EXHIBIT NO. ___(JHS-1T)
DOCKET NO. UG-10___
WITNESS: JOHN H. STORY

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of **PUGET SOUND ENERGY, INC.'S** **Natural Gas Tariff Increase**	**Docket No. UG-10____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF JOHN H. STORY ON BEHALF OF PUGET SOUND ENERGY, INC.

OCTOBER 1, 2010

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF JOHN H. STORY

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Please state your name, business address, and present position with Puget Sound Energy, Inc.

A. My name is John H. Story. I am Director of Cost and Regulation for Puget Sound Energy, Inc. ("PSE" or "the Company"). My business address is 10885 N.E. Fourth Street, Bellevue, Washington, 98009.

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

A. Please see Exhibit No. ___(JHS-2).

Q. What topics are you covering in your testimony?

A. I describe the natural gas results of operations and natural gas revenue deficiency. I describe the different allocation methods used to allocate common expenditures between electric and natural gas operations. I explain the various adjustments to the results of operations for the test year used for this proceeding, plus changes to rate base, working capital, conversion factor and the overall revenue requirement

and the resulting revenue deficiency. I will also discuss the current results of operations compared to the results of operations in the last general rate case and the resulting causes of the current revenue deficiency.

Based upon the adjusted test year operating revenues of $1,065,818,560, the total revenue deficiency is $24,643,004 and, as explained by Janet Phelps in her Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), the tariff increase requested in this filing is $24,384,451, which represents a 2.3 percent average increase for natural gas customers.

II. TEST YEAR FINANCIAL STATEMENTS AND RATE BASE

Q. Please explain Exhibit No. ___(JHS-3).

A. Exhibit No. ___(JHS-3) presents the financial statements for the current test year and last test year before any pro forma or restating adjustments. Page 3.01 of Exhibit No. ___(JHS-3) presents a comparison between the unadjusted natural gas income statement for the test year ending December 31, 2008, in Docket No. UG-090705 et al. (the "2009 general rate case") and the unadjusted natural gas income statement for the year ending June 30, 2010, the test year for this tariff increase filing. Page 3.02 of Exhibit No. ___(JHS-3) presents the combined balance sheet, on both an end of period and average-of-the-monthly-averages ("AMA") basis, for the same time periods. Page 3.03 of Exhibit No. ___(JHS-3) presents the comparative rate base calculations and page 3.04 shows the working capital calculation that is included as part of the rate base calculation. The rate

base and working capital exhibits represent the current test year results prior to any pro forma and restating adjustments.

Q. Are rate base and working capital calculated in the same manner as allowed in the last general rate case?

A. Yes.

Q. Has there been a change in natural gas rate base since PSE's most recent general rate case?

A. Yes. In the last general rate case filing, actual natural gas rate base was $1,468 million. In this proceeding the natural gas rate base is $1,616 million, which is an increase of $148 million in rate base.

Q. What are the major causes of the increase in rate base since the last proceeding?

A. The majority of plant additions are attributable to investments in the replacement of aging infrastructure and new distribution plant, with approximately $137 million invested in replacement of aging infrastructure and $121 million invested in new distribution plant, excluding depreciation and deferred taxes.

Q. Do all of these investments in rate base generate revenue?

A. No. The investment in replacement of existing assets does not generate new revenue; therefore, the Company does not earn a return on the incremental increase of new plant costs over the replaced plant until it is included in rates.

Q. Please explain the working capital calculation.

A. The working capital calculation is the measure, for ratemaking purposes, of investor funding of daily operating expenditures and a variety of non-plant investments that are necessary to sustain ongoing operations in order to bridge the gap between the time expenditures for services are required to be provided and the time cost recovery occurs. The purpose of this calculation is to provide a return on the funds the shareholders have invested in the Company for utility purposes that have not been accounted for elsewhere by investment in plant or that are not otherwise already earning a rate of return. The calculation is based on the average of the monthly averages of the actual amounts in the asset and liability accounts for these items during the test year.

The first part of the working capital calculation determines the total average invested capital that has been utilized during the test year. The total average investments which include natural gas, electric and non operating investments and construction work in progress ("CWIP") are deducted from average investment to calculate the total investor supplied capital. The natural gas portion of working capital is calculated by taking the relationship of the total investor supplied

capital to the total average investments, shown on line 98 of page 3.04 of Exhibit No. ___(JHS-3), multiplied by the natural gas operating investment. The natural gas working capital ratio is determined by deducting electric and natural gas construction work in progress ("CWIP") from total average investments using the same methodology that has been approved in the 2009 general rate case.

