EXHIBIT NO. ___(CEP-11T)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: COLLEEN E. PAULSON

**BEFORE THE**
**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| **WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,**<br><br>**Complainant,**<br><br>**v.**<br><br>**PUGET SOUND ENERGY, INC.,**<br><br>**Respondent.** | **Docket No. UG-040640**<br>**Docket No. UE-040641**<br>**(*consolidated*)** |
| **In the Matter of the Petition of**<br><br>**PUGET SOUND ENERGY, INC.**<br><br>**For an Order Regarding the Accounting Treatment for Certain Costs of the Company's Power Cost Only Rate Filing.** | **Docket No. UE-031471 (*consolidated*)** |
| **In the Matter of the Petition of**<br><br>**PUGET SOUND ENERGY, INC.**<br><br>**For an Accounting Order Authorizing Deferral and Recovery of the Investment And Costs Related to the White River Hydroelectric Project.** | **Docket No. UE-032043 (*consolidated*)** |

**PREFILED REBUTTAL TESTIMONY OF**
**COLLEEN E. PAULSON (NONCONFIDENTIAL)**
**ON BEHALF OF PUGET SOUND ENERGY, INC.**

**NOVEMBER 3, 2004**

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY OF COLLEEN E. PAULSON**

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**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY OF COLLEEN E. PAULSON**

## I. INTRODUCTION

**Q. Are you the same Colleen E. Paulson who submitted direct testimony in this proceeding on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?**

A. Yes, I am.

**Q. What is the purpose of your rebuttal testimony?**

A. I respond to the testimony of other parties with regard to cost of service for both electric and natural gas service and identify a number of areas where the Company's case was mischaracterized or incorrectly interpreted. In these cases, this testimony is intended to clarify the Company's initial position and point out inaccuracies in the testimonies of other parties. I also identify which proposals from other parties are considered acceptable alternatives to the Company's pre-filed proposal.

## II. PSE'S RESPONSE TO GENERAL OBJECTIONS TO ITS COST OF SERVICE STUDY

**Q. Have you reviewed the criticisms of the Company's cost of service study?**

A. Yes. There are two types of criticisms; criticisms leveled at a policy and methodological level and criticisms related to the classification and allocation of specific costs. In this section, I first address the over-arching policy and methodological issues.

**Q. What are the major criticisms of the Company's proposed cost of service methodology?**

A. First, Commission Staff and Public Counsel raise objections based upon the outcome that results in shifting costs on to the residential class. Second, Public Counsel appears to object on the basis that the Company's proposal deviates from Commission Basis. Finally, Public Counsel incorrectly characterizes the Company's methodology as using the minimum system method that this Commission has previously rejected.

### A. COST SHIFTING AND CUSTOMER CLASS IMPACTS

**Q. Should decisions regarding cost of service methodologies be determined based on the impacts a particular methodology may have on a given class of service?**

A. No. Cost of service decisions should *not* be made on the basis of targeting an outcome, but should be made based solely on reflecting cost causation. If non-cost drivers are allowed to influence the choice of cost of service methodologies, the cost results no longer provide an effective benchmark by which to measure the effectiveness or appropriateness of alternative rate

**Q. Please give an example of separating out cost causation in cost of service from other considerations?**

A. Take for example, Mr. Lazar's concern regarding the allocation of distribution plant. Mr. Lazar states that the methodology "... imposes additional costs on many low-income and fixed income residents of multi-family units who can least afford these increases." [1] Although this may be an appropriate concern, this argument is not appropriate in the context of the cost of service analysis, and is more appropriately addressed in the rate spread and rate design steps of this case or through other means.

**Q. Should the results of the Company's cost of service study by strictly applied to identify class revenue requirements?**

A. No. The purpose of conducting a cost of service study, as described by the Commission in Docket No. UE-920499 [2] is to determine the contribution each class makes to the Company's overall revenue requirement based on an analysis of cost causation for the utility system. However, the Commission has traditionally

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[1] See Mr. Lazar's testimony at page 25 at lines 7 to 9 of Exhibit No. __ (JL-1T).

[2] See Ninth Supplemental Order in Docket No. UE-920499 at page 6.

used the results of this study as one tool, rather than the exclusive tool, for deciding rate spread, or how much of an approved increase should be recovered from each class.

