EXHIBIT NO. ___(RCS-1T)
DOCKET NO. UE-060266/UG-060267
2006 PSE GENERAL RATE CASE
WITNESS: RALPH C. SMITH

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF RALPH C. SMITH ON BEHALF OF THE NAVY UTILITY RATE AND STUDIES OFFICE AND FEDERAL EXECUTIVE AGENCIES

JULY 19, 2006

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL)
OF
RALPH C. SMITH

I. INTRODUCTION

Q. Please state your name and business address.

A. Ralph C. Smith, 15728 Farmington Road, Livonia, Michigan 48154.

Q. What is your occupation?

A. I am a certified public accountant and a senior regulatory utility consultant with the firm Larkin & Associates, PLLC, certified public accountants and regulatory consultants.

Q. What is your educational background and professional experience?

A. These are presented in Exhibit No. ___(RCS-2). This exhibit also summarizes some of my regulatory experience and qualifications.

Q. On whose behalf are you appearing?

A. My firm is under contract with the Navy Utility Rate and Studies Office (URASO) to perform utility revenue requirement studies on behalf of the consumer interests of the Navy and all other Federal Executive Agencies (FEA).

Q. Please describe the tasks you performed related to your testimony in this case.

A. We reviewed and analyzed data and performed other procedures as necessary (1) to obtain an understanding of the Puget Sound Energy's ("PSE," "Puget" or "Company") rate filing package as it relates to the Company's proposed Depreciation Tracker and (2) to formulate an opinion concerning the reasonableness of the Company's proposed Depreciation Tracker. These procedures included reviewing the Company's testimony, exhibits and workpapers, issuing information requests, and analyzing PSE's responses to them.

Q. What issues will you be addressing in your testimony?

A. My direct testimony discusses Puget's proposal for a Depreciation Tracker and recommends that this Company proposal be rejected.

II. DEPRECIATION TRACKER

Q. Please summarize your understanding of Puget's proposed Depreciation Tracker.

A. The Company apparently believes that it has an unusual attrition problem and is therefore proposing a new Depreciation Tracker mechanism that would true up revenues for changes in depreciation expense related to natural gas and electric transmission and distribution capital investment. As proposed by Puget, the tracker mechanism would provide for recovery of the Company's investments in transmission and distribution infrastructure through a surcharge to the Company's existing tariff schedules. This surcharge would be based on the incremental depreciation expense of natural gas and electric transmission and distribution investment over and above the depreciation expense reflected in existing rates. The Company proposes to calculate the change in revenue deficiency for depreciation expense based on the unit cost recovery for this item that was allowed in the Company's most recent general rate case. If the Depreciation Tracker is approved, this unit cost would be adjusted each year to reflect the additional costs recovered in rates due to implementation of the surcharge.

Q. How does Puget characterize the proposed mechanism?

A. Puget witness Story states at page 73 of his direct testimony that basing recovery on the unit cost associated with depreciation expense is similar to the calculation the Company currently utilizes for power cost recovery in its PCA Mechanism.

Q. What impact does Puget estimate that its proposed Depreciation Tracker would have on the revenue requirement in the current proceeding?

A. Page 75 of Puget witness Story's direct testimony estimates an increased revenue requirement for Puget's electric and gas operations of $7.879 million and $10.885 million, for a total increase of $18.764 as summarized in the following table:

Line No.	Depreciation in Test Year	9/30/2005	2007	2007 Tracker
1	Electric			
2	Transmission	2,162,707	2,154,681	
3	Distribution	69,255,510	77,619,411	
4		71,418,217		79,774,092
5	Delivered Load (MWH)	21,853,035	22,107,507	72,249,861
6	Unit Cost ($/KWh)	0.003268		
7	Adjustment			7,524,231
8			Conversion	0.9549744
			Revenue Def.	7,878,988
9	Gas			
10	Transmission	2,911,749	3,752,000	
11	Distribution	47,386,339	57,900,661	
12		50,298,088		61,652,661
13	Delivered Load (thousand therms)	1,038,451	1,057,971	51,243,553
14	Unit Cost ($/therm)	0.048436		
15	Adjustment			10,409,108
			Conversion	0.9563082
16			Revenue Def.	10,884,680
17			Total	18,763,667

Additionally, as an automatic adjustment clause with a surcharge, Puget's proposal could also result in additional subsequent increases to customer rates, on an annual basis, without the benefit of a complete review of Puget's operations

and without reflecting other offsetting adjustments that could decrease the revenue requirement.

Q. Should Puget's proposed Depreciation Tracker be adopted?

A. No. For several reasons, including the following, Puget's proposed Depreciation Tracker should be rejected:

1) It would inappropriately shift responsibility and risk of increasing Depreciation Expense between rate cases away from shareholders and onto ratepayers.

2) It could remove or reduce incentives to prudently control the cost of plant additions.