The resulting natural gas working capital represents the investors' average investment, which is required to provide utility service but which would otherwise not earn a return. The working capital calculation is shown in Exhibit No. ___(JHS-3), page 3.04, which adds $76,948,024 to natural gas rate base.

Q. Please explain the remaining page of Exhibit No. ___(JHS-3).

A. Page 3.05 of Exhibit No. ___(JHS-3) presents the allocation methods, or factors, used in allocating common expenditures between electric and natural gas. Common utility plant is that portion of utility operating plant that is used to provide services for both electric and natural gas customers. Common plant includes costs associated with land, structures, and equipment, which are not charged specifically to electric or natural gas operations. The Company allocates its common utility plant for electric and gas by using the four-factor allocation method as authorized in the stipulation approving the merger of Puget Sound Power & Light Company and Washington Natural Gas Company. Components of the four-factor allocator include the number of customers, direct labor charged to

operations and maintenance ("O&M"), Transmission and Distribution O&M, and net classified plant (excluding general plant).

Common operating costs are those costs that are incurred on behalf of both electricity and natural gas customers. The Company incurs common costs related to: customer accounts expenses, customer service expenses, administrative and general expenses, depreciation/amortization, taxes other than federal income tax, and deferred federal income taxes. The common costs are allocated to electric and gas using the most appropriate allocation method for the type of cost being allocated. Allocation methods used include: (1) twelve month customer average, (2) joint meter reading customers, (3) non-production plant, (4) four factor allocator, and (5) employee benefits.

III. CAUSES OF THE NATURAL GAS REVENUE DEFICIENCY

Q. Please describe the causes of the natural gas revenue deficiency and the analysis undertaken by the Company to determine these causes.

A. To determine the major causes of the change in the natural gas revenue deficiency, a unit cost analysis is performed which compares the major components of the revenue requirement calculation between the current filing and the 2009 general rate case, filed in May 2009. The unit cost analysis divides the major categories of the income statement and rate base that have been pro formed and restated for the current and prior test years, by the delivered load for each test

period. This calculation determines the unit cost for each major category for each particular test period. The test period for the 2009 general rate case has also been adjusted for the restating and pro forma adjustments that were allowed in that case. The differences in unit costs for each of the major components between the two filings are then multiplied by delivered loads for the current test year. This product determines how much that major category has increased or decreased in cost since the last test year, taking into consideration load growth.

This method of determining the causes of a revenue deficiency is essentially the same theory used in ratemaking for determining revenue requirement. For example, in this state a historical test period is used that sets a relationship of costs to revenues. It is not expected that the exact same relationship will exist in the rate year as costs will shift between categories of accounts, and revenues will change based on load mix and customer changes. In theory, it is expected that all the changes will offset each other to allow a company the opportunity to earn its return. By comparing the unit cost of a particular component of cost between two test periods, the Company can measure shifts caused by time, load and actual expenditures, which can be used to determine the sources of cost pressures within the business.

Exhibit No. ___(JHS-6) shows this calculation for the difference between the adjusted test year for this tariff increase filing, as determined in Exhibit No. ___(JHS-4) and the adjusted test year after the rate increase for the 2009 general rate case. Major cost drivers of the proposed tariff change include: 1)

increase of $2.7 million for administrative and general expenses, 2) increase of $3.1 million for customer account expenses, 3) decrease of $1.1 million for distribution expense, 4) increase of $5.8 in depreciation and amortization, and 5) increased rate base and the resulting increase in the return on rate base of $24.5 million. Along with the offset for the change in income taxes discussed later in my testimony, these items all net to the revenue deficiency of $ 24.6 million.

IV. NATURAL GAS PRO FORMA AND RESTATING ADJUSTMENTS

Q. Please explain Exhibit No. ___(JHS-4).

A. Exhibit No. ___(JHS-4) presents the impact of each of the natural gas pro forma and restating adjustments being made to the June 30, 2010 operating income statement and balance sheet. The first page of Exhibit No. ___(JHS-4), titled Summary page, presents the unadjusted operating income statement and average of the monthly averages rate base for the Company as of June 30, 2010 in the column labeled "Actual Results of Operation". The various line items are then adjusted for the summarized pro forma and restating adjustments, as shown in the column labeled "Adjusted Results of Operations". This column is the source used to calculate the revenue deficiency. In the second to last column the revenue deficiency is added to the adjusted income statement, and the impact on the operating income statement and rate base is presented in the final column. The remainder of Exhibit No. ___(JHS-4) is composed of two sections, described below.

