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BY U. S. EXPRESS MAIL - OVERNIGHT DELIVERY

Mr. Paul Curl, Secretary
Washington Utilities and Transportation Commission
Chandler Plaza Building
1300 S. Evergreen Park Drive SW
Olympia, Washington 98504

Re: Puget Sound Power & Light General Rate Case
Washington Utilities & Transportation Commission
Docket Nos. UE-920433, UE-920499, and UE-921262

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Dear Sir:

Enclosed please find the original and nineteen copies of the opening brief of the Federal Executive Agencies (FEA) on the cost of capital and accounting issues in the matter referenced above.

Copies of this brief are being served on all parties of record.

Yours truly,

Norman Furuta

NORMAN J. FURUTA
Associate Counsel
(Regulatory Law)

Enclosures: as stated

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Petition of PUGET SOUND POWER & LIGHT COMPANY for an Order Regarding the Accounting Treatment of Residential Exchange Benefits	Docket No. UE-920433
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	Docket No. UE-920499
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	Docket No. UE-921262

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OPENING BRIEF OF THE FEDERAL EXECUTIVE AGENCIES
ON COST OF CAPITAL AND ACCOUNTING ISSUES

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I. INTRODUCTION

The Secretary of Defense, through authorized counsel, hereby files the Brief of the Department of the Navy on behalf of the consumer interest of all Executive Agencies of the Federal Government (FEA) on cost of capital and accounting issues.

II. COST OF CAPITAL

The determination of the weighted average cost of capital requires three steps: (1) the determination of the proper capital structure; (2) the determination of the cost rates for the capital components, debt, preferred stock, and common equity; and (3) the application of the cost rates to the adopted capital structure thereby resulting in the weighted average cost of capital.

This brief will discuss each of these three steps with particular emphasis on the appropriate capital structure and cost of equity. FEA believes that its position on these issues reflects fairness and equity to the Company's shareholders and ratepayers.

A. Capital Structure

The Company proposes the use of a projected capital structure consisting of 47.00% total debt, 8.00% preferred stock, and 45.00% common equity. This capital structure is represented to be an average capital structure rather than a year-end capital structure. Staff recommends a capital structure consisting of 46.5% long-term debt, 5% short-term debt, 7.5% preferred stock, and 41.05% common equity. This capital structure is based on Dr. Lurito's projections and is represented as a projected year-end 1994 capital structure. The Staff is joined in its position that the equity ratio should be lower than proposed by the Company by Dr. Dennis Peseau, witness for Washington Industrial Committee for Fair Utility Rates, recommends a capital structure consisting

of 49.5% debt, 8.0% preferred stock, and 42.5% common equity. Dr. Peseau suggests that the 42.5% equity ratio is the actual equity ratio. Mr. Stephen Hill, witness for the Attorney General of Washington, recommended virtually the same capital structure as Dr. Peseau, distinguishing a 4.0% short-term debt component and describing his recommended capital structure as a "target capital structure".

Based on the facts known at the time he prepared his testimony, FEA's witness Legler, recommended a capital structure consisting of 47.85% debt, 8.15% preferred stock, and 44% common equity. Legler recognized that any projected capital structure necessarily involves estimates and the amount of retained earnings will be dependent upon what return on equity the Commission allows in this case. Consistent with his return on equity recommendation which is lower than requested by the Company, Legler suggested that should the Commission allow a lower return, the common equity ratio should be set lower than the 45% requested by the Company.

FEA believes that the Company should manage its own capital structure, and the Company's actual capital structure should be used unless the Commission determines that it is inappropriate or imprudent. Dr. Legler demonstrated that the 45% equity ratio requested by the Company would be reasonable in comparison with other single-A rated electrics and noted that very few single-A electrics had equity ratios as low as Puget's actual December 1992 equity ratio. FEA also believes that, should the Company be permitted to increase its equity ratio (which would reflect lower financial risk), the authorized return on equity should be lowered to some extent.

FEA also notes that Puget Sound has achieved an equity ratio of 45% according to the rebuttal testimony of Mr. R.E. Olson. Despite Mr. Olson's assertion that Puget will continue to have a 45% equity ratio, FEA believes that it could be temporary if past equity injections are an indication of how the proceeds of the equity sale are used. FEA believes that its capital structure

recommendation represents a reasonable compromise. It reflects both reasonableness and attainability. FEA's recommendation should not be judged independently from its recommendation on the cost of equity, however. Ratepayers should share the benefits of the lower financial risk reflected in the move to a higher equity ratio.

B. Cost of Debt

In its original testimony, the Company proposed a cost for long-term debt of 7.91%. Dr. Legler reviewed the Company's data and made adjustments for changes that had taken place since the Company filed its testimony and for more recent interest rate forecasts than were available to the Company. Dr. Legler's revised figures indicated an embedded cost for long-term debt of 7.99%. The Company's rebuttal testimony does not appear to update any of the calculations from its original testimony. Based on a long-term debt ratio of 42%, the difference amounts to about 1 basis point in the overall cost of capital calculation. Since the Company has not claimed an embedded cost higher than 7.91%, FEA recommends that the Company's proposed embedded cost of debt be accepted.

The Company's original testimony placed the cost of short-term debt at 5.39%. Following the Company's procedure for calculating the cost of short-term debt and using a more recent interest rate forecast than was available to the Company, Dr. Legler estimated the short-term cost of debt to be 4.63% at the time he prepared his testimony. The Company's rebuttal testimony (Mr. R.E. Olson at page 17), based on even more recent interest rate forecasts, now indicates a short-term cost rate of 4.42%. FEA believes that the Company's estimate is reasonable. Based on FEA's recommended short-term debt ratio of 2.04%, the difference between a short-term cost rate of 4.00% compared to 4.42% is less than 1 basis point on the weighted average cost of capital.

C. Cost of Preferred Stock

The Company proposes a cost of preferred stock of 8.10%. The Staff recommends a cost rate of 8.09%. Dr. Legler noted that there was a projected retirement in July 1993 and attempted to adjust for this retirement. He calculated an embedded cost of preferred stock of 8.12%. Mr. R.E. Olson recalculated the embedded cost rate for preferred stock in his rebuttal testimony. The recalculated rate turned out to be the same 8.10% originally calculated even taking into account the elimination of FLEX DARTS, Series B, which was called on June 1, 1993. Thus, there is only a 1 basis point difference in the positions of the Company and the Staff. Based on FEA's recommended capital structure which includes 8.15% preferred stock, there is virtually no difference in the weighted average cost of capital between the Staff and Company positions. FEA recommends that the embedded cost of preferred stock be set at 8.10%.

D. Cost of Common Equity

By far the most controversial issue with respect to the cost of capital is the cost of common equity. The Company has requested a cost of common equity of 12.25%. Staff recommends a return on equity of 11.0%. The Attorney General through the testimony of Mr. Hill recommends a return of 10.0%. The Washington Industrial Committee for Fair Utility rates, through the testimony of Dr. Peseau, recommends a range of 10.5% to 10.8%. FEA, through its witness, Dr. Legler, recommends a return on common equity of 11.25%. Thus, the recommendations range from a low of 10.0% (Mr. Hill) to a high of 12.5% (Dr. C.E. Olson). While the difference between FEA's and the Staff's recommendations is minor, the difference between FEA's and the Company's recommendations appears to be large. In reality, most of the difference may be attributed to opposing points of view on a limited number of issues. FEA believes that its positions are

well reasoned and that its recommended cost of equity is reasonable and should be adopted by the Commission.