> Third, the commission may consider non-cost factors in determining whether rates are fair just and reasonable and sufficient. These statutory tests do not inherently connote the strict application of cost study results. Instead, they not only suggest but require the exercise of judgment. Other non-cost elements that the commission may consider include "rate shock", or the need of an affected class of customer to bear required increases gradually, and susceptibility of a customer or class to receiving competitive service. Sometimes pertinent factors lead in different, even opposite, directions.
>
> Rate spread and rate design therefore call forth the exercise of commission judgment in light of the best cost information available.[3]

**Q. How can the issue of ability to pay be addressed outside of cost of service?**

A. The rate spread and rate design steps are the next steps in the ratemaking process after cost of service. In these steps, consideration may be given to the impacts the proposed pricing structure would have on customers subject to that pricing structure. For example, the amount of increase spread to a class may be reduced. In addition, there are other means currently available to address the ability to pay issue. This assessment is easier and more transparent when starting with a cost of service that has not been influenced by non cost considerations.

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[3] See Fifth Supplemental Order in Docket No. UE-940814 at page 17.

**Q. What other means are currently available to address the non-cost consideration of low income customer's ability to pay?**

A An example is the Commission approved implementation of a low- income program for PSE's gas and electric customers. This program provides assistance through fourteen community service agencies to customers' qualifying as low income. The Company's low-income program is based on an annual funding target of $10,000,000. In the test year, this program assisted about 20,000 households. In addition, the Company has conservation programs targeted to assist its low-income customers.

Given these type of programs, there is no need to make modifications to the underlying cost of service methodology.

## B. COMMISSION BASIS

**Q. Is it sufficient reason to reject a proposed cost of service methodology solely on the basis of it being other than Commission Basis?**

A. No. "Commission Basis" just means that the study or methodology reflects the outcome of the last litigated case decided by the Commission. For the natural gas industry, that was Docket No. UG-940814; for electric that was Docket No. UE-920499. It is appropriate to make changes to the cost of service methodology in response to the evolution of the industry, changes in the Company's cost structures and new studies analyzing cost causation. The proper place to revisit such issues is in a rate case.

In this case, PSE presents more detailed analysis of costs based upon information that it did not have ten or twelve years ago. In addition, the Company also has a different electric resource mix than it had during the last rate design case. Rather than dismissing proposals out of hand just because they are new or because the Commission did not accept a proposal in past proceedings, the proposal should be considered in light of whatever new information may be available.

**Q. Do you have any comments regarding Public Counsel's summary of rate design and cost of service decisions in Washington?**

A. Yes. Mr. Lazar has laid out his opinion of these decisions in his Exhibit No. __(JL-3). However, his exhibit excerpts parts of Commission orders without providing the full context. Also the exhibit does not include more recent Commission decisions on some items. For example at page 17 of Exhibit No. __(JL-3), Mr. Lazar does not mention a decision in 1994 in which the Commission accepted a cost of service study that classified 100% of service costs as customer related.[4]

[4] See page 15 of the Fifth Supplemental Order in Docket No. UG-940814 (the last sentence in Section G). Footnote 7 in the Order clarifies that the Company's proposal which was accepted by the Commission treated service costs as 100% customer related for the purpose of rate design.

## C. MINIMUM SYSTEM VS. DIRECT ASSIGNMENT

**Q. Public Counsel argues that the Company is using the minimum system cost allocation method that has been rejected by the Commission, is Mr. Lazar correct?**

A. No. A defining element of the minimum system method is the separation of distribution costs into customer and demand components followed by the allocation of those costs according to the appropriate allocation factor(s). The Company's cost study unequivocally does not use that method since all distribution costs (other than those classified as customer related using the Basic Customer Method) are classified as demand related and are allocated according to non-coincident peak demands.

**Q. Please clarify the methodology that the Company did use to allocate distribution costs that were not subject to the Basic Customer Methodology.**

A. The Company's proposal relies on direct assignment of costs and allocates these remaining joint costs solely on the basis of non-coincident demands (NCP demands). Use of NCP demands have historically been used by this Commission for allocating distribution costs.

**Q. The Company's proposal makes use of direct assignments and presents that as an improvement over reliance on indirect allocations methods. Is this consistent with Commission precedent?**

A. Yes. In its order in Docket No. 89-2688-T, the Commission describes the cost of service process as follows:[5]

> ...cost-of-service studies analyze the revenue requirements of various customer load classes on the basis of cost incurrence. *After direct assignment of any costs which are directly assignable to a particular class*, the remaining costs are assigned using three basic steps... (emphasis added).

The use of direct assignments of costs to customer classes is preferred to the alternative three-step process of cost of service.

**Q. Please describe the three-step process used to assign remaining costs?**

A. Mr. Higgins at page 8 of his testimony for Kroger presents the three steps of the cost of service process:

> Cost-of-service analysis is conducted to assist in the determination of appropriate rates for each customer class. It involves the assignment of revenues, expenses, and rate base to each customer class, and includes the following steps:
>
> - Separating the utility's costs in accordance with the various functions of its system (e.g., production, transmission, distribution);
> - Classifying the utility's costs with respect to the manner in they are incurred by customers (e.g., customer-related costs, demand-related costs, and energy-related costs); and
> - Allocating responsibility for causing the utility's costs to the various customer classes."