Pages 4-A through 4-D of Exhibit No. ___(JHS-4) present a summary schedule of all the pro forma and restating adjustments. The first column of numbers on page 4-A is the unadjusted net operating income for the year ended June 30, 2010 and the unadjusted rate base for the same period. Each column to the right of the first column represents a pro forma and/or a restating adjustment to net operating income or rate base. Each of these adjustments has a supporting schedule, which is referenced by the page number shown in each column title.

The second to the last column, shown on page 4-D of the summary schedule, summarizes all of the adjustments and the final column shows the adjusted test period results used to calculate the revenue deficiency.

Q. Please describe each adjustment, explain why it is necessary, and identify the effect on operating income or rate base.

A. I will explain the adjustments in the same order as they are shown on the summary schedule, by reference to the page number in each column and the title for each adjustment.

Temperature Normalization (JHS-4, page 4.01)

This restating adjustment removes the effect of non-normal temperatures from test year loads, so that test year loads are more reflective of normal operating conditions. The adjusted therms are then priced based upon current rates after the therms are allocated to the appropriate customer class. Please see Ms. Phelps's

Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), for the detailed discussion of the Company's weather normalization adjustment.

This adjustment increases net operating income by $5,099,850 for natural gas operations.

Revenue and Expenses (JHS-4, page 4.02)

This restating and pro forma adjustment restates sales revenues and purchased gas costs to reflect only those rate schedules included in the current filing and to pro form in the full year effect of the general rate increase that occurred during the test year in this proceeding. This adjustment also annualizes the effect of the October 2009 Purchased Gas Adjustment ("PGA") rate change filed under Docket No. UG-091372.

Additionally, the Everett Delta lease revenue is being removed, as the Everett Delta lease expired in November 2009 and the revenues were passed through to the customer in the PGA mechanism.

The revenues associated with leasing of temporary excess capacity at Jackson Prairie of $1.3 million were removed due to the expiration of the contract in March 2011. This excess capacity at Jackson Prairie began in November 2008, after the capacity at the Jackson Prairie facility was expanded. The expansion temporarily created excess capacity related to the need for serving natural gas customers. At the same time, PSE's gas for power portfolio, which is used to

serve electric customers, was seeking storage capacity. To mitigate the cost of the temporary surplus capacity for PSE's Core Gas Book, internal capacity assignment agreements were executed wherein PSE's gas operations charged electric operations for the reservation of excess Jackson Prairie capacity. If such an assignment occurs in the future, the revenue resulting from such assignment to gas customers will flow through the PGA and the cost resulting from such assignment to electric customers will flow through the Power Cost Adjustment mechanism.

Finally, test year revenues associated with the merger rate credit provided under Schedule 132 are removed as this schedule is not a general rate tariff.

The remaining adjustments are necessary test year true up adjustments consistent with what was filed in the 2009 general rate case. Please refer to Ms. Phelps's Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), for further discussion of these adjustments.

These adjustments increase net operating income by $7,203,788 for natural gas operations.

Tax Accounting Method Change for Repairs (JHS-4, page 4.03)

This restating adjustment removes the Accumulated Deferred Income Tax for the Tax Method Change for Service Repairs until the IRS has fully audited and

approved the accounting method. As stated in the Commission Final Order 11 in Docket No. UE-090704 and UG-090705:

> We accordingly reject FEA's adjustment in this case as an inappropriate pro forma adjustment. The final disposition with the IRS is not known and the tax impact is in any event subsequent to the test-year. Having made this determination for purposes of this proceeding, we note that the Company should implement an increase to ADIT in a future case if the IRS approves its methodology for treatment of repair costs following an audit.[1]

This adjustment increases natural gas rate base by $17,882,767.

Federal Income Taxes (JHS-4, page 4.04)

This restating adjustment adjusts actual federal income tax ("FIT") expense to the test year for the tariff filing.

