Exhibit T-___ (MRL-1T)
Docket No. UE-011570
Witness: Merton R. Lott

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission,	)	**DOCKET NOS. UE-011570 and UG-011571 (Consolidated)**
Complainant,	)	
v.	)	
Puget Sound Energy, Inc.,	)	
Respondent	)	
___________________________________	)	

TESTIMONY OF

MERTON R. LOTT

PUBLIC VERSION

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

January 30, 2002

Q. Please state your name and business address.

A. I am Merton R. Lott. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission as the Energy Coordinator.

Q. How long have you been employed by the Commission?

A. Since May 1974.

Q. Would you please state your educational and professional background?

A. I received a Bachelor of Arts Degree in Business Administration, with a major in accounting, from Seattle University in June 1973. I am a certified public accountant in the state of Washington and have taken numerous courses in accounting, management, and regulation theory and practice in order to maintain the continuing CPA education requirements of the state of Washington. In addition to the duties listed below, I have represented this Commission on the NARUC Staff Subcommittee on Accounts since approximately 1991.

Prior to July 1990, I was employed by the Utilities and Accounting Division of the Commission in an auditing and then supervisory capacity. During this period, I performed various phases of accounting and financial analysis of both utility and transportation companies. I worked on the investigation of Washington Natural Gas Company (WNG) in Cause No. U-80-27. I was lead auditor in the filings of Pacific Power and Light (PacifiCorp), Cause Nos. U-82-12/35, U-86-02 and Docket No. 991832; The Washington Water Power Company (WWP), Cause Nos. U-83-26, U-85-36, U-87-1570 and Docket No. UE-900093; and Puget Sound Power & Light (Puget), Cause No. U-83-54 and Docket No. U-89-2688. Further, I was in charge of Staff's analysis of attrition in Cause Nos. U-83-26, U-83-54 and U-86-02. I audited Spokane Suburban and Clarkston General Water companies in Cause Nos. U-84-45 and U-84-46. I participated as lead auditor in the determination of proper rates and principles negotiation with United Telephone. I was also the lead auditor in the analysis of General Telephone (GTE) that led to its filing in Cause No. U-85-33. I was the lead analyst in Continental Telephone's (Contel) filing in Cause No. U-87-640-T. Further, I participated or testified in various limited issue filings in gas, electric and telephone proceedings, including several Energy Cost Adjustment Clause (ECAC) proceedings, the reopened Cause No. U-81-41, PacifiCorp's merger proceeding in Cause No. U-87-1338-AT, and WWP's PCA proposal in Docket U-88-2363-P. I participated as either lead analyst or as a supervisor in 22 of Puget's ECAC proceedings starting with the third trimester. During this period, I testified in several of the dockets listed above.

In July 1990, I transferred to the Regulatory Affairs Section as the Commission's accounting advisor. In this capacity, I advised the Commissioners and Administrative Law Judges on most of the formal dockets before the Commission, including major rate cases of WNG, Puget, Waste Management, and U S West; cost of service and rate design cases of WWP, Puget, WNG and U S West; merger dockets of WWP, U S West, GTE and Contel; purchased gas adjustment and deferral proceedings; all of Puget's Periodic Rate Adjustment Mechanism (PRAM) proceedings; and various rule makings and notices of inquiries.

In June 1996, I transferred to the Regulatory Services Division as the Gas Industry Coordinator, where I coordinated and supervised the Division's Gas Section. Under my supervision, Staff processed several tariff filings and rulemakings, including the 1997 and 2000 general rate filings of WWP (gas) and Northwest Natural Gas. I also participated in several electric dockets including PacifiCorp's general rate case in Docket No. UE-991832, and on occasion, acted as the accounting advisor to the Commission in a number of telephone proceedings.

In January 2001, the gas and electric sections were reunited and I was given the title of Energy Coordinator.

Q. Please describe what you have reviewed with regard to PSE's interim relief request.

A. I have reviewed Puget Sound Energy's (PSE or "the Company") proposed Schedule 128, and its testimony, exhibits and petition in this docket. Further, I have reviewed the workpapers, data request responses, and other available documents concerning PSE's projected and historical results of operations and power supply costs.

Section 1: Purpose of Testimony

Q. What is the purpose of your testimony?

A. Ms. Steel recommends that the Commission grant PSE $42 million of interim relief, with conditions. My testimony addresses the mechanism to implement any relief granted PSE by the Commission, whether or not that level of relief is consistent with Ms. Steel's recommendation. I also critique the Company's proposal to recover its deferred power costs through an interim surcharge under Schedule 128.