Both Dr. Olson and Dr. Legler agree that the annual constant growth version of the discounted cash flow (DCF) model is proper for estimating the cost of common equity. (Transcript, Volume VI, page 773) Much of the difference in their bare-bones estimate of the cost of equity is attributable to the more recent data used by Dr. Legler and to the difference in the growth rates each of them adopted. For the application of the DCF model to Puget, Dr. Legler reviewed historical growth rates, analyst forecasted dividend growth rates, and retention growth. He utilized a growth rate of 3.0% to 4.0%. FEA notes that Dr. Peseau used a growth rate of 3%; Dr. Lurito used a growth rate of 3.5%. In contrast, Dr. Olson adopted a dividend growth rate of 4.5 to 5.0 percent. Dr. Olson reviewed much the same data as the other witnesses and found that historical dividend growth, analysts' forecasted growth, and retention growth all produced results below his adopted 4.5 to 5.0 percent. What Dr. Olson did find was that Puget's stock price has increased by an average compound rate of 6.0 percent over the last 10 years. Based on this he concluded that "the increases in Puget's stock price have been a major factor driving investor growth expectations for the Company." (Olson, Testimony, page 31, lines 23-25)

Dr. Olson's implementation of the DCF method is a classic example of a major criticism of this model. You can get any expected return you want simply by picking the necessary growth rate. FEA is not disputing Dr. Olson's sincerity or suggesting that he does not believe that his adopted growth rate is proper. It does appear, however, that Dr. Olson searches for some shred of evidence to support growth rates higher than the conventional methods suggest. FEA suggests that there is little reason to believe that Puget's Board of Directors will vote for dividend increases tied to its past history of stock appreciation. (Transcript, Volume VI, page 777, lines 4-12) Dividend growth must be grounded in the fundamental financial performance of the

Company. Investor expectations must be rational. It is FEA's position that the evidence in the record clearly shows the superiority of Dr. Legler's analysis on this issue. The difference in the adopted growth rate explains roughly 1 to 1.5 percentage points of the difference in Dr. Legler's and Dr. Olson's DCF estimates for Puget Sound.

FEA recognizes that the Company would be quick to point out that Dr. Legler's recommended 11.25% return on common equity is not solely based on his DCF analysis for Puget, and it would be unfair to attempt to characterize the entire difference in Dr. Olson's and Dr. Legler's recommendations on the difference in their adopted growth rates. Dr. Legler's DCF estimate for Puget Sound was in a range from 9.8% to 10.8%. This range would be more consistent with the DCF findings of Dr. Lurito who concluded based upon his DCF study for a group of comparable electrics that the equity capitalization rate for Puget is 10.25%. Dr. Legler's DCF results are also reasonably consistent with Mr. Hill's results of 9.94% for a sample group and 9.97% for Puget. His results are also reasonably comparable to Dr. Peseau's range of 10.5% to 10.8%.

It would seem that all cost of capital witnesses should be recommending practically the same cost of equity based on the DCF analysis. (Transcript, Volume XIX, page 2333, lines 1-16). Because that is not the case, we will try to explain the major difference in the recommendation of Dr. Legler compared to those of Mr. Hill, Dr. Peseau, and to a lesser extent Dr. Lurito. First, Dr. Legler did not limit his analysis to the DCF model. He performed, in addition, risk premium analysis, Capital Asset Pricing Model (CAPM) analysis, and reviewed comparable return data. In contrast, Dr. Olson used an interest premium approach and found a equity return presumably for a double-A utility of 15 percent. He then concluded that this approach indicates an investor required return for Puget of 12.5 to 13.0 percent. FEA does not have the slightest idea how he arrived at this estimate for Puget. Puget Sound is a single-A utility, and we would

expect the cost of equity for a single-A rated utility to be higher not lower than a double-A utility. (Transcript, Volume VI, page 782, lines 3-14).

Mr. Hill provided corroborative analyses which included the earnings to price method, a market-to-book ratio analysis, and a CAPM approach. Of these methods, only the CAPM has much regulatory acceptance despite Dr. Olson's claim that it should not be used. (Olson, Rebuttal Testimony, page 17, lines 1-4) Mr. Hill's results using the CAPM indicate a return of 9.23% for Puget and 9.10% for his sample group. These results compare with Dr. Legler's CAPM results of 9.9% to 11.1% for Puget and 9.7% to 11.3% for Dr. Legler's comparable electrics. Mr. Hill does not provide the source of the data he used to implement his CAPM model. One major difference between his results and those of Dr. Legler appears to be the risk-free rate used in the analysis. It appears that Mr. Hill used a short-term government rate compared to Dr. Legler's use of the long-term government rate. As explained in Dr. Legler's testimony, there is growing support for the use of a long-term risk-free rate in CAPM analysis, and regardless of which risk-free rate is used, short or long-term, the market premium should be consistent with that premium.

Mr. Hill notes that the CAPM has many shortcomings and used this method only in support of his DCF analysis. (Hill, Testimony, page 35, lines 9-11) FEA agrees that the CAPM has many shortcomings, but this is true of all the financial models. The DCF model also requires assumptions and has its own shortcomings. Simply because it has not been put under the same microscope as the CAPM does not mean that it does not suffer from shortcomings. FEA believes that virtually all of the financial models would be discarded if their assumptions were subjected to real world tests of accuracy. For example, the DCF model relied upon by Dr. Olson and virtually exclusively by Dr. Lurito, assumes that the market price of the Company's stock will fall to book value. Certainly this has not happened since the Company's last rate case despite the fact that the Commission set the

return on equity below the Company's requested return. (Transcript, Volume VI, page 738). It is for this reason that FEA believes that the cost of equity should not be based on a single estimating technique, and that Dr. Legler's approach using several methods is to be preferred.

A second major difference in the ultimate recommendations of the witnesses has to do with the necessity and magnitude of an issuance cost adjustment to the bare-bones estimate of the cost of equity. Dr. Olson proposes an adjustment of roughly a full percentage point. Staff proposes an adjustment of 75 basis points. FEA believes that Dr. Peseau implicitly accepted Dr. Olson's adjustment. Mr. Hill rejected any adjustment. Dr. Legler recommends an adjustment of no more than 20 basis points.

Dr. Lurito proposes an issuance expense adjustment of 4.1% based on Dr. Olson's study and a 3% market pressure adjustment for a combined 7% adjustment. Dr. Olson proposes a combined 8% adjustment. Dr. Olson made his adjustment simply by multiplying his bare-bones cost estimate by 1.08. Dr. Lurito's approach is more involved and results in a slightly lower adjustment. In any event, roughly half of the adjustment is to protect shareholders from dilution (which would be caused by the price of the Company's stock falling below book value if the Company was forced to issue new common equity below book value). At the present time, the market-to-book ratio for Puget is approximately 1.5x. (Transcript, Volume VI, page 739, lines 22-24). FEA submits that it is unlikely that the Company will be forced to sell stock below its present book value or that the sale of stock will force the price of the Company's stock down to book value. Dr. Olson acknowledged that the recent sale resulted in proceeds well above book value. (Transcript, Volume VI, page 783, lines 9-22) FEA believes that the market pressure adjustment is unnecessary at this time. Indeed, even taking into account the actual issuance expenses, it is likely that the net proceeds would be **well above** book value at this time.

