Exhibit No. __ (JOINT-19T)
Docket Nos. UE-060266/UG-060267
Witnesses: Jim Lazar
Donald Schoenbeck
Yohannes Mariam

BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**DOCKET NO. UE-060266** **DOCKET NO. UG-060267** ***(Consolidated)***

JOINT TESTIMONY OF JIM LAZAR, DONALD SCHOENBECK AND YOHANNES MARIAM

ON BEHALF OF

STAFF OF THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION
PUBLIC COUNSEL
THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

POWER COST ADJUSTMENT MECHANISM

July 25, 2005

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I. INTRODUCTION

Qualifications of Jim Lazar

Q. Please state your name and the party for whom you are appearing.

A. My name is Jim Lazar and I am appearing on behalf of Public Counsel. My business address is 1063 Capital Way S. #202, Olympia, WA. My qualifications are included in Exhibit No. __ (Joint-2) to my joint testimony on natural gas rate spread and rate design issues.

Qualifications of Donald Schoenbeck.

Q. Please state your name and the party for whom you are appearing.

A. My name is Donald Schoenbeck and I am appearing on behalf of the Industrial Customers of Northwest Utilities (ICNU), a non-profit trade association whose members are large industrial customers served by electric utilities throughout the Pacific Northwest, including Puget Sound Energy, Inc. My business address is 900 Washington Street, Suite 780, Vancouver, WA 98660. My qualifications are included in Exhibit No. __ (Joint-3) to my joint testimony on natural gas rate spread and rate design issues.

Qualifications of Yohannes Mariam

Q. Please state your name and the party for whom you are appearing.

A. My name is Yohannes KG Mariam and I am appearing on behalf of the Staff of the Washington Utilities and Transportation Commission. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504. My

qualifications are included in my response testimony on weather normalization, Exhibit No. __ (YKGM-1T).

II. SCOPE AND SUMMARY OF JOINT TESTIMONY

Q. What is the purpose of your joint testimony?

A. The purpose of this joint testimony is to present the recommendation of Staff, Public Counsel and ICNU (hereinafter collectively referred to as the "Joint Parties") on issues related to the Power Cost Adjustment ("PCA") mechanism of Puget Sound Energy, Inc. ("PSE", "Puget" or "the Company). We very briefly review the history of the current PCA mechanism, examine Puget's proposed changes to the PCA, and recommend improvements and changes that we think are necessary and important.

Q. What are your principal recommendations?

A. The current PCA mechanism should remain basically unchanged. It is working as designed. The dead band should remain at $20 million. The sharing bands should remain at the current levels of $40 million and $120 million. Power supply contracts should continue to be priced according to the current mechanism. We do support one change proposed by Puget: to include hedging expenses as an allowable cost within the PCA mechanism.

Q. How is your testimony organized?

A. Our testimony consists of the following elements:

- First, we very briefly discuss the history of power cost mechanisms and decisions by the Commission affecting these mechanisms since 1979.
- Second, we discuss how the current PCA mechanism is working more-or-less as expected, providing the stability of earnings the Company desires and the stability of rates that consumers desire.
- Third, we compare the current Puget PCA mechanism and the Company's proposed changes to the recent Energy Recovery Mechanism ("ERM") changes just approved for Avista Utilities by the Commission, concluding that the Puget's PCA is more favorable for shareholders than the ERM.
- Fourth, we discuss how Puget is in much better financial condition today than when the PCA was adopted, and how it could absorb a greater amount of power cost variation without experiencing greater financial risk than the original PCA mechanism involved. Under our proposal to allow hedging costs as a PCA-eligible expense, Puget will likely absorb less risk than at the time the PCA was adopted.
- Fifth, we discuss why most of Puget's proposed changes to the PCA mechanism are contrary to the public interest, unnecessary and should be rejected.
- Finally, we discuss the pros and cons of updating the current mechanism, and reach the conclusion that, at least for the present proceeding, the current mechanism should remain unchanged.

Q. Have you prepared an exhibit in support of your joint testimony?

A. Yes, it is Exhibit No. ___ (JOINT-20C), entitled "Earnings Per Share Impact of Existing PCA Mechanism and PSE Proposed Changes to PCA Mechanism".

III. POWER COST MECHANISMS AND DECISIONS

Q. Please describe the evolution of the current PCA mechanism?

A. Puget has had a drought surcharge in 1980-81, an Energy Cost Adjustment Clause ("ECAC") from 1982-88, a Periodic Rate Adjustment Mechanism ("PRAM") from 1991-96, and the current PCA from 2002 to present.