Q. Please summarize your conclusions.

A. The Company's proposal to recover its deferred power supply costs through interim relief is inappropriate single issue ratemaking. It also does not meet the Commission's requirements for establishment of a power cost adjustment (PCA) mechanisms and it relies upon an improper baseline from which to defer power costs. Therefore, if the Commission grants PSE interim relief, the relief should not be designed to recover power cost deferrals as proposed by the Company. Rather, based on the evidence in this proceeding, the Commission should determine the level of interim relief required between the order in the interim proceeding and the order in the general rate proceeding. That level of relief should then be recovered on a uniform cents per KWh, excluding Schedules 448 and 449, and special contract customers.

Further, the Commission's determination of any need for interim relief will be based on projections of PSE's earnings during the period January 1, 2002 through October 31, 2002. The major unknown variable included within those projections is the level of power supply costs. Therefore, the Commission should order the refund of interim relief to the extent that actual power supply costs during this period are below the projections used to make the decision to grant interim relief. As described later in my testimony, this refund mechanism should also apply to power supply costs that are ultimately determined to be the result of imprudent actions or which are determined to be inappropriate for recovery from ratepayers.

Section 2: PSE's Proposed Interim Surcharge

Q. Please describe PSE's proposed tariff filing.

A. PSE filed Schedule 128 to implement the requested interim relief. This schedule imposes an equal cents per KWh surcharge on all retail customers, excluding Schedules 448 and 449, and special contract customers. The proposed rate schedule describes its purpose as twofold: first, to recover the deferrals of power costs approved by the Commission on December 19, 2001, in Docket No. UE-011600; and second, to recover the projected power supply costs during the period March 1, 2002 through October 31, 2002. The total rate of 1.4568¢ per KWh recovers projected January and February deferrals at a rate of 0.566¢ per KWh (note Exhibit___ (WAG-3) shows this amount as 0.5666¢ per KWh), and the projected unrecovered power costs during the March through October period at a rate of 0.8902¢ per KWh.

Q. Does the Company propose a true-up through rate Schedule 128 to the actual level of power supply costs?

A. It is unclear. The tariff filing includes no description of a true-up mechanism, nor do the petition or testimony directly refer to any true-up mechanism. That being said, Schedule 128 indicates that the Commission may order a refund in this proceeding, and the direct testimony of Ms. Luscier (Exhibit ___(BAL-1T)) describes the deferral as being tracked to actual recovery, thus, possibly leaving a balance of over- or under-collection at the end of the interim period. The tariff indicates that the refund will be ordered on or before the effective date of rates approved by the Commission in Docket No. UE-001570, (referring to rates in the general rate case portion of this docket).

Section 3: Staff Recommendation

1. Rate spread and rate design recommendation

Q. If the Commission grants PSE interim rate relief, do you agree with PSE's proposal to spread rates on an equal cents per KWh, excluding Schedules 448, 449 and special contract customers?

A. Yes, any interim surcharge should be based on a uniform cents per KWh. Further, while some of the requested relief may be related to costs other than power supply, a majority of any needed relief is driven by increases in power supply costs. Therefore, it is appropriate to exclude Schedules 448, 449 and special contract customers, as these customers do not receive power at cost from PSE.

Q. Please describe the impact of Staff's proposed revenue increase on rates?

A The $42,000,000 interim relief proposed by Ms. Steel results in a surcharge rate of 0.421¢ per KWh compared to the Company's proposed 1.4568¢ per KWh. The Company's proposed rate is based on 11,719,546 MWh of delivered load from March through October of 2002 (See Exhibit___(WAG 3), Spreadsheet A, page 1). My rate is calculated using the same loads, but excluding March 2002 (9,983,987 MWh). Staff's proposed $42 million increase represents an average increase of approximately 6.29% of affected revenue during the months from April through October 2002. If the Commission grants the Company's interim request over the April through October 2002 period, the $170 million increase proposed by PSE would result in a rate of 1.71¢ per KWh which is an average increase of 25.6% of affected revenues.

2. Refund mechanism recommendation

Q. You testified that it would be appropriate to tie the refund of interim relief to the actual versus projected power supply costs. Please explain how this is different than setting interim rates to recover the power cost deferrals as proposed by the Company?