Using the same example found on page 39 of Dr. Olson's direct testimony, it can be demonstrated that his adjustment is excessive. Dr. Olson argues that if the investors' required return is just earned, the Company's stock would sell at book value. FEA disagrees that the real world replicates this theoretical preciseness he suggests but will accept it for purposes of this example. Both Dr. Olson's and Dr. Lurito's approach assume that the Company's market-to-book ratio will fall to less than 1.1. Assuming that issuance expenses are 5%, new shares would net the Company $23.75 (.95 times $25.00 = $23.75). Now suppose that investors' required return is 11%. Dr. Olson would argue that it is necessary to increase the 11% to 11.55% on the $23.75 in order to provide investors with an 11% return on their $25.00 investment (.1155 times $23.75 = $2.75; $2.75/$25.00 = 11%). Dr. Olson's example fails to take into consideration that the new stock is but a part of the Company's equity balance, and that the 11.55% return will be earned not only on the new, but also on the old stock as well. As can be seen from the example below, if a Company had 1,000,000 shares outstanding and issued an additional 100,000 shares at net proceeds of $23.75, a return on book equity of 11.55% would not result in an investor required return of 11.00% but rather 11.50%.

Shares	Number	Book/Proceeds	Book Equity	Market Value
Existing	1,000,000	$25.00	$25,000,000	$25,000,000
New	100,000	$23.75	2,375,000	2,500,000
Total	1,100,000	$24.89	$27,375,000	$27,500,000

Book Return = .1155 x $27,375,000 = $3,161,812.50

Market Return = $3,161,812,50/$27,500,000 = 11.50%

The necessary adjustment must take into consideration the relationship between the number of new and old shares. Dr. Olson's proposed adjustment simply does not consider this aspect and, therefore, must be rejected. Dr. Olson's proposed adjustment translates into a very large revenue requirement each and every year that the adjustment is embedded in rates.

The only theoretical support for the adjustment proposed by Dr. Olson is based on the assumption that the adjustment is required to compensate investors for past as well as future expenses if the Commission has not provided for past expenses in past decisions. The simple fact is that there is no evidence on the record that FEA can find regarding the adequacy or inadequacy of past Commission orders dealing with this issue.

Although the Company may not view Dr. Legler's proposed adjustment as sufficient, Dr. Legler did recommend a modest adjustment to the cost of equity for flotation costs. (Olson, Rebuttal Testimony, page 27, lines 17-21) With regard to the past issues, it is FEA's position that it would be improper for this Commission to compensate the Company in this proceeding for expenses that may have been incurred years ago and which may not have been adequately treated in some rate proceeding. Such compensation would amount to retroactive ratemaking. FEA believes that Dr. Legler's proposed adjustment is fair and could actually be viewed as generous by some parties.

It is FEA's position that Dr. Legler's recommended return on equity is fully supported. Even Dr. Olson admitted that "his estimated return of 11.25 percent is close to what investors require." (Olson, Rebuttal Testimony, page 25, lines 15-16) Updating Dr. Olson's DCF analysis for more recent stock prices, using his growth factor of 4.5 to 5.0 percent, <u>which FEA regards as excessive</u>, results in an investor required return of 11.06% to 11.56%. (Transcript, Volume VI, page 778, lines 6-15)

E. Weighted Average Cost of Capital

The weighted average cost of capital (Rate of Return) is 9.34% as shown below, based on a cost of equity of 11.25%. This calculation is based on revised embedded cost rates and compares with the 9.37% cost rate originally proposed in Dr. Legler's prefiled testimony.

Component	Ratio	Cost	Weighted Cost
Debt	47.85%	7.79%	3.73%
Preferred Stock	8.15%	8.10%	.66%
Common Equity	44.00%	11.25%	4.95%
RATE OF RETURN			9.34%

FEA respectfully recommends that the Commission adopt a weighted average cost of capital of 9.34%.

III. ACCOUNTING ISSUES

FEA sets forth its brief on accounting issues using the adjustment headings as designated by the Staff and utilizes the Staff's numbering. Where the Staff has eliminated an adjustment, the number used agrees with the Company's original filing.

A. Future Use Plant, Adjustment No. 4.05

FEA witness, Mr. Larkin, made three separate adjustments to Puget's Plant Held for Future Use ("PHFFU") claim. His adjustments included the removal of items that Puget has agreed should not be included in PHFFU, removal of items that have remained in PHFFU for over 10-years, and removal of the remaining amount of PHFFU with the allowance of an accrual of a carrying charge on such property similar to AFUDC.

FEA's first adjustment, shown in Exhibit 793, Schedule 4, removed $994,882 from PHFFU for items which the Company agreed should not be included in PHFFU, along with the associated property taxes of $6,558. The Company agreed to this adjustment (Rebuttal Testimony of J.H. Story, T-965, p. 21).
FEA's second adjustment removed PHFFU items which the Company does not expect will be used within 10 years as stated by in Exhibit 792 at p. 8.

Staff witness Martin, in T-749, proposed a similar adjustment, suggesting a 20-year benchmark rather than the 10-year proposed by the FEA. The FEA recommends that the Commission adopt a 10-year benchmark as a more reasonable period for inclusion in rates.

FEA's final adjustment removes from rate base the remaining balance of PHFFU. As calculated in Exhibit 793, Schedule 3, ratepayers would pay Puget $22.057 million in conservatively estimated financing cost on $14.446 million of PHFFU prior to the PHFFU being used to provide utility service. The estimated financing cost to ratepayers for such PHFFU is approximately $2

million annually. It is costly to ratepayers to have to pay the utility a return including tax gross-up on PHFFU. As an alternative to rate base inclusion, FEA recommended that Puget be allowed to accrue an AFUDC-like carrying charge on such property to compensate the Company for financing costs. The Company's authorized overall cost of capital would be applied as the carrying charge. At the time the property is placed into service, the carrying charges as well as the original cost would be evaluated for rate base inclusion. If the property is sold prior to becoming plant in service, the accumulated carrying cost would become part of the Company's cost basis to be used in computing the gain or loss. This proposal would protect ratepayers from having to pay returns on PHFFU that may never be used to provide utility service or that remains in rate base, unused in providing utility service for years or even decades. The proposal also recognizes that the utility has a carrying cost associated with such property and protects the utility by permitting capitalization of such carrying cost. This method also achieves the "matching principle" of charging ratepayers for a utility's investment during the period when that investment is being used to provide utility service.

B. Working Capital, Adjustment 2.24

FEA made several adjustments to Puget's working capital claim in order to derive an appropriate and valid amount of working capital allowance for inclusion in rate base. Puget has agreed to some of these adjustments.

FEA's adjustment on Exhibit T-793, Schedule 8, removed $8,118,272 for dividends declared, which Puget treated as part of investor-supplied working capital. Such dividends constitute zero-cost capital. They are a source of working capital, not a use of working capital, and, like other zero-cost capital, do not represent a working capital requirement. This is in line with

pages 53-54 of the Commission's order in Puget's last rate case, Docket No. U-89-2688-T:

> The Commission staff excluded dividends declared, contending they constitute zero-cost capital to the company, on which ratepayers should not pay a return. The Commission staff cited prior Commission orders in Cause Nos. U-81-41, U-83-54, and U-79-66. ...
>
> * * *
>
> ... The Commission accepts the Commission staff approach on this adjustment. The Commission staff calculation is consistent with the approach used by the Commission in the past.
>
> As the Commission indicated in its order in Cause U-79-66, dividends declared are available to the company as zero-cost capital and it is not proper that a return be allowed.

In its calculation of working capital, Puget originally included $147,158 of Prepaid EPRI Research Support, which Puget had recorded in Account 165-10. Puget also included in its working capital calculation $101,194 for the net of Accounts 188-01, 188-02 and 188-03, which are R&D contribution and clearing accounts. FEA recommended removal of all of these costs. The Company agreed with the removal of accounts 188-01, 188-02 and 188-03 (See Rebuttal Testimony of Story, T-965, at 45), however, it did not remove the amount associated with Account 165-10. Puget's action ignores the fact that R&D cost is not an investment item, but an expense. The rationale for expending R&D costs is that any future financial value stemming from R&D is highly uncertain. Consequently, R&D costs do not represent an asset, and ratepayers should not be required to pay Puget a return on the Company's prepaid EPRI research support. R&D is a periodic expense, not an investment. This is why Generally Accepted Accounting Principles require that all R&D expenditures be expensed.

