I am assuming that what decoupling
7 does is remove that kilowatt hour index that's
8 implicitly used now and replace it with something
9 else. In Puget's case currently that would be the
10 growth in the number of customers so that one simply
11 is comparing the growth indicated as appropriate by
12 the growth in the number of customers you replace that
13 growth rate, you use that growth rate to tell you how
14 much the utility's revenue should have been allowed to
15 grow. If you find that they grew more than that, the
16 utility loses those additional revenues.

17 Q. And symmetric if it works the other way?

18 A. Absolutely.

19 Q. You were here this morning when there was a
20 talk about the current structure of the decoupling
21 mechanism, that it is symmetric currently, that it
22 works in both directions?

23 A. Yes. The decoupling mechanism should --
24 has to be symmetric or you really haven't decoupled,

25 so that if the utility's revenues have not grown, and

(POWER - CROSS BY MARSHALL)

1 this is what people are interested in, DSM are
2 primarily interested in, if the utility's revenues
3 have not grown by as much as the decoupling index
4 indicates is appropriate, especially if they haven't
5 grown because of DSM activity on the part of the
6 utility but depending on how you've structured things
7 for whatever other reasons, then that inadequate
8 growth in revenues is made up for by temporarily
9 raising rates.

10 Q. Like you to turn to page 3 of your
11 testimony. At lines 19 to 21 you say, "With the
12 purchased power and fuel cost adjustment mechanism
13 that Puget has usually had available, these rising
14 supplies costs were automatically
15 covered." By that were you referring to the ECAC
16 mechanism that was in effect for about 12 years before
17 PRAM decoupling?

18 A. Yes.

19 Q. Have you made any sort of study to
20 determine how many of the utilities around the country
21 have automatic fuel adjustment mechanisms or purchased
22 power mechanisms?

23 A. I don't know what percentage. I know many
24 do but I don't know what percentage.

25 Q. I would like you to turn to the page where
(POWER - CROSS BY MARSHALL)

1 you talk about whether this mechanism is a cost-based
2 mechanism compared to traditional kilowatt hour sales
3 mechanisms. Are you familiar generally with some
4 positions that have been stated that decoupling is not
5 cost-based rate making compared to traditional rate
6 making?

7 A. Yes. My testimony at some point speaks
8 directly to that.

9 Q. I believe at page 18 I think you begin
10 discussing that issue?

11 A. Yes.

12 Q. Is it true that you found no relationship
13 between the change in kilowatt hours and the change in
14 fixed costs?

15 A. Yes. In the several utilities that I've
16 analyzed the statistical relationship is near zero.

17 Q. So under traditional kilowatt hour sales
18 rate making, after you get beyond the first year,
19 what's your opinion about whether that's cost-based in
20 any meaningful way?

21 A. Well, I think that it's clear that it's
22 not. Part of that discussion of whether decoupling
23 shifts regulation into a noncost-based arena may be
24 tied to semantics, although I think it's also tied to

25 some confusion. My understanding of what cost of

(POWER - CROSS BY MARSHALL)

1 service-based utility regulation is all about is that
2 what regulators -- one thing that regulators are
3 trying to do in regulating rates is make sure that
4 utilities don't earn monopoly profits and one way to
5 assure that they don't is to analyze the utility's
6 costs including cost of capital and set rates so that
7 the revenues will just cover those costs and no more.
8 That's usually done with reference to a test year. So
9 it's only in the context of a test year where the
10 utility's revenues and profits are set with respect to
11 the utility's costs including the cost of capital. As
12 soon as those rates are set and time proceeds the
13 relationship between the utility's revenues and their
14 profits and the utility's costs immediately begin
15 drifting apart. As utility's loads grow, their
16 revenues grow. The revenues, the utility's revenues
17 and profits don't stay at the test year levels. The
18 utility's costs don't stay at the test year levels.
19 So that through almost all of the time that the
20 utility is operating its revenues and its profits
21 aren't tied in any direct way to costs. We only do it
22 historically with respect to one point in time and
23 then we let them drift apart and then we have a rate
24 case and we try to bring them back together again and

25 then they drift apart, so that between all rate cases
(POWER - CROSS BY MARSHALL)

1 the rates are drifting away from cost of service
2 unavoidably.

3 Q. So in terms of comparing PRAM decoupling to
4 practice additional rate making with kilowatt hour
5 sales, is there any meaningful distinction that you
6 can find between whether one is cost based and the
7 other isn't cost based?

8 A. No. If we didn't have the PRAM, if we had
9 no decoupling arrangements so there was no hearing in
10 between and no adjustment, no nothing in between,
11 rates would continue to move away from the costs.
12 They would drift, depending on just where costs and
13 revenues are going so that the decoupling mechanism
14 simply recognizes that and recognizes the fact that
15 the drift that takes place when it's tied to kilowatt
16 hours has a perverse incentive aspect and so we have a
17 process to try to remove that perverse incentive
18 aspect. But relative to what would have happened had
19 there been no decoupling mechanism, one is no more, no
20 less cost based than the other.

21 Q. At page 16, lines 24 to 26, you state that
22 if decoupling is not intended to hurt utilities it
23 needs to confront the utility with the same earnings
24 potential that the utility has under traditional

25 kilowatt hour index arrangement; is that correct?

(POWER - CROSS BY MARSHALL)

1 A. Yes.

2 Q. Now, between rate cases under traditional
3 kilowatt hour sales rate making a utility management
4 can increase its earnings, increase its revenues by
5 selling more electricity?

6 A. Yes.

7 Q. And under decoupling that aspect is taken
8 away? In other words, a utility management under
9 decoupling cannot increase revenues by just selling
10 more kilowatt hours; isn't that true?

11 A. Right. The intent is to remove that
12 possibility, yes.

13 Q. So a valuable management tool in
14 controlling the risks that a utility faces in terms of
15 earning their allowed rate of return is in effect
16 taken away by decoupling and then replaced with
17 something else?

18 A. Exactly.

19 Q. What you're pointing out here is that
20 whatever that something else is it has to have the
21 same earnings potential that traditional kilowatt hour
22 sales has. Is that a fair statement?

23 A. Exactly.

24 MR. MARSHALL: I don't have any further

25 questions.

(POWER - CROSS BY TROTTER)

3343

1 JUDGE HAENLE: Mr. Trotter?

2

3 CROSS-EXAMINATION

4 BY MR. TROTTER:

5 Q. Let's start with the last point on earnings
6 potential. For a utility that has an inclining cost
7 curve will selling more KWH always result in higher
8 earnings?

9 A. As long as as the incremental cost of
10 supply is less than the rate being paid by the
11 customer to whom the kilowatt hour is sold it would be
12 able to earn, add to its earnings. Secondly, if there
13 is a fuel adjustment or purchase power adjustment
14 mechanism in place then no matter what the incremental
15 costs are it will add to its earnings.

16 Q. Let's assume just a utility that doesn't
17 have an adjustment clause but does have a marginal
18 cost of additional KWH is higher than the tariff rate.
19 If they sell more KWH, they're not going to add to
20 earnings, are they?

21 A. Right. For instance, Puget's rates for
22 residential customers are somewhere up around 7 cents
23 I think. To the extent that costs more than 7 cents
24 to purchase the power to sell to that customer, and

25 there's no purchase power adjustment mechanism then

(POWER - CROSS BY TROTTER)

3344

1 the utility, in fact, would see its earnings harmed by
2 those increased sales. I am not aware of any utility
3 in the United States that's currently in that
4 situation. Almost any utility I've looked at has
5 rates, retail rates that are well above the
6 incremental cost of supply, and the reason for that is
7 that in most customers -- majority of customers,
8 residential and commercial customers especially, built
9 into those rates are the fixed costs associated with
10 distribution and customer facilities so that the
11 utility is counting on recovering the costs associated
12 with those facilities via its kilowatt hour charge and
13 the net result is that rates almost uniformly are well
14 above the incremental cost of supply.

15 Q. Isn't it true that Puget's tail block for
16 commercial industrial customers is significantly below
17 7 cents?

18 A. Yes, it is, and to the extent -- I think
19 that's something that's important to look at when one
20 is crafting the appropriate decoupling index and
21 trying to see that what you're putting in place of the
22 kilowatt hour index is similar in the earnings
23 potential that confronts the utility with. In doing
24 that, one wants to look at the -- not just what the

25 average margins are being earned on kilowatt hour

(POWER - CROSS BY TROTTER)

3345

1 sales but the different margins being earned by
2 different classes of customers.

3 Q. You were asked some questions about cost of
4 service rate making. Do you recall that?

5 A. Yes.

6 Q. And you were talking about the time period
7 between rate cases?

8 A. Yes.

9 Q. Do I understand you to say that PRAM is no
10 less cost based than the situation that would normally
11 occur between rate cases when costs and revenues and
12 rate base diverge? Let me put it to you differently.
13 You said PRAM was no less cost based than something
14 else and do you recall what that something else was?