A. PSE's proposal is intended to recover the projected unrecovered power costs as defined in its testimony and petition. The Company's proposal identifies one portion of the Company's revenue requirement from its 1992 general rate case, and adjusts it to include the impacts of the Periodic Rate Adjustment Mechanism (PRAM) and merger proceedings. Measuring this one portion on a per KWh basis, the Company then compares this to the level of power costs incurred currently and projected to occur during the remainder of 2002. In this fashion, the Company modifies its overall revenue requirement by reviewing just a single issue. This method ignores the question of the overall need for revenue interim relief.

It is Staff's position that the Commission should grant interim revenue relief based on the total actual and projected financial conditions the Company is experiencing. The determination of any need for interim rate relief should not be directly tied to any one specific cost occurrence, but rather, it should attempt to maintain the Company's overall financial viability.

Staff, however, notes that the projections of income for 2002 are heavily dependent on the Company's projection of its power costs. Staff also notes that the projection of power supply costs has been a highly speculative endeavor in recent years. Therefore, while Staff cannot make projections of the actual power costs any more accurately than PSE in this interim proceeding, Staff believes that the Company should not be allowed to earn a windfall if the actual power costs are below its projections. Therefore, Staff proposes that the Commission establish a refund mechanism.

Q. Please describe your proposed refund mechanism?

A. Staff proposes that the projected unit costs as identified in Mr. Gaines' Exhibit (WAG-3), Spreadsheet A, (Part 2 of 3) on line 29 be compared to the actual unit costs of power incurred during the 10 months, January – October 2002. The refund should be calculated by, first, determining the difference between the actual unit cost during this period and the unit cost calculated in the "Total Jan-Oct" column. Second, to the extent the actual cost is lower, the difference should be multiplied times the actual total affected classes' volume during this period. This product would then be refunded. An example calculation follows:

1) Total load January through October (MWh)		16,000,000
2) Projected average costs	$35.33/MWh	
3) Actual unit costs	$33.83/MWh	
4) Difference	$ 1.50/MWh	
5) Refund to affected customers (line 4 times line 1)		$24,000,000

The calculation is relatively simple and relies on the actual MWh load, rather than the projected. Further, it is calculated on a total period basis, rather than on a monthly basis to avoid changes in the weighted average calculations that would result from any inaccuracy in the monthly projections.

Q. When should the Commission determine any refund consistent with your proposal?

A. The Commission should conduct a proceeding after October 31, 2002, to compare the power supply cost projections to the actual power supply costs incurred. To proceed with this review as quickly as possible, the Commission should order PSE to make monthly filings, which should include the filings identified by Ms. Luscier. Exhibit No. (BAL-1T), page 2. Further, the Commission should order PSE to file monthly financials (30 days after the end of each period) through October 2002, as opposed to the quarterly statements required in Commission rules.

Q. Are there other factors related to a refund of an interim surcharge that the Commission should consider?

A. Yes. The calculation of actual power supply costs during the 10-month period January 1, 2002 through October 31, 2002 should exclude the excess costs that are found ultimately to be either imprudent or inappropriate for recovery from core retail customers.

Q. Does Staff have any concern that the costs included within PSE's projections are either imprudent or inappropriate for recovery from retail customers?

A. Yes. As described later in my testimony, the projections of power supply costs include the cost of certain hedges for natural gas in Account 547. While these hedges may be considered prudent from a purely business sense, they may represent costs that are either unrelated to the procurement of fuel for the subject period, or represent risks taken by PSE not primarily to serve core customers.

Section 4: Critique of PSE's Deferral Proposal

Q. Please summarize why you believe it is inappropriate to set any interim rates to recover the proposed power cost deferrals?

A. There are several reasons. Most important, it constitutes improper single issue ratemaking. PSE's power costs represent only one factor in the Company's current financial condition. Other factors have not been considered and may have positive or negative impacts. Second, the Company's proposal is the equivalent of a PCA. This Commission has addressed the establishment of a PCA mechanism in several prior orders, see, e.g., Sixth and Seventh Supplemental Orders in Cause No. U-81-41; First Supplemental Order in Docket No. U-88-2363-P; and Third Supplemental Order in Docket Nos. UE-991606 and UG-991607. These orders prescribed requirements for establishing a PCA. These requirements have not been met in this proceeding, as I will discuss later in my testimony. Third, the ability to establish a proper baseline from which to defer simply does not exist at this time. Finally, even if the baseline was accurately established, the portion of unrecovered power costs consistent with the risks included in the last authorized return for PSE's electric operations has not been determined by PSE.