Puget witness Story has agreed with several of FEA's adjustments to the Company's cash working capital claim. (See T-965 at 45) The Company agreed to the removal of $15,435 for Merchandise Inventory in Account 155-01 from working capital as it does not relate to the provision of utility service and Puget disposed of its entire merchandise inventory.

The Company also agreed to the removal from the working capital component of its proposed rate base of Accumulated Deferred Income Tax debit balances (ADIT) of $41,708 and $322,292 associated with environmental clean-up (Account 190-20) and superfund site clean-up (Account 190-23), respectively.

Also accepted by the Company was the adjustment to remove from rate base the balances in Accounts 190-13, Materials Management Loss, and Account 190-14, Land Sales, totaling $417,714. Puget has these ADIT debit balances because the property was transferred within Puget's affiliated group. Puget is precluded from recognizing the loss as a tax deduction until the property is transferred outside the affiliated group. Ratepayers should not be required to pay a return on such balances.

C. Other Accumulated Deferred Income Taxes

Exhibit 793, Schedule 12, removes three debit-balance ADIT items that Puget included in rate base. These three items include: (1) Interest income - Colstrip, Acct. 190-11; (2) Non-qualifying supplemental retirement plan - officers, Acct. 190-17; and (3) Non-qualifying supplemental retirement plan - directors, Acct. 190-18.

In 1989, Puget received interest in associated with a settlement agreement between the owners of the Colstrip project. For tax purposes, Puget recognized the interest as taxable income in 1989. For book purposes, Puget amortized the interest to income over a three-year period. This timing difference will have completely reversed as of January 1993. Consequently, it

does not represent a proper going-forward ADIT balance that should be reflected in rate base.

During October 1991, Puget's Board of Directors approved two new supplemental retirement plans, one for Company officers and one for director-level employees. For tax purposes, these are non-qualified plans, and no deduction is allowed until benefit payments are made. For book purposes, Puget accrues an expense pursuant to FAS 87. Consequently, Puget has experienced book-versus-tax timing differences for these supplemental pension plans since 1991 which have led to the ADIT debit balance. It would not be appropriate for the Company to charge ratepayers a rate base return on these non-qualified and unfunded supplemental retirement plans. Puget's response to DOD-3089 agrees that these balances should be removed from rate base.

D. Bad Debt Expense, Adjustment No. 2.17

FEA recommended use of the actual test year bad debt rate of 0.25550% in determining the pro forma bad debt adjustment. This would result in decreasing pro forma bad debt expense by $417,968. The Company's adjustment for bad debt expense on Exhibit T-558 (JHS-3), page 2.17, uses a bad debt rate of .29927%, which is obviously overstated. The Company's proposed adjustment to test year bad debt expense, based on the five year average of the uncollectible write-offs to revenues, inappropriately ignores the lower percentage of bad debts currently being experienced and ignores the declining trend of net write-offs to revenues. The Company has changed its credit practices within the past few years and this fact has influenced the level of write-off. The Company has, in fact, taken the following steps to reduce uncollectibles:

Formation of the Corporate Credit Dept. centralized the Closed Account Collection function and provided for additional attempts to reach

customers with unpaid closing bills before referring that bill to a collection agency.

Automation of active credit system functions in 1989 resulted in improved credit follow up.

Institution of late payment/disconnection visit fee authorized by the Commission in October 1990. (See Knutsen's T-539, p.14)

Each of these activities improved the collection of revenues and reduced write-offs as a percentage of revenues.

In its rebuttal testimony, the Company argues that: "...the positive effect of these collection procedures has been captured in the five-year average used in the Company's and Staff's calculation..." (T-965, at 40). However, these improved collection procedures were only in effect during the last few years of the five-year period used in averaging, which does not allow them the appropriate weight.

In fact, the Company's bad debt rate has continued to decrease. As was stated in Exhibit 792:

> According to Puget's response to Record Requisition 531, the 1992 net write-offs as a percentage of net revenues was 0.18644%. (p. 25)
>
> ***
>
> Puget's actual 1992 uncollectibles rate is even lower than the 0.25550% rate I am recommending. This would indicate that my adjustment to decrease expenses by $417,968 on Schedule 15, may be conservative, because it does not reflect the decline in Puget's uncollectibles rate that has occurred subsequent to the test year. (p.25)

Puget's response to DOD-3138(e), T-977, indicates that Puget's bad debt rate for the twelve months ending May 31, 1993 is .1725%, which is even lower still.

FEA believes there is sufficient evidence to reduce the pro forma bad debt expense by $417,968 and the bad debt rate portion of the revenue conversion factor to 0.25550%.

E. Wage and Salary, Adjustment 2.14

FEA proposed adjustments to salaries and wages in order to: (1) correct for Puget's failure to exclude employee bonuses prior to the application of the payroll increase percentage; (2) correct for Puget's use of a 4.5% increase for management, when the Company's actual 1993 increase was 3.0%; and (3) address the fact that, in each year for which Puget has provided data, its actual non-union wage increases have averaged $42,485 annually below the increases suggested by Puget's merit budget pool. FEA's recommendation reduces Puget's proposed pro forma payroll expense by $581,622 and reduces payroll tax expense by $41,588. This results in an increase in net operating income of $411,319, after income taxes.

The total of all merit increases provided to non-union employees cannot exceed the overall merit budget pool. Puget uses the merit budget pool percentage to calculate its pro forma payroll adjustment. This results in overstating the actual wage increase. Puget indicated that the total of the Company's merit increases provided to its non-union employees has been less than the overall merit budget pool in each year, 1990, 1991 and 1992. Puget's annual overstatements of non-union increases have averaged $42,485. That is, Puget's use of its budgeted merit increase would overstate the amount of non-union wage increase by $42,485 annually. Because Puget's budgeted increases have exceeded (by an annual amount averaging $42,485) the actual increases granted, and because pro forma payroll reflects 18 months of pay increase beyond the test year, FEA made an adjustment to reduce pro forma payroll for 18/12ths of the $42,485 average annual overstatement produced by Puget's merit increase procedure. This resulted in adjustment of $34,413 after applying Puget's O&M expense factor of 54%.

FEA also proposed adjustments to: (1) remove a lump-sum distribution to officers and directors, and (2) for Puget's

failure to achieve a pay-at-risk goal specified in its Energy Plus program. These resulted in a net adjustment of $507,540. However, through Puget's rebuttal testimony, T-965, it has come to the FEA's attention that several of these items were excluded from the Company's filing. These are $100,440 of Stock Appreciation Rights that were recorded below the line and $25,000 of the lump sum salary payment that was removed in Company adjustment 2.14 as nonrecurring. Therefore, FEA's original proposed adjustment for distributions to officers and directors of $507,540 should be reduced by these amounts for a net adjustment of $382,100.

FEA also made an adjustment to the Company's pro forma Pay-at-Risk program costs. Puget management achieved 5 of the 6 goals of the Energy Plus portion of the primary funding amount to the pay-at-risk figure. The Board of Directors decided to treat all 6 goals as being met because the Company came within .5% of the target budget. However, this inclusion of the sixth goal is inappropriate for ratemaking purposes and should be removed from operating expenses. Although the Company came close to the actual targeted goal, it was not achieved, and, therefore, the corresponding amount should be removed from the primary funding calculation. An adjustment of $25,299 is necessary to remove these amounts.

