EXHIBIT NO. _____ (SDW-1T)
DOCKET NO. UG-060267 & UE-060266
2006 PSE GENERAL RATE CASE
WITNESS: STEVEN D. WEISS

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UG-060267** **Docket No. UE-060266**

PREFILED DIRECT TESTIMONY OF STEVEN D. WEISS ON BEHALF OF NW ENERGY COALITION

July 19, 2006

NW ENERGY COALITION

PREFILED DIRECT TESTIMONY OF STEVEN D. WEISS

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Steven Weiss. I am employed by the NW Energy Coalition, 219 First Ave. South, Suite 100, Seattle, WA 98104.

Q. What are your position and responsibilities?

A. I am a Senior Policy Associate and represent the Coalition in regulatory proceedings with the Bonneville Power Administration and in the State of Oregon. I am also an advocate for clean and affordable energy in many other forums including the NW Power and Conservation Council, Columbia Grid and the Oregon Legislature.

Q. Please summarize your educational background and professional experience.

A. I received a Masters in Science Education from Bucknell University in 1976 and a Bachelor of Arts in Physics and Math from the University of California at Berkeley in 1968. Previous professional experience includes employment as Assistant Professor at Clarion State College in Pennsylvania from 1975-79 and I was elected to the Board of Salem Electric (Co-op) four times from 1982-94. I also owned and operated a retail bicycle shop from 1980-96. I have been employed by the Coalition since 1994 and have participated in numerous Oregon, BPA and regional policy forums and rate cases. I also co-authored Oregon's electricity restructuring law (SB1149). My resume is included as Exhibit ____(SDW-2).

Q. Have you appeared before utility regulatory Commissions in other proceedings?

A. Yes, I have represented the Coalition in numerous dockets, including rulemakings. Examples in Oregon include Northwest Natural's filings regarding its Weather Adjusted Rate Mechanism (UG 152) and decoupling (UG 143), Portland General Electric's decoupling filing (UE 126), and Cascade Natural Gas Corporation's Conservation Alliance Plan, inclusive of a decoupling mechanism (UG 167). I served as a witness for the Coalition in the 2004 Puget Sound Energy (PSE) rate case, focusing on rate design issues. Also I have represented the Coalition in numerous Integrated Resource Planning Processes, as well as at workshops and conferences over the past dozen years.

Q. Please summarize the contents of your testimony.

A. My testimony focuses on the Gas Revenue Decoupling Mechanism proposed by PSE witness Ronald J. Amen in Exhibit ____(RJA-1T). A properly structured decoupling mechanism provides benefits to both consumers and the utility by: (a) reducing volatility in utility earnings and consumer bills due to weather; (b) reducing volatility in utility earnings due to changes in commodity costs and business conditions; and, (c) removing disincentives to the acquisition and encouragement of energy efficiency and other economically and environmentally efficient resource decisions, such as distributed generation on the customer's side of the meter. All of these benefits lower Company and customer costs. A fair and timely sharing of these benefits is in the public interest. To this end, my testimony proposes several significant modifications to PSE's decoupling mechanism that, if approved by the Commission, would result in the implementation of a 3-year decoupling pilot for residential

customers with annual rate adjustments no greater than 3% and annual recovery of approved margin tied to achievement of ambitious yet achievable energy efficiency targets.

II. Background

Q. What incentives and disincentives are embedded in traditional utility price cap regulation and what effect do they have?

A. All ratemaking regulation provides utilities with incentives or disincentives to behave in a certain manner. Ideally, utilities should be rewarded based on how well they meet their customers' energy service needs. Traditional rate design ties recovery of fixed costs directly to commodity sales. This encourages increased use and discourages even the most economical investments if they are likely to reduce throughput. If sales go down, Company shareholders forego cost recovery of recognized and prudent costs with every unsold therm. Under this system, supply expansion is the primary response to projected load growth - to the exclusion of investments in energy efficiency, peak load pricing and distributed energy resources. This is economically inefficient because there is a disincentive to choose the least-cost mix of options to provide energy service or to encourage such investments by customers.

This regulatory paradigm places the utility's interest (to increase sales) in conflict with the customers' interest (to reduce their total energy costs). Not only does this foster a corporate culture that opposes direct utility investments in programs that reduce energy use, but also it further motivates the utility to discourage customer-

financed reduction measures and to oppose efforts to tighten building codes and appliance standards.

Current regulation also has the effect of magnifying weather and business cycle risks and volatility to both the utility and to customers. During periods of higher than average usage caused by weather extremes, low commodity prices or economic boom, customers overpay fixed distribution costs, and utilities likely earn more than their allowed return on equity (ROE), essentially a windfall completely unrelated to the utility's behavior. Conversely, with mild weather, high commodity prices, or during more difficult economic times, consumers reduce usage and their payments fall short of covering approved fixed costs. The utility suffers a loss, again not connected to the utility's actions.