1. Other factors that impact PSE revenue requirement

Q. What are some of the other factors that affect PSE's income?

A. The Company's revenue requirement in 1992 was composed of numerous factors, such as payroll, power supply, cost of money, pension costs, taxes and fees, conservation, and customer loads. Any one of the factors impacting the revenue requirement in that proceeding may be causing increased or decreased pressure on rates today. Below I discuss some significant factors that have impacted the Company's cost structure. These factors are interest, other power supply costs, BPA exchange credit, and revenue (load). Some of these items may put upward pressure on rates, while others may have the opposite effect.

Q. Before turning to those four items, are there any major events that may have substantially impacted PSE's cost structure since the 1992 electric rate case?

A. Yes, there are several. The significant events include the merger between Washington Energy and Puget Sound Power & Light, the sale of the Centralia Steam Plant, the restructuring of industrial service, the creation of and then sale of ConneXt (a billing subsidiary), and the restructuring of the maintenance operations.

a) Interest

Q. Please describe the impact of interest on operating and net income during the recent past and projected 2002.

A. There are two impacts. First, as PSE has increased its debt portion in the capital structure, it has directly impacted operating income and net income. Increased interest as a tax deduction increases operating income. At the same time, the interest expense decreases net income. The larger decrease in net income in PSE's projections compared to operating income is partially the result of the increase in debt in PSE's capital structure.

The second impact is more troublesome. As PSE increases debt in its capital structure, the volatility in its equity rate of return increases. During a period when the Company earns close to or above its authorized overall return, the increased leverage increases the Company's equity rate of return. However, when periods occur as projected by PSE for 2002, the Company's equity return declines more rapidly than it would if the Company had maintained the Commission-authorized equity ratio in Docket No. UE-921262.

b) Other power supply costs

Q. Please discuss the impact on revenue requirement of other power supply costs.

A. Other power supply costs include capital costs, return and depreciation on plant, plus the operation and maintenance expenses associated with operating the Company's owned generation. In the 1992 general rate case, these costs represented a substantial portion of Puget Sound Power & Light Company's total power supply costs.

Q. Has the issue of capital costs versus purchased power been an issue in other PCA filings?

A. Yes. One of the issues that the Commission identified in the Energy Cost Adjustment Clause (ECAC) proceedings was the inclusion of new capital costs in the purchased power account, while the fixed costs associated with Company-owned generation were not included. As a result, the average power supply costs recovered through ECAC increased faster than the total power supply costs experienced by the Company. This issue was addressed in PRAM where the Company's total resource costs were included in the calculation of the PCA portion of the mechanism.

Q. The Company proposes an interim relief mechanism for only this year. Why would the long-term impacts caused by the change in purchasing versus owning power resources make a difference?

A. PSE's proposal establishes a baseline from a ten-year old rate case, Docket No. UE-921262. It attempts to measure the impact of a single set of costs from its calculated baseline, a baseline which represents approximately 30% of PSE's residential rates. As I discussed earlier, tracking the interim surcharge to the projected versus actual power supply costs for this period may be entirely appropriate. But, it is the use of the deferrals and, thus, the baseline determined by PSE that is objectionable.

c) BPA exchange credit

Q. Please discuss the BPA exchange credit.

A. Ordinarily, the BPA exchange credit is not an issue in general rate filings. However, in the merger proceeding, the merging companies agreed to maintain the level of the BPA credit to ratepayers during the rate plan period at 10.85 mills per KWh despite the anticipated phasing out of credits from BPA. In an attempt to shape PSE's power supply costs, PSE requested that the credits from 1997 through 2001 be recognized as shown at page 2 of the Commission's order in Docket No. UE-970451, rather than as actually received. For 1999, 2000, and 2001, PSE was to recognize $39 million, $41 million, and $27 million, respectively, as a credit to its power supply expense. Subsequent to 2001, it was anticipated that there would be no credit from BPA to offset the 10.85 mills credit included in rates. Schedule 94 credits (PSE's electric tariff pass through of BPA credits) totaled $111 million, XXXXXXX, and XXXXXXX for 1999, 2000, and 2001, respectively. I estimate XXXXXXX related to the 10.85 mills per KWh in 2002.