F. Employee Benefits, Adjustment 2.11

An adjustment to the Company's average monthly contribution for employee insurance was made by the FEA. Puget assumed a 10% increase in the contribution amount to be paid by the Company as of July 1, 1993 in its calculation of the average monthly contribution to insurance expense. As stated in FEA's testimony, T-792, this assumption is unsubstantiated, and Puget's proposed expense increase should be removed from test year expense. The assumed 10% increase is not verifiable and does not meet the known and measurable test. O&M expense should be decreased by

$279,165 to remove the Company's assumed 10% increase in the contribution amount.

G. FAS 106, Adjustment 2.12

1. Background

The Commission's Policy Statement on FAS 106 established certain requirements in Docket No. A-921197, summarized in the following, for utilities subject to its jurisdiction:

- Utilities are required to demonstrate in a general rate case that the greater expense level of expense associated with FAS 106, required to be recognized for financial reporting purposes, is reasonable, prudently incurred, and determined under conservative assumptions. "Conservative assumptions" means that the lowest reasonable assumptions for the medical cost trend rate and the lowest reasonable cost should be used;

- The utility must demonstrate that its requested level of FAS 106 expense reflects prudent and safe funding of the entire amount based on tax-free asset transfers and fund income;

- The utility must demonstrate that there is a benefit to ratepayers, over time, from reflecting the higher FAS 106 expense in rates currently;

- Prior to a general rate case in which recovery of the higher FAS 106 level of OPEB expense is an issue, the utility may record in a deferred account, for future rate consideration, the difference between the amount of pay-as-you-go expense and FAS 106 accrual expense;

- The FAS 106 amount must be determined as if the full amount were funded on a fully tax deductible basis;

- In the interim period, prior to rate inclusion, no return shall be earned or accrued on any deferred balance;
- No portion of any deferred balance can be capitalized into plant accounts prior to Commission acceptance of the expense portion in rates;
- The utility must prove that none of its recorded deferral amounts occurred during periods when a utility earned in excess of its last authorized return;
- Permissible deferred amounts would be amortized and recovered through rates over a period not to exceed ten years from the effective date of FAS 106.

Staff's July 1992 "White Paper" report on Accounting for Post Retirement Benefits other than Pension, presented Staff's research and recommendations on the FAS 106 accrual issue.

2. Emerging Issues Task Force 92-12 Phase-In

At the time of Staff's White Paper and the Commission's policy statement, the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board ("FASB") had not yet issued its consensus view which suggests a phasing-in of the FAS 106 accrual for rate recognition purposes that would support the recognition of a regulatory asset for deferred amounts. The EITF's view is important for a number of reasons.

First, it impacts upon the amount of the FAS 106 accrual expense that a utility is required to recognize for financial reporting purposes. To the extent that a portion of the FAS 106 accrual can be deferred as a regulatory asset, that portion is not recognized as a current expense for financial reporting purposes. The Commission's Policy Statement addresses "the greater expense level of PBOP expense, required to be recognized for financial reporting purposes under FAS 106 ..." (Emphasis supplied.) Paragraph 364 of FAS 106 recognizes that:

> For some rate-regulated enterprises, FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation, may require that the difference between net periodic postretirement benefit cost as defined in this Statement [FAS 106] and amounts of postretirement benefit cost considered for rate-making purposes be recognized as an asset or liability created by the actions of the regulator. Those actions of the regulator change the timing of recognition of net periodic postretirement benefit cost as an expense ... (Emphasis supplied.)

EITF 92-12 (provided as T-793, Schedule 22) attempts to provide additional guidance concerning the circumstances under which the regulatory asset treatment (deferral) will be permitted for financial reporting purposes; an action which affects the amount of expense that must be reported on the utility's financial statements.

Second, although controversy exists with respect to EITF 92-12[1], the consensus view expressed therein will generally be followed by SEC registered companies and their auditors. That is, a phase-in plan for the FAS 106 accrual would permit deferred

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[1]Controversy exists with respect to whether the EITF 92-12 consensus guideline falls within the scope of the EITF's authority. Other have voiced concern that the EITF under-represents FASB constituent groups, and that its procedures violate FASB due process requirements in the interest of expediency. The EITF lacks formal authority to promulgate accounting standards, yet many view its consensus views as de facto GAAP for public companies. Standard-setting authority rests with the FASB and the Securities and Exchange Commission; however, their acceptance of an EITF consensus can result in a de facto standard. The SEC's Chief Accountant, for example, has indicated that he would challenge registrant accounting that differs from an EITF consensus because the consensus would represent the best thinking on areas for which there are no specific standards. In the hierarchy of GAAP (as delineated in Statement of Auditing Standards no. 43), "other accounting literature" including the minutes of the EITF meetings (level (d) authority) cannot overrule first level authority, "standards enforceable under Rule 203 of the AICPA Code of Professional Ethics," which includes FASB Statements. Concerning the recording a regulatory asset by a public utility, existing Standards include FAS 71 and paragraph 364 of FAS 106 address this already, and it would not be within the purview of the EITF to issue a contradictory consensus view. The EITF could elaborate upon but cannot contradict such existing authority.

costs to be recognized as a regulatory asset on the utility's financial statements, and such treatment would be approved by the utility's auditors and would not be subject to challenge by the SEC.

Third, the Commission's Policy Statement, issued prior to EITF 92-12, had indicated that permissible deferred amounts of a utility's FAS 106 accrual would be amortized and recovered through rates over a period not to exceed ten years from the effective date of FAS 106. Given that EITF 92-12 would now permit phasing-in of FAS 106 accruals over a 5-year period with subsequent rate recognition of deferred amounts over the next 15 years (i.e., years 6 through 20), FEA witness Larkin recommended that the Commission consider use of the recovery period for FAS 106 deferrals suggested by the EITF's consensus view (See T-792).

Finally, although following the phase-in suggested for FAS 106 accruals articulated in the EITF's consensus view is not mandatory for ratemaking purposes, it would provide a method of mitigating the impact on current ratepayers of changing from pay-as-you-go to accrual accounting for a utility's OPEB cost in a manner that would not adversely impact the utility's financial statements.

Company witness Story's direct testimony at page 35, T-556, asserts that calculating OPEB cost pursuant to FAS 106 would provide the following benefit:

> It would allow accounting for ratemaking purposes to follow the required treatment for financial reporting purposes, and thereby avoid any negative financial impact associated with implementation of SFAS 106.

FEA submits that using the phase-in suggested in EITF 92-12 would avoid any negative impact for financial reporting because amounts deferred for rate recognition would receive regulatory asset treatment.

3. Pay-As-You-Go Continuation

Information provided by Puget in response to record requisition no. 550 indicates a net present value detriment to ratepayers over the period covered by the Company's projections. Puget's response indicates that the present value of the Company's proposed FAS 106 accruals, with funding, for the years 1993 through 2012 exceeds the comparable pay-as-you-go present value by $5.530 million, or 27%. In other words, ratepayers would be disadvantaged by $5.530 million on a present value basis through 2012, the entire 20-year period covered by Puget's projections.

Pay-as-you-go has been employed for OPEB cost recognition purposes consistently in the past. It provides the lowest cost to ratepayers currently and for the next several years, and places the maximum pressure on management to take steps to control nonpension postretirement benefit costs. Continuing pay-as-you-go would provide a consistent method for rate recognition of OPEB costs for all ratepayers for all periods. Puget's proposed pro forma adjustment for the FAS 106 accrual should be rejected in its entirety if the pay-as-you-go method is adopted. This would reduce pro forma operating expense by $934,119 and would increase net income after income taxes by $616,519. However, in view of the Commission's Policy Statement concerning FAS 106 and the Company's evidence presented in this case, FEA recommended another alternative that would mitigate the impact of this accounting change upon Puget's ratepayers for Commission's consideration.