This structure is particularly difficult for low-income customers. During cold winters, for example, they must struggle with paying energy bills which are needlessly inflated by the current rate structure and which provide for more-than-full recovery of distribution costs. Low-income households spend a higher percentage of their annual income on energy costs than average residential customers and face dramatic reductions in their budgets for food, housing, medicine, and other necessities. In warmer winters they can more easily handle their (smaller) utility bills, and the underpayment contained in their bill is not as much of a benefit. In addition, because their shareholders are harmed by reductions in usage, utilities have a disincentive to adequately fund low-income weatherization programs that could help these customers reduce their energy burden.

At the same time, volatility in revenues raises the utility's cost of capital, which also adds to customer costs.

Weather, commodity price and business cycle risks have traditionally been borne both by utilities (between rate cases) and by customers (in the rate of return set in each rate case, and in the purchased gas adjustment mechanism). Risk is often a valuable tool to incent parties to take actions to reduce their exposure. However, risks which are outside of anyone's control serve no other purpose than to raise costs. If those costs can be reduced and shared fairly, both the Company and customers benefit.

Q. How does decoupling, or revenue cap regulation, overcome the disincentives to conserve energy that are embedded in traditional regulation?

A. Breaking the link between the utility's commodity sales and revenues removes both the utility's incentive to increase energy sales and the disincentive to run effective energy efficiency programs or invest in or encourage other activities that may reduce load. Decision-making can then focus on making least-cost investments to deliver reliable energy services to customers even when such investments reduce throughput. The result is a better alignment of shareholder, management and customer interests to provide for more economically and environmentally efficient resource decisions. A decoupling mechanism is essential to establishing a corporate culture that promotes aggressive cost-effective conservation investments. A decoupling mechanism is able to do this much more successfully and comprehensively than other alternatives.

Q. Are there other benefits of a decoupling mechanism?

A. Yes. Decoupling distribution revenues from throughput reduces the volatility and risk of weather and business cycle variability to both customers and the utility. A decoupling mechanism can smooth out over- and under-collections due to these factors for both parties. Exposing utilities and customers to weather and business volatility serves little useful purpose because they are not subject to either party's control. In fact, the one action the Company can take to reduce its downside risk -- encourage increased (and discourage decreased) consumption between rate cases -- is a policy that increases customer costs and is the key policy we seek to eliminate. Reducing volatility with a decoupling mechanism is a win-win proposition.

As an added benefit, breaking the sales-revenue link can streamline the regulatory process for rate adjustments. For example, contention over the definition of "normal" weather and weather normalization (especially in light of global warming) can consume extensive resources in a rate case. If the sales-revenue link is broken, these definitions and related calculations have little or no economic impact, so the incentive to game is removed. In this way a comprehensive decoupling mechanism that includes margin adjustments for weather variability can improve the efficiency of the regulatory process and allow attention to focus on matters of broader public import.

Q. Could you provide some examples of how decoupling is preferable to alternatives?

A. A more narrowly focused incentive that rewards the utility for running effective conservation programs, for example, does not create a regulatory framework that

encourages a broader change in corporate culture. Another proposed alternative, significantly raising the fixed customer charge, is also not as effective as decoupling, because it lowers the marginal price signal customers face, thus making them less likely to participate in conservation programs or adjust usage as a result of the cost of energy.

Q. How does decoupling affect the risks faced by customers and the Company?

A. Some parties mistakenly view risk as a zero-sum game. They see that decoupling reduces the utility's risk and then jump to the false conclusion that it must increase customers' risk. They perceive decoupling as a shift of risk from shareholders to customers. This argument fails to recognize that customers bear the same weather and business cycle risks that the company does. Customers face the risk of overpayment if usage is more than expected, symmetrically to the utility's risk of under-collection if usage is less than expected. Decoupling is best understood as a trading of risk between customers and shareholders, not a shift.

Q. Why should a decoupling mechanism include weather variability?

A. From the customers' point of view, decoupling works best in countering weather volatility. Rebates can provide relief after especially cold weather, and surcharges are needed only after mild weather.

Q. Do other Northwest gas utilities have decoupling mechanisms that include weather?

A. Yes, NW Natural and Cascade Natural Gas in Oregon both include weather variability in their decoupling mechanism. NW Natural has a weather adjustment mechanism that works well because it adjusts rates in each month's billing cycle.

Q. Are monthly rate adjustments necessary?

A. No. Monthly adjustments are advantageous because they are more immediately tied to changes in consumption patterns, but they result in customers seeing bill changes each and every billing cycle and not all utilities' billing systems can do this. A second-best approach is to provide yearly adjustments, so long as there is a reasonable cap on the annual adjustment.

Q. Are there other reasons to require an "annual cap?"

A. Yes. For example, a surcharge necessitated from under-collection of distribution costs during periods of high commodity prices or recession could hit customers just when they can least deal with it. This is a valid concern, and another reason to limit the size of the decoupling adjustment in any one year.