3) Depreciation Expense is not similar to fuel cost and Puget has demonstrated no history of volatile and uncontrollable Depreciation Expense.

4) It could encumber ratepayers with additional revenue requirements annually into the future for Depreciation Expense without capturing offsetting benefits.

5) It is a distortion of the test year relationships.

6) It is not beneficial to ratepayers.

7) It is an unusual and extreme ratemaking proposal that has apparently not been adopted for any other utility in the country.

Q. Please explain how Puget's proposed Depreciation Tracker would shift risk of fluctuating Depreciation Expense between rate cases away from shareholders and onto ratepayers, and why such a shift is inappropriate.

A. If Puget believes that its expenses or costs, including Depreciation Expense, are increasing more rapidly than its revenues such that a revenue deficiency is being created, Puget can file for a rate increase. Currently, the risks and benefits lie with Puget's shareholders during the period between rate cases if revenues grow more slowly or more rapidly than Puget's costs. Puget's proposed Depreciation Tracker would result in shifting the risk of expense growth onto ratepayers by making ratepayers responsible for all Depreciation Expense changes occurring between rate cases. Puget would retain the benefit of any rapid revenue growth for the shareholders.

Q. How could Puget's proposed Depreciation Tracker remove or reduce incentives to prudently control the cost of plant additions?

A. One of the useful functions of regulatory lag is to place financial responsibility upon the utility for fluctuations in costs between rate cases. The regulatory lag feature of Rate Base/Rate of Return regulation is essential to effective and efficient operation of such a regulatory régime. Because of the lag between placing new plant into service and obtaining rate recognition of such plant, the utility may bear the cost of new plant additions temporarily. This can encourage management to emphasize cost control to a higher degree that might be expected

if cost responsibility for plant additions during the periods between rate cases were shifted away from the utility and onto ratepayers.

Q. Please elaborate on how Depreciation Expense is not similar to fuel cost and Puget has demonstrated no history of volatile and uncontrollable Depreciation Expense.

A. Puget witness Story's direct testimony at page 73 suggests that its proposed Depreciation Tracker would be: "similar to the calculation the Company currently utilizes for power cost recovery in its PCA Mechanism." Depreciation expense, however, is not similar to fuel expense as demonstrated in the following table:

Fuel Expense	***Depreciation Expense***
Fuel costs are determined by the world wide energy market.	Capital Expenditures, that drive depreciation expense, are subject to utility management, both as to timing and cost control.
Fuel consumed has no significant impact on other operating costs,(assumes fuel grade standards remain constant).	Installed plant may either increase or decrease operations and maintenance expenses, particularly for repairs, maintenance and operating efficiencies.

Fuel expense both increases and decreases in consort with fluctuating energy markets.	Depreciation expense changes very slowly, normally only increasing in consort with plant replacement and additions. A decrease in depreciation expense could signal that plant investments are shrinking and the Utility is disinvesting in the service territory, which in turn could be a harbinger of deferred investments and future increases of greater magnitude.

The primary factor typically cited in justifying the implementation of fuel cost recovery mechanisms for utilities – that such expenses can be extremely volatile between rate cases and are beyond the control or ability of management to influence or control – does not apply to Depreciation Expense.

Q. How could Puget's proposal encumber ratepayers with additional revenue requirements annually into the future for Depreciation Expense without capturing offsetting benefits?

A. Puget proposes that its Depreciation Tracker calculations result in annual rate adjustments to recognize the presumed increase in depreciation expense. Moreover, by focusing only on certain isolated components of the revenue requirement formula, and ignoring offsetting components, Puget's proposed Depreciation Tracker could produce rate increases without capturing offsetting benefits, such as increased revenues and expense reductions.

Q. Please explain how Puget's proposed Depreciation Tracker distorts test year relationships.

A. To understand how Puget's proposed Depreciation Tracker distorts test year relationships it may be helpful to review the basic ratemaking calculus, i.e., the formula used to determine a utility's revenue deficiency (or sufficiency). In the standard formula, rate base is multiplied by a rate of return to derive a return requirement. The return requirement is added to test year operating expenses to determine the utility's revenue requirement. The revenue requirement is then compared with the utility's revenues at current rates. The difference is the revenue deficiency or sufficiency. It is critically important that representative values for each of the key elements of the revenue requirements be determined in a balanced and consistent manner. By using a test year, each element of the revenue requirement is properly matched and coordinated. For a growing electric utility, future sales and revenues, future expenses and future rate base investment levels will all likely, though not always, be larger in nominal terms. The use of a

test year to quantify ratemaking values for these variables is intended to determine a revenue requirement based upon the relationship between revenue and cost levels at a common point in time. Consequently, while absolute precision in ratemaking is not required, basic consistency in the elements of the ratemaking formula is essential, such that representative levels of ongoing revenues and costs are captured in a balanced way, within a consistently applied test year approach.