If the concept is that current ratepayers should pay for the cost of the service being provided by the utility's employees in the current period, the FAS 106 accrual fails to achieve this. The Service Cost component of FAS 106 accrual represents the cost of utility employees' service attributed to the current period; hence, that component, if subject to accurate measurement, would represent the true current cost of service. However, the Service

Cost is typically only a small portion of the total FAS 106 accrual.

4. FAS 106 Transitional Costs

Most of the accrual relates to transitional costs, including the Transition Obligation and interest on it. For example, Puget's disclosure of net periodic postretirement benefit cost for 1992 shows an Interest Cost of $2.313 million and transition obligation amortization of $1.144 million, which together comprise 99% of the Company's net periodic postretirement benefit cost of $3.488 million under the FAS 106 accrual method for 1992. Puget's response to DOD-3111 stated that "[t]he transition obligation is projected to be paid over the next 90 years." Some method of mitigating the impact on current ratepayers of these tremendous transitional costs associated with implementing the FAS 106 accrual would be highly appropriate. FEA recommends use of the EITF 92-12 phase-in plan for Puget in order to achieve such mitigation.

5. Recovery of Deferred FAS 106 Accruals

Puget proposes to amortize deferrals of FAS 106 accrual costs over 5 years. FEA believes a five-year recovery period for deferrals of FAS 106 cost would be too short. The Commission's Policy Statement, issued prior to EITF 92-12, suggested a 10-year amortization period for deferrals. EITF 92-12 suggests a 20-year deferral and recovery period, consisting of 5 years of deferral and recovery of deferred amounts during the subsequent 15 years as we stated earlier.

6. Proposed Adjustment

Mr. Larkin proposed an adjustment to the amount of nonpension postretirement benefit cost Puget has requested be charged to ratepayers in this case to reflect the phase-in of FAS 106 accounting for ratemaking purposes, in accordance with the consensus position of the Emerging Issues Task Force as stated in EITF 92-12.

As mentioned, the EITF 92-12 phasing-in to full FAS 106 accrual recognition for ratemaking purposes, would be appropriate and would support the recognition of a "regulatory asset" for a utility's deferred FAS 106 accrual amounts that are not recovered currently through rates. Use of such a "phase-in" approach would be entirely consistent with generally accepted accounting for regulated companies and would substantially reduce the amount of the FAS 106 accrual to be charged to ratepayers in 1993. Essentially, this phase-in approach permits charging ratepayers in 1993 with the pay-as-you-go amount plus 20% of the difference between the pay-as-you-go amount and the FAS 106 accrual amount. The balance of the FAS 106 accrual would be deferred, for subsequent recovery in years 6 through 20 of the phase-in period. The calculation of this adjustment was presented on Schedule 21 of T-793. This Schedule shows the calculation of the pro forma adjustment for the test year. Under the EITF 92-12 phase-in approach, the total expense to Puget for OPEBs to be recognized would be $1.202 million, as shown on line 3. This is $725,000 less than Puget's proposed expense.

Schedule 21, page 2, T-793, also shows how the EITF 92-12 phase-in would operate for the years 1993 through 2012. As the phase-in period progresses, Puget's actual amounts would be substituted for the projections. Additionally, the Commission would retain responsibility and oversight concerning the prudence and reasonableness of the Company's OPEB cost.

In summary, the Commission can mitigate the impact on ratepayers ($725,000 less expense) of this accounting change, and

avoid any adverse impact on the utility's financial statements, by utilizing the phase-in method suggested in EITF 92-12. Implementation of this procedure will enable Puget to record a regulatory asset for deferred FAS 106 amounts.

7. Treatment of Regulatory Asset

No return is required on the regulatory asset corresponding to the deferred FAS 106 accrual amounts, nor would granting a return on the regulatory asset be appropriate. Puget would not have funded any amounts associated with the regulatory asset. Puget would not have made any cash outlay. Moreover, Puget would have recognized a corresponding OPEB liability account on its balance sheet. That liability represents a full offset to the regulatory asset. Neither the regulatory asset, nor the OPEB liability which corresponds with that asset represent rate base items.

H. FAS 106 Deferral in Rate Base

On page 2.12 of Company Exhibit T-558, Puget proposes to add $1,167,427 to rate base for deferred FAS 106 accrual amounts. Puget's proposed rate base inclusion is improper because of the reasons given above which would produce a net rate base impact of zero. Accordingly, Puget's proposed adjustment should be rejected.

Puget has not demonstrated that is has any investment in deferred FAS 106 accrual amounts which requires a return through rate base inclusion. The Commission's Policy Statement from Docket No. A-921197 addresses the amortization of prudently incurred cost to be included in rates, but does not appear to authorize rate base treatment for such deferrals. FEA believes that the Policy Statement clearly prohibits rate base treatment prior to approval of the expense in rates. Moreover, the recording of the FAS 106 accrual involves recognizing a liability

account, which represents cost-free capital that would offset deferred accrual amounts. The liability account is credited and the expense account debited for the FAS 106 accruals. To the extent that amounts are transferred from expense to a deferral account, such deferrals would be offset by the existence of the liability, thus there is no justification for a rate base amount for FAS 106 deferral at this time.

I. Directors and Officers Liability Insurance, Adjustment No. 2.13

FEA recommended that 50% of the cost of the Directors and Officers liability insurance be allocated below-the-line. This results in a $346,875 reduction to expense. The Directors and Officers (D&O) liability insurance coverage benefits Puget's shareholders just as much as, if not more than, it benefits the ratepayers. The purpose of D&O liability insurance is to protect the Company's directors and officers in the event that there are lawsuits. The majority of these potential lawsuits would be initiated by the Company's shareholders, not its ratepayers. Therefore, shareholders should, at least, equally share the burden of this insurance cost. Indeed, if shareholders are suing either Company management or the board of directors, there is a question as to what ratepayer interests are being served. Puget should not be allowed to include 100% of the costs above-the-line.

Puget's D&O liability insurance also covers Puget's subsidiaries. In response to Staff data request no. 2329(b), (see T-792), the Company stated that "(t)here is no additional premium charged for adding the subsidiaries to the Puget policies nor would there be any reduction in the premium if the subsidiaries were removed from the policies." However, the insurance covers, and hence benefits, the Company's subsidiaries, so they should also bear part of the costs. It is unfair for Puget's ratepayers to fund the entire cost of the D&O policy when

such insurance also benefits Puget's subsidiaries. Staff witness Nguyen, in T-738, correctly argued that a portion of the D&O insurance should be allocated to the Company's subsidiaries.

J. Environmental Costs, Adjustment 2.10

In its Order in Docket No. UE-911476, the Commission allowed the Company to defer amounts paid to outside vendors and contractors for certain environmental remediation programs for recovery in future rate proceedings. In this proceeding, the Company is requesting that the balance of these deferred environmental costs, totaling $5,881,944 at the end of the test year, be amortized over three years. This results in an annual amortization expense of $1,960,648.

FEA recommended that the Company continue to defer the environmental costs paid to outside vendors and contractors until a future rate proceeding in which its liability for such costs and the extent of insurance reimbursement is actually known.

One of the conditions the deferred costs are subjected to, according to the Commission's Order in Docket No. UE-911476, Page 5, section (d), states as follows:

> Deferred costs will be reduced by any insurance proceeds or payments from other responsible parties recovered by Petitioner in respect of such costs.