This description is consistent with my understanding of the process and prior Commission orders describing the process.

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[5] See page 70 of Third Supplemental Order in Docket No. U-89-2688-T.

**Q. In your opinion why is direct assignment preferable to the three step cost of service method which relies on indirect allocation methods?**

A. Direct assignment is preferable since it reduces debate over the calculation of indirect allocation methods. These indirect methods typically involve allocation of cost based upon proxy measures such as energy, demand and counts of customers. In this case, for example, a major issue for both the natural gas and electric cost of service studies is the allocation of shared plant using customers' peak demand. If it were possible to directly assign all costs, debates over such issues as the definition of peak could be avoided. The Company's proposal is an important step in this direction.

**Q. How did the Company use direct assignments in it proposal?**

A. The Company first reviewed its costs to identify where direct assignment is feasible. We found that distribution facilities costs were most readily and appropriately directly assigned given the current available record keeping and information. Based on that information, the proposed methodology was developed for transformers, circuits and substations.

**Q. Is it a precondition for direct assignment of costs that those costs be classified as customer related?**

A. No. The classification step of the three step cost of service process *is not necessary* when costs are directly assigned. The classification of costs (to demand, energy and/or customer) is a convenience for the rate design step of ratemaking and not a requirement for cost allocation. In this case, the directly assigned electric distribution costs are classified as demand, consistent with the last approved method regarding classification of distribution plant.[6] Public Counsel also supports this classification method.[7]

**Q. Does the Company's proposed method regarding distribution plant conflict with the Commission Basis method of Basic Customer?**

A. No. The Company's cost allocation schema does not change the Basic Customer method.

## III. ELECTRIC COST OF SERVICE

### A. Overview

**Q. Has the Company reviewed the pre-filed direct testimony of the intervenors on the subject of the Company's proposed electric cost of service?**

A. Yes. In general, intervenors' testimony regarding electric cost of service focused on the following elements:

- *Peak Credit Methodology* (used to classify production and transmission costs into demand and energy components).

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[6] That is distribution plant that is not subject to the Basic Customer method.

[7] See Mr. Lazar's testimony in Exhibit No. __(JL-1T) at page 24.

- *Coincident Peak (CP) Demand Allocation Factor* (used to allocate production and transmission costs classified as demand related).

- *Allocation of Distribution Plan,* and

- *Allocation of A&G Expense.*

Ms. Steward on behalf of Commission Staff recommends that the Commission not accept the Company's cost of service methodology in this case. In general, Ms Steward is concerned about the potential impacts of the Company's proposed direct assignment allocation methodology, rather than errors in calculations or application. Nonetheless, Commission Staff states that the Company's proposal may warrant a broader policy discussion. Commission Staff does state that it may be time to reevaluate some of the Commission's previously accepted methodologies.

Mr. Schoenbeck on behalf of ICNU has proposed modifications to the peak credit calculation as well as to the calculation of the coincident peak (CP) allocation factor. The CP allocation factor is used in conjunction with the peak credit results to assign production and transmission costs to the rate classes in the cost of service study.

Mr. Lazar's cost of service testimony, on behalf of Public Counsel, The Energy Project and A.W.I.S.H, selectively argues for retaining his view of Commission Basis methodologies as it pertains to cost of service. His proposals for modifying the Commission Basis cost of service methodology reduce the amount of costs assigned to his constituency (such as his proposed modification to the Commission Basis of allocating certain A&G expense) while he rejects other changes to Commission Basis that would shift costs towards his customer base (such as the direct assignment of distribution costs). In addition, Mr. Lazar proposes a change that shifts costs away from the residential class through his theories of unbundled rate of return.

Mr. Higgins, on behalf of Kroger, supports the Company's proposed changes to the distribution allocation methodology, but advocates for a revision to the peak credit methodology so as to include 100% of the capital cost and fixed O&M costs of the CT, the proxy peaking resource.

## B. Peak Credit Methodology

**Q. What is the peak credit methodology?**

A. The peak credit methodology is the method used to classify production and transmission costs between demand and energy. Peak credit is also applied to conservation costs and is relied upon for certain components of the PCA mechanism.[8] In this case, roughly 74% of the total electric cost of service is classified (either directly or indirectly) based on the peak credit factor.[9]

The use of the peak credit methodology by the Commission to split production

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[8] See page 7 of Settlement Terms for PCA in Docket No. UE-011570.

[9] From Exhibit No. __(CEP-13) page 30.

and transmission costs components into demand and energy goes back to the early 1980's.