Q. What is the most appropriate rate design with a decoupling mechanism?

A. With decoupling customer charges are best reduced to a diminishing minimum charge reflecting only meter-reading and billing costs.[1] Decoupling reduces some of the bill volatility due to changes in weather and thus stabilizes Company revenues. In general, the rate changes due to decoupling pale in comparison to the magnitude of reductions that customers can affect in their bills when charged on a volumetric basis. In other words, rates may go up slightly to restore lost distribution revenue from customer reductions, but bills will drop as voluntary reductions and cost-effective

[1] This means that all customers would provide a minimum monthly revenue to the Company sufficient to recover metering and billing costs, but at higher usage levels this "minimum" is rolled into the rate per therm to ensure that incentives for the wise use of natural gas are not adversely affected by the customer charge. Pacific Gas and Electric Company in California current has such a rate schedule (G-1) for its Residential Service.

efficiency eliminate the need to purchase therms that would have cost more. The utility will distribute less commodity with no corresponding loss of distribution revenue, while customers will benefit from avoiding the economic and environmental costs of unnecessary energy consumption. Shifting charges from volumetric to fixed is exactly the wrong signal to customers.

III. NW ENERGY COALITION'S RECOMMENDED DECOUPLING PILOT

Q. Why is the NW Energy Coalition recommending that the Commission approve a gas decoupling pilot mechanism at this time?

A. At a time of unprecedented increases in gas and other energy costs, it is imperative that the Company be allowed, and encouraged, to promote reduced energy usage. Without a well-designed decoupling mechanism, PSE's management is forced into a position where its interests are opposed to those of its customers.

Q. Do you support PSE's decoupling proposal?

A. We commend PSE for proposing a decoupling mechanism in this general rate proceeding but believe it must be modified in several important ways if it is to effectively align shareholder and customer interests.

Q. How does PSE's decoupling proposal address energy efficiency performance?

A. The Company's proposed decoupling mechanism does not require any defined level of conservation achievement. Furthermore, its stated "stretch" gas efficiency target for 2006 and 2007 is 2.1 million therms/year, considerably less than its notable achievements in the previous two years:

2004 Gas Efficiency Achievement	3.2 million therms
2005 Gas Efficiency Achievement	2.9 million therms

This is particularly troubling as the Company's own 2005 Least Cost Plan (VII, page 10) identified the amount of cost-effective natural gas efficiency that is technically available from 2006 to 2025 as 382,239,120 therms. PSE estimates that 28% or 105,137,410 therms of the conservation that is technically available is achievable over the twenty-year period. Thus if PSE invests in 5.25 million therms of cost-effective conservation each year for 20 years, it would implement this achievable conservation. Instead the Company has reduced both its "base" and "stretch" goals, respectively, to 1.7 and 2.1 million therms/year.

Q. Are conservation targets important in a decoupling mechanism?

A. Yes, ambitious conservation targets are a critical component of an effective decoupling mechanism. The Coalition will support a pilot of a decoupling mechanism with PSE that provides for rate adjustments when sales fall below expected levels if and only if it includes aggressive yet achievable conservation targets. This is the key immediate customer benefit of a decoupling mechanism.

Q. What conservation targets do you recommend?

A. PSE would earn annual fixed cost true-ups when it achieves ambitious yet achievable gas conservation targets consistent with the schedule below. Conservation achievement in each year of the pilot would define the recovery in the following year. (The Company's stretch target was set following discussion with the Company's Conservation Resource Advisory Group (CRAG) at 2.1 million therms/year for 2006

and 2007. The Commission would have to approve a "stretch target" for 2008 and 2009.)

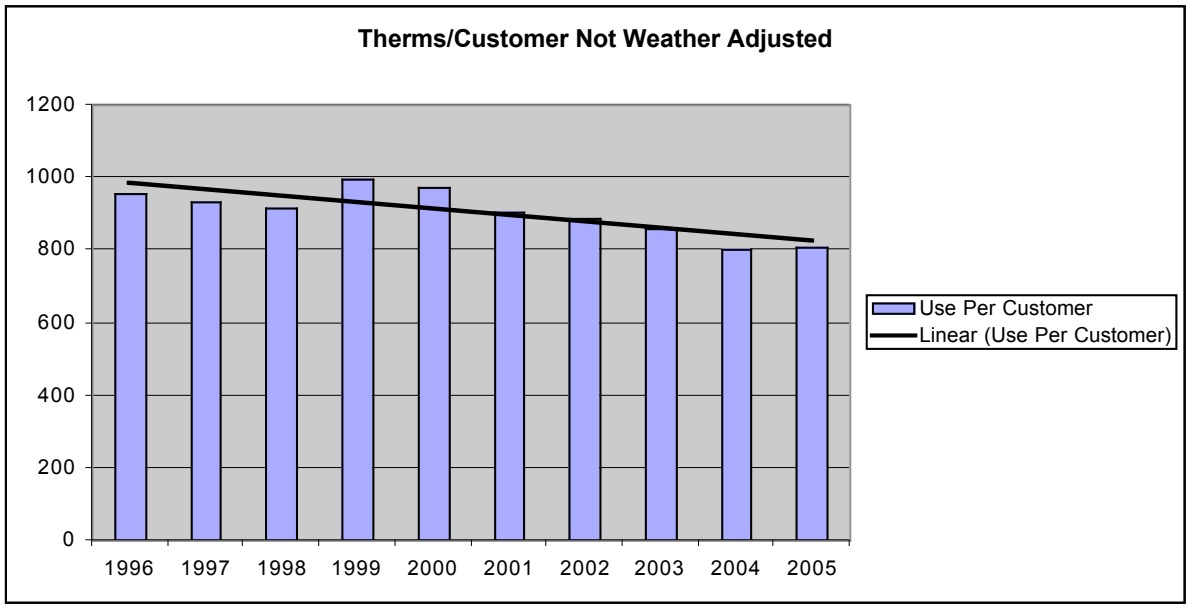
Annual Threshold Achievement (Relative to existing PSE targets)	**% Recovery of Approved Margin**
150% of stretch (3.15 million therms)	100%
135% of stretch (2.84 million therms)	75%
120% of stretch (2.52 million therms)	60%
Stretch target (2.1 million therms)	50%
Base target (1.7 million therms)	0
75- 90% of base target	Shareholder Penalty of $ 500,000
Less than 75% of base target	Shareholder Penalty of $ 1.2 million