In response to Staff data request no. 2332(c) (Exhibit T-630), the Company states that it has recovered from insurers some amounts for costs incurred. Such recoveries total $901,129. Record Requisition #541 asked the Company to "...provide the estimated insurance recoveries in subsection (b) of section (c) of Exhibit 630." The Company responded, in part, as follows:

> The Company believes it is entitled to complete recovery of the costs it incurs, and the estimates reflect this position unless indicated otherwise in the detail below...

The following estimated insurance recoveries are equal to the projected costs for the sites indicated.

Coal Creek - $900,000
Electron - $3,300,000
Underground Tanks - $2,600,000

As is demonstrated above, the Company is estimating it will receive full insurance recoveries for some of the projects and believes that it is entitled to complete insurance recovery of all the costs it incurs for the environmental remediation projects.

In response to Staff data request no. 2332 (Exhibit T-630), the Company indicated it is pursuing the recovery of such costs from insurance companies. Puget has been meeting with the attorneys from several of these companies to discuss potential settlements, and has filed and is participating in several law suits. The Company also states that it intends to pursue recovery in instances where the "...insurance carriers have taken the position that cleanup costs which occur on the insured's own property are not covered by the policies." In summary, the Company is aggressively attempting to recover its environmental remediation costs from insurance companies and other responsible entities.

Puget's ratepayers are funding these litigation costs. As part of the Order in Docket No. UE-911476, the Commission stated that legal costs associated with Puget's environmental remediation programs would be expensed as incurred. Since the Company's ratepayers are funding the litigation costs, equity dictates that they should also receive the benefits that will result from the litigation.

Considering the insurance recoveries being pursued and the Company's recovery expectations, it would be premature to charge ratepayers for such costs. If Puget can recover these costs from other parties, such as insurance companies, reimbursement from ratepayers would be inappropriate. It would be inappropriate to

allow the Company to recover these expenses in rates when they are likely to recover a large proportion, if not all, of the expenses from the insurance companies.

Company witness Story states, at page 41 and 42 of his rebuttal testimony (T-965), that:

> The ability of a utility to defer an incurred cost is defined in Statement of Financial Accounting Standard 71 (SFAS 71). To be able to defer an incurred cost it must be "probable" that the cost will be recovered in rates. If the Commission did not allow recovery of these costs in this proceeding, the "probable" recovery test would not be met.

While Mr. Story is correct that it must be "probable" that the cost will be recovered in rates, not allowing the costs in the current rate proceeding will not effect the "probable" recoverability. FEA recommended that the environmental remediation costs for outside vendors and contractors continue to be deferred until the actual insurance recoveries are received. The difference between the deferred amounts and the amounts actually recovered from insurance companies could then be included for recovery from the Company's ratepayers in a future rate proceeding when the actual amounts are known.

K. Storm Damage, Adjustment 2.08

Puget is requesting about $9.68 million in revenue requirements for storm damage cost in this proceeding. Puget has requested an annual expense allowance of $8.068 million for storm damage cost. Puget has also requested inclusion in rate base of $14.6 million of storm damage cost recorded in Account 1821000. Net of deferred taxes for storm damage charge-offs in Account 2831200, Puget's rate base claim amounts to $9.026 million. Schedule 25 of T-793 shows that these components of Puget's rate filing equate to a revenue requirement claim of about $9.68 million.

Puget used a four-year average for the period ending June 30, 1992. This produced a storm damage expense claim of $6.693 million. Additionally, Puget is requesting $1.375 million for additional amortization of its debit balance of deferred storm damage cost.

Puget's recorded storm costs are <u>substantially</u> higher than in prior cases. This may indicate that the use of an average longer than four years would be more appropriate for use in this case to determine a normal level of storm damage expense for inclusion in rates.

Puget's claim of $8.068 million substantially exceeds the amounts of annual storm damage cost allowances included in rates in prior cases, including the $2.038 million from Docket No. U-82-38, the $2.712 million from Docket No. U-83-54, the $2.422 million from Docket No. U-85-53, and the $1.633 million from Docket No. U-89-2688-T. Specifically, Puget's claim in this case is 197% higher than the $2.712 million amount from Docket No. U-83-54, and is 394% higher than the $1.633 million from Docket No. U-89-2688-T, Puget's most recent general rate case.

Puget's claim appears to be so much higher in this case because of the large amounts of cost, including substantial amounts of overheads, the Company recorded as storm damage cost in 1990 and 1991. Schedule 26, page 1, (T-793) lists Puget's annual storm damage cost for each year during the period 1979 through 1991, i.e., for the calendar years for which information has been made available. Average storm damage cost is $3.410 million. In comparison, Puget's recorded storm damage cost for 1990 and 1991 is $9.146 million and $12.297 million respectively.

Puget provided details for 19 work orders from the period July 1988 through June 1992 under which it recorded storm damage cost. Costs accumulated under these work orders totaled $25,102,613. During this period, Puget also recorded insurance reimbursements totaling $8.68 million for two of the storms, which reduced the Company's recorded storm cost.

The Company added $10.35 million for non-work order charges, which brought Puget's net charges to the storm reserve account to $26.772 million for this four-year period.

Puget's response to Staff Informal Data Request 1087(i) describes these. Puget recorded storm costs under three work orders for an "Arctic Express" storm which occurred in December 1990 and January 1991. Puget recorded $16,270,368 for this storm under work orders 9011625, 9011626, and 9100368. Puget explains that its storm damage carried a $3 million deductible at the time of these storms. For this storm, Puget received insurance proceeds of $8.4 million. Puget's response states that "[t]he insurance carrier, per the terms of the policy, did not reimburse the company for overheads deemed to represent fixed costs." Notwithstanding Puget witness Story's rebuttal testimony at page 12 of Exhibit T-965, utilizing the $16,270,368 costs Puget recorded under the three work orders, less the $3 million deductible, and less the $8.4 million proceeds, suggests Puget came up $4,870,368 short in insurance reimbursement for these storms. Mr. Story's rebuttal on this is further refuted by his own Company's response to Staff Informal Data Request 1087(i), quoted above, as to the insurer's reasoning for not reimbursing Puget for the $4.87 million. While it might be appropriate to charge ratepayers for the cost associated with the $3 million deductible, ratepayers should not be required to pay for the other $4,870,368 that Puget was unable to collect from its insurers.

In work order 9101030, Puget recorded storm damage cost of $3,496,144 associated with a November 1991 wind storm. Puget received insurance proceeds of $279,852 for this storm. Subtracting these insurance proceeds and the $3 million deductible from the Company's recorded cost for this storm suggests that Puget came up $216,292 short on this storm as well. Such shortfalls on insurance reimbursement should not be charged to ratepayers.

Puget has allocated tremendous amounts of overhead costs to "storm damage" when such overheads are not truly incremental storm damage costs. Rather, such costs were "fixed" in the sense that Puget would have incurred such cost in the absence of the storm. Puget's recording of such overheads and other costs in the storm cost reserve may represent an attempt to defer ordinary operating expenses, which occur between rate cases, for later attempted recovery from ratepayers. Moreover, allowing Puget to include in rate base ordinary operating expense which the Company has deferred as "storm damage" between rate cases would not be appropriate. Ratepayers should not be required to provide Puget a return on ordinary costs which Puget would have incurred with or without a storm. Only incremental costs that have been directly caused by the storm should be recorded in the storm reserve account. Ordinary operating expenses and indirect costs, including overheads, should not be afforded deferral treatment.

FEA Exhibit T-793, Schedule 27, summarized those costs. As can be seen there, Puget's recorded storm costs include items such as labor cost (straight-time and overtime), contractor costs, miscellaneous employee expenses, and other miscellaneous expenses as "direct" costs. Additionally, Puget's recorded storm damage includes other indirect costs, including transportation expense and overheads.