**Q. Please summarize the Company's proposal regarding peak credit.**

A. The Company's peak credit calculation applies the methodology adopted in Docket No. UE-920499. The calculation compares the cost of a proxy capacity resource to the cost of a proxy base load generation resource. In the last rate case, as well as in the Company's original filing in this case, the proxy capacity resource was based on 50% of the capital and fixed O&M costs of a simple cycle combustion turbine (CT) "reflecting the fact that CTs provide benefits in addition to peak capacity."[10]

**Q. Have you prepared a table comparing the results of the various peak credit proposals submitted in this case?**

A. Yes. The following table is a comparison of the results of the various peak credit calculation proposals.

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[10] See Ninth Supplemental Order in Docket No. UE-920499 at page 9.

| Party | Demand Factor | Energy Factor |
|---|---|---|
| PSE Direct[11] | 13% | 87% |
| ICNU Response[12] | 16% | 84% |
| Kroger Response[13] | 21% | 79% |
| PSE Rebuttal[14] | 21% | 79% |

**Q. Does the Company agree with Mr. Schoenbeck's and Mr. Higgins' proposal to increase the percentage of the CT for the peak credit calculation?**

A. Mr. Schoenbeck and Mr. Higgens propose using 100% of the CT capital and fixed costs for the proxy capacity resource rather than the 50% proposed by the Company in its direct testimony. In their opinion, the 50% assumption understates the value of capacity on the PSE system. The 50% was a qualitative assessment of the benefit of the CT's value associated with firming the hydro system in low-water years.

The Company believes there is some merit to their argument that the current calculation may understate the cost of capacity. The percent of PSE's energy sourced from hydro has been declining more or less steadily as shown in the chart below. In 1978 (when, according to Mr. Lazar, the peak credit concept was first

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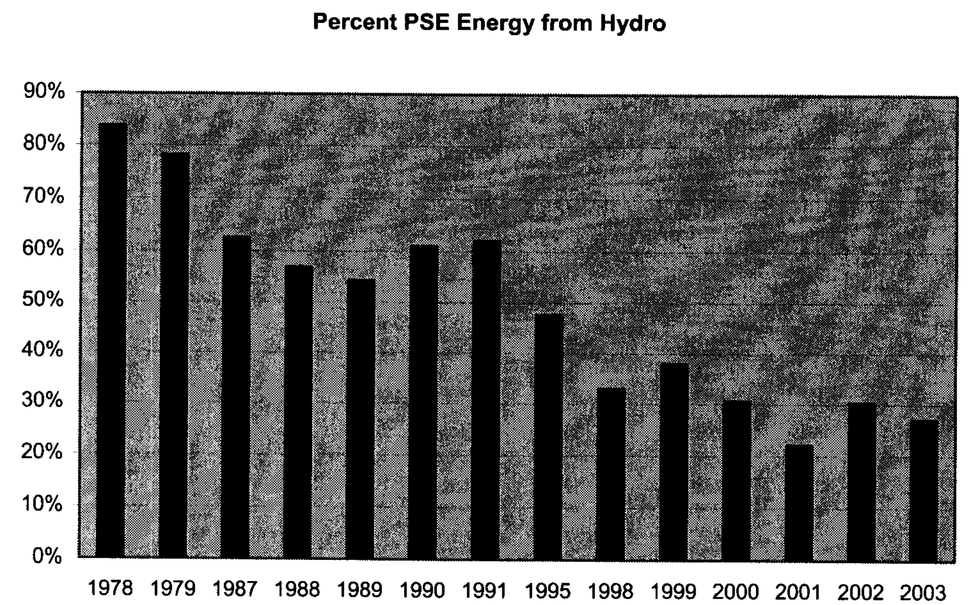
[11] See Exhibit No. __ (CEP-10).

[12] See Exhibit No. __(DWS-1HCT) at page 33.

[13] See Exhibit No. __(KCH-2) at page 3.

conceptualized), the percent of total energy production sourced from hydro was over 80%. In 1992, when the order in Docket No. UE-920499 was being developed hydro amounted to approximately 60%. Today, hydro represents only approximately 30% of the portfolio.




This suggests that it would be reasonable to reconsider the role of the CT and the percent that should be allocated to hydro firming in the peak credit calculation. On the other hand, given that as recently as April 2003 in the Company's Least Cost Plan CTs have still been identified as having multiple benefits, it may not be appropriate to completely abandon the concept of allocating only a part of CTs as a peak cost. [15]

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[14] See Exhibit No. __(CEP-13) at page 3.

[15] See page 3 Chapter IX - Electric Load-Resource Outlook, April 2003 Least Cost Plan.