15 A. Between rate cases under the traditional
16 regulatory regime between rate cases utility's
17 revenues are allowed to grow in proportion to sales
18 weighted by fixed cost margins associated with the
19 sales. So that it's in that way -- and since that is
20 unrelated to cost we know that the utility's earnings
21 are moving upwards in a noncost-based way. What
22 decoupling does is take that noncost-based index that
23 would have been operating and replace it with another
24 noncost-based index. In that sense one is just

25 maintaining the status quo.

(POWER - CROSS BY TROTTER)

3346

1 Q. So you have no cost-based rate making in
2 either scenario?

3 A. Right.

4 Q. Okay. Turn to page 3 of your testimony.
5 And at the bottom you talk about incentives and DSM,
6 and you said on line 25 through 29 you suggest that
7 there is an incentive for the utility to oppose DSM
8 and build load. Utility can schedule new supply and
9 its rate cases -- new supply costs and rate cases so
10 that those higher supply costs can be dealt with
11 in frequently scheduled rate cases. Is that a fair
12 paraphrasing?

13 A. Yes.

14 Q. What you mean here is that the utility can
15 build load and justify higher rates by doing so?

16 A. Or that more importantly that it can make
17 sure it can schedule its rate cases so that
18 significant chunks of supply costs get accounted for
19 quickly in a rate case and then again proceed to
20 build load until it has to attain another resource,
21 then schedule a rate case so it can get the costs
22 associated with that resource in place so that there's
23 no revenue attrition associated with its supply costs.

24 Q. And rates keep going up?

25 A. Yes.

(POWER - CROSS BY TROTTER)

3347

1 Q. In that scenario a utility's claim that it
2 is subject to significant competition would be highly
3 suspect. Would you agree?

4 A. Very much so. If there is a significant
5 amount of competition operating, a utility would not
6 be in a position to be raising its rates.

7 Q. Page 7 of your testimony, line 12 you
8 indicate that for PRAM 2 the increase in that docket
9 only 8 percent of the total increase was tied purely
10 to decoupling. Is that your testimony?

11 A. Yes.

12 Q. Further down the page, line 27, you
13 indicate that tying revenues to a number of customers
14 instead of to number of KWH will reduce revenues by
15 about 24 million and your cite is to Mr. Lauckhart's
16 supplemental direct testimony; is that correct?

17 A. Yes.

18 Q. Am I correct that you did not independently
19 evaluate that \$24 million figure?

20 A. No, I did not.

21 Q. You accepted it for purposes of your
22 analysis?

23 A. Yes. I just accepted it as Puget's
24 description of the situation they expected to be

25 facing in the future.

(POWER - CROSS BY TROTTER)

3348

1 Q. On page 30 of your testimony you give a
2 number of ways that DSM reduces risk of utility
3 operations, and including in that list is reduction of
4 overall cost of providing service, DSM is considerably
5 less risky; it is lower cost; shorter lead times; is
6 more easily divisible into appropriately sized units;
7 and is amortized over a shorter time period. Are
8 those some of the reasons that you cite?

9 A. Yes.

10 Q. For a utility that is focusing on the long
11 term, do you agree that it should need no incentive to
12 produce DSM in that context because of those benefits?

13 A. I think one could definitely argue that if
14 a utility was focused on long-term minimizations of
15 costs the utility ought to be pursuing DSM, all cost
16 effective DSM that's available to it. The problem is
17 that in the current structure, within the current
18 regulatory structure is that there are immediate
19 short-term revenue consequences of it doing that so
20 that what regulation has confronted the utility with
21 is that if it does what in its own and its customers
22 long-term interest it has to sacrifice earnings in
23 the short term. And American businesses for better or
24 for worse, mostly for worse, have a very heavy

25 emphasis on the short term, partly because Wall Street

(POWER - CROSS BY TROTTER)

3349

1 won't let them have any other focus.

2 So regulation creates a mixed sort of
3 incentives short and long term. And I guess the
4 question is, which is likely to dominate when a
5 utility looks at those DSM investments, and my -- it's
6 not just an impression but as a result of my work
7 around the country dealing with utilities and their
8 DSM activities, I think the evidence is overwhelming
9 that the utility is more affected by those short-term
10 earnings losses, losses in revenues than it is by the
11 long-term minimizations of costs. And so the net
12 result is that except in unusual circumstances where
13 the utility has no other alternative, the utility will
14 slight DSM and will not stay on the least cost path.

15 Q. Turn to page 31 and here you discuss
16 Mr. Sonstelie's testimony on the regulatory asset
17 character of DSM. It's your testimony, I take it
18 that much of Puget's revenues rely on regulatory
19 assets?

20 A. Yes, they are regulatory assets.

21 Q. You cite examples of the nuclear plant
22 abandonment costs as regulatory assets; is that
23 correct?

24 A. Yes.

25 MR. TROTTER: No further questions.

(POWER - CROSS BY FURUTA)

3350

1 JUDGE HAENLE: Have you questions,
2 Mr. Richardson?

3 MR. RICHARDSON: No questions, your Honor.

4 JUDGE HAENLE: Mr. Furuta?

5 MR. FURUTA: Thank you.

6

7 CROSS-EXAMINATION

8 BY MR. FURUTA:

9 Q. Good afternoon.

10 A. Good afternoon.

11 Q. As I understand your testimony, you view
12 the purpose of what you referred to as the pure
13 decoupling mechanism as only to eliminate the
14 disincentive associated with lost sales as a result of
15 demand side management; is that correct?

16 A. Yes.

17 Q. And you don't feel that the purpose of such
18 a decoupling mechanism is to insulate the utility from
19 economic changes, weather changes or other elements
20 that are normally associated with a utility's risk of
21 doing business?

22 A. Let me phrase my answer in a way that
23 doesn't directly answer your question. Decoupling,
24 the focus, the purpose of decoupling has nothing to do

25 with shifting risk. There may be reasons and there

(POWER - CROSS BY FURUTA)

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1 may be good reason, convincing reasons for Commissions
2 to shift risk from the utility to customers, but these
3 are regulatory policies that are unrelated to the
4 point of decoupling, and I think it's very important
5 to separate them conceptually and in terms of
6 establishing policy. The PRAM is only a tiny part of
7 that, is decoupling. The rest has to do with a bundle
8 of policies approved by this Commission that are
9 completely unrelated to decoupling, and I just don't
10 think it helps the public or parties or even the
11 Commission in terms of focusing its policy decisions
12 to mix them all up and bundle them together.

13 Q. Fair enough. Like to turn for a moment to
14 pages 24 and 25 of your testimony. Is it fair to look
15 upon your testimony here as stating that you would
16 prefer to keep the normal business risks squarely upon
17 the utility rather than shifting such risks to
18 customers?

19 A. Yes. As a general matter of policy and as
20 a general matter of economic principle, risk should
21 rest with those most able to manage it and minimize
22 the costs associated with it. That's what the profit
23 that a private business is allowed to earn is all
24 about. It's a payment for that business having taken

25 on risk so that -- and it doesn't matter what the

(POWER - CROSS BY FURUTA)

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1 source of risk is or how much the business has -- how
2 much control the business has over that risk.

3 Economic principle is that a party that is best able
4 to manage and control the costs of it ought to be the
5 one wrestling with it. To shift that risk to some
6 other party encourages irresponsible economic
7 behavior.

8 Q. I believe it's your testimony that you feel
9 that utility managers are in a better position to
10 manage risk than utility customers?

11 A. I think in most circumstances that
12 definitely is the case.

13 Q. Now, in addition to the decoupling
14 mechanism, does the current PRAM also insulate Puget
15 Sound Power and Light from deviations in sales caused
16 by other factors, for example, temperature, hydro
17 conditions and customer initiated conservation?

18 A. Yes. Let me divide those two. The weather
19 and hydro conditions and one might say fuel costs or
20 purchased power costs in general is one set of risks
21 or one set of characters of the economic environment
22 in which the utility operates. And those are
23 unrelated to the focus of decoupling. The third one
24 you mentioned, though, which is customer or a third

25 party-initiated DSM is an intended focus of

(POWER - CROSS BY FURUTA)

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1 decoupling. The advantage, one of the primary
2 advantages of decoupling as opposed to some lost
3 revenue adjustment mechanism is that decoupling will
4 compensate the utility for revenues lost as a result
5 of customer or third party-initiated DSM activities.
6 That's intentional. The idea is to not have the
7 utility operating in opposition to other sources of
8 DSM, to not make utility DSM, programmatic DSM the
9 only DSM game in town with the utility opposing, for
10 instance, energy efficiency standards for housing or
11 for appliances or the utility directly or indirectly
12 trying to discourage third party DSM programs. It's
13 to arrange things so that the utility enthusiastically
14 embraces cost effective DSM measures wherever
15 they're initiated.

16 Q. So with regard to the first category of
17 factors that we discussed, weather, hydro and fuel
18 costs, those sorts of things, at least with regard to
19 those, would you recommend that this Commission either
20 eliminate that portion of PRAM or at least recognize
21 the risk shifts that occur between ratepayers and
22 stockholders?

23 A. My position in this case is not to offer
24 recommendation as to whether those -- that implicit

25 shifting of risk associated with weather, water

(POWER - CROSS BY FURUTA)

3354

1 conditions, purchased power costs, et cetera, should
2 be shifted. I will leave. I am just not testifying
3 on that. But it is my position that one should not
4 shift risk in that sort of way without compensating
5 customers for the fact they now are carrying that risk
6 and the utility isn't by adjusting rates appropriately.