Q. Why do you recommend increased margin recovery for greater conservation achievement?

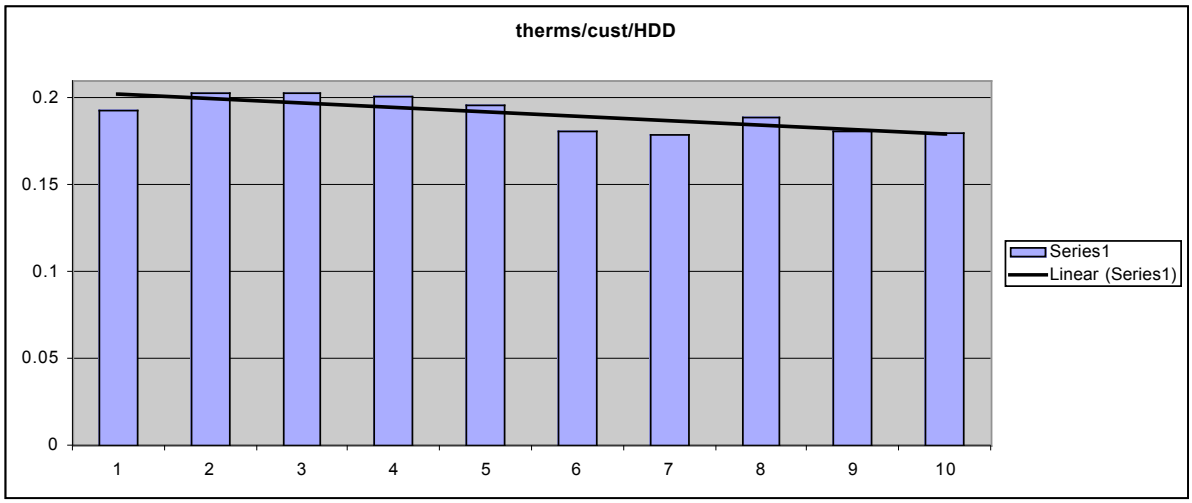
A. Implementation of a decoupling mechanism eliminates a strong financial disincentive for ambitious investments in cost-effective conservation. But it is important to note that *removing a disincentive is not the same as providing an incentive*. Decoupling is a *necessary* condition for allowing for a change in corporate culture to support efforts to reduce consumption, but it is not *sufficient* in itself. The Company still needs an incentive to ensure that it will aggressively act to fund and operate conservation programs. "Pay for performance" is a well-respected and effective principle of compensation. Recent Company performance and Least Cost Plans indicate there is considerable room for improved conservation performance. Full margin recovery in a decoupling mechanism should require at least 150% achievement of the Company's stated stretch goal. The Commission would need to approve a stretch goal for 2008 and 2009 that is informed by the Company's next Integrated Resource Plan and input from the Company's Conservation Resource Advisory Group.

Q. Why do your recommended percentages not go over 100% for superior performance?

A. Evidence from the PSE system over the past decade shows that average residential customer usage is trending down. The graph below summarizes data directly from PSE's Annual Reports. It does not adjust for differences in weather by year.



If we adjust the Annual Report data to reflect the differences in weather across the years, we see that the number of therms used by the average residential customer per "heating degree day" is also declining. This is presented in the table below.



This reduction in residential usage is probably due to a combination of factors: higher bills, more efficient appliances, and utility- and customer-financed conservation investments. There are good reasons to believe this trend will continue. Under traditional ratemaking in Washington that uses a historic test year, the lost margin from this downward trend would be absorbed by shareholders (until incorporated in a new rate case). Thus *any* recovery goes directly to shareholders, and is over-and-above what they would have received absent decoupling. Any percentage above 0% is an incentive to the Company beyond what it currently receives, and anything over 100% would, in my opinion, be an unwarranted windfall.