**Q. What does the Company propose regarding this matter?**

A. The Company proposes using 75% of the CT's capital and fixed costs for the peak credit calculation as a reflection of the declining role of hydro in PSE's system.

**Q. Are there other aspects of Mr. Schoenbeck's proposal regarding the peak credit calculation that the Company reviewed?**

A. Yes. Mr. Schoenbeck states that the CT fuel cost assumptions (both natural gas and oil) should be adjusted to reflect a premium over average annual fuel costs. Mr. Schoenbeck suggests that fuel costs during peak periods are far greater than average annual fuel costs.

**Q. Does the Company support Mr. Schoenbeck's proposal to include a fuel premium for the peaking resource in the peak credit method?**

A. It may be appropriate to apply a premium to natural gas during the peak periods. However, the Company does not believe it is appropriate for oil costs since there is sufficient oil storage capacity to meet the 50 hours of oil burn assumed in the peak credit calculation. The following table shows the oil storage capacity for PSE's CTs and the number of hours of oil burn supported by the storage tank capacity.

| Combustion Turbine Units | PSE Storage Tank Capacity (Gallons)[16] | Run Hrs @ Storage Capacity |
|---|---|---|
| Frederickson 1 & 2 | 4,300,000 | 286 |
| Fredonia 1 - 4 | 4,300,000 | 137 |
| Whitehorn 2 & 3 | 4,300,000 | 298 |

**Q. What does the Company propose regarding this matter?**

A. A peak period premium adjustment should *not* be made for the 50 hours of oil burn for the CT. The Company proposes adjusting the cost of natural gas for the 150 hours for the CT to reflect a premium in the cost of natural gas during critical peak periods. Absent an alternate study, the Company proposes using the 70% premium identified by Mr. Schoenbeck.

While reviewing the gas costs included in the study, the Company found an error in that the original proposal did not include costs associated with firm transportation of the commodity. The Company proposes that this correction be included as well.

**Q. Are there other aspects of their proposal regarding the peak credit calculation that the Company supports?**

A. Yes. Mr. Schoenbeck correctly identified an error in the calculation in that property taxes should be included in the cost of the proxy capacity resource.

Further Mr. Higgins has pointed out some minor spreadsheet errors in the calculation. PSE has adopted these changes.

**Q. Have you calculated a revised peak credit factor that incorporates these items?**

A. Yes, Exhibit No. ___ (CEP-12) shows the results of these modifications on the peak credit results. The calculation uses 75% of the capital and fixed cost of the CT for the proxy resource cost, applies a premium of 70% to the natural gas fuel cost used by the CT for 150 hours and includes the cost of firm transportation. Also, the revised calculation utilizes a fixed charge rate which incorporates property taxes, O&M and capital recovery over the life of the plant.

The result of this calculation is that 21% of production and transmission related costs are classified as demand related and the remainder - 79% -is classified as energy related.

## C. Coincident Peak (CP) Demand Allocation Factor

**Q. What is the CP Demand Allocation Factor and how is it used in the cost of service study?**

A. The CP demand allocation factor is used to allocate production and transmission costs that have been classified as demand related based on the peak credit factor. Generally, the more hours included in the calculation, the lower the percentage of

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[16] From April 2003 Least Cost Plan, Appendix E - SCGT Operational Considerations.

costs assigned to the residential class. The selection of which hours to use is based on an analysis of total system peak load. Once the appropriate hours are selected (200 hours in the Commission Basis), the class level contributions to each hour is determined, using load research data, assumptions regarding losses, etc. The resulting class estimates are then adjusted to reflect normal temperature. These then form the basis for allocating production and transmission related costs.

**Q. Do you agree with Mr. Schoenbeck's assertion that using the 200 highest system peak hours in the CP demand allocation factor needs to be reconsidered?**

A. Yes, the Company agrees it should be reconsidered, but has not done any studies in order to develop a recommendation for an alternative.

Mr. Schoenbeck argues that there is too wide of a range in the magnitude of the hourly demand estimates within the 200 highest system peak hours.

Mr. Schoenbeck correctly points out that the peak responsibility of certain classes (those having poorer load factors) are benefited when more hours are included in the calculation. The Company agrees that this may result in an under allocation of demand costs to these relatively poorer load factor classes.

Regarding planning assumptions - over the years, discussion on this topic have focused on the difference between the number of hours in the test year in which the CT was *planned* to operate versus the number of hours in recent years that the CT *actually* operated. Given the objective of the peak credit calculation to be forward looking, it seems appropriate to reflect planning assumptions in this calculation.

Q. **What does the Company recommend regarding the number of hours to use in the CP Demand Allocation factor?**

A. The Company recommends continuing to use 200 hours for the calculation of CP Demand Allocation Factor until such time as a complete study is available on which to base a change.