Puget's Depreciation Tracker distorts the relationships between the components of the ratemaking formula by focusing on elements which increase the revenue requirement; plant additions and depreciation expense on such additions, without considering other components, such as increased revenues and other expense changes in a balanced manner.

Q. Is Puget's Depreciation Tracker proposal beneficial to ratepayers?

A. No, it is not. It would substantially increase Puget's revenue deficiencies for both gas and electric service in the current case, and could produce additional increases annually in an unbalanced manner that considers only one component of the revenue requirement. Additionally, if Puget's proposed Depreciation Tracker had been in place in prior years, it would have resulted in increased customer rates. The response to FEA DR 02-008 and PC-056 indicates that the Company's rates

in 2003, 2004 and 2005, would have been higher by a cumulative net amount of $13.148 million.[1]

Q. Is Puget under any restrictions that would prohibit the Company from filing for rate relief if needed?

A. No. Under the present ratemaking regime, I am not aware of any restrictions on Puget that would prevent the Company from filing subsequent rate cases. Puget's response to FEA data request (DR) 02-007 states that it "is unaware of any restriction that would limit PSE's ability to file subsequent rate cases or power cost-only rate cases to address growth in rate base."

Q. Has Puget demonstrated that it has a unique problem with regulatory lag that requires an extraordinary and unusual ratemaking mechanism?

A. No, it has not. While Puget has characterized its proposed Depreciation Tracker as being an attempt to address an issue of regulatory lag, Puget has not demonstrated that it has a unique problem with regulatory lag that is substantially different from other regulated public utilities that would require such an extraordinary and unusual ratemaking mechanism.

[1] Attachment A to PSE's response to PC-056 shows that, for 2003-2005, gas rates would have been higher by $13,756,104 and electric rates lower by $607,704, for a net increase of $13,148,400.

Q. Is Puget's proposed Depreciation Tracker good regulatory policy, and if not, why not?

A. This would be bad regulatory policy. The Company's proposal is the equivalent of single-issue ratemaking and should not be allowed. In the past, the Company has not had an automatic recovery mechanism for Depreciation Expense. It is not appropriate to now set aside this one single issue for automatic deferral and future recovery. Providing what essentially would amount to as a guarantee of future depreciation expense recovery could also remove incentives on the Company to prudently plan construction and manage costs and shifts the burden of cost increases between rate cases from shareholders onto ratepayers. Indeed, throughout the country many electric utilities have fuel cost recovery mechanisms and many gas utilities have gas cost recovery mechanisms, but no other utility has a Depreciation Tracker mechanism such as Puget proposes.

Q. Has Puget indicated whether it is requesting an attrition adjustment in the current case?

A. Page 64 of PSE witness Story's direct testimony states that the Company is <u>not</u> requesting an attrition adjustment in this case based on the trended methodology that the Commission has accepted in some historic rate cases.

Q. Does Puget's lack of a request for an attrition allowance based on historic trended analysis in the current rate case appear to be consistent with other recent Puget rate cases?

A. Yes. This appears to be consistent with recent prior Puget rate cases. The Company's response to FEA DR 02-004 states that PSE "neither filed for an attrition allowance nor performed an attrition analysis in its last three rate cases."[2]

Q. Has a Depreciation Tracker mechanism similar to Puget's proposal in the current case been adopted for any other utilities in the country?

A. No, not to my knowledge. Puget's response to FEA DR 02-005 indicates that Puget is not aware of any other utility that has proposed a Depreciation Tracker mechanism like the one Puget has proposed in this proceeding. Puget's Depreciation Tracker proposal is an unusual and extreme ratemaking proposal that has apparently not been adopted for any r utility in the country.

[2] FEA DR 02-0104 asked Puget to: "Provide all exhibits, calculations and supporting workpapers for the 'traditional WUTC attrition allowance' in the Company's last three electric and gas rate cases. PSE witness Story had referred to that "historic methodology" at page 64 of his direct testimony.

Q. Please summarize your conclusion regarding whether Puget's proposed Depreciation Tracker should be adopted.

A. Puget's Depreciation Tracker represents an unusual, one-sided and extreme ratemaking proposal that inappropriately distorts the ratemaking calculus and should therefore be rejected.

Q. Can you suggest a reasonable alternative to Puget's Depreciation Tracker proposal?

A. Yes. If the Commission wants to address post-test year plant additions in the current case, I would recommend accomplishing this through a known and measurable adjustment to recognize non-revenue producing, non-expense reducing transmission and distribution plant additions for a limited period (such as one calendar quarter) beyond the end of the test year. Moreover, in order that such a post-test year adjustment be computed in a balanced manner, the Company's continued accruals of accumulated depreciation on transmission and distribution plant should be recognized through the same date as the plant additions.

