EXHIBIT NO. _______ (TL-1T)
DOCKET NO. UG-040640
PREFILED DIRECT TESTIMONY OF
THEODORE S. LEHMANN FOR CMS (NONCONFIDENTIAL)

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission, Complainant, v. Puget Sound Energy, Inc., Respondent.	Docket Nos. UG-040640 & UE- 040641

PREFILED DIRECT TESTIMONY OF THEODORE S. LEHMANN ON BEHALF OF COST MANAGEMENT SERVICES, INC. (NONCONFIDENTIAL)

SEPTEMBER 23, 2004

COST MANAGEMENT SERVICES, INC.

PREFILED DIRECT TESTIMONY OF THEODORE S. LEHMANN

I. INTRODUCTION AND PURPOSE OF TESTIMONY

Q. Please identify yourself for the record.

A. My name is Theodore S. Lehmann. I am founder and president of Direxx Energy, Inc., a competitive, retail natural-gas marketer, headquartered in Portland, Oregon. I also serve as a professional consultant on issues relating to gas marketing and the tariff structures of local distribution companies relating to commercial and industrial classes of service. My business address and further details about my education and experience are specified in Exhibit ____ (TL-2).

Q. On whose behalf are you appearing as an expert witness in this proceeding?

A. I am testifying on behalf of Cost Management Services, Inc. ("CMS"), an independent marketer that sells natural gas at retail to industrial and commercial customers, many of which are located within the gas service territory of Puget Sound Energy, Inc. ("PSE" or "Company").

Q. What is the interest of CMS in this proceeding?

A. As a gas marketer, the CMS has a direct interest in PSE's Schedule No. 57, "Distribution System Transportation Service (Firm and Interruptible)," and in the relationship between Schedule No. 57 and bundled-service Schedule Nos. 85 and 87. CMS asks the Commission to ensure that Schedule No. 57 provides reasonable, non-discriminatory transportation-only service opportunities for PSE's commercial and industrial gas customers.

II. INDEPENDENT GAS MARKETING

Q. To enhance the Commission's understanding of the competitive retail marketplace for natural gas, please describe the business of an independent natural gas marketer.

A. CMS and other independent marketers provide market knowledge and expertise to help medium- to large-demand industrial and commercial end-users lower their delivered cost of natural gas. Independent marketers make forward purchases of natural gas for resale to their customers. In getting this gas to their customers, marketers arrange transportation on interstate pipelines and assume the nominating, scheduling and balancing functions specified under the transportation-only tariffs of local distribution companies ("LDCs") such as PSE.

Q. How do gas marketers line up supplies?

A. Gas is purchased at various supply points and transported into western Washington via Northwest Pipeline, the only one interstate pipeline serving PSE's service territory. Pacific Northwest supplies come from British Columbia, Alberta, Wyoming, Colorado, Utah and New Mexico. The two most prevalent pricing points are Sumas (for Canadian supplies) and Rockies (for domestic supplies). Costs associated with purchasing and transporting those supplies vary from marketer to marketer and different companies have access to different amounts of firm and interruptible supplies and pipeline capacity.

Q. What are the business risks faced by independent marketers?

A. Marketers face numerous risks associated with procuring large gas volumes for which wholesale suppliers impose collateral and other credit-support obligations. Marketers also face the risk of lining up and holding primary firm access on interstate pipelines, which is obtainable but often at a premium and always with demand charges (take-or-pay).

Marketers face credit risk associated with retail customers going out of business, or otherwise defaulting on purchase obligations, thereby saddling the marketer with gas-supply commitments. Purchasing either a fixed forward contract or an index based contract usually requires the marketer to carry a receivable for that client for several months, and carry credit and collateral obligations for much longer.

Q. How do marketers share risk with customers?

A. Customers may either agree to absorb part of the risk or pay to have the marketer do so. Customers wishing to minimize risk can purchase fixed price contracts. This imposes most of the risk on the marketer and is priced accordingly. Customers willing to accept market risk can opt for index-based pricing, using Sumas, Rockies or other relevant indexes, or a mixture of indexes depending on what type of transportation the marketer has access to on Northwest Pipeline. Marketers can also offer hybrid solutions where a portion of the customer's price is fixed and the remainder is priced according to a market index.