7 Q. I will like to explore for a moment that
8 concept of compensating customers and if we could turn
9 to page 28 of your testimony. I believe line 8 the
10 question set forth there is if the Commission concludes
11 that it is appropriate to shift risk from the utility to
12 customers, what other adjustments are appropriate and in
13 your testimony you respond, "if the risk faced by the
14 utility is reduced so should the return to investor be
15 reduced. Uncompensated shifts in risk are simply an
16 inappropriate windfall to stockholders. With the
17 reduction in risk should go a conscious reduction in the
18 estimated costs of capital and the allowed return on
19 equity." Did I read that correctly?

20 A. Yes.

21 Q. With regard to the PRAM, if this Commission
22 determined that the reduction in cost of capital
23 resulting from the market's reaction to this risk
24 shifting involved in the PRAM mechanism, if it

25 determined that the reduction of cost of capital

(POWER - CROSS BY FURUTA)

3355

1 insufficiently compensated ratepayers and results in a
2 windfall to stockholders, would it be appropriate for
3 the Commission to reduce the company's estimated cost
4 of capital and return on equity as you mentioned in
5 your answer on page 28?

6 A. Yes. If there's reasons to believe that
7 the current analysis of capital market conditions and
8 the estimate of the cost of capital based on them is
9 not reflecting at this point the benefits to the
10 utility associated with the PRAM, then to get an
11 accurate measure of the cost of capital, including the
12 benefits of PRAM, the Commission would have to adjust
13 that cost of capital downward.

14 Q. Thank you, Dr. Power.

15 MR. FURUTA: No further questions.

16 JUDGE HAENLE: Mr. Adams?

17 MR. ADAMS: Mine will be shorter now that
18 Mr. Furuta has asked his questions. He must have been
19 reading off my list.

20

21 CROSS-EXAMINATION

22 BY MR. ADAMS:

23 Q. Dr. Power, first of all, I heard you say
24 that you are not making specific recommendations as to

25 what the Commission should do. I think your testimony

(POWER - CROSS BY ADAMS)

3356

1 is more of a discussion of the implications of many of
2 the various things involved in the PRAM and decoupling;
3 is that correct?

4 A. Yes.

5 Q. But am I correct that you believe that, for
6 instance, weather normalization is consistent with
7 decoupling?

8 A. Certainly. One can normalize for weather,
9 for economic conditions, et cetera, and proceed with
10 decoupling. The decoupling mechanism that has been
11 developed in the collaborative for Montana Power
12 that's about to be presented to the Commission in
13 Montana, as well as the decoupling mechanisms being
14 proposed both in the Pacific and PGE collaboratives in
15 Oregon all leave the risks associated with weather on
16 the shoulders of the utility by using weather
17 normalized data in making the adjustment.

18 Q. And have you participated in both of those
19 collaboratives?

20 A. I have not. I have simply been monitoring
21 the Oregon collaboratives. I've been an active
22 participant in the Montana collaborative.

23 Q. Aside from your position in this case, do
24 you have an opinion on the weather normalization issue

25 as to whether it is a desirable policy or not?

(POWER - CROSS BY ADAMS)

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1 A. Well, in Montana I do, and if I had been
2 more deeply involved in this case and knew more of the
3 history of the PRAM and what preceded it I might have
4 an opinion in this case. But I don't. Given that I
5 haven't studied the particular situation for this
6 particular utility here, I am not willing to offer
7 policy advice to the Commission based on the limited
8 information I have with respect to this particular
9 case. In general, I can say that I am opposed to
10 shifting the risks associated with weather from the
11 utility to customers. That's been the general
12 position I've taken in cases around the country.

13 Q. Would I also be correct that there's
14 nothing inconsistent between decoupling and the
15 treatment of hydro on a normalized basis as well?

16 A. Not at all.

17 Q. Again, I know you will give me the same
18 hedge but in general do you support or not support
19 normalized hydro?

20 A. Well, I can just tell you in cases I've
21 testified I've supported the usage of normalized hydro
22 conditions in setting the utility's revenue
23 requirements and rates.

24 Q. If we focus on decoupling itself, and let

25 me go back a step here. My understanding from

(POWER - CROSS BY ADAMS)

3358

1 Mr. Parcell's testimony that he felt that decoupling
2 reduced volatility and risk to a utility. I heard you
3 say a little earlier here that you -- not sure of your
4 exact quote but I think you said that decoupling per
5 se does not shift risk as between the company and
6 customers, but does decoupling reduce risk?

7 A. I think that decoupling in several
8 different ways does help the utility reduce its risks.
9 To the extent that DSM resources are less risky and
10 lower cost, to the extent that my characterization at
11 the end of my testimony of the DSM resources is
12 correct, anything that helps the utility more
13 enthusiastically embrace DSM will have helped reduce
14 the level of risk without shifting the risk. There is
15 a pay in which pure decoupling does shift risk and
16 that goes back to this customer-adopted or third
17 party-provided DSM. Decoupling intentionally between
18 rate cases protects the utility's revenues against
19 erosion from that particular type of competition, if
20 you want, from DSM. To the extent that the utility
21 would have otherwise faced -- otherwise have faced
22 attrition from nonutility-sponsored DSM, decoupling
23 protects the utility between rate cases against that.
24 But I would add that the bulk of the revenue

25 stabilization that Mr. Parcell was talking about is

(POWER - CROSS BY ADAMS)

3359

1 associated with the nondecoupling aspects of the PRAM.

2 It's associated with the adjustment for weather or the

3 lack of adjustment for weather -- that's the part of

4 the PRAM that compensates the utility for unusual

5 weather conditions, hydro conditions, purchased power

6 costs. That's the vast majority of the revenue

7 stabilizing aspect. It's not the decoupling that is

8 responsible for that.

9 Q. But getting back to decoupling, would it be

10 fair to characterize your testimony that there are

11 somewhat I will call win-win benefits that you see to

12 decoupling that does not involve shifting risk from

13 one party to the other?

14 A. Yes, definitely.

15 Q. At page 22 line 11 you say stability in

16 rates or utility revenues may be the larger concern.

17 Do you believe stability in rates is important for

18 customers under a decoupling mechanism?

19 A. I think stability in rates has been an

20 objective of regulation, not the only objective, and I

21 won't attempt to assign it a priority but it's been a

22 very important objective of regulation for at least a

23 half century. Bonbright listed it -- it's been part

24 of the litany of what it is that regulation ideally

25 tries to accomplish.

(POWER - CROSS BY ADAMS)

3360

1 Q. So I would gather that you believe --

2 A. That is one consideration. Of course, once
3 you've drawn up a list of a dozen objectives some of
4 them are bound to conflict and then one is going to
5 have to find some way of balancing or weighing the
6 trade-offs involved.

7 Q. If you look off that same page 22 where
8 where you recite the language from the Commission's
9 notice of inquiry. Do you see that?

10 A. Yes.

11 Q. I want to ask you a quick question about
12 this because you did respond to a question from
13 Mr. Trotter on the same objective. Says the four
14 objectives are one, adjustment for changes in revenues
15 and costs beyond a utility's control. Am I correct
16 from your testimony and from your prior answer that
17 you do not believe that that should be an objective,
18 that is, shifting the risks associated with revenues
19 and costs beyond a utility's control to customers is
20 desirable? I don't think I would want to read that
21 question back, but I think you understood what I said?

22 A. Yes, I think I do. I think it would be
23 very dangerous to offer as a business principle that
24 we should not hold economic factors responsible for

25 events that are beyond their control. Free enterprise

(POWER - CROSS BY ADAMS)

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1 economy, a market economy would collapse if we adopted
2 that as a general business principle or a general
3 economic principle. Businesses are held responsible
4 for outcomes, final outcomes, regardless of what the
5 source of those final outcomes were. And it has to be
6 that way or we encourage, as I characterized it
7 before, economically irresponsible behavior. If we
8 shift those risks because there's aspects of them that
9 are beyond a business's control, if we shift those to
10 someone else, we are encouraging that business to act
11 as if it's operating in a riskless environment when,
12 in fact, we know that's not truth. To create a make
13 believe world of risklessness as a matter of public
14 policy and to turn a business loose to operate in that
15 make believe world is bound to lead to higher costs
16 than are necessary, more risk than is necessary,
17 because even when things are mostly beyond your
18 control there's ways of adapting to manage and reduce
19 the risk.

20 If we don't ask and give businesses an
21 incentive, motivation to try and manage and reduce the
22 risk and minimize the costs associated with the
23 remaining risk, if we don't insist that they do that,
24 the costs of doing business and providing us with

25 goods and services in our economy will rise and we

(POWER - CROSS BY ADAMS)

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1 will all be poor as a result.

2 Q. You prefaced your remarks as "a business
3 principle." Am I correct that you also do not believe
4 that it would be good regulatory principle?

5 A. Not at all. I think it undermines an
6 appropriate set of incentives that the utility as a
7 private business ought to be facing.