Q. Please describe the drought surcharge and how it came about.

A. Prior to 1979, Puget's rates were set based upon an average of the costs predicted to occur under a variety of historical hydro conditions, and those rates stayed in effect during any deviations from those weather conditions. In 1977, and again in 1979, the region experienced severe droughts. In 1980, the Commission rejected a proposed mechanism to flow through variations in power costs, stating that the mechanism proposed by the Company "would not establish a rate sufficiently specific to conform to the requirements of RCW 80.28.080."[1] The Commission did, however, authorize a one-time surcharge of $14.4 million over a six-month period to address the known and measurable impacts of the drought.

[1] Cause No. U-79-73, Order at 6 (Dec. 1979).

Q. Please describe the development and evolution of the ECAC mechanism.

A. The ECAC was established in Cause No. U-81-41. It initially allowed Puget to submit dockets every four months to flow through actual variable purchased power and fuel costs. It resulted in a succession of rate increases over time, as the Company acquired many new power supply resources by "contract" rather than by "ownership" during this period. The two company-owned resources added during the ECAC era – Colstrip units 3 and 4 – were large and expensive enough additions to trigger general rate cases in 1983 and 1985.

In 1988, the Commission reopened the original docket, Cause No. U-81-41, to hear evidence on whether the mechanism should be continued or changed. It eventually ruled that the ECAC mechanism would continue, but changed in two crucial ways:

- First, it would be changed to a six-month period, which allowed for seasonal synchronization of surcharges (or credits); excess costs incurred in one summer (or winter) were recovered in the subsequent summer (or winter).
- Second, only variations in cost resulting from weather would be included; new resources would no longer be included in ECAC proceedings.

The Commission clarified and emphasized that the ECAC was for tracking weather-related changes in cost, stating:

> The Commission wants every proposed cost change in an ECAC proceeding to be traceable to changing weather patterns. Other cost changes will be the subject of general or other rate proceedings.[2]

[2] Cause No. U-81-41, 6th Supplemental Order at 21 (Dec. 1988).

Q. Did other utilities seek power cost mechanisms during this period?

A. Yes. Washington Water Power ("WWP") secured a PCA mechanism in Idaho as part of a settlement of the abandoned project costs associated with the WPPSS #3 nuclear plant in 1988.[3] WWP then sought a PCA mechanism in Washington. In rejecting that request,[4] the Commission adopted specific principles to guide the establishment and retention of power cost mechanisms, including:

- A PCA should be linked to weather-related causes;
- A PCA should exclude the cost of long-term resource acquisitions; and
- A PCA mechanism should include a cost-of-capital adjustment reflecting the risk shift from shareholders to consumer.

Q. How long did the ECAC last after the 1988 review?

A. The Commission terminated the ECAC as part of Puget's 1989 general rate case.

Q. What was the next Puget power cost mechanism?

A. In April, 1991, the Commission approved what was known as the Periodic Rate Adjustment Mechanism, or PRAM.[5] The PRAM was comprised of two components. First, non-power costs were "decoupled" to be recovered on a "revenue per customer" basis. Second, power supply costs were to be recovered on an as-incurred basis, subject to specific protocols and definitions. Rates were adjusted annually

[3]Idaho Public Utilities Commission, Case No. U-1008-204, Stipulation and Settlement, dated April 26, 1988.
[4]Cause No. U-88-2363-P, 1st Supplemental Order at 8-9 (Sept. 1989).
[5]Docket Nos. UE-901183-T and UE-901184-P, 3rd Supplemental Order (Apr. 1991).

under the PRAM, truing up actual cost recovery for power supply, and implementing decoupling adjustments.

Q. How long was the PRAM in effect?

A. The PRAM was in effect until the Puget/Washington Natural Gas merger in 1996. The five-year rate plan that accompanied the merger stipulation and approval did not provide for rate adjustments other than those agreed to except upon showing of severe financial stress pursuant to a formula adopted by the Commission in its 1972 proceeding, *WUTC v. Pacific NW Bell Tel. Co.*, Cause No. U-72-30, 2nd Supplemental Order. The Company had no power cost mechanism from 1996 through 2002.

Q. When was the current PCA established?

A. The current PCA was negptiated as a part of the complex set of settlements in Puget's 2001 general rate case. There was an agreement on interim rate relief reached in March, 2002, which committed the parties to negotiate a PCA, and a final settlement in June that resulted in the current mechanism. The mechanism was not adopted for a limited term, but it contained one provision that applied only for the first four years – a cumulative "cap" on the amount of power cost exposure that Puget would be required to absorb of $40 million. That cap expired June 30 of this year. It is our understanding that the cap was never actually triggered – actual power cost variation over the 4-year period resulted in deferrals for Puget that were within the $40 million limit.