Q. Please explain the characteristics of customers with whom CMS does business.

A. CMS focuses on customers with intermediate-sized loads who typically do not have access to upstream capacity and do not have in-house energy professionals. They rely, instead, on a third party marketer like CMS or on PSE for transportation, purchasing, nomination, balancing, billing and other services. Most of them require primary firm gas supplies because they lack back-up fuel systems. Their volumes typically vary from 200,000 to 2,000,000 therms/year. Although volumes are smaller, their total costs of delivered gas can still be a major cost of doing business. Competitive supply options can be very important to their long-term survival. In CMS's experience, most of these intermediate-sized customers prefer a fixed pricing structure and do not like to take the market risk of index pricing. Customers in the intermediate sized category are usually not big enough to justify or execute an independent hedging program and do not have the ability to spread risk across a number of different divisions.

Q. Explain how LDC rates affect CMS's ability to compete for customers.

A. The customers that independent marketers can serve are largely dictated by the economics and rules established in LDC tariffs. Rate structures that unduly favor "bundled" LDC service over transportation-only service create economic hurdles that stack the deck against gas marketers. Sometimes these economic hurdles cannot be overcome by a marketer attempting to provide a potential customer with a delivered gas cost lower than bundled service. Unlike LDCs, independent marketers do not have monopoly classes of service with which to cross-subsidize favored classes of service.

In addition to unfavorable rate structures, transportation-only tariffs can impose arbitrary terms and conditions that have the effect of deterring customers from switching between an LDC's bundled and transportation-only services. Customer convenience and flexibility are also important features of the services marketers provide. If an LDC tariff denies a marketer the ability to offer potential customers these features, those customers may decide to continue bundled service from the LDC.

III. RATE LEVEL CONCERNS

Q. *What are your specific criticisms of PSE's gas rate-increase proposal?*

A. Schedule No. 57 rate levels are grossly excessive, even before the Company's proposed increase. The prefiled direct testimony of PSE witness, James Heidel, contains the admission that Schedule No. 57 has a parity ratio of 171%, at present levels. PSE Exhibit No. ___ (JAH-IT), page 25, chart at line 6. By far, this is the highest parity ratio of any PSE gas rate schedule, resulting in a cross-subsidization of nearly every PSE rate for bundled gas-service. Compare, for example, Mr. Heidel's parity ratio calculations for Schedule No. 85 (80% parity ratio) and Schedule No. 87 (51% parity ratio).

Along with the Northwest Industrial Gas Users ("NWIGU"), CMS is co-sponsoring the testimony of Donald Schoenbeck in Docket No. UG-040640, Exhibit ___(DWS-1T). Mr. Schoenbeck's testimony addresses the concerns of both CMS and NWIGU regarding Schedule No. 57, from a cost-of-service standpoint. From a competitive standpoint, it is my testimony that such cross-subsidization makes it difficult for independent marketers such as CMS to compete against PSE's bundled services under Schedule Nos. 85 and 87. A customer electing Schedule No. 57 transportation-only service is forced to pay for more than a cost-based share of PSE's total costs. As Mr. Shoenbeck demonstrates, Schedule No. 57 customers are now forced to pay even for PSE's gas procurement and storage-related costs that have no relationship to transportation-only services. The anti-competitive result of PSE's pricing structure, both existing and proposed, is to make it more difficult for independent marketers to reduce the delivered gas cost of PSE customers currently served under Schedule Nos. 85 and 87. The changes recommended by Mr. Schoenbeck would help lessen the existing competitive imbalance.

IV. CONCERNS ABOUT TARIFF TERMS AND CONDITIONS

Q. Aside from the issues addressed in Mr. Schoenbeck's testimony, what is the single biggest obstacle faced by PSE industrial and commercial gas end-users as they contemplate competitive purchases of gas through use of an independent marketer?

A. PSE's arbitrary and antiquated sales-to-transport conversion rules force customers to make supply decisions during randomly determined periods that may be least suited for such decisions.

Q. Please explain.

A. Each of PSE's Schedule Nos. 57, 85 and 87 require customers to execute a service agreement covering the relevant tariff service. Section 4, paragraph 1, of Schedule No. 57 specifies service agreement minimum term of one year from the effective date of the agreement. Section 1, paragraph 3, of Schedule No. 85 and Section 1, paragraph 4, of Schedule No. 87 each require a service agreement, but contain no additional information about the term of that agreement. To obtain any information about customer rights and obligations regarding contract term, a customer must refer to section 3 of PSE's standard service agreement for Schedule Nos. 57, 85 and 87, which provides:

> 3. <u>AGREEMENT TERM:</u> The initial term for service under this Agreement is ______ years, beginning on the commencement date. The Agreement continues in effect from year to year thereafter until written notice of cancellation is given by either party at least 90 days prior to the expiration of the original term or an annual anniversary date thereafter.