8 Q. Would you agree that in the nonregulated
9 world even prudent decisions often are not rewarded?

10 A. Quite definitely. People don't ask whether
11 you're prudent or you tried hard. They look at the
12 final outcome and the reward is based on that.

13 Q. I want to ask you one last question
14 relating to page 27 of your testimony, the line that
15 begins at 9. You say it is very difficult to
16 distinguish between utility management, utility
17 stockholders and representatives of investors. It
18 establishes a principle of regulation that we have to
19 give investors what they request is to abandon
20 regulation altogether. By those comments are you
21 specifically referring to the testimony of Mr. Miller
22 and Abrams?

23 A. I would include their testimony in that,
24 yes.

25 Q. I gather that in terms of policy

(POWER - CROSS BY ADAMS)

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1 perspective what you're saying is that the Commission
2 ought to do what it thinks is right and then see how
3 the market reacts. Is that a fair statement?

4 A. Yes. That unless the Commission is facing
5 a policy choice where the results on costs of capital
6 can be fair market accurately measured so that one can
7 do the equivalent of a benefit cost analysis for
8 customers, I think heading in this direction of asking
9 what will make Wall Street happy can lead nowhere.
10 Now, I am not offering a general principle there in
11 the sense that there may be situations where the
12 Commission can comfortably conclude that the benefits
13 to customers of doing what Wall Street would also like
14 us to do are real and measurable and they outweigh
15 whatever the costs to the customers may be, that in
16 that situation clearly one should do what's in the
17 best interests of the customers. But in general the
18 Commission is not in a position to be able to measure
19 that impact, and as a result it never knows whether
20 what it's done is in the best interests of customers
21 or not.

22 In that situation I think the best thing to
23 do is to adopt appropriate regulatory policies and
24 simply measure the cost of capital. Cost of capital

25 will tell the Commission what investors think about

(POWER - EXAM BY COMMISSIONER HEMSTAD)

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1 the risk and profitability of this particular company
2 and the risks associated with its serving its
3 customers and those appropriate costs can then simply
4 be passed on to customers as accurate measure of the
5 cost of providing those customers with service.

6 MR. ADAMS: Thank you.

7 JUDGE HAENLE: Commissioners, do you have
8 questions?

9 CHAIRMAN NELSON: No.

10

11 EXAMINATION

12 BY COMMISSIONER HEMSTAD:

13 Q. I would like to pursue the last discussion
14 you had with Mr. Adams about cost of capital. You
15 were not expressing any views in this case as to what
16 should be the appropriate cost of capital?

17 A. No, I'm not.

18 Q. Have you done that in other proceedings?

19 A. I have never been a cost of capital witness
20 per se in the sense of estimating the cost of capital.
21 I have regularly testified on the impact of regulatory
22 decisions on the cost of capital.

23 Q. Well, we have various opinions expressed
24 here as to what should be an appropriate cost of

25 capital although the testimony would suggest that

(POWER - EXAM BY COMMISSIONER HEMSTAD)

3365

1 those opinions once analyzed aren't too far apart from
2 one another, but I was intrigued by your testimony at
3 27 that Mr. Adams also referred to, in the very last
4 line or the last sentence where "it should regulate
5 utilities appropriately and then simply measure the
6 cost of capital and incorporate it into the rates that
7 its set. Are you suggesting that if you've done
8 everything else appropriately or correctly that the
9 cost of capital to be plugged in is self-evident?

10 A. Well, I think that except in unusual
11 circumstances the Commission will be presented with a
12 reasonably narrow range of costs of capital and will
13 have to make a choice within that range. The
14 contested case format encourages each side to go to
15 the extreme that's intellectually defensible and then
16 leave it to the Commission to find a middle ground,
17 but my point here is more that the Commission should
18 avoid trying to second guess Wall Street because then
19 you get into this infinite regression thing, if we do
20 this how will they react, how will they think about
21 what we're thinking about what they're thinking, that
22 sort of thing. I think that's an unproductive
23 direction for regulators to go. That the emphasis
24 should be on encouraging good management, that one

25 crucial thing for regulation is to impose enough

(POWER - EXAM BY COMMISSIONER HEMSTAD)

3366

1 normal business market like discipline on a utility so
2 that utility managers make good cost minimizing
3 decisions. Anything that relaxes the pressure on
4 utility management to make good cost minimizing
5 decisions is bound to leave customers worse off in the
6 long run because they're going to get saddled with
7 unnecessary costs.

8 Q. Well, what is your view about the kind of
9 testimony that has been presented here that would say
10 that because of the shift in risk to the ratepayers
11 that the cost of capital should be reduced by 50 basis
12 points?

13 A. I will shy away from the quantification. I
14 think I am convinced that a PRAM as comprehensive as
15 the one this Commission has approved and has been
16 operating represents a fundamental change in the risk
17 situation confronted by Puget and that that has to be
18 reflected somehow in the cost of capital. It's
19 absolutely necessary that that be the case. And I
20 have not attempted to quantify that so I can't speak
21 to whether that's the appropriate quantification or
22 not.

23 COMMISSIONER HEMSTAD: I don't have any
24 other questions.

25 JUDGE HAENLE: Have you any redirect?

(POWER - RECROSS BY MARSHALL)

3367

1 MR. WELLINGHOFF: No, I don't.

2 JUDGE HAENLE: Anything more?

3 MR. MARSHALL: Yes.

4

5 RECROSS-EXAMINATION

6 BY MR. MARSHALL:

7 Q. Do you know Mr. Moskovitz?

8 A. Yes, I do.

9 Q. Have you spoken to him here in the last few
10 months?

11 A. Yes, I have.

12 Q. Do you agree with the following statement
13 of his: "The risk is symmetric, that is severe
14 weather is also a possibility and would result in
15 ratepayers seeing a benefit when the additional
16 revenues are returned to them"?

17 A. I, of course, heard that quote somewhere else
18 this morning, maybe twice. I am confused by the
19 quotes and don't tell David that but the risk isn't
20 symmetric. I think what's being said is that there is
21 a symmetrical upside and downside and that the net,
22 the expected value over a long period of time is going
23 to be zero, but to say that the expected value
24 associated with the risky situation is zero is not to

25 suggest that in some sense the risk isn't there. One

(POWER - RECCROSS BY MARSHALL)

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1 measures risk usually by variation, how much variation
2 there is. Even if the expected value of the variation
3 is zero, even if on average there will be zero net
4 impact, say of weather or of hydro conditions, even if
5 that were the case, there's still substantial risk
6 there, and that risk, that variation imposes
7 substantial costs on people.

8 So it's like a gambling game. One can
9 imagine a card game, I guess, or just flipping pennies
10 or something or a card game, something else that has
11 an expected value of zero that you win some, you lose
12 some, if you keep playing it on average you won't win
13 or lose in the aggregate. That doesn't mean that
14 everybody will enjoy playing that game. That doesn't
15 mean that people are going to be neutral about being
16 asked to play that game. The risk is still there and
17 and the risk is real, and because most people are risk
18 averse, there is a very substantial cost or at least
19 there's a potential for a substantial cost associated
20 with the risk. So just pointing out that there's
21 upside and downside and that it will net out to zero
22 doesn't -- shouldn't put anybody at ease. That
23 doesn't mean that there's no risk and that there's no
24 cost associated with that. It doesn't mean anything

25 of the sort. The risk is still there, the cost is

(POWER - RECCROSS BY MARSHALL)

3369

1 still there and most people won't enjoy having to play
2 that game unless they're doing it for recreational
3 purposes.

4 Q. But in terms of what Mr. Moskowitz was
5 saying, the ratepayers do benefit from this in terms
6 of having that upside potential that used to belong to
7 the utility no longer there?

8 A. It's true that there's a positive side to
9 the risk to customers, but if, for instance, you ask
10 -- let's shift it slightly and ask workers whether
11 they would be willing to accept having 50 percent of
12 their pay fluctuate with weather conditions and said
13 don't worry, some days, sometimes your pay will be low
14 but other times an equally probable number of other
15 times your pay will be high, so don't worry that we're
16 changing your pay from a reliable stream to this
17 stream that fluctuates all over the place. Don't
18 worry, the fluctuations are symmetric. People will
19 worry. They will care. They will try to avoid --
20 except for the addicted gamblers among them they will
21 care.

22 So I think it's factually correct that we
23 shouldn't just grouse about the fact that rates went
24 up and some other conditions rates will go down. But

25 that's not -- that's factually relevant, but that is

(POWER - RECROSS BY MARSHALL)

3370

1 irrelevant to the issue of whether risk has been
2 shifted from one party to another and whether in the
3 process of shifting that risk some cost has been
4 shifted too.

5 Q. Do you also agree with Mr. Moskowitz that
6 if there is a risk transferred that's significant then
7 it will be reflected in the price of the utility's
8 stock and ultimately in the amount of rate of return
9 that the utility is allowed?

10 A. I think ultimately -- and I think the
11 testimony this morning spoke to that. I think you
12 ultimately that will be reflected. The problem, as
13 pointed out in the testimony this morning, the problem
14 is that given the uncertainty about the PRAM that has
15 been made explicit in the financial press, the cost of
16 capital as measured now may well not be reflecting the
17 benefits of the PRAM because the capital markets see
18 the PRAM or have been seeing the PRAM as at risk.
19 They haven't been acting as if it's in place and
20 secure.