Q. Why are shareholder penalties included in your proposed performance chart?

A. At present the Company, pursuant to the 2002 Conservation Settlement[2], faces the following financial penalties for failure to achieve annual conservation targets. Note that the original base conservation target referenced in the Settlement Stipulation was 2.1 million therms annually, to be adjusted with development of conservation supply

[2] Exhibit F of Settlement Stipulation for Electric and Common Issues and Application for Commission Approval of Settlement on behalf of Parties, Dockets UE—011570 and UG-011571.

curves and as modifications occurred to avoided cost analyses. For 2006-2007, the first years in which the Settlement penalty could be implemented, PSE set its base target at 1.7 million therms/year.

Conservation Achievement	Settlement Penalty
90-99% of base target	$200,000
75-89% of base target	$500,000
Less than 75% of base target	$750,000

The Coalition proposes that, if a decoupling mechanism is piloted, the first "band" of penalty be eliminated, the "second" remain the same, and the "third" be increased to $1.2 million.

Q. Why do you recommend the penalties be changed to those levels?

A. The $12.2 million conservation budget proposed by the Company for the 2006/07 biennium is sufficient for PSE to achieve its stretch goal of 4.2 million therms of conservation. The Company's conservation budget is thus $2.9 million per million therms of conservation. If the Company achieves only 75% of its base target, it would have lost 0.425 million therms of cost effective conservation compared with that base target. Shareholders should pay a penalty of at least as much as the $1.2 million that the Company or a third party would need to implement an amount equivalent to this "lost conservation."

Q. Isn't it "penalty enough" for the Company not to recover a share of "lost margin?"

A. No, for three reasons. First, if the Company is not delivering targeted cost-effective conservation to its customers, it is costing customers money, and it is appropriate for shareholders to pay for these services to be delivered by a third party or a redoubled

Company effort. Second, there may be years when there is little or no lost margin, depending on other events that affect usage. Thus a penalty for failure to meet minimum targets is appropriate. Finally, as was explained in a response to a previous question, *any* share of lost margin is more than the current regulatory treatment provides.

Q. What customer classes, i.e. rate schedules, should be included in the decoupling mechanism? Why?

A. The Company proposed a decoupling mechanism to apply to all customers served under Schedule 23 (Residential General Service), Schedule 31 (Commercial and Industrial General Service), Schedule 36 (Special Commercial Heating Service-Optional), Schedule 51 (Special Multiple Unit Housing Service-Optional), and Schedule 53 (Propane Service), We recommend that only the customers on Schedule 23 be included in the piloted decoupling mechanism.

Q. Why do you limit decoupling to residential customers?

A. Larger customers' bills are dominated by the commodity cost, so lost margin is much less an issue for them. Many commercial and industrial customers, in fact, have facility charges that completely cover their fixed costs, eliminating the problem addressed by decoupling entirely. Also, it is difficult to set a baseline usage for these customers, in that they are much more liable to change usage suddenly due to their own business conditions. Finally, their usage is usually not weather-related, so adjusting for weather provides no benefit. Small customers are the most important for inclusion in the pilot program. We would be open to considering the inclusion of small commercial customers, whose usage is similar to residential customers, at this

time, but the merit of including additional customer groups in the decoupling mechanism can be considered when the pilot is reviewed.

Q. Does PSE's proposed decoupling mechanism appropriately address margin adjustments for new customers?

A. No. The Company's proposed gas decoupling mechanism freezes the margin per customer at a level based on historical usage despite clear information to the contrary. The prefiled Company testimony of Janet Phelps (Exhibit ____JKP-7, p2) calculates the average weather normalized use of an existing Puget Sound Energy residential customer as 816 therms/year in 2005.[3]

The average usage of new customers is dropping for many reasons - - improved building codes, improved appliance efficiency, a tendency for gas to be installed in multi-family condominiums where use per customer is dramatically lower, installation of heat pumps, etc. The Company's responses to Public Counsel data requests 14 and 15 indicate that the average use of residential customers "new to Puget's system" is significantly less than the 816 figure above. Residential customers new to Puget's system in 2003 used on average 727 therms/year; those new to the system in 2004 used on average 718 therms/year. Given that the trend of declining use per customer has been experienced for many years, there is no reason to make any assumption other than that this trend will continue downward. We can review the average customer use of the residential customers new to Puget's system in 2005 and project "new customer use" for the three-year pilot.