PSE's standard form of service agreement is Exhibit ___ (TL-3) to this testimony.

Thus, for example, a Schedule No. 57 customer who had happened to execute a PSE service agreement in March would be locked into a cycle of one or more annual periods during which it must make gas-supply decisions sometime in late November or early December in order to give PSE the requisite 90-day notice of termination prior to the contract anniversary date. This is completely contrary to the way in which prudent supply decisions are made. No one would wish to make a gas forward-purchase decision during the height of the winter heating season.

The foregoing example is driven solely by the assumed month in which a customer chose to execute a service agreement. One could assume any other month of the year, and the result would be comparable. The customer would be locked into a similarly rigid annual cycle of gas-supply decision making. I cannot think of a reason why PSE would want to force a customer into such an arbitrary cycle of decision making, unless it wanted to deter the customer from selecting Schedule No. 57 in the first place.

Q. Is it reasonable for PSE to demand 90-days advance notice of termination under its service agreement?

A. No. While I do not take issue with PSE requirement of a minimum initial term of one year, I believe that 30-days advance notice of termination should provide adequate protection to the Company. I offer two reasons to support reducing the notice of termination from 90 days down to 30-days.

First, Schedule 57 already protects the Company through an "Uncollected Gas Cost Adjustment for Migrating Customers." Schedule 57, Section 4, paragraph 2. As the title of this provision suggests, PSE and its customers already settle-up their additional charges or credits whenever migrates to, or from, transportation-only service. A reasonable *quid pro quo* to the customer would be increased flexibility as to the timing of customer decisions to migrate.

Second, there is supporting precedent for the reasonableness of a 30-day termination notice. Last year, the Oregon Public Utilities Commission approved revisions to the transportation-only tariff of Northwest Natural Gas Company, Schedule T, "Customer Owned Natural Gas Transportation Service. Schedule T, attached as Exhibit ___ (TL-4). NW Natural's Schedule T now specifies a one-year minimum term of service, followed by service from month to month until terminated by the customer. This liberalization of the contract terms for transportation-only service had been advocated in the case by my company, Direxx, on behalf of marketers and their industrial and commercial end-user customers. Northwest Natural dropped its own transportation-only proposal in that case and, instead, adopted the Direxx proposal as its own. Significantly, Northwest Natural's Schedule T requires the utility and its customers to settle up gas imbalances upon termination of service, comparable to the Schedule 57 "Uncollected Gas Cost Adjustment for Migrating Customers."

Once Schedule T was put into effect in Oregon, Northwest Natural and the parties to Commission Docket No. UG-031885 agreed to an identical provision in Northwest Natural's transportation-only tariff in the State of Washington. Northwest Natural's Washington version of Schedule T was approved by this Commission in its Order Approving and Adopting Settlement Stipulation as Amended (Docket No. UG-031885, June 23, 2004).

Q. *What is your proposed solution to the arbitrariness now facing PSE customers under Schedule Nos. 57, 85 and 87?*

A. As a matter of regulatory policy, I believe that questions about the term of a service agreement is too important to be left to PSE's unilateral discretion outside the applicable tariffs. Contract-term requirements are a matter of serious concern to the customer. Those requirements should be specified by tariff. I propose the following provision to be inserted into Section 1 of each of Schedule Nos. 57, 85 and 87, paralleling the language now found in Northwest Natural's Schedule T:

> "The minimum term for service under this Schedule shall be one year. At the end of the minimum term, service shall continue on a month-to-month basis thereafter until terminated by the Customer or otherwise terminated in accordance with this Schedule."

PSE should also be directed to make a corresponding change to its standard service agreement, deleting the existing contract-term requirements of section 3 and replacing that language with a reference to the applicable rate schedule – either Schedule No. 57, 85, or 87 as appropriate.

Q. *How would this rate-schedule change affect customers under existing service agreements now in effect?*

A. It is not a purpose of my testimony to offer legal opinions. I would note, however, that section 12 of PSE's standard service agreement states: "In the event of a conflict between this Agreement and an applicable rule, regulation or tariff, the provisions of the rule, regulation, or tariff shall control." As a layman, it would seem to me that once Schedule Nos. 57, 85 and 87 are revised to include my recommended contract-term provision, that new tariff language would "control" existing service agreements. However, if there is any doubt about this question or if the Company disagrees with my layman's conclusion, then I would ask the Commission to direct PSE to amend all service agreements now in effect so that the more liberal termination requirement can be explicitly added to each agreement.

Q. *Does this conclude your direct testimony?*

A. Yes.

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