Q. Why did you suggest a calendar quarter for the post test year update period and what is the significance of the update period beyond the end of the test year?

A. The further outside the test year the net additions to plant in service are recognized, the greater the danger of completely destroying the test year relationships between rate base, revenues and expenses. In my judgment, allowing recognition of non-revenue producing, non-expense reducing T&D plant additions for one additional quarter beyond the end of the test year would not result in a complete distortion of the test year relationships, as would extending for a longer period could. Also, Puget's transmission and distribution additions during the calendar quarter following the end of the test year has a closer temporal connection to the test year than a more extended time period. Some of the plant placed in service during the quarter may have been under construction by the end of the test year. Finally, in other jurisdictions with which I am familiar that undertake post-test year rate base updates for periods as long as six months, the updates are usually for all test year components, and not limited to net plant additions. Because recognition of post-test year net plant additions, without other post test year changes, is inherently unbalanced, providing a means of addressing Puget's attrition concern by recognizing post-test year plant additions, if allowed, should be confined to one quarter subsequent to the test year.

Q. Why should only non-revenue producing and non-expense reducing plant additions be considered?

A. Only non-revenue producing and non-expense reducing plant additions should be considered to achieve proper matching. Plant installed to serve customer growth will generate additional revenues, which are not being recognized in the limited adjustment to update rate base. Other things being equal, increased customer revenues tend to reduce the utility's revenue deficiency. Consequently, without quantifying and reflecting the additional annualized customer revenues, enabled by the plant additions to serve growth, an unbalanced result is produced that would overstate the net revenue requirement. Post-test year plant additions that increase capacity should not be included because this creates a mis-match between the adjusted rate base and the test year quantity of utility service. Similarly, plant additions that improve efficiency or reduce costs, such as maintenance or operations expense, should not be considered because the efficiency improvements and cost reductions are not being captured in the pro forma adjustment to offset the revenue requirement increase related to the plant addition. For example, replacing manually read meters with meters capable of remote electronic reading would increase depreciation expense, but the payroll cost for labor to read meters would remain the same. Therefore, the utility would be over collecting for meter reading expenses. By limiting the known and measurable adjustment to only plant additions that are non-revenue-producing and non-expense-reducing, this would capture only the components that do not have offsetting impacts.

Q. If a known and measurable adjustment were to be allowed for non-revenue producing and non-expense reducing plant additions through December 31, 2005, why should changes in accumulated depreciation also be recognized through that same date?

A. Since plant in service is being extended beyond the test year by three months, the accumulated depreciation on existing T&D plant that continues to accrue should also be extended by the same period, as an offset to the increased Plant. Ratepayers continue to pay Puget for the cost of utility service, which includes depreciation expense. If rate base is going to be adjusted to recognize T&D plant additions for a certain period beyond the test year (such as three months), the change in accumulated depreciation for that same period should also be recognized. In other words, if a known and measurable adjustment is going to be made, it should reflect the increase in non-revenue producing, non-expense reducing T&D plant net of accumulated depreciation on T&D plant through the same date.

Q. Have you quantified the adjustment that would implement such a recommendation?

A. No. As of this time I have not identified a specific adjustment for known and measurable non-revenue producing, non-expense reducing transmission and

distribution plant additions for a limited period, such as three months, beyond the test year, or the offset for an additional three months continuation of accumulated depreciation on T&D plant.

Q. Can you please provide a hypothetical example to illustrate how this type adjustment could be made?

A. Yes. The following example using hypothetical information for electric operations illustrates how such an adjustment could be made:

Electric Rate Base	Illustration Using Hypothetical Amounts
Net Addition for Non-Revenue Producing, Non-Expense Reducing Plant Adds 10/1/05-12/31/05	
- Distribution Additions	$ 29,000,000
- Distribution Retirements	$ (4,000,000)
Net Distribution	$ 25,000,000
- Transmission Additions	$ 6,000,000
- Transmission Retirements	$ (1,000,000)
Net Transmission	$ 5,000,000
Addition to Plant, net of retirements	$ 30,000,000
Accumulated Depreciation Accruals on T&D Plant, 10/1/05 through 12/31/05	$ (22,000,000)
Accumulated Depreciation-Retirements	$ 5,000,000
Deferred FIT	$ (3,000,000)
Total Electric Rate Base	**$ 10,000,000**
Net of Tax Rate of Return	7.00%
Operating Income Requirement	700,000
Net of Tax Depreciation	$ 200,000
Adjustment to Net Operating Income	900,000
Conversion Factor	0.6207334
Revenue Requirement Deficiency	**1,450,000**

The above calculations are hypothetical, to illustrate how such an adjustment could be made. Using this example, an adjustment would be made to increase Puget's electric revenue requirement by $1.45 million.

Q. Does that conclude your prefiled direct testimony?

A. Yes.