Puget's storm damage claim should be adjusted in the following manner. First, Puget's work order costs which do not appear to be incremental to or directly caused by the storms, including ordinary payroll costs and indirect overhead costs, should be removed. The other indirect costs -- i.e., the non-work order costs -- which Puget cannot attribute to a particular storm should also be excluded. Puget has utterly failed to demonstrate how such costs are directly tied to its experiencing storms, as opposed to merely representing general non-incremental overheads which Puget would have incurred even in the absence of such storms. Puget presented no detail at all on the non-work order costs it is claiming as storm costs, which suggests

rejection of such costs. After making these adjustments, FEA witness Larkin averaged the remaining costs over a four-year period, and determined an annual amortization amount of $2.9 million.

The non-incremental costs incurred during the test year should be added back, since these would represent ordinary operating expenses. FEA also allocated Puget's non-work order overhead costs proportionately to the work order costs. Where such overhead costs were allocated to test-year storms, FEA appropriately reflected such costs as ordinary operating expenses.

Puget has indicated that it would view annual storm cost of about $4 million as being normal. As shown on Schedule 28 of T-793, FEA proposed an annual allowance of $6,573,954. This is about 64% higher than Puget's normal annual level. It includes about $2.9 million of incremental storm cost amortization and $3.67 million restoration of test year overheads and non-incremental cost. The $2.9 million amortization is in line with Puget's storm cost allowances from prior rate cases.

L. Storm Damage Cost in Rate Base

The storm damage reserve account should typically have a credit balance. Due to Puget's recording of large amounts of overhead cost and costs not directly assignable to a particular storm into this account, it has grown to a large debit balance during the test year: in excess of $16 million. FEA reduced the balance for these inappropriate overhead items (discussed above) which should not have been charged to a storm damage reserve or deferral account. This produces a credit balance in the storm damage reserve account which should be reflected as an offset to rate base as shown on Schedule 13 of FEA Exhibit T-793. A corresponding adjustment for the associated accumulated deferred income tax balance was also made.

Aside from the fact that it is abnormal to have a debit balance in such a reserve account, Puget's proposed balance would begin to decline to zero and resume its normal credit-balance status as the allowance for storm cost is adjusted. The credit entries to this account will be reducing Puget's claimed debit balance. Consequently, Puget's debit balance represents an unusual situation and would not be appropriate for rate base inclusion on a going-forward basis.

M. Edison Electric Institute Dues, Adjustment No. 2.27

FEA recommended the disallowance of 27.71% of Puget's regular EEI dues, as this represents both the percentage of EEI dues that are expended for legislative advocacy, 14.05%, and EEI dues that are expended for other unallowable activities such as regulatory advocacy, institutional advertising, contributions and other activities which promote the electric utility industry's position on controversial issues or which have no direct benefit to ratepayers. The costs for these activities should not be passed on to ratepayers. The Company, at page 56 of the Rebuttal Testimony of J. H. Story, T-965, agreed with the 27.71% disallowance. This results in a reduction in pro forma expense of $83,695.

FEA also made an adjustment to remove 84.44% of EEI Media Communication Fund expenditures that support institutional advertising and promote consumption. Puget removed $76,477, which equates to 55% of the payments. An additional $40,940 should be removed to reflect a total disallowance of 84.44%. It is inappropriate to have ratepayers support these programs, which promote consumption and institutional advertising and provides them no direct benefit.

N. Other Membership Dues, Adjustment No. 2.27

FEA recommended the removal of $41,953 of the test year expense for membership dues. Exhibit 793, Schedule 31 itemizes the membership dues which comprise this adjustment. It also describes the mission or purpose of each of the organizations for which disallowance is recommended. These organizations serve no benefit to the Company's ratepayers and, therefore, should be disallowed. Some of the organizations even appear to serve mainly legislative or lobbying functions.

In the Rebuttal Testimony of C. A. Knutsen, T-882, he mentioned that Puget is no longer a member of several organizations that Staff witness Thomas Schooley recommended for disallowance in Exhibit 734 (TES-6, p.2). The total cost in the test year was $12,960 for these organizations, $5,000 of which was already included in FEA's proposed adjustment. The entire cost dues to the organization that Puget is no longer a member of should also be removed.

O. Research and Development

The test year contains expenses for Electric Power Research Institute ("EPRI") dues, a 20% EPRI dues hold-back for local research of $900,510 and $687,490 for additional in-house research and development (R&D) expenditures beyond the EPRI hold-back amount. FEA recommended that the amount of Puget's internal R&D expenditures that exceed the 20% EPRI hold-back amount be removed.

As part of the calculation in determining each utility's annual EPRI dues payment, the utility is authorized to deduct 20% of its calculated EPRI dues payment for local and regional research and development projects. Puget's EPRI membership dues for 1991 and 1992 were $3,531,592 and $3,672,856, respectively. These funds go predominately towards research projects conducted on behalf of the electric utility industry. The test year

contains over $3.5 million for EPRI membership dues, $900,510 for the 20% EPRI local research hold-back and $687,490 for additional in-house research and development. The ratepayer is being asked to fund this total amount, which exceeds $4.5 million. The total EPRI dues and 20% EPRI local research hold-back should be sufficient for Puget's research and development needs. Puget should be required to provide substantiated evidence that the additional in-house R&D expenditures beyond the 20% EPRI hold-back amount are truly necessary, reasonable and will produce a definite benefit to the Company's ratepayers, which it has not done in this proceeding.

P. Bank Fees -- Fees Paid to Agents

In Exhibit 793, Schedule 33, FEA reduced test year expense by $24,570 to reflect a normal, ongoing level of agent fees. Puget had included in test year expense $54,570 for bank fees paid to agents. As mentioned in Exhibit 792, page 71, "Puget's response to DOD-1889 indicated that the high level of test year fees was attributable to two credit agreements which overlapped a time period encompassed in the test year. Puget's response to DOD-1889(b) agrees that $30,000 would be an appropriate estimate of annual agent fees for its current agreements."

Q. Miscellaneous Expense Adjustment, Adjustment No. 4.06

Several inappropriate expenses were recorded above-the-line in the test year, which the Company did not remove in the filing. Many items on Puget's executive expense reports were for expenses for several Company officers' involvement in community leadership roles to enhance the Company's image in the community. These public relations and charitable organization activities should not be charged to ratepayers. Another expense that is inappropriate for inclusion in rates is Puget's subsidization of employee activities. Puget subsidized $14,000 in the test year

for employee activities such as water raft trips, golfing and bowling tournaments. There is no direct benefit to Puget's ratepayers for either of these expense categories; therefore, the amounts should be removed from the test year. FEA recommended a reduction to expenses of $19,000 in order to remove these inappropriate items.

IV. CONCLUSION

FEA urges this Commission to adopt the following capital structure and cost components:

Component	Ratio	Cost	Weighted Cost
Debt	47.85%	7.79%	3.73%
Preferred Stock	8.15%	8.10%	.66%
Common Equity	44.00%	11.25%	4.95%
WEIGHTED AVERAGE COST OF CAPITAL			9.34%

FEA also recommends that this Commission make the accounting adjustments as set forth in this brief.

Respectfully submitted,

Norman Furuta

DATED: August 12, 1993

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CERTIFICATE OF SERVICE

I hereby certify that I have on this day served the foregoing Opening Brief on Cost of Capital and Accounting Issues on behalf of the Department of the Navy and all other Federal Executive Agencies upon all parties of record in Docket Nos. UE-921262, UE-920499 and 920433, as identified on the attached service list, by mailing a copy thereof, properly addressed with postage prepaid, through the United States mail.

Dated at San Bruno, California, this 12th day of August 1993.

NORMAN J. FURUTA

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