Q. Are there any changes to the Federal Income Tax Adjustment?

A. Yes, previously the Company had included all interest associated with the test year as a deduction to taxable income and then corrected the interest deduction to reflect only interest associated with rate base in Adjustment 4.05 Tax Benefit of Pro Forma Interest. To eliminate the need to include the test year interest in two separate adjustments, the Company is now handling the entire adjustment for tax benefit of interest in Adjustment 4.05. This change does not affect the overall

[1] *See Wash. Utils & Transp Comm'n v. Puget Sound Energy, Inc.,* Order 11 ¶ 197, Docket No. UE-090704 & UG-090705 (2010).

revenue requirement from what would have been calculated in the old presentation as it just moves the interest deduction from the Federal Income Tax Adjustment to the Tax Benefit of Pro Forma Interest Adjustment.

This adjustment decreases net operating income by $27,711,479 for natural gas operations.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustment is:

Tax Benefit of Pro Forma Interest (JHS-4, Page 4.05)

This pro forma adjustment uses a rate base methodology to calculate the tax benefit of pro forma interest. As described above, the calculation no longer needs to include test year interest as only the interest associated with rate base is included in this adjustment and the customer gets the benefit of this tax deduction. This adjustment increases net operating income by $19,510,606 for natural gas operations.

Normalize Injuries and Damages (JHS-4, page 4.06)

This restating adjustment is prepared in accordance with the 2009 general rate case order in Docket No. UE-090704/UG-090705, which restates injuries and damages by adjusting actual test year accruals and payments of injuries and

damages to the three year average of accruals and payments. The adjustment normalizes injuries and damages for the test year.

This adjustment decreases net operating income by $32,445 for natural gas operations.

Pass Through Revenues and Expenses (JHS-4, page 4.07)

This restating adjustment removes from operating revenues all rate schedules that are a direct pass through of specifically identified costs or credits to customers, such as the conservation tracker, municipal taxes and the low-income program. The associated expense that is recorded in the test year for these direct pass through tariffs are also removed in this adjustment.

This adjustment increases net operating income by $123,066 for natural gas operations.

Bad Debts (JHS-4, page 4.08)

This restating adjustment calculates the appropriate bad debt rate by taking the bad debt rate for each of the last five years, removing the highest and lowest years of bad debt write offs, and averaging bad debt percentage for the remaining three years. Since it takes four months to write-off a bill, the ratio of the write-off versus revenue is offset by four months. In other words, a write-off booked during the twelve months ending in June 2010 really relates to revenue that was

recognized during the twelve months ending in February 2010. Using this relationship between February revenues and June write-offs results in the calculation of an appropriate percentage of write-offs associated with revenues. The bad debt percentage for a given year is calculated by taking the actual write-offs for that year and dividing them by the net revenues to which bad debt expense relates for twelve months ending in February for each of the years.

The net test year revenues from line 7 are multiplied by the average bad debt percentage, line 9, to determine the amount of restated bad debt expense. This amount is compared to the actual test year level of bad debt expense on line 12 to determine the effect on income. This bad debt percentage is also used in the conversion factor when determining the final revenue requirement.

This adjustment increases net operating income by $2,499,581 for natural gas operations.

Miscellaneous Operating Expenses (JHS-4, page 4.09)

This restating adjustment removes the costs for dedicated parking spaces at Sea-Tac Airport and downtown Seattle as well as the costs of athletic events that were charged above the line. These adjustments are consistent with adjustments approved in the 2009 general rate case.

The total impact of these adjustments increases net operating income by $5,749 for natural gas operations.

Property Taxes (JHS-4, page 4.10)

This restating adjustment calculates the property tax based on the methodology approved by the Commission in the Company's last general rate case, Docket Nos. UE-090704 and UG-090705. There are three major components to the property tax calculation for centrally assessed properties: value as determined by the Washington Department of Revenue, the system ratio, and the levy rate. In the last general rate case the Commission approved Commission Staff's determination of property taxes, which was based on the most recently completed property tax cycle. At that time, the property tax reflected the property owned as of the January 1, 2008, which was the beginning of the test year. In applying this methodology in the current filing, this restating adjustment uses the property tax from the most recently completed cycle which covers property owned as of January 1, 2009. For purposes of this filing the Company is not proposing to change the method the Commission accepted in the last general case filing; however, this methodology does create a mismatch between the property included in rate base versus what is being taxed.

The effect of this adjustment increases net operating income by $614,816 for natural gas operations.

Water Heater Depreciation (JHS-4, page 4.11)

This pro forma adjustment restates the test year to reflect depreciation expense associated with gas water heaters using lower depreciation rates that were

developed based on a limited scope depreciation study performed specifically for gas water heaters.