21 Q. If the PRAM decoupling mechanism is changed
22 in significant ways, that's a risk, a regulatory risk,
23 if you will, correct?

24 A. Well, but one has to measure everything

25 relative to something where we are now, and given the

(POWER - RE CROSS BY MARSHALL)

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1 uncertainty that the final community already feels
2 about the PRAM, they don't know what the Commission is
3 going to do. They know it's an open question. I am
4 not sure that if the Commission were to explicitly
5 adopt or continue the PRAM but modified somewhat, I
6 suspect that would be a better situation than what we
7 face right now in the sense that the financial
8 community would be seeing the Commission reaffirm its
9 commitment to the PRAM. And even if it modified
10 the PRAM so it wasn't quite as favorable to the
11 utility they would see it as a longer run commitment
12 on the part of the Commission to that mechanism and in
13 that sense it would -- there would be a positive
14 impact.

15 Q. If changes were made that disallowed
16 legitimate costs, costs without interest or other
17 sorts of changes that had an economic impact, that is,
18 it just wasn't changed to reaffirm PRAM decoupling but
19 changes to the underlying mechanism itself that
20 created more uncertainty about whether costs would be
21 allowed, would that have the effect of increasing risk
22 or the perception of risk?

23 A. Well, I think it would -- I think what it
24 would have an impact on is how positively investors

25 looked upon the mechanism. So to the extent that the

(POWER - RE CROSS BY MARSHALL)

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1 Commission were to continue the PRAM but change the
2 rules of the game in a way that left it uncertain as
3 to what the utility was likely to be able to recover
4 so it left things confused -- I doubt that the
5 Commission would do that, but if the Commission's
6 order primarily muddled the current situation I think
7 one would see a continuation of a confusion that
8 currently exists as to whether the PRAM is real and
9 whether it's going to -- it can be relied upon to
10 stabilize Puget's revenues.

11 Q. Is there a difference between establishing
12 rate of return on equity and establishing a bond rating?

13 MR. TROTTER: Your Honor, I am going to
14 object to this. First of all, these are questions that
15 have been asked the first time around. This is not
16 recross of anything that was asked by the bench.

17 Second, this witness has already said he is
18 not holding himself out as a cost of capital witness in
19 this case. This is just another --

20 MR. MARSHALL: There is just a followup to
21 what Mr. Adams asked.

22 MR. TROTTER: I think it's a complete
23 initial round of additional recross.

24 JUDGE HAENLE: It doesn't sound like it's

25 responsive to what they asked.

(POWER - RECROSS BY MARSHALL)

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1 MR. MARSHALL: He referred directly to
2 Mr. Abrams' and Mr. Miller's testimony.

3 JUDGE HAENLE: It doesn't mean you need to
4 go back to Abrams' and Miller's testimony.

5 MR. MARSHALL: Not intending to. I was
6 just trying to draw the distinction clearly to see if
7 the witness at least drew the distinction between the
8 cost of capital issues and the bond rating issues
9 because I do think that they're different issues.

10 JUDGE HAENLE: I will sustain the
11 objection.

12 Q. Do you venture any opinion in this case as
13 to whether Puget's bond ratings are at risk?

14 A. In general?

15 Q. Yes.

16 A. No. I have not, although I have read the
17 testimony, I have limited my analysis and testimony to
18 the suggestions that DSM investments in some sense
19 increase the risk faced by Puget. That's the only
20 issue, only related issue that I dealt with.

21 Q. Mr. Furuta asked you some questions about
22 the security of those conservation assets that Puget
23 has. Are you aware of how much in the way Puget has
24 on its books in conservation assets?

25 A. I have read that in some party's testimony.

(POWER - RECROSS BY MARSHALL)

3374

1 It's substantial.

2 Q. Around \$200 million?

3 A. I would have to go back and reread the
4 testimony. I am willing to accept that subject to
5 check.

6 Q. Are those assets owned by Puget or are they
7 owned by customers?

8 A. Those assets, the regulatory asset is owned
9 by Puget. The physical asset is owned by the
10 customers.

11 JUDGE HAENLE: I think we're again getting
12 beyond the scope on what was asked on any of the
13 rounds, Mr. Marshall.

14 MR. MARSHALL: Again, I don't believe. I
15 think Mr. Furuta touched exactly on this issue.

16 MR. FURUTA: I don't believe I did.

17 JUDGE HAENLE: I agree. This is way beyond
18 what we've covered and what he covered.

19 MR. MARSHALL: I have no further questions.

20 JUDGE HAENLE: Anything more of the
21 witness?

22 Thank you, sir. You may step down. Take
23 our afternoon recess. Come back at 20 minutes after 3
24 and take the last witness who has been patiently

25 waiting.

(POWER - RE CROSS BY MARSHALL)

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1 (Recess.)

2 JUDGE HAENLE: Let's be back on the record
3 after our afternoon recess. That completes your
4 witnesses, does it, Mr. Wellinghoff?

5 MR. WELLINGHOFF: Yes, that completes the
6 witnesses of the NCAC.

7 JUDGE HAENLE: I had asked you while we
8 were off the record about the revised errata sheet for
9 Mr. Bell's testimony which Ms. Williams promised us
10 the other day.

11 MR. WELLINGHOFF: Apparently Ms. Williams
12 has served via fax with the corrected errata sheet
13 for Kevin Bell and has in addition mailed 19 copies to
14 the Commission.

15 JUDGE HAENLE: I assume then that we will
16 just make the corrections to the official copy
17 according to that errata sheet if that's all right
18 with everybody.

19 MR. MARSHALL: That's fine.

20 MR. TROTTER: That's fine.

21 MR. ADAMS: That's fine.

22 JUDGE HAENLE: Problem from any intervenor?

23 We'll do it in that manner and you're free
24 to go, as far as I'm concerned, Mr. Wellinghoff.

25 MR. WELLINGHOFF: Thank you very much.

(POWER - RE-CROSS BY MARSHALL)

3376

1 JUDGE HAENLE: Next witness we have is for
2 WICFUR.

3 (Marked Exhibits T-826, 827-831.)

4 While we were off the record, I marked a
5 number of documents for identification as follows:

6 Marked as T-826 for identification is a multi-page
7 document. In the upper right-hand corner it has
8 DEP-1.

9 827 for identification DEP-2 in three
10 pages.

11 DEP-3 in one page will be 828.

12 DEP-4 in one page, 829.

13 DEP-5 in one page, 830.

14 And DEP-6 in two pages, 831.

15 Whereupon,

16 DENNIS PESEAU,

17 having been first duly sworn, was called as a witness
18 herein and was examined and testified as follows:

19

20 DIRECT EXAMINATION

21 BY MR. RICHARDSON:

22 Q. Dr. Peseau, would you please state and
23 spell your name and provide your business address?

24 A. My name is Dennis E. Peseau, P E S E A U.

25 My business address is 1500 Liberty Street Southeast.

(PESEAU - DIRECT BY RICHARDSON)

3377

1 Q. Dr. Peseau, did you prepare or were these
2 exhibits that are identified as 826 through 831
3 prepared by you or under your direction?

4 A. Yes, they were. I should point out that my
5 business office is in Salem, Oregon. I think we
6 missed that.

7 Q. Do you have any corrections to your
8 exhibits?

9 A. I have one.

10 Q. Would you make that now, please, for the
11 record?

12 A. On page 5 of Exhibit T-826, line 18, the
13 year 1993 should read 1992. That's all the
14 corrections I have.

15 Q. With that correction, to the best of your
16 knowledge are your exhibits true and correct?

17 A. Yes.

18 MR. RICHARDSON: Your Honor, move the
19 admission of Exhibits 826 through 831.

20 JUDGE HAENLE: Any objection, Mr. Marshall?

21 MR. MARSHALL: No objection.

22 JUDGE HAENLE: Mr. Trotter?

23 MR. TROTTER: No.

24 MR. ADAMS: No objection.

25 MR. FURUTA: No objection.

(PESEAU - DIRECT BY RICHARDSON)

3378

1 JUDGE HAENLE: Exhibits T-826 and then 827
2 through 831 will be entered into the record.

3 (Admitted Exhibits T-826, 827 through 831.)

4 BY MR. RICHARDSON:

5 Q. Dr. Peseau, were you the -- you were the
6 industrial customers groups' technical participant,
7 were you not, in the PGE and PP&L decoupling
8 collaboratives?

9 A. Yes, that's correct.

10 MR. RICHARDSON: With that, Dr. Peseau is
11 available for cross-examination.

12

13 CROSS-EXAMINATION

14 BY MR. MARSHALL:

15 Q. Good afternoon, Dr. Peseau.

16 A. Good afternoon.

17 Q. You've been involved with rate cases
18 involving Puget before, correct?

19 A. Yes, I have.

20 Q. And you understand that for many years
21 going back to around 1981 Puget had an automatic fuel
22 adjustment clause, an ECAC?