## D. Allocation of Distribution Plant

Q. **Please summarize the issue surrounding the allocation of distribution costs?**

A. The Company has proposed a new methodology to assign the demand related costs on the distribution system. The new approach analyzes customer / class demands at the transformer, circuit and substation level versus the current method that ignores which customer class is using the components of the system. Mr. Lazar incorrectly characterizes this as utilizing the minimum system methodology. As discussed above, the objective of the minimum system method is to identify customer and demand components of the overall system.

The allocation basis for each type of plant is based on a combination of direct assignment and allocation factors for plant that was not directly assigned. In the last approved cost of service the Company allocated meters and services based upon the customer classes using those facilities.

Here, the focus is in the cost of service debate for distribution costs is centered on the assignment of costs associated with the following subset of plant accounts: distribution substations, overhead conductor and related poles and fixtures, underground conductor and conduit, and line transformers.

**Q. Please summarize why the Company's proposal is preferable to the Commission Basis.**

A. The Company's proposed cost of service applies three important Commission approved principles. First, direct assignments of costs are preferred to indirect cost allocations. The second principle is that customer costs should be based on the Basic Customer methodology. The third principle is that the distribution costs not considered in the Basic Customer methodology should be classified as being demand related costs.

**Q. How does the Company's proposal apply these principles?**

A. First, the Basic Customer method is used exclusively for determining customer related costs. Second, direct assignment is used to assign costs to the actual classes taking service from any distribution plant not included in the Basic Customer method. Third, these directly assigned costs are classified as demand related.

**Q. How does the Company's distribution cost allocation proposal compare to the method approved by the Commission over a decade ago?**

A. In the 1992 Puget case in Docket No. UE-920499 (the most recent order addressing this issue), less than 2% of total distribution plant was directly assigned. The remaining 98% was allocated using indirect allocation.[17] These indirect allocation factors did not include any consideration of what equipment was actually used by the different customer classes. For example Schedule 26 customers may not use a specific transformer, however though indirect allocation they may get a share of that transformer's cost. In this proceeding, the proposed methodology reflects the use customers in a class make of a substation, circuit, or transformer. This process results in a cost study which better reflects cost causation.

**Q. Please explain.**

A. In the Company's proposed study *all* distribution line transformers and *all* distribution circuits and substations are each individually analyzed to determine the *actual* customer or customers served from the facility. Each individual facility is then directly assigned to the specific class or, at most, subset of classes served from the specific facility based on this inventory of actual customers served. If a particular facility serves more than one class of customer, the facility is assigned to the participating classes of customers pro rata based on each of the actual classes of customers' demand on the facility. This process precludes the double counting to which Mr., Lazar incorrectly attributes to the proposed methodology. See Mr. Lazar's testimony at page 23 in Exhibit No.__ (JL-1T).

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[17] See Revised Attachment 1 in Response to Bench Request No. 515-e dated October 21, 1993 at pages 11-13 in Docket No. UE-920499.

**Q. Does the proposed method, as Mr. Lazar represents, double count the cost of providing transformation to the residential class?**

A. No. Each transformer on the distribution system is assigned to only those customers who use the transformer. Once a customer is assigned to a transformer, neither the customer nor the customer's load is used to assign additional transformer costs to the class. There are no *residual* transformers which would potentially result in double counting.

**Q. Commission Staff expresses concern about the cost shifts that result from the proposed method. Please comment.**

A. The Company's proposal is to implement improved costing methodologies based on extended use of direct assignment, the benefit of which is to better reflect the cost to serve each class. Considerations of the proper rate making response to shifting parity ratios as a result of improved costing methodologies should be addressed in the rate spread and rate design steps.

**Q. Commission Staff, at page 3, is concerned that the proposed allocation methodology does not reflect design considerations of the distribution system. Please comment.**

A. The assignment of costs in the proposed study does reflect both design and operation of the distribution system. As Ms. Steward points out, the system is designed with multiple loops or connections for, among other things, enhanced reliability. By assigning each circuit to customers on the given circuit based on their load on that circuit, a circuit that is not fully loaded for reliability considerations is allocated pro rata to the classes based on their demands on the circuit. Therefore classes that receive enhanced reliability pay for it.

**Q. Please comment on Commission Staff's contention that the Company's methodology brings the issue of customer density into the discussion.**

A. The Company's proposal identifies the cost of serving each of the customer classes that uses the distribution system. To the extent part of the distribution system serves customers in rural areas, more costs are assigned to those customers as a result of a lower load density on the circuit. This cost allocation approach can result in inter-class and / or intra-class equity issues. The Company is not proposing to use the study to establish urban versus rural rate classes. The issue of cross subsidization, to the extent that it may exist, is a separate policy issue to consider outside of the context of the Company's proposal. As previously noted, the rate and parity implications associated with the utilization of more accurate cost allocation methodology should be addressed in rate spread and rate design and not be used as a rationale to forego improved cost allocation.