Q. Why are you proposing a depreciation adjustment for the gas water heater and conversion burner rental program in this case?

A. The purpose of this adjustment is to correct for the high depreciation rates for gas water heaters that are in current rates. If the rates are not adjusted, the projected net balance of these assets will become negative (over-depreciated) some time in 2011.

Q. Why are the rental depreciation rates too high?

A. In its 2001 general rate case, Docket Nos. UE-011570, et al., the Company filed a new depreciation study which showed that water heater and conversion burner rental equipment had been significantly under depreciated for a number of years. The Company should have been recovering more through depreciation from historical rental customers than it had been recovering. Consequently, new and significantly higher rental depreciation rates were proposed and agreed upon.

Q. Did the Company increase rental rates to recover the higher depreciation?

A. Yes, because of the resulting rate spread and rate design implemented to begin recovering the new rates, a higher burden was placed on existing rental customers. However, because it would not have been appropriate to put the entire burden of rental depreciation issues related to prior years on current rental

customers, and because there were also concerns that raising rental rates too far or fast would cause attrition in rental customers and reduced recovery of rental costs, only a portion of this increase had been allocated to current rental customers. The remainder is being recovered in general rates through allocation to non-rental customers.

Q. How were the new depreciation rates determined?

A. The Company engaged the depreciation consultant, Mr. C. Richard Clarke, Director of Western U.S. Services for the Valuation and Rate Division of Gannett Fleming, Inc. ("Gannett Fleming") to complete a limited depreciation study of this category of Plant assets in 2010. Mr. Clarke sponsored the results of PSE's 2006 Depreciation Study and depreciation rates approved in PSE's 2007 general rate case, Docket Nos. UE-072300 and UG-072301. To restate the depreciation expense, the Company applied the new deprecation rates against the monthly balance for gas water heaters for the test year. As net plant for this item is now at a reasonable level, there is no longer a need for the excess depreciation expense that was being booked for this equipment.

This adjustment increases net operating income by $6,126,949 for natural gas operations and natural gas rate base by $3,063,475.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustment is:

Director and Officer Insurance (JHS-4, page 4.12)

This restating adjustment removes the portion of Directors and Officers ("D&O") insurance that should be allocated to non-utility activity. This adjustment also annualizes the most current premiums, which became effective during the test year for the Directors and Officers insurance as it relates to the Company Directors.

In the 2009 general rate case the allocation of D&O insurance was based on the ratio of utility versus non-utility assets. Continuing to use an asset based methodology has become more difficult due to the impacts of business combination accounting (Accounting Standards Codification 805) resulting from the merger. In other words, the assets and liabilities have different carrying values at PSE than they do in the upstream entities.

To better allocate the utility versus non-utility activity, the Company is using an allocation methodology evenly weighted between the allocation of directors' fees and direct labor charges for Company personnel who are covered by D&O insurance between utility and non-utility charges. The methodology results in 9.1 percent of the premiums being allocated to non-utility. The resulting amount is allocated to operating expenses based on the Direct Labor O&M - Capital split and then further allocated to gas operation based on the number of customers' allocator.

This adjustment increases net operating income by $46,173 for natural gas

operations.

Interest on Customer Deposits (JHS-4, page 4.13)

This pro forma and restating adjustment adds to operating expense the cost of interest for this item based on the most currently implemented interest rate which is 0.33 percent. Pursuant to WAC 480-90-113(9), the interest rate paid on customer deposits is determined annually based on the interest rate for a one year Treasury Constant Maturity as of the fifteenth day of January of that year. This adjustment reflects the expense impact associated with using customer deposits as a reduction to rate base.

This adjustment decreases net operating income by $27,363 for natural gas operations.

Rate Case Expense (JHS-4, page 4.14)

This restating adjustment uses the amount of rate case expense allowed in the Company's last general rate case. These average costs were normalized for recovery over two years and this cost is compared to the amount the Company actually recorded in the current test year for rate case expense. The result decreases net operating income by $79,723 for natural gas operations.

Deferred Gain/Loss on Property Sales (JHS-4, page 4.15)

This restating and pro forma adjustment provides the customer with the gains and

losses from sales of utility real property since the last general rate case. The gains and losses are allocated to gas and electric based on the use of the property. The amount of the gains and losses are amortized over a three-year period from the date they were first approved for recovery in a general rate case filing, with the deferred amount being included in working capital. This adjustment is done in compliance with the settlement agreement for property sales from Docket UE-89-2688-T. For natural gas operations, there were no new deferred gains or losses not already approved in rates. This adjustment decreases net operating income by $68,481 for natural gas operations.