Q. How does the single issue of the BPA credit affect PSE's earnings?

A. As indicated in the prior answer, PSE reported a reduction to revenue of $111 million in 1999 and a reduction to power supply costs of only $39 million. Thus, net of revenue taxes and before federal income taxes (FIT), the Company incurred a net cost of approximately $65 million ($111 million times 95% minus $39 million). For 2000, the numbers are similar. In 2001, the anticipated net cost would have been approximately XXXXXXXXXXXXXXXXXX times 95% minus $27 million). Finally, in 2002, the anticipated net cost would have increased to approximately XXXXX pre-FIT (XXXXXXXXXX times 95%, no costs anticipated).

This, of course, is not what happened. The new BPA contract resulted in increased credits for PSE in both 2001 and 2002. For 2002, under the new BPA contract PSE will record no net cost. As a result, and related to just this single issue, PSE's operating and net income for 2002 will increase over 2000 by XXXXXXXX pre-FIT, or approximately XXXXX after FIT. Further, for 2002, operating and net income will be approximately XXXXX pre-FIT, or XXXXX after FIT, greater than anticipated in previous rate setting proceedings for that period.

d) Customer load

Q. Please explain how changes in customer load impact PSE's earnings?

A. Monthly reports submitted to this Commission indicate that the KWh load for PSE's total residential load has XXXXXXXXXX for the year-ended December 2001 over the same period a year earlier. Further, PSE projects that core load will not grow in 2002. Response to Staff Data Request 72, Attachment C. In fact, excluding the Internet service providers, the Company projects a decrease in core load. As the total class load remains constant, PSE's customer count grows (1.5% based on the same data request response). The lower or flat consumption despite increased customer counts is the result of a decrease in consumption per customer.

The major impact on PSE's earnings is lost revenues without offsetting decreases in expenses. A majority of PSE's revenues are collected on a per KWh basis. These charges are intended to recover both the variable and fixed costs associated with providing customers service. Therefore, loss in sales results in a reduction of recovery of fixed costs.

e) Conclusion on "single issue"

Q. What is your conclusion with respect to PSE's request to recover all unrecovered power supply costs as it relates to the recovery of PSE's revenue requirement?

A. PSE's proposal is "single issue" ratemaking. It has identified one cost that the Company claims is not being fully recovered in today's rates in absence of a review of the total costs of providing service. It ignores all other factors such as those discussed above, whether those factors have negative or positive rate impacts. In addition, other cost factors have been declining, as testified to by several PSE witnesses in both the interim and general rate filings. (Mr. Swofford in the interim and Mr. Weaver, Ms. McLain and Mr. Shearman in the general)

The problem with "single issue" ratemaking is that it considers one cost factor in isolation. In PSE's case, that request is to recover the calculated increase in power supply costs.

2. PCA standard

Q. Has the Commission established standards related to the establishment of a PCA?

A. Yes. In previous cases, including Avista's general rate case in Docket No. UE-991606, the Commission discussed PCAs. On page 52 of its Third Supplemental Order in that proceeding, the Commission determined that such proposals need to equitably balance risk between shareholders and ratepayers. On page 50 of the Order, the Commission identified conditions it had established in prior cases regarding the implementation of a PCA mechanism: ratepayers should receive a cost of capital reduction; a mechanism should be weather-related; and the mechanism should measure short-term impacts related to unusual weather.

Q. Does PSE's proposal meet the standards identified in the Commission's Order in Docket No. UE-991606?

A. If the criteria are modified, as I discuss below, the proposal meets only a portion of the standards. Without these modifications the proposal totally fails to meet any of the standards.

The Company proposes no method to compensate ratepayers for the additional risk they assume during the interim period. There is no rate of return reduction and there is no dead-band about the baseline. In fact, because the deferrals are for a surcharge with no possibility of a credit, the proposal is not really a risk for the ratepayer, it is a cost.

A substantial portion of variable power costs assumed by the Company in its last general rate case and merger proceeding was related to the range of power supply costs used in the stream flow normalization process. The standard deviation of the normalized power costs was $20 million, based on Exhibit 867, in Docket No. UE-921262. The maximum deviation included in the 40-year study was $50 million from the mean.

Q. The second condition says that the proposal should be weather-related. Does the Company's proposal meet this standard?