[3] Note that this figure is less than the Annual Residential Use Embedded in Section 5 of the proposed Schedule 118 Gas Revenue Normalization Account (Exhibit ____RJA -9)

A properly structured decoupling mechanism must take new customer use into account for each participating customer class so that the margin generated by the mechanism will be equal to that which would be generated under conventional regulation. New customers are subject to Puget's Line Extension Policy and that policy requires them to contribute, in the form of a Contribution in Aid of Construction, an up-front payment to the Company to the extent their average use is insufficient to generate incremental margins to cover incremental Company costs. If new customer margins are fixed at the higher, historic level within the decoupling mechanism, the Company will, in effect, collect twice for the lower usage of new customers - - first through the up-front payment and again in the "new customer growth adjustment." For this reason, the Company's proposal must be modified.

The Coalition proposes that for each one-year period, the Company would collect for existing customers the margin revenue per customer authorized in its most recent general rate case. In addition, the Company would be permitted a different margin revenue for new customers (new service connections) in participating customer classes. These "new service connection" figures would reflect: a) the fact that average new customer use is considerably less than that of existing customers; and b) the cost assumptions embedded in the Company's existing line extension policies.

The decoupling proposal should be modified to address this issue. I recommend developing an average annual new customer use figure for each year for each participating customer class based on the two factors discussed above. If for some reason this is not possible, all new service connections should be excluded from

the annual true-up calculations between rate cases so as to avoid over-collection of margin from new service connection customers.

Q. How and when should the benefits of the inclusion of weather variability in the pilot decoupling mechanism be shared between the Company and its customers?

A. Conventional wisdom would say that PSE's cost of capital should decline to the extent a weather decoupling mechanism is approved by the Commission. This is especially true for weather-related elasticity for natural gas utilities. Conventional wisdom also recognizes, and supports, the purpose of "regulatory lag" which rewards a utility between rate cases for actions that lower its costs. If all reductions in cost were immediately reflected in lower rates, utilities would have little incentive to be creative or risk investing in cost-cutting initiatives. Balancing the incentive of regulatory lag, however, is the principle of cost-based rates. Customers should not have to pay more than reasonable and prudent costs any longer than is necessary to provide utilities the incentive to reduce costs.

These concerns lead to questions like: Will the cost of capital decline, and, if so, when? And, if it does, how and when shall any reduced costs be shared between shareholders and the different customer classes?[4]

[4] (For example, because this pilot would only target residential customers, it might be appropriate to target any cost-of-capital savings to only the residential class. But that is the subject of a future rate case.)

Q. Are you aware of evidence that the financial markets recognize the value of decoupling, particularly weather-related decoupling?

A. Yes, the Christensen report[5], evaluating the Northwest Natural Gas decoupling mechanism, specifically cited the weather-related decoupling as a basis for Standard & Poor's (S&P's) assigning a risk profile rating of "1" (the lowest risk profile applicable to any utility). According to S&P, a one-step reduction in the risk profile equates to about a 3% reduction in the required equity capitalization ratio to maintain any given bond rating.[6] This makes intuitive sense since without weather decoupling, a gas utility needs more equity to carry it through warm years without dipping into retained earnings to pay dividends. With decoupling, a gas utility needs less equity to do this.

Q. How might a change in equity structure result in cost savings?

A. We use the idea from Standard and Poor's Revised Financial Guidelines to approximate some cost savings the Company could realize, for example, if it were to modify its capital structure and reduce its common equity from 43%, as in the current capital structure, to 42%. With its current capital structure, the Company's after tax cost of capital (COC) is 7.013% as calculated in the table below.

[5] Christensen Associates Energy Consulting, "A Review of Distribution Margin Normalization as Approved by the Oregon Public Utility Commission for Northwest Natural," March 31, 2005. (4610 University Ave, Suite 700, Madison, WI 53705-2164 (206-231-2266)

[6] Standard & Poor's, "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised, 02-June-2004.

Current Capital Structure	COC	Weighted Av COC	After Tax COC
43% Common Equity	10.3%	4.429%	4.429%
0.7% Trust Preferred	8.54%	0.060% x 0.65 =	0.039%
3.75% Preferred Stock	7.61%	0.285%	0.285%
2.68% Short-term Debt	6.19%	0.166% x 0.65 =	0.108%
49.87% Long-Term Debt	6.64%	3.311% x 0.65 =	2.152%
TOTAL			7.013%

Reducing common equity to 42% by increasing long-term debt to 50.87% would reduce the weighted average "after tax" cost of capital above to 6.954%. At the Company's requested rate base of $1.179 billion, this would reduce the Company's annual costs by roughly $1.1 million:

Requested Rate Base	$1,179.0 Million
Return at 43% (rate base x 7.013% /.0.6207) =	$ 133.2 Million
Return at 42% (rate base x 6.954% / 0.6207) =	$ 132.1 Million
Cost Savings from 1% change in capital structure =	$ 1.1 Million

If the Company "phased in" to a 40% equity structure over a three-year period, annual cost savings would increase from roughly $1.1 million in 2007 to $3.3 million in 2009. If savings such as these could be realized, they could be shared with customers at no cost to shareholders or bondholders, creating a true "win-win."