Property and Liability Insurance (JHS-4, page 4.16)

This restating adjustment reflects the actual premium changes occurring during the test year for property and liability insurance expense. These costs are allocated between electric and natural gas depending on the purpose of the insurance. Additionally, this adjustment removes $533,000 of property insurance costs in the test year that were booked to common but which should have been directly assigned to electric, and thus 39.16 percent of the total cost was incorrectly allocated to natural gas operations. The effect of this adjustment is to increase net operating income by $455,852 for natural gas operations.

Pension Plan (JHS-4, page 4.17)

This restating adjustment calculates the pension based on a four year average of cash contributions to the Company's qualified retirement fund and removes the Supplemental Executive Retirement Plan expense from test year expense.

In the 2009 general rate case, the Commission affirmed that the actual four year average of cash contributions ending with the historical test year should be used for setting rates. Using cash contributions instead of SFAS expense allows for consistency when applying this adjustment.

As determined by the plan actuary, the Company made a $24.5 million tax deductible cash contribution in 2008, $18.4 million in 2009 and $12 million through June 2010, totaling $54.9 million for the four year period ending June 2010. The calculation is consistent with previous general rate cases in which the Commission has used the normalized four year average of cash contributions ending with the test year to determine the amount that is to be included in operating expense. The qualified retirement plan is allocated to O&M based on the distribution of wages and then allocated between electric and natural gas based on the employee benefit assessment allocator from Exhibit No. ___(JHS-3), page 3.05.

The expenses associated with Supplemental Executive Retirement Plan were disallowed in the 2009 general rate case; therefore, the test year expenses for that plan are eliminated from the current filing.

This adjustment decreases net operating income by $568,623 for natural gas operations.

Wage Increase (JHS-4, page 4.18)

This restating adjustment reflects the full annual impact of wage increases that occurred during the test year. The wage increase for International Brotherhood of Electrical Workers ("IBEW") union employees was 3.00 percent effective January 1, 2010. The wage increase for United Association of Plumbers and Pipefitters ("UA") union employees was 3.00 percent effective October 1, 2009. The contract for IBEW ran through March 31, 2010 with an extension through May 31, 2010, and the UA contract runs through September 30, 2010. Non represented employees did not receive wage increases in 2010, therefore no wage increase for non represented employees was included in this adjustment.

Q. Are there any changes to the wage increase calculation?

A. Yes, the Company's calculation for payroll taxes takes into account the cap limits for FICA, SUTA and FUTA by each individual employee. Prior to the 2009 general rate case this was the accepted methodology.

The adjustment decreases net operating income by $161,249 for natural gas operations.

Q. Please continue describing the restating and pro forma adjustments.

A. The next adjustment is:

Investment Plan (JHS-4, page 4.19)

This restating adjustment reflects the additional expense associated with the wage increases and is based on the current employee contribution rates. The investment plan adjustment only includes wage increases associated with union increases since non-represented employees did not receive wage increases in 2010.

This adjustment decreases net operating income by $4,928 for natural gas operations.

Employee Insurance (JHS-4, page 4.20)

This restating adjustment reflects the full annual impact of contractual increases that occurred during the test year for employee insurance. In January 2010 the Company's contracted average flex credit per employee per month was raised to $953. The average flex credit per employee per month prior to that was $920 which translates into a 3.6 percent increase for employee insurance. To restate the test year expenses, this percentage increase was applied to the employee insurance expenses for union and salaried employees from July through December 2009 when the lower $920 credit was in effect.

Employee insurance costs are allocated to natural gas based on the labor benefit

assessment allocator from Exhibit No. ___(JHS-3), page 3.05 and then to O&M based on test year payroll distribution.

This adjustment decreases net operating income by $72,199 for natural gas operations.

Incentive Pay (JHS-4, page 4.21)

This restating adjustment uses a four-year average of employee incentive compensation instead of the test year expense. For purposes of this filing, officer incentive pay is excluded from the calculation. For this calculation, the Company has used the payouts which were made in March of the years 2007 through 2010 for each of the prior calendar years and allocated the four-year average to electric and natural gas using the labor benefit assessment allocator. The incentive payment is allocated to O&M expense and other accounts based on the allocation of payroll charges that occurred during the test year. This O&M amount is then compared to actual incentive pay expenses during the test year. This adjustment increases net operating income by $270,866 for natural gas operations.