A. Not entirely. If a baseline could be appropriately established, including increases in PSE's long-term normalized power supply costs, then, because of the short duration of the proposal (i.e. January through October 2002), the remaining variability is related to costs arising from factors not under PSE's control (market prices, in addition to weather). It is the baseline that causes the problem, however. A substantial portion of the increased costs is related to the escalating costs of PSE's long-term contracts. Unlike weather and market prices, these long-term contracts are within the Company's knowledge and control.

Q. Are the increased costs a direct result of unusual weather?

A. A portion of them may be. Even though the unusual weather of 2001 does not appear to continue into 2002, a portion of the costs for 2002 represent hedge contracts for gas associated with the Company's combustion turbines (CTs). These contracts are one of the concerns raised in discussing whether costs were appropriately incurred to serve retail loads. These costs may well be supported by the concern over the extraordinarily low hydro conditions, but this is an issue Staff has not fully evaluated at this time. However, much of the cost increases do appear to be long-term in nature and are not related to the unusual weather.

Q. Is it your testimony that Staff is opposed to a PCA under any circumstances?

A. No. It is my testimony only that the Company's proposed surcharge does not address PCA requirements established by the Commission. Staff is open to considering a PCA in the general rate case portion of this docket, or in another proceeding.

3. Problems with the baseline of $24.74 per MWh

Q. PSE proposes a baseline of $24.74 per MWh to measure the level of unrecovered power costs. How did the Company derive that baseline?

A. The Company starts with a calculation of power supply costs in the 1992 rate case (Docket No. UE-921262) of $16.62 per MWh. To this total, the Company allocates a portion of the PRAM 3, 4, and 5 increases. The amount is further adjusted by an allocation of the rate changes the Company agreed to in the merger rate plan.

Q. Please describe how the Company calculated the power supply cost increases associated with the PRAM proceedings?

A. The Company took the total resource cost portion of each PRAM increase and multiplied it by the ratio of net power supply costs (included in this mechanism) and total expenses on the resource portion of the PRAM. No study was done of the actual costs that caused the increases, nor was there any accounting for the differences in load levels from the PRAM to the loads in Docket No. UE-921262. The resource increases for PRAMs 3, 4, and 5 were multiplied by 77%, 68%, and 69%, respectively. Note, the PRAM was not used to track changes in fixed costs, but rather followed the impact of new power contracts, and hydro and market impacts on purchases and secondary sales, along with changes in the Company’s wheeling costs. Excluding conservation, 100% of the PRAM changes are related to the power supply costs included in PSE’s proposed deferrals.

Q. Please describe how the merger rate plan increases and decreases were calculated to impact the baseline.

A. PSE assumes that 100% of all rate plan increases and decreases were production-related. PSE did not complete a review of how actual power supply costs increased. Instead of the total increase, PSE treated 80% as coming from power supply costs. The 80% was determined by an analysis of 1992 production expenses. PSE split total production expenses between those included in the deferral and those not included in the deferral. The 80% represents the costs that the Company proposes to be in the deferral. The remaining 20% from the 1992 case includes the amortizations of property loss, Creston, and the BEP/WNP-3 (Bonneville exchange power). These three amortization accounts have not grown and the largest of these, the "property loss," should have gone to zero. The result is that PSE assigned a portion of the increases away from power supply costs, thereby lowering the baseline number and increasing the level of deferrals.

Q. Is it appropriate to consider 100% of the rate changes from the merger rate plan to be production-related?

A. Yes. The agreement was that the need for revenue increases was driven by production cost increases. But, this does not imply that 100% of the anticipated increases in power supply costs resulted in increases in rates.

The merging companies proposed that there would be substantial synergies related to the merger, and also that the new company (PSE) was implementing a program of "best practices." As a result of review of all of the cost pressures and anticipated cost savings, the parties worked out an agreeable rate plan. Therefore, the increase in rates from the merger rate plan may be more than 100% derived from production costs increases.

Q. Does this case support the idea that the Company actually achieved savings that may have offset some of the power costs increases mentioned above?

A. Yes, as indicated earlier in my testimony, the Company has provided numerous general and interim rate case witnesses to discuss this subject.

Q. Does the merger agreement include other items supporting the idea that costs other than power supply were anticipated to decrease, thus possibly offsetting some of the power supply increases?

A. Yes. The stipulation agreement in Docket Nos. UE-951270 and UE-960195 provided for a decrease in natural gas rates of 1% of margin. Admittedly the 1% decrease is not large, but it was intended as a method of sharing some of the cost synergies PSE expected to obtain.