Q. What decisions has the Commission issued since the current PCA mechanism was adopted that provide guidance on how a PCA mechanism should be structured?

A. The two key decisions are the recent decision in the Pacific Power & Light Company general rate proceeding, Docket No. UE-050684, and the recent approval of changes to the Avista Utilities Energy Recovery Mechanism in Docket No. UE-060181.

Q. What is the guidance provided in the Pacific Power decision that is relevant to PSE's proposed changes to the PCA mechanism?

A. Puget's proposed changes appear to be seriously at odds with the recent guidance given by the Commission in the Pacific Power rate decision issued on April 17, 2006. *WUTC v. PacifiCorp d/b/a Pacific Power & Light Co.*, UE-050684, Order No. 04. ¶¶90-100. The Pacific Power decision reiterated previous determinations that a PCA mechanism needs to have specific benefits to consumers, and address only specific changes in power cost. The current Puget PCA meets those standards.

The Pacific Power decision also clearly enunciated that a "deadband" is an appropriate element of a PCA mechanism, citing this as a positive feature of the Puget and Avista mechanisms.[6] Puget's proposed changes eliminate the deadband.

Finally, the Pacific Power decision reiterates that there is a linkage between the characteristics of a PCA mechanism and the cost of capital and/or capital structure required for a utility. Puget's proposed changes shift risk without a

[6]Docket No. UE-050684, Order No. 04 at ¶¶ 93 and 96 (April 17, 2006).

corresponding reduction in the cost of capital or equity capitalization ratio. In fact, the Company is seeking an increased equity ratio, despite the fact that its financial risk has been reduced by the maturation of the existing PCA, and would be further reduced by the Company's proposed changes to the PCA. In the fifth section of our testimony, we show very clearly how Puget's proposal is incompatible with the guidance provided in the Pacific Power decision.

Q. What is the guidance contained in the Avista ERM settlement decision that has bearing on PSE's proposed changes to its PCA?

A. The Avista modifications approved by the Commission retained the deadband, which Avista originally proposed to eliminate. It reduced the size of the deadband and created a new 50/50 sharing band. Avista is a company with a lower bond rating, less equity, and much less ability to absorb power cost risk than PSE. As we will detail later in this testimony, Puget's current deadband and current sharing bands are very similar to those in the mechanism just approved for Avista. The Avista decision, if anything, suggests the deadband and sharing bands for Puget should be enlarged to reflect earnings and sales growth since they were originally adopted. We discuss this concept later in this testimony.

IV. THE PSE PCA MECHANISM IS WORKING AS EXPECTED

Q. What were the original goals of PSE's PCA mechanism as you understood them?

A. One goal was to protect Puget shareholders against severe earnings attrition caused by power cost variations beyond the Company's control. Another goal was to provide strong incentives for power supply cost control. A third goal was to provide relatively stable rates for electric consumers.

Q. How were these goals enshrined in the PCA mechanism?

A. The mechanism was designed so that Puget is at risk for only a portion of its power supply cost variations that result from weather or power market conditions. The amount of risk was designed to be only a fraction of the Company's "retention" each year. The term "retention" or "retained earnings" means the difference between the Company's annual earnings and the amount paid in dividends to shareholders. Because only a fraction of the retention was put at risk, Puget's ability to pay its dividend out of current earnings was no longer at risk due to weather or power market conditions.

Q. Why was the linkage between the PCA mechanism and the utility's earnings and retention important to the original design of the PCA?

A. Those of us who worked on the development of the original PCA understood that the financial communities look quite differently at companies that can pay their dividend out of current earnings year after year than they view utilities that need to dip into

prior retained earnings to pay current dividends. This approach balanced the need of shareholders for protection against extreme conditions with the need of electric consumers for a mechanism that resulted in strong incentives for utility cost control and relatively stable electricity prices.

Q. What are the specific elements of the PCA that achieve these goals?

A. First, the PCA mechanism holds the costs associated with the coal resources fixed. Inflation in some operating costs can be offset by declining rate base and/or other operating costs.

Second, the mechanism has a +/-$20 million "dead band", in which the Company absorbs any power cost variation. The Company bears the risk (or benefit) for the first $20 million of power cost variation.

Third, the mechanism has three "sharing bands", in which consumers shoulder an increasing share of the burden. The table below shows the dead band, sharing bands, and the Company's before-tax and after-tax exposure at each point. This shows that Puget's maximum earnings exposure due to power cost variations is about $27 million per year.