**Q. Commission Staff notes that the proposal does not assign transformer costs to the lighting schedules. Is this a critical issue?**

A. No, this is not a critical issue. Lighting represents 0.5% of the distribution system's non-coincident peak. Since transformers are allocated on non-coincident peaks, lighting will only be allocated a small portion of the transformer costs. Just because 0.5% of the load can not be directly assigned to a transformer, improved cost allocation should not be abandoned.

Nevertheless, the Company agrees that transformer costs should be allocated to the lighting class and proposes to make a cost assignment based on lighting class NCP demand. The transformer costs could then be removed from the costs directly assigned to each class using the Company's proposed method, pro rata.

## E. Allocation of A&G Expense

**Q. Please describe the Commission Basis for A&G Expense allocation.**

A. The methodology allocates more than $40 million of the total $75 million of A&G expense based on the overall results of allocating production (not including purchase power and fuel costs), transmission, distribution and customer service related expense. The remaining A&G costs are allocated primarily based on a salary and wage allocation factor.

In this case, prior to the Company spreading A&G costs, it first directly assigned the administrative salary costs of personnel assigned to serve large customers. The Company's proposed allocation is shown on Exhibit No. __ (CEP-13) pages 9 and 10 of 31. The exhibit shows the allocation method and the amount of A&G expense allocated to each class of service as based on the allocation method.

**Q. Please summarize the methodology change proposed by Mr. Lazar.**

A. Mr. Lazar proposes to allocate A&G expense using a combination of 50% energy and 50% on the current Commission Basis method. Mr. Lazar is concerned that

PSE's large electric customers who do not buy electricity from PSE are not properly sharing in the allocation of these costs under the Commission Basis method. To address this, Mr. Lazar proposes an application of the method utilized in the natural gas Commission Basis, which has a similar issue with its transportation customer class.

**Q. Do you agree with his proposal?**

A. I agree it is an appropriate issue to investigate. However, I do not think it is appropriate to simply apply a method used elsewhere without exploring other available options. Also, as already pointed out, the Company's proposal includes several direct assignments intended to address this specific issue.

The costs that Mr. Lazar is particularly concerned about are the costs associated with the fact that "...The Company assigns high level personnel to work with and meet with large-use customers...."[18] Rather than applying another indirect allocation factor to these costs as Mr. Lazar proposes, the Company recommends directly assigning costs associated with serving the large customers and retaining the Commission Basis method for the remaining costs. The Company's proposal in its prefiled cost of service study did in fact directly assign a portion of costs in FERC Accounts 902, 903 and 920 to large customers in an attempt to address the very issue Mr. Lazar identifies.

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[18] See Mr. Lazar's testimony at page 21 of Exhibit No. __ (JL-1T).

**Q. What do you recommend?**

A. For purposes of this proceeding, the Company's proposed methodology for allocating A&G Expense should be accepted. Until further basis for Mr. Lazar's cost allocation is developed the Company recommends that his proposal not be adopted since it would likely result in double counting the costs.

**Q. Has the Company incorporated unbundled cost of capital in its cost of service study as recommend by Mr. Lazar?**

A. No. Dr. Cicchetti in his rebuttal testimony explains why the unbundled cost of capital is not appropriate.

**<u>F. Summary of Effects of Proposed Changes</u>**

**Q. Have you calculated an electric cost of service which incorporates the changes described above and reflects the revenue requirement presented by Mr. Story?**

A. Yes. Exhibit No. ___ (CEP 13) is a recast of the Company's proposed cost of service at the revenue requirement presented by Mr. Story and incorporating the changes discussed previously.

## IV. NATURAL GAS COST OF SERVICE

### A. Overview

**Q. Has the Company reviewed the testimonies of the other parties on the subject of the Company's proposed natural gas cost of service?**

A. Yes I have. In general, intervenors' testimony regarding natural gas cost of service focused on the following elements:

- *Definition Of Peak Day* (used to classify and allocate main costs),
- *Classification Of Main Costs* (used to classify main costs into demand and commodity components), and
- *Transportation Service* (as a component of the service provided to customers).

Mr. Russell takes issue with the peak day calculation claiming that it is not Commission Basis. He explains the Commission Basis methodology for classifying and allocating distribution main - the peak and average methodology. And, although he does not propose an alternative to the peak and average methodology, he questions its basis and application.