General Plant - Depreciation (JHS-4, page 4.22)

This restating adjustment corrects a calculation error in the fixed asset system for general plant assets in FERC Accounts 391-398.

When implementing the Final Order approving current depreciation rates in PSE's 2007 general rate case, Docket UE-072300 and UG-072301, the Net Book Value balances in these accounts at October 31, 2008 were to be amortized over the new amortization periods applicable to each FERC account, with an implementation effective date of November 1, 2008.

The new rates were implemented November 1, 2008 in PowerPlant, the Company's fixed asset detail accounting system. The intent was to amortize the remaining net plant value as of November 1, 2008 evenly over the new life of the account (e.g., 391.2 computers over five years) resulting in a zero balance.

Instead, the method chosen in PowerPlant did not result in the intended calculation, but rather recalculated the net book value each month instead of using the fixed November 1, 2008 value, resulting in a smaller and smaller depreciation expense being calculated each month, which would not result in a zero balance at the end of the asset's life. This resulted in not enough depreciation expense being calculated from November 1, 2008 to March 31, 2010. An entry was posted in April 2010 to correct depreciation expense for this error.

This adjustment restates the test year to remove from depreciation expense the portion of the April 2010 correction that relates to periods prior to the test year. Additionally, accumulated depreciation at the beginning of the test year is increased for the impact of the additional depreciation that should have been

booked prior to the test period along with the AMA impact of the additional depreciation expense applicable to the test year.

This adjustment increases net operating income by $190,398 and decreases rate base by $357,945 for natural gas operations.

Fleet Vehicles (JHS-4, page 4.23)

This pro forma adjustment increases rate base and the associated operating expenses to amounts that would be in effect during the rate year. These vehicles were previously -leased and were purchased from GE Capital on January 13, 2010.

This adjustment is calculated in the same manner as was approved in the 2009 general rate case. The rate base is calculated by using the purchase price paid to GE Capital plus sales tax. Deducted from this purchase price were the accumulated depreciation and deferred federal income taxes on an average basis through the end of the rate year. The depreciation rates that were used for the vehicles were based on the average service lives that were approved in the 2007 general rate case, Docket Nos. UE-072300 and UG-072301, and they are the same as were used in the original adjustment approved in the 2009 general rate case.

To determine operating expenses, lease payments occurring in the test year were removed and book depreciation expense calculated as discussed above was added.

This adjustment increases rate base by $1,363,548 and net operating income by $133,074 for natural gas operations.

V. CALCULATION OF THE NATURAL GAS REVENUE DEFICIENCY

Q. Would you please explain what is presented in the Fourth Exhibit to your Prefiled Direct Testimony, Exhibit No. ___(JHS-5)?

A. The Fourth Exhibit to my Prefiled Direct Testimony, Exhibit No. ___(JHS-5), presents the calculation of the natural gas revenue deficiency based on the pro forma and restated test period. The different pages in Exhibit No. ___(JHS-5) are discussed below.

5.01 Gas Tariff Increase

This schedule shows the test period pro forma and restated rate base, line 1, and net operating income, line 6. Based on $1,615,785,171 invested in rate base, an 8.10 percent rate of return and an adjusted net operating income of $115,555,727, the Company would have an overall revenue deficiency of $24,643,004. As explained by Ms. Phelps in her Prefiled Direct Testimony, Exhibit No. ___(JKP-1T), the tariff increase requested in this filing is $24,384,451, which represents a 2.3 percent average increase for natural gas customers.

5.02 Cost of Capital

The cost of capital remains unchanged from the cost of capital approved in the Company's most recent general rate case UG-090705. The rate of return is 8.10 percent and 6.90 percent net of tax.

5.03 Conversion Factor

The conversion factor, shown on Exhibit No. ___(JHS-5), page 5.03, is used to adjust the net operating income deficiency by revenue sensitive items and federal income tax to determine the total revenue deficiency. The revenue sensitive items are the Washington State utility tax, WUTC filing fee, and bad debts. The conversion factor used in the revenue requirement calculation, taking into consideration the adjustments discussed earlier, is 62.1794 percent.

VI. CONCLUSION

Q. Does this conclude your testimony?

A. Yes, it does.