Q. Does the Coalition have a recommendation?

A. Yes. The Coalition's expertise is not utility financing, so we do not have a specific recommendation on cost of capital, ROE adjustments or capitalization structure. We do recommend that the Commission require and review a thorough, independent evaluation of the decoupling pilot. We propose that the Company fund that evaluation. The Commission should approve a process by which PSE works with interested Parties to this proceeding to determine the timing and scope of the evaluation and choice of consultant. Should the Company file a general rate case

prior to the conclusion of the pilot, an evaluation of the financial impacts should be conducted at that time. The evaluation will inform the best sharing of any benefits of decoupling between shareholders and customers.

If we don't take the step to pilot a decoupling mechanism that includes weather adjustments and may reduce the Company's costs, customers may forego substantial savings indefinitely. In that world no one wins. We encourage the Commission to create a decoupling mechanism that includes adjustments for weather.

Q. Would the NW Energy Coalition support a decoupling mechanism that does not include an adjustment for weather variability?

A. Yes, we would support a more limited pilot. However, we emphasize that any decoupling mechanism must include a schedule of ambitious conservation targets to incent cost-effective energy efficiency investments. And, it must appropriately and fairly adjust for "new customer use" that is different than that of existing customers.

IV. CONCLUSION

Q. Please summarize the intent of your overall testimony.

A. The main goal of the Coalition in this proceeding is to align the interests of consumers and shareholders in order to encourage and empower consumers to participate in both utility and non-utility measures that cost-effectively reduce gas usage. The results will be good for both the economy and the environment. Decoupling does this in a comprehensive manner that helps change corporate culture. Decoupling has the additional benefit of reducing a utility's margin recovery volatility. This can translate into a lower cost of capital, thus saving customers' money.

However, the devil is in the details. As David Moskovitz, founder of the Regulatory Assistance Project and author of several decoupling mechanisms, has put it:

1. Get the policies right;
2. Get the structure right;
3. Get the numbers right.

A decoupling proposal that fails to account for the trend in lower usage per customer of both existing and new customers can provide an unwarranted windfall profit. A decoupling proposal that has no concrete commitments and incentives for conservation is also inadequate, because removing a negative incentive is not the same as providing a positive one. A decoupling proposal that fails to cap adjustments can harm customers, especially those with low incomes, in the event a warm winter is followed by a cold one. We believe our proposal addresses these and other pitfalls while preserving the positive benefits of decoupling.

Q. Please summarize your specific recommendations for a decoupling mechanism to be approved by the Commission in this case.

A. The Coalition recommends that the Commission approve the following modifications to the proposal outlined by the Company:

1. A three-year pilot effective January 1, 2007, which could only be extended as part of a general rate case proceeding. Any deferral balance in existence at the end of the three-year period would be amortized over the next 12 months until it is reduced to zero.
2. The pilot mechanism would apply to Schedule 23 (Residential General Service) only.

3. Margin recovery is for both weather and other non-weather factors that impact customer use.
4. For each one-year period, the Company would collect for existing customers the margin revenue per customer authorized in its most recent general rate case. In addition, the Company would collect a different margin revenue for new customers (new service connections). These "new service connection" figures shall be based on a forecast of use and would reflect: a) the fact that average new customer use is considerably less than that of existing customers; and b) the cost sharing embedded in the Company's existing line extension policies.
5. If the Company's margin revenues in a given year exceed those calculated in (4) above, the surplus plus accrued interest is credited back to customers the following year without limitation through a reduction in the per-therm rate.
6. If the Company's margin revenues in a given year are less than those calculated in (4) above, Puget Sound Energy would receive annual fixed cost true-ups, through an increase in the per-therm rate amortized over the following year, when it achieves ambitious yet achievable gas conservation targets consistent with the recovery schedule below. Conservation achievement in each year of the pilot defines the eligibility for recovery of any margin shortfall in the following year. (PSE set its stretch target at 2.1 million therms/year for 2006 and 2007 following discussion with the its Conservation Resource Advisory Group. The Commission shall approve a "stretch target"

for 2008 and 2009 that is informed by the Company's next Integrated Resource Plan and comments of the CRAG.)

Annual Threshold Achievement (Relative to existing PSE Annual targets for 2006 and 2007))	**% Recovery of Approved Margin**
150% of stretch (3.15 million therms)	100%
135% of stretch (2.84 million therms)	75%
120% of stretch (2.52 million therms)	60%
Stretch target (2.1 million therms)	50%
Base target (1.7 million therms)	0
75- 90% of base target	Shareholder Penalty of $ 500,000
Less than 75% of base target	Shareholder Penalty of $ 1.2 million

7. Existing penalties for failure to meet conservation targets that were outlined in the 2002 Conservation Settlement would be replaced by those outlined in (6) above.

8. Annual rate adjustments pursuant to this pilot mechanism are limited to a 3% maximum.

9. The Company will fund an independent evaluation of the pilot decoupling mechanism. The Commission will define a process by which PSE works with interested Parties to this proceeding to determine the timing and scope of the evaluation and choice of consultant. Should the Company file a general rate case prior to the conclusion of the pilot, the evaluation of the financial impacts should be completed for review in that proceeding.