Figure 1

Puget Sound Energy Earnings Exposure Under Current PCA Mechanism

Current PCA Mechanism	Shareholder Exposure	Expense Level	Earnings Level @ 35%
First $20 million	100%	$ 20,000,000	$ 13,000,000
Next $20 million	50%	$ 10,000,000	$ 6,500,000
Next $80 million	10%	$ 8,000,000	$ 5,200,000
Over $120 million (at $200m)	5%	$ 4,000,000	$ 2,600,000
Total Exposure at $120 Million		$ 42,000,000	$ 27,300,000

Finally, the mechanism has a "trigger point" of $30 million in deferred power costs. If the amount of power costs attributable to consumers under the sharing bands exceeds $30 million, Puget is allowed to request a rate adjustment. The idea is that sometimes "dry" years are followed by "wet" years, and if the power cost deferrals are offsetting, there is no need to have rate changes. The $30 million deferral was determined to be a level that did not put Puget at severe financial risk. It is still within the "retention" band, where the Company's ability to pay dividends out of current earnings would not be impaired.

Q. How does the potential exposure of $27 million fit within the "retention" concept underlying the current PCA?

A. At the time the PCA was originally adopted, Puget had about 89 million shares outstanding. A $27 million earnings variation worked out to about $.30 per share. At the time, the Company's book value per share was $16.27, and the allowed return on equity in the 2002 proceeding was 11%, producing expected earnings of $1.79 per share. After paying the Company's dividend of $1.00 per share, the expected "retention" was about $0.79 per share. Thus, the PCA mechanism put Puget at risk for about 40% of its retention even if power costs rose by $200 million above the base level established in a general rate case. Coupled with the dollar-for-dollar recovery of prudently-incurred natural gas expenses in the Company's gas system PGA mechanism, this provided a very high level of certainty that Puget would be able to pay its dividend with current earnings from the utility operations.

Q. In fact, have Puget's utility earnings been adequate to support the dividend since the PCA was adopted?

A. Yes. The table below shows the Company's annual earnings per share from continuing operations (not including the effect of a one-time write-off of $70 million related to the non-utility Infrastrux operation) since the PCA was adopted. As is evident, the earnings have consistently exceeded the $1.00 dividend. This is despite the annual losses related to the regulatory disallowance for the Company's imprudent management of the Tenaska fuel contract, which has suppressed earnings during this period.

Figure 2

PSE Earnings Per Share
Not Including 2004 Infrastrux Writeoff

2002		**$ 1.13**
2003		**$ 1.21**
2004		**$ 1.26**
2005		**$ 1.43**

Q. Has the goal of providing relatively stable rates to consumers been achieved?

A. In our opinion, this has been less successful than the protection of shareholder interests, but the PCA mechanism is not the source of the steadily rising electric rates. While there have not been rate increases under the PCA mechanism, the Company has had three Power Cost Only Rate Case increases (the most recent effective July 1, 2006), and one general rate increase since the PCA was adopted. Each of these has been the subject of considerable examination by the parties, and review by the Commission. They are, perhaps, unfortunate sources of rate volatility

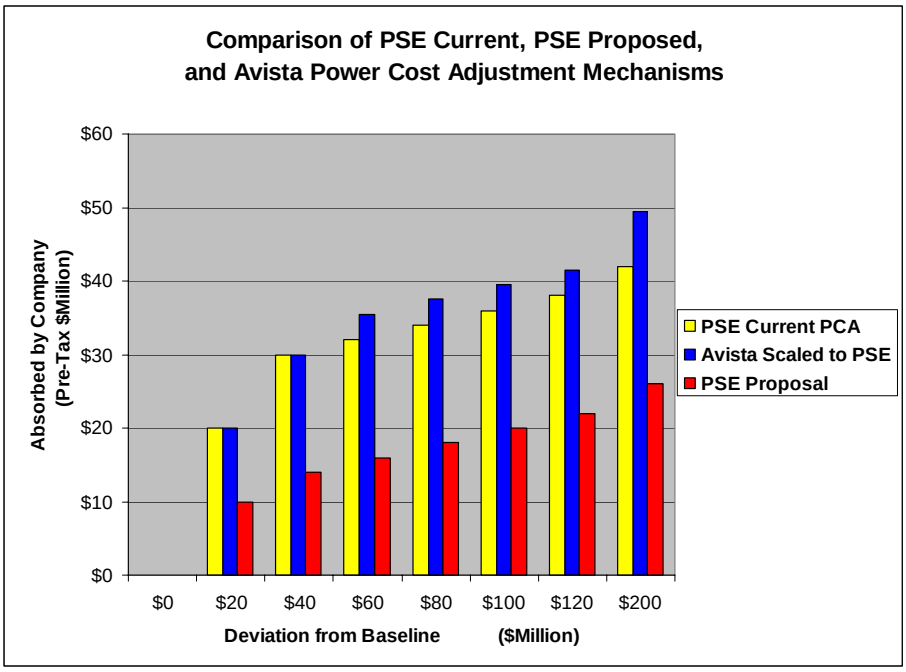
from a consumer perspective, but they are not the kind of sudden or erratic rate changes that occurred under the ECAC and PRAM mechanisms where expenditures were flowed through into rates with very little notice, review, or analysis.