Mr. Schoenbeck on behalf of NWIGU and CMS generally supports the Company's proposed cost of service but take issue with how the cost of service results are implemented in rate spread and rate design for large volume and transportation service customers. Mr. Yarborough (on behalf of NWIGU) and Mr. Lehmann (on behalf of CMS) express similar concerns.

Mr. Young on behalf of Seattle Steam expresses concerns with how the cost of service results are implemented in rate spread and rate design for large volume and transportation service customers.

Mr. Lazar takes issue with the definition of peak day used in the natural gas study and claims the Company calculation is not Commission Basis, although represented to be so by the Company. Additionally, Mr. Lazar applies his unbundled rate of return approach to the natural gas cost of service.

## B. Definition of Peak Day

**Q. Please describe the issue.**

A. One of the key assumptions in the natural gas cost of service study is the definition of peak day. As is the case for electric cost studies, a key consideration in selecting cost of service methodologies is the degree to which the allocation factor adequately reflects cost causation.

The debate often includes a discussion of design day (the temperature at which the natural gas distribution is planned/designed to be operated in order to ensure that the distribution system can meet extreme peak requirements and constraints) versus the recent or actual peak days experienced by the Company.

Allocation factors based on design day peak day usually result in more costs being allocated to the residential class of customer, while allocations based on actual peak day result in fewer costs being assigned to residential class. This is due to the fact that at design day temperatures, it is assumed (and it is the practice as demonstrated in the recent extreme peak period experienced in January 2004) the large volume customers' interruptible load is curtailed so that only their firm requirements are served.

**Q. What method has the Company used?**

A. The Company used the Commission Basis method - the same method that was used as the basis of settlement in the 2001 general rate case natural gas settlement. As Mr. Lazar points out in his testimony at page 37 line 19, Commission Basis refers to the five highest days in the most recent three years whether consecutive or not. At page 5 of my direct testimony I present the five days that were used in the peak day calculation. As shown, the five days include 4 days during the January 2004 cold snap and a day in December 2003.

**Q. Is Mr. Lazar's contention that the Company uses only a single day to establish the peak day correct?** [19]

A. No. The Company used the five highest days in the most recent three year period.

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[19] Exhibit No. __ (JL-1T) at page 35.

**Q. Mr. Lazar describes the Commission Basis as being the five highest days in the most recent three years whether consecutive or not. Mr. Russell says that it is the five highest days in each of the three most recent years. What is the Company's opinion?**

A. The Company's interpretation is that the current Commission Basis method (in practice) is the five highest days in the most recent three years whether consecutive or not. This method was used in the Company's proposed cost of service.

## C. Classification of Main Costs

**Q. Please comment on Mr. Russell's testimony regarding the peak and average method of classifying main costs?**

A. Mr. Russell testifies that the Commission Basis method of classifying main costs when calculated for the test year in this GRC overstates the amount of demand related costs, even when calculated using Commission Staff's definition of peak day. Commission Staff argues that the 58% that would be classified as demand is too high based on an analysis done for the 2001 rate case. The Company has some concerns with the assumptions that form the basis of Commission Staff's alternate main classification methodology. However, since Mr. Russell is not advocating using the alternate methodology in this case, it is not necessary to debate the issue at this time.

## D. Transportation Service

**Q. Please summarize the concerns raised by CMS, Seattle Steam and NWIGU regarding transportation cost of service.**

A. Seattle Steam suggests that they are different from Schedule 87 customers because they are a non-firm transportation customer, while CMS argues for a non-discriminatory rate in order to remove barriers if any for customers desiring to switch between sales and transportation service. NWIGU supports the Company's prefiled cost of service, however Mr. Schoenbeck links the rate design for certain components across the large customer classes.

**Q. What is the Company's response?**

A. Delivery service aspects of the current Schedule 87 and 57 are the same. Some of the differences in parity are probably the result of the direct assignment of delivery costs. Absent the Commission designing customer specific rates, the recommended approach to creating stable non-discriminatory rates between sales service and transportation service is to create a single class. This results in similarly situated customers with regards to transportation receive similar treatment in cost of service. Accordingly the Company has modified its prefiled cost of service proposal to combine these schedules.

Mr. Heidell's rate design differentiates between the costs that are attributed to transportation service vs. the costs that are attributed to sales service.

## E. Summary of Effects of Proposed Changes

**Q. Have you calculated a natural gas cost of service that incorporates the Company's cost of service changes and reflects the revenue requirement presented by Ms. Luscier?**

A. Yes. Exhibit No. __ (CEP-14) summarizes the recast of the Company's proposed cost of service at the revenue requirement presented by Ms. Luscier and incorporating the changes discussed previously. Exhibit No. __ (CEP-15) provides detailed results of the updated study.

**Q. Does that conclude your testimony?**

A. Yes, it does.

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