23 A. Yes, I am aware of that.

24 Q. And you use in your testimony the DCF model

25 to make some of your computations; is that correct?

(PESEAU - CROSS BY MARSHALL)

3379

1 A. Yes.

2 Q. And is it true under the DCF model that
3 that model will reflect risk in the price of the
4 utility stock and ultimately in the return, rate of
5 return the utility is allowed?

6 A. That is correct.

7 Q. And how does the risk that a company has
8 and doesn't have get automatically reflected in the
9 price of the utility stock? What do you look at when
10 you look at the Wall Street Journal or stock prices
11 and some other publications to determine what that
12 risk is?

13 A. Are you asking the question of me as a
14 potential investor?

15 Q. You just corrected on page 5 the dividend
16 yield data, at least you changed the date from
17 September of 1993 to September of 1992. Does dividend
18 yield tell an investor anything at all about risk?

19 A. It can. I guess I never answered your
20 previous question because I wasn't certain whether I
21 was being placed as an investor or generally, but the
22 way of course investors adjust for risk and express
23 risk, of course, is in their ability to affect stock
24 price.

25 Q. And when you have the dividend yield of

(PESEAU - CROSS BY MARSHALL)

3380

1 6.87 percent here on page 5, line 17, that's something

2 you can compute from what figures?

3 A. From the quarterly dividend rate and the

4 stock price.

5 Q. And how does Puget's dividend yield reflect

6 this risk as perceived by investors, just in general

7 terms?

8 A. Well, again, it depends on certain

9 circumstances, but the less enthusiastic an investor

10 is toward the outlook for a stock, that is, the

11 outlook for risk, the investor has the ability to bid

12 down the price or not purchase at all, therefore

13 instigating a decrease in the stock price.

14 Q. So the price goes down, then the dividend

15 yield goes up; is that correct?

16 A. Assuming the quarterly dividend rate stays

17 the same, yes.

18 Q. How does Puget compare today in terms of

19 dividend yield with other regional utilities or

20 national utilities and electric utilities? Is it

21 high, medium, low?

22 A. It's medium.

23 Q. Have you done any computations here lately

24 to make that comparison?

25 A. This morning.

(PESEAU - CROSS BY MARSHALL)

3381

1 Q. What did you determine Puget's dividend
2 yield was compared to Pacific Corp?

3 A. I didn't check Pacific Corp's this morning.

4 Q. I mention them only because they've been
5 here. How about Washington Water Power?

6 A. I checked Puget's this morning. I might
7 add before we go on, the dividend yield is certainly
8 one component and a very important component of
9 investor's rate of return, but it's not the only one
10 and I wouldn't expect of course a comparison of
11 dividend yield, perhaps, from Pacific Corp versus
12 Puget to tell me the whole story. If, for example, I
13 had a more optimistic outlook for Pacific Corp in
14 terms of my growth component G in the formula for DCF
15 then I could certainly as an investor accept a lower
16 dividend yield for Pacific Corp and vice versa.

17 Q. For how many years did Puget have an
18 installed ECAC, an automatic fuel adjustment clause,
19 do you recall from having testified previously?

20 A. I believe it was 10 or 11 years. I
21 testified at the original hearing on that but I simply
22 -- it was just too long ago, several years.

23 Q. And it was just off briefly for a time
24 before it got reincorporated into the so-called PRAM

25 decoupling mechanism?

(PESEAU - CROSS BY MARSHALL)

3382

1 A. That is correct.

2 Q. In that 10 or 11 year period, going back to
3 1981, is it fair to say that the DCF model that you
4 used did incorporate whatever risk transfers or
5 whatever risk shifting there may have been as a result
6 of that ECAC, automatic fuel adjustment mechanism?

7 A. Did the cost of capital resulting from
8 application of DCF --

9 Q. Right.

10 A. Yes, it did.

11 Q. Are fuel adjustment clauses common in the
12 electric utility and gas utility industries or in the
13 United States or uncommon?

14 A. Your question was fuel adjustment clauses?

15 Q. Right. Or ECAC-like mechanisms?

16 A. That was the purpose for my clarification.
17 Fuel adjustment clauses are fairly common. As they
18 expand into other areas of automatic compensation,
19 they're less common.

20 Q. And as a fuel adjustment clause I take it
21 you would put hydro in the category of fuel, the water
22 for hydro is the fuel for hydro?

23 A. I would not. I'm not sure what the
24 question gets at. It's very much different than a

25 fuel adjustment clause for a terminal generation

(PESEAU - CROSS BY MARSHALL)

3383

1 system. It could or could not be, depending on the
2 degree of fuel and other risks that you wanted to
3 cover for the utility.

4 Q. And because Puget Power has a lot of hydro
5 which is low cost hydro, but nevertheless a lot of
6 hydro, it has a lot of hydro fuel risk in terms of
7 water risk. Is that fair to state?

8 A. Hydro generation as a percentage of total
9 generation for Puget is relatively high and therefore
10 variations in the cost of that, supply of that of
11 course would be significant.

12 Q. In the past 11 to 12 years when Puget had a
13 fuel adjustment clause, an ECAC clause, did you
14 estimate what the market did with respect to that, how
15 it treated that in the cost of capital, how it
16 incorporated that in, or happened so suddenly that
17 it's hard to separate those things out, just happens
18 automatically?

19 A. I will answer your question a little
20 generally if I might. The risk change, if there is
21 one from an implementation for example of an ECAC for
22 Puget, though it happened suddenly the market does not
23 appraise that risk suddenly. People are making bets
24 one way or the other from the time the Commission

25 determines that it's going to investigate whether it's

(PESEAU - CROSS BY MARSHALL)

3384

1 a good idea or not it will -- investors' expectations
2 will be formulated and changed as the course of
3 proceeding goes on and anticipate that and by the time
4 the particular order is issued by a Commission
5 accepting or rejecting it the markets very often don't
6 react at all because they've anticipated one way or
7 the other what was the result of that.

8 Now, you can observe changes in the cost of
9 capital by computing using a DCF method or some other
10 means, annual estimates of costs of capital even if
11 there wasn't a rate case, for example. The difficulty
12 is how much of that change in the required return on
13 capital is attributable to the fuel cost adjustment.
14 My firm -- in fact, I personally undertook an
15 econometric study in one of the cases here before
16 Puget to determine whether the ECAC should be
17 continued. I'm sorry, I don't recall the docket
18 numbers. And our determination was that comparing
19 Puget versus other fuel adjustment utilities and
20 comparing those utilities that did not have fuel
21 adjustment clauses, I determined it was impossible to
22 quantify any changes in risk and therefore cost of
23 capital as a result of the ECAC.

24 Q. Do you have that study that you have

25 available that you reviewed here for your testimony

(PESEAU - CROSS BY MARSHALL)

3385

1 that you've given today, too?

2 A. Study just referred to?

3 Q. Yes.

4 A. No, I didn't testify on this issue
5 specifically with ECAC in this proceeding. It would
6 be, whatever docket it was, it would be my direct
7 testimony.

8 Q. Now, after a period of 11 years or so of an
9 ECAC mechanism, is it fair to say that the market will
10 have taken into account those risks or nonrisks?

11 A. Will have or --

12 Q. Yes.

13 A. Yes. In fact, it would have as well.

14 Q. Turning to another topic altogether, you
15 referred in your testimony to gas distribution
16 companies that purchase all of their energy?

17 A. Yes.

18 Q. Do you know whether the rating agencies
19 require higher equity ratios, common equity ratios,
20 and coverages for gas distribution companies than for
21 electric utilities?

22 A. In some instances they do but if you use
23 comparably rated -- I'm sorry, was your question to
24 debt rating or other types of --

25 Q. Well, rating agencies that rate debt, they

(PESEAU - CROSS BY MARSHALL)

3386

1 require higher equity ratios and coverages for gas
2 distribution companies compared to electric utilities,
3 don't they?

4 A. As a general matter I don't think that's
5 true. I think they certainly do in certain instances
6 and again it depends on the nature of the LDC or
7 local distribution company.

8 Q. Are fuel adjustment clauses for gas
9 distribution companies very common?

10 A. Yes.

11 Q. Do you know what the rating agencies
12 require for a common equity ratio for gas distribution
13 companies that are A rated?

14 A. May I have a moment?

15 Q. Sure.

16 A. Readily I can reference Northwest Natural
17 Gas which, for 1992, appears to do a common equity
18 ratio of about 41 percent.

19 Q. Is that the only gas distribution company
20 that you have reference to? Let me ask you this
21 generically. Where would you find a current listing
22 of what the common equity ratios are for gas
23 distribution companies?

24 A. Well, it depends on what type of data I

25 would want. I could find that in Compuserve, Value

(PESEAU - CROSS BY TROTTER)

3387

1 Line they would not perhaps be projected out the way
2 you want in terms of short-term long-term debt but
3 they would give you essential capital ratios.

4 MR. MARSHALL: No further questions of the
5 witness.

6

7

CROSS-EXAMINATION

8 BY MR. TROTTER:

9

Q. Beginning with questions asked by
10 Mr. Marshall. Northwest Natural Gas's current equity
11 ratio is 41 percent. Does that include or exclude
12 short-term debt in the capitalization -- in the
13 capital structure?