10. Monthly customer charges consistent with the "Joint Proposal of Commission Staff, Public Counsel and the NW Industrial Gas Users on Natural Gas Rate Spread, Rate Design and Low-Income Bill Assistance" are reasonable during the three-year pilot of this decoupling mechanism. In that Joint Proposal, monthly residential customers charges are set at $7.00. The Coalition holds that implementation of a full decoupling

mechanism should result in customer charges being reduced to "disappearing minimum bills."

Q. Would you be willing to provide a simple example to illustrate the way your recommended decoupling mechanism would work?

A. Yes, I would like to do that. First, full margin recovery in the first year of the pilot, 2007, would be the sum of the Commission approved margin for residential customers in the 2005 test year plus a "reduced" margin recovery for the cohort of new customers added in 2006 and 2007, respectively.

This amounts to $206,220,000 if we assume, for simplicity, that:

PSE has 600,000 test year customers in 2005; average annual use is 800 therms

20,000 new customers are added in 2006 with average annual use of 710 therms

20,000 new customers are added in 2007 with average annual use of 700 therms

Monthly customer charge is $7/month

Approved margin is $0.30/therm

Given these assumptions, the allowable full margin for 2007 is the sum of:

(600,000 customers x $7/month x 12 months) =	$ 50,400,000
(20,000 customers x$7/month x 12 months) =	1,680,000
(20,000 customers x $7/month x 12 months) =	1,680,000
(600,000 customer x 800 therms x $0.30/therm) =	$ 144,000,000
(20,000 customers x 710 therms x $0.30/therm) =	4,260,000
(20,000 customer x 700 therms x $0.30/therm) =	4,200,000
100% Margin	$206,220,000

Q. What would happen if 2007 were a cold winter and customers used 10% more energy than "on average?"

A. In that circumstance, PSE would have sold 10% more therms than the 508,200,000 therms estimated above. Since PSE would collect an additional $0.30 margin for each additional therm sold, the Company's margin revenues would be $15,246,000 greater than allowed and this amount would be rebated, with interest, to customers in reduced per therm rates in 2008.

Q. What would happen if 2007 were a "normal weather" year and existing customers reduced their energy use by 5%?

A. Given it's "normal weather" we'll assume this means that the existing customer energy use is 95% of the "test year use" of 480,000,000 therm (800 therms x 600,000). In that circumstance, margin revenues would be down $7.2 million from that which is allowed. If PSE were to achieve 120% of its stretch conservation target in 2007, it would be eligible to collect 60% of the $7.2 million under recovery or $4.32 million from its residential customers in adjustments to its per therm rate, not to exceed 3%.

Q. Finally, how might this work if the circumstance above were combined with a warm year in which energy sales were 10% less than average?

A. In this circumstance, PSE's margin revenues would be down $ 22.446 million (the sum of the $7.2 million and $15.246 million estimated in the previous two examples). PSE's eligibility for margin recovery would again be a function of its conservation performance. If PSE were successful in meeting 150% of its stretch target and were thus eligible to fully recover the lost margin, the annual rate cap would limit the

increase in residential rates to a three percent increase. If the rate cap were not in place, the residential rate per therm would have increased by a roughly approximated $0.043 from $1.11 to $1.153 per therm, a temporary rate adjustment of 3.9%[7].

Q. Do your recommendations align with guidelines issued by this Commission?

A. Yes. We appreciate the Commission's clarifying earlier this year (Section IIC of Orders 04 and 03 pursuant to Pacificorp's Dockets UE-050684 and UE-050412, respectively) the specific information, at a minimum, that it would need to review before any decoupling mechanism might be approved. That list included:

- Analysis of implementation costs and its impact on the company's overall revenues and cost of equity;
- Identification of incremental conservation measures expected to be implemented;
- Development of a target for energy conservation to be achieved through this mechanism relative to the baseline conservation programs currently in rates and the Company's Integrated Resource Plan.
- Scope of risk to be covered by the mechanism;
- Scope of fixed costs included;
- Customer classes to be included and whether the baseline would be on an individual or class basis;
- Complete detail of the accounting for and calculation of any true-up;
- Rate of return implications;
- Method of cost recovery;
- Design of pilot test period and evaluation of the mechanism before determining whether to make it permanent;
- Timing and calculation of rate adjustments;
- Impact of new customers on revenue recovery under the mechanism;
- Impact of the mechanism on low-income customers.

We believe that list is comprehensive and that our modifications to the Company's proposal are responsive to the issues the Commission raised.

[7] This rough approximation assumes that the rate adjustment was based on a projected 2008 residential usage of 522 million therms. Projected 2008 usage assumes an additional 20,000 residential customers would be added in 2008 with an average new customer use of 690 therms/year.

Q. Does this conclude your testimony?

A. Yes.