4. Summary of problems with PSE's deferral proposal

Q. Please summarize your testimony concerning the use of the proposed power cost deferrals as a recovery mechanism for any interim relief granted the Company in this proceeding.

A. The deferral is a comparison of the unit costs of one portion of the electric Company's unit costs from a 1992 rate case to the actual unit cost to be incurred in 2002. To isolate one portion, large as it may be, from a rate case 10 years ago, considering the changes in operations the Company has experienced in the meantime, is inappropriate.

Even if there were a way to include the net impact of offsetting cost reductions, the calculation of the baseline for the deferrals is inaccurate and understated. An understated baseline results in deferrals that are too large.

Further, assuming that the first two problems were fixed, there would still be the question of risk-sharing within the current rate structure with respect to variability in power supply costs. Under the risk scenarios assumed in rates today, it would be expected that the range of power supply costs from previous proceedings such as the 1992 rate case would properly be absorbed by the Company. That range was $50,000,000 in the 1992 rate case, the difference from the mean to the most extreme year in the 40-year water study.

Q. What adjustments would be necessary to PSE's proposals which would make establishment of power cost deferrals for PSE appropriate at this time?

A. There would be several necessary adjustments. For most, the information does not exist in the interim proceeding. The most significant offsetting factor would be an adjustment for the BPA credit discussed earlier in my testimony. This item represents over XXXX XXXX in operating income. We would also need to establish a proper baseline, based on long-term normalized costs. The calculation the Company made concerning the PRAM and merger plan rate changes appears to understate the impact of the rate increases during the merger plan for power supply costs and, as a result, increases the level of deferrals. Third, we would need to identify a method to recognize the risk assumed by PSE in prior rate settings. This could be accomplished by creating a dead-band around the baseline, such as the $50 million variance from the 1992 rate case, or by offsetting the deferrals by an assumed reduction in the cost of money. While these items do not exist in the record for this interim request, nor is there time to address them in this filing, they can be fully addressed in the general rate proceeding. My discussion here is not directed at the Company's rate proposal, including its PCA in the general proceeding.

Section 5: Power Supply Costs

Q. Has Staff completed a review of the power supply costs projected by Mr. William Gaines for 2002 in this proceeding?

A. No. The projections supported by Mr. Gaines are based on assumptions input into the AURORA model, including stream flows based on the 40-year rolling average. The inputs include several assumptions such as the incremental monthly gas costs for the gas fired generating plants and load factors. To the model results, the Company made several adjustments for costs that would be an exception to the results of the AURORA model run. These adjustments include items such as lease payments for Fredonia, oil backup for capacity purposes at the CTs, and contracts related to fixing the price of gas at the various gas fired plants.

Q. Do you believe the projections are accurate?

A. I am not taking a position on the accuracy of the AURORA model or the adjustments made by the Company at this time. Staff is reviewing the Company's model in the general rate case. However, while the projections may have been reasonable at the time they were made, some inputs appear to be higher than what is currently being experienced, for example, cost of gas for generation. As indicated earlier, the model in the 1992 rate case showed a deviance from average of over $50,000,000. I would expect that the potential deviation in this rate case, given today's market, may be even greater.

Q. What conclusion have you drawn concerning the potential variability in PSE's projected power supply costs?

A. As I testified earlier, I believe the Commission will have to rely upon the income projections of the Company as modified by Staff and other parties. These projections include the power supply projections of Mr. William Gaines. Because there is a strong possibility that the actual power supply costs may vary substantially from these projections, it is Staff's position that, if interim relief is granted, the Commission should adopt a refund mechanism that will address the possibility of actual power supply costs being lower than the projections.

Q. Are there any costs identified in Staff's review that would appear to be inappropriate for recovery from retail customers?

A. At this time, Staff has not been able to determine whether any specific cost is imprudent or inappropriate for recovery. However, the gas hedges associated with PSE's CTs for the first three months of 2002 raise several questions that Staff needs to answer. These XXXXXXXXXXXXXXXXXXXXXX to the Company's power supply costs. They represent the Company's XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXX. Today's price is around $2 per decatherm. Staff needs to look into the appropriateness of fixing fuel prices for a peaking resource, and whether those purchases, although possibly prudent from a pure business perspective, were consistent with providing service to retail core customers.

This issue, along with issues arising from review of other costs to be incurred by PSE during this period, is why I also propose a refund of any costs found to be imprudent or inappropriate.

Q. Does this conclude your testimony?

A. Yes.