14 A. For some computations I made from my
15 testimony I have the debt ratio at approximately 59
16 percent. I don't have the information in front of me
17 whether that included short term or not. I think it
18 must have given that the equity ratio is rather low at
19 41 percent.

20 Q. The PRAM is much more than just a fuel
21 adjustment clause, is it not?

22 A. Yes, it is.

23 Q. With respect to dividend yield telling us
24 anything about risk, you would have to include

25 analysis of the growth rate in order to get the

(PESEAU - CROSS BY TROTTER)

3388

1 investors' equity capitalization rate, wouldn't you?

2 A. Yes. I alluded to the fact that there's a
3 self-equilibrating mechanism for cost of capital.

4 There are two components, one being the dividend yield
5 which you referred to, the other being the growth
6 rate. If I expect for a utility, or for that matter
7 any company stock, the growth rate in dividend to
8 occur very quickly, I don't need today a very high
9 dividend yield. The bottom line is that risk you're
10 incurring, not necessarily the mix of growth
11 expectations versus growth in dividend yield or
12 income.

13 Q. So you have to put the two together?

14 A. Certainly.

15 Q. Turn to page 13 of your testimony. States
16 the actual equity component of Puget's capital
17 structure is 42 and a half percent, do you see that?

18 A. Yes.

19 Q. Am I correct that that figure is the
20 company's expected equity ratio sometime this fall.
21 Could you tell us where you got that number?

22 A. Yes. To determine the actual equity
23 component I used a figure from company witness Russel
24 Olson, his Exhibit REO-3, I believe it was. On page

25 19 of that exhibit he listed monthly expected capital

(PESEAU - CROSS BY TROTTER)

3389

1 ratios -- excuse me, equity ratios. The one I chose
2 was the first one listed there which was September
3 1993.

4 JUDGE HAENLE: REO-3 is Exhibit 520.

5 Q. And that capital ratio is based on a
6 short-term debt ratio of 3.9 percent; is that right?

7 A. Let me turn to that if I might. That's
8 correct.

9 Q. And a preferred stock ratio of 8.7 percent?

10 A. Yes.

11 Q. Would you accept subject to check that
12 Puget's year end equity ratios, including short-term
13 debt for 1988 was 41.1 percent; for '89, 41.3 percent;
14 for 1990, 41.5 percent; for 1991, 41.4; and for 1992,
15 40.0.

16 A. These were the equity ratios year end?

17 Q. Yes.

18 A. Yes, that's my understanding.

19 Q. Puget is basing its case on a capital
20 structure including 2 percent short-term debt; is that
21 correct?

22 A. You're not referring to the figures we were
23 just talking -- yes, that's correct.

24 Q. You would not support a short-term debt

25 ratio that low, would you?

(PESEAU - CROSS BY TROTTER)

3390

1 A. That appears low for the upcoming year. It
2 will require some certainly changes in capital
3 structure and financing to get there.

4 Q. Turn to page 9 of your testimony. And here
5 you're talking about growth in stock price as a
6 determinant of expectations of future growth in
7 dividends?

8 A. Yes.

9 Q. You state on line 26 that you are -- and
10 this is what you believe Dr. Olson used as a measure
11 of expected growth rate?

12 A. If he used a quantitative measure at all,
13 it appears from the range he used for expected growth
14 of 4.5 to 5 percent. I know he discarded or dismissed
15 as being unreasonable all the dividends earnings and
16 book value measures of growth that he discussed. He
17 then went on to observe that the stock price of Puget
18 stock had increased at an annual rate of 9 percent.
19 And from that he concluded that that 4 and a half to 5
20 percent was a reasonable expectation for dividend
21 growth, and I assume that those figures were placed
22 there in lieu of outright judgment and so I did make
23 that conclusion, although it's not very explicit in
24 the testimony.

25 Q. And you conclude that use of a stock price

(PESEAU - CROSS BY TROTTER)

3391

1 growth is not consistent with DCF model?

2 A. No. It's not consistent and it's really, I
3 think, backwards. Stock price is a function of an
4 investor's expectations towards earnings, dividends or
5 book value. Dr. Olson, if he's assuming stock price,
6 he's assuming that dividend rates and earnings are a
7 function of the utility stock price and that's simply
8 not true.

9 Q. You have -- you are supporting an estimate
10 in growth rate of 3 percent; is that correct?

11 A. Yes.

12 Q. And in reaching your 10 and a half percent
13 cost of equity you used Dr. Olson's 6.87 percent
14 dividend yield as well as his market pressure and
15 financing cost adjustment; is that right?

16 A. Yes. In fact as I state in my testimony it
17 occurred to me that the only difference, significant
18 difference between, I think a typical DCF estimate and
19 that of Dr. Olson was all couched in one variable,
20 that is, the expected growth rate. After observing
21 that I decided rather than come up with yet another
22 approach to the DCF model for dividend yield periods,
23 estimates of growth and so forth, adjustments to
24 growth, and periods for estimating that, that I would

25 adopt each and every step used by Dr. Olson and make

(PESEAU - CROSS BY TROTTER)

3392

1 but one change and that is the expected growth rate.

2 So it is exactly as you indicated, Dr. Olson's
3 dividend yield.

4 Q. On page 6 of your testimony, lines 5
5 through 7 you state that in your opinion the dividend
6 yield range of 6.6 percent to 6.87 percent is
7 reasonable for Puget in this proceeding. Had you used
8 the 6.6 percent yield with your 3 percent growth rate
9 your 10.5 percent would have reached a lower number;
10 is that correct?

11 A. Yes. As I indicate on lines 20 and 21 of
12 the preceding page Dr. Olson recommended, and I agree,
13 that the dividend yield can and should be updated as
14 the period of decision takes place anyway, and that
15 would -- since the writing of that testimony the
16 dividend yield has really remained around 6.6 percent.

17 Q. What would your equity cost rate be with
18 the 6.6 percent dividend yield and the 3 percent
19 growth?

20 A. 10.5 percent.

21 Q. I thought that was the result with the
22 higher growth rate.

23 A. It's 10.8 percent with the higher.

24 Q. Turn to page 22 of your testimony. Here

25 you applied the -- what you characterize as the

(PESEAU - CROSS BY TROTTER)

3393

1 phantom debt imputation. You apply a debt imputation
2 for two natural gas distribution companies, Northwest
3 Natural and Washington Energy; is that right?

4 A. Yes.

5 Q. And those are both A-rated companies?

6 A. That is correct.

7 Q. And did you use the same debt imputation
8 methodology as the company witnesses have proposed in
9 this case?

10 A. Yes.

11 Q. On line 19 and 20 you came up with coverage
12 ratios of .9 and .8 for those two companies?

13 A. Yes.

14 Q. Now, generally, am I correct that as a
15 broad generalization the bond or that the mortgage --
16 or that bond indentures require generally a two times
17 coverage test?

18 A. Yes.

19 Q. And that means again in general terms there
20 needs to be net income just to pay the interest twice?

21 A. Yes. Interest coverage needs to be two
22 times.

23 Q. At .9 and .8 that means they can't pay it
24 once, right?

25 A. That is correct.

(PESEAU - CROSS BY TROTTER)

3394

1 Q. That would mean if this was true that
2 Northwest Natural and Washington Energy would be in
3 default?

4 A. That's correct. If the imputation that
5 I've made to show what this Duff & Phelps imputation
6 does, if that actually were indeed debt and fixed
7 obligation they could not pay interest.

8 Q. How long have Northwest Natural and
9 Washington Energy been A-rated utilities?

10 A. Northwest Natural for some time. Tell you
11 the truth I don't know how long Washington Energy has
12 been A-rated.

13 Q. But do I take it correctly that they have
14 not been substantially downgraded recently because of
15 this imputed debt phenomenon?

16 A. No, and that's obviously why I used that
17 example. The situation for LDCs or local distribution
18 companies has not been changing the way that Puget has
19 been changing in terms of meeting its power needs.
20 Actually, I think that's not true. It's been pointed
21 out Puget's level of purchased power has not grown
22 over time but one of the purposes of choosing LDCs
23 was to show that these companies have basically
24 purchased 100 percent of their power as opposed to

25 building plant to produce gas or owning their own

(PESEAU - CROSS BY TROTTER)

3395

1 fields and such for some time.

2 Q. On line 7, the 42 and 46 percent equity
3 ratios for those companies?

4 A. Yes, I may have misspoke. I may have said
5 41 percent for Northwest. It should have been 42
6 percent.

7 Q. I asked you whether for Northwest it
8 included short-term debt in the capital structure and
9 you said you thought probably it did. Is your answer
10 the same for Washington Energy?

11 A. Yes.

12 MR. TROTTER: No further questions.

13 JUDGE HAENLE: Do you have questions,
14 Mr. Furuta?

15 MR. FURUTA: No, your Honor.

16 JUDGE HAENLE: Mr. Adams?

17 MR. ADAMS: Yes, I do have a few.

18

19 CROSS-EXAMINATION

20 BY MR. ADAMS:

21 Q. I want to go back to as a starting point
22 the responses to a question by Mr. Trotter. You
23 indicated, I believe, that the current dividend yield
24 is 6.6 percent?

25 A. Yes.

(PESEAU - CROSS BY ADAMS)

3396

1 Q. And am I correct that Dr. Olson's dividend
2 yield was based on Puget stock prices during the
3 period of April through September 1992?

4 A. That is correct.

5 Q. And am I correct that you believe Puget
6 stock priced data which is more than a year old
7 shouldn't be categorized as most recent information?

8 A. That is correct.

9 Q. I think you indicated you think the
10 dividend yield should be updated as we go through this
11 proceeding?

12 A. Yes, and I want to be certain that I did
13 adopt Dr. Olson's method of using six months just so
14 that there would be no question in the Commission's
15 mind that that's an area that differs in fact -- I
16 used that six month period, used the adjustment to the
17 dividend rate that he uses for a half a year. I tried
18 to use every piece of data and every adjustment used
19 by Dr. Olson except his expected growth rate to show
20 that. So while I continue to think that the use of a
21 more current six months would be appropriate, I don't
22 differ -- I don't think it's that significant in this
23 case if it was a three month or two month average, but
24 in any event the six month average brought up to date

25 would be somewhat lower than

(PESEAU - CROSS BY ADAMS)

3397

1 Dr. Olson's dividend yield.

2 Q. It would be right around 6.6?

3 A. It would be, I would bet it would be 6.6
4 percent.

5 Q. Now, if we add the 6.87 percent dividend
6 yield that Dr. Olson used and that you sort of assumed
7 for purposes of your analysis, plus the 3 percent
8 growth rate that you recommend, we get 9.87 percent
9 which is 60 to 90 basis points below your final
10 recommendation of 10.5 to 10.8 percent, correct?

11 A. Yes.

12 Q. If we were to instead of using 6.87 percent
13 we would use the 6.6 percent we would then get to 9.6
14 percent?

15 A. That is correct.

16 Q. Now, according to your testimony at the top
17 of page 13, as I read it, we can attribute this
18 difference, that is, between the addition of the two
19 numbers to your final recommendation as being caused
20 by several factors. One is increasing the dividends
21 by one plus one half the growth rate and also
22 accounting for market pressure and issuance costs; is
23 that correct?

24 A. That is correct. That's another area, and

25 I am glad you asked the question -- another area where

(PESEAU - CROSS BY ADAMS)

3398

1 I simply adopted exactly Dr. Olson's adjustments
2 rather than argue that flotation costs or market
3 pressure would be something other than that. I
4 thought it was important to show that again there's
5 only one variable I think at issue in this case among
6 all the rate of return analysts and that's the
7 expected growth rate achieved.

8 Q. Does that mean you don't necessarily agree
9 with those adjustments?

10 A. I don't necessarily agree. They're
11 somewhat higher than I used and have seen in other
12 instances.

13 Q. Getting back to the current dividend yield
14 of 6.6 percent. Would you agree that the company just
15 increased its dividend to \$1.84 per share?

16 A. On an annual basis that's right.

17 Q. Do you believe it is likely that the
18 company will increase its dividend again within two
19 quarters?

20 A. If it does it would certainly seem to me
21 it's in an awfully strong financial condition. I
22 would think that that would be too soon for another
23 increase.

24 Q. But that's what is assumed in increasing the

25 dividend by one plus 0.05 G, that is one plus one half

(PESEAU - CROSS BY ADAMS)

3399

1 the growth rate?

2 A. Yes.

3 Q. But as I think I just heard you say, you
4 don't think it's a very likely event?

5 A. That is correct.

6 Q. Would you agree that if one were to use
7 Puget's most recent dividend yield of 6.6 percent in
8 performing a DCF analysis because the company has just
9 increased its dividend it would not be necessary to
10 increase the dividend by one plus 0.5 G?

11 A. I think that's correct. I can't remember,
12 there have been so many cost of capital witnesses, but
13 one of the witnesses observed that it's really more
14 consistent in the use of quarterly type adjustment
15 anyway and that might be too ambitious given the
16 information you've just given anyway. But I think in
17 any event a quarterly adjustment is really more
18 appropriate.

19 Q. So in other words you're saying that 1.5 G
20 adjustment is not really called for in light of the
21 recent dividend?

22 A. Yes.

23 Q. Isn't it true that because utility
24 capitalization and rate base are often similar in

25 magnitude the book value of equity capital as used by

(PESEAU - CROSS BY ADAMS)

3400

1 investors is the equity base in which the utility

2 earnings are allowed and earned?

3 A. That the book value is the earnings base

4 from which investors derive return?

5 Q. They basically look at utility

6 capitalization and rate base, that is book value, if

7 you will, and rate base as basically being similar,

8 this is investors, not regulators necessarily?

9 A. The only interpretation I can give your

10 question is does that mean that you are suggesting a

11 market-to-book ratio of one since the market value of

12 the capitalized value of the stock is the same as

13 the book value?

14 Q. Well, I am not suggesting, the question is

15 if you can't agree with that statement, that's fine.

16 A. I don't know whether I can agree with it.

17 I just don't understand the question.

18 Q. Well, is it correct that if I own a utility

19 stock and its book value per share increases for some

20 reason then that would be considered a plus?

21 A. Yes.

22 Q. And isn't that one of the reasons that the

23 utility earnings base has gotten bigger or at least

24 that's the perception?

25 A. Yes. That's correct.

(PESEAU - CROSS BY ADAMS)

3401

1 Q. So when a utility stock -- issues stock at
2 a market price which is, let's say 50 percent above
3 book value, does the book value per share of that
4 utility increase as a result of the equity issuance?

5 A. Yes, it does.

6 Q. One last general question because this
7 question has been asked to some of the other financial
8 witnesses. Do you believe that the analytical
9 results, and I am not saying the recommendations here,
10 but the analytical result of the various cost of
11 capital witnesses in this proceeding have been similar
12 or divergent?

13 A. I think the estimates among all the
14 witnesses that -- I know they're closer than I've ever
15 seen, especially in a case with this number of
16 witnesses. For comparable approaches, that is, some
17 cases market approaches, DCF risk premium and the
18 capital asset pricing model, they're remarkably close.

19 MR. ADAMS: Thank you. That's all I have.

20 JUDGE HAENLE: Commissioners, have you
21 questions?

22

23 EXAMINATION

24 BY CHAIRMAN NELSON:

25 Q. As a follow-on to that last question of

(PESEAU - EXAM BY CHAIRMAN NELSON)

3402

1 Mr. Adams, we haven't had this number of witnesses in
2 my period on this Commission. Do you think this is a
3 trend we should encourage, and I want you to set aside
4 your own self-interests. Or are we content these days
5 about minimizing costs of regulation and of government
6 in general.

7 A. I think in many instances where you haven't
8 had significant changes in capital markets one can
9 almost predict the cost of capital or the range by the
10 particular party. Commissioner Casad has pointed that
11 out and I think that's true. So I think, especially
12 in this instance where it seems like most of the
13 analysts have used similar approach, that is a
14 discounted cash flow, I think some of the testimony
15 appears to be redundant.

16 On the other hand, we have undergone
17 changes in capital markets that I can remember
18 testifying for probably the first time in the early
19 1970's on this issue and capital markets are better
20 today than they were then, and while I don't testify
21 frequently on cost of capital I have other people who
22 do that, I think it's remarkable and important that
23 people be aware of the fact that capital markets have
24 changed and I think it's important in this instance

25 that so many analysts came so -- are so close together

(PESEAU - EXAM BY CHAIRMAN NELSON)

3403

1 on that issue because it's seldom -- I've never been
2 in a case where there haven't been two or 300 basis
3 points difference, and I think someone pointed out if
4 there's some changes in Dr. Olson's growth rate alone
5 then he's right down with the rest. I am not saying
6 that he would agree that he should have to come down
7 on the growth rate. But I think it's important given
8 the financial impact of this on ratepayers if indeed
9 the cost of capital -- we all agree it shouldn't be
10 below the cost of capital, I think everyone is
11 agreeing we should adjust the cost of capital for some
12 pressure and allow that to Puget, if that's the case I
13 think it's maybe well worth the additional time on the
14 record given the current situation in the capital
15 market.

16 Q. Certainly the parties couldn't know it when
17 they hired all of you how it would turn out.

18 A. It's true. Now, had the parties got
19 together -- I mean the numbers were quite readily
20 available and it was an easy task for everyone to come
21 in, but at least on my part that was not the case.

22 JUDGE HAENLE: Commissioner, do you have
23 questions?

24 COMMISSIONER HEMSTAD: No questions.

25 JUDGE HAENLE: Do you have any redirect?

(PESEAU - EXAM BY CHAIRMAN NELSON)

3404

1 MR. RICHARDSON: I don't, your Honor.

2 JUDGE HAENLE: Anything more of the
3 witness?

4 Thank you, sir. You may step down. I
5 believe that's all of the witnesses we had scheduled
6 for today. We have two scheduled tomorrow. 9:00
7 again. Anything we need to discuss before we go off
8 the record? We will recess until nine tomorrow then.
9 Thank you.

10 (Hearing adjourned at 4:00 p.m.)

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