V. COMPARISON OF PSE'S PCA TO AVISTA'S ERM

Q. The Commission just approved agreed modifications to the Avista Energy Recovery Mechanism, or ERM. How does the new ERM compare with the current Puget PCA?

A. The "new" Avista ERM significantly reduces the risk that Avista bears from the level established five years earlier. The "deadband" was reduced from $9 million per year to $4 million per year. Nonetheless, the "new" Avista ERM leaves more risk with Avista shareholders relative to Avista revenues than the Puget PCA does relative to Puget revenues. The figure below shows this comparison.

Figure 3



Q. How did you prepare the comparison above?

A. Puget's Washington electric revenues are about five times as large as Avista's Washington electric revenues. Therefore, we multiplied the Avista sharing bands by 5 to put them on a comparable basis with Puget. The current Puget deadband -- $20 million – is indeed 5 times as big as the revised ERM deadband of $4 million, so up to that point the mechanisms are about the same. However, above that level, the Puget sharing bands put more of the burden on consumers and less on shareholders.

Q. What about doing the comparison on an allowed earnings basis. How would you make that comparison?

A. Puget and Avista have different mixes of investment, and therefore the ratio of electric revenues does not necessarily provide the only accurate comparison of the financial impacts of the PCA and ERM. Avista owns a larger proportion of its generating facilities than does Puget. While Puget's revenues are about five times those of Avista, Puget's rate base is only about four times as large as Avista. Therefore, while the exposure of Puget under the current PCA is smaller on a revenue basis, it is slightly larger on an income basis. We prepared this comparison based on a $40 million power cost variation for Avista, and $200 million for Puget, consistent with the 5:1 revenue ratio between the two companies.

Figure 4

Percentage of Washington Electric Earnings At Risk Under Power Cost Mechanisms

Puget:	21%
Avista:	16%

Q. What do you conclude from the above comparison with the Avista ERM recently approved by the Commission?

A. The current Puget PCA exposes Puget shareholders to a comparable level of risk to the recently updated Avista ERM. Measured on a revenue basis, it is somewhat smaller, while measured on an earnings basis, it is slightly higher.

Q. Is it essential that the power cost mechanisms for different companies be identical?

A. No. The companies have different mixes of resources, and different characteristics of their service territories, making the variance that they experience in their power costs quite different. Avista has a much higher dependence on hydropower, while Pacific Power has a much higher dependence on coal. Both Avista and Pacific have significant summer-peaking irrigation loads, and Puget does not. In the recent Pacific Power order the Commission said: "We agree with Staff that all power cost adjustment mechanisms for Washington utilities need not be the same." (Order No. 04 at ¶ 91.) Nonetheless, the purpose of both the Avista ERM and the Puget PCA are to protect the shareholders from extreme power cost variations, and to protect electric consumers from unnecessary volatility in rates, so it is appropriate to make the comparison in comparison to revenues and earnings, the factors that directly affect consumers and shareholders.

VI. PUGET IS IN MUCH BETTER FINANCIAL CONDITION NOW THAN WHEN THE PCA WAS CREATED

Q. When the PCA was created, what was Puget's financial condition?

A. The Company was in a quite precarious condition. The dividend had been set at $1.84 during a period of rapid inflation, when allowed returns were much higher. It then suffered a decline in book value due to the premium it paid when it acquired Washington Natural Gas. The $1.84 dividend was unsustainable in the wake of the merger and declining interest and allowed equity return rates. Book value per share had been declining. The previous management had funded substantially all capital improvements for many years with debt, leveraging the Company to enhance short-term earnings per share. The utility's equity ratio had declined to 31 percent, a level that most analysts would agree is inadequate for an electric utility in the current financial environment (and much lower than the 43 percent currently authorized). Puget needed some tools to allow it to strengthen its balance sheet. The PCA was one of the tools the parties agreed to in the 2002 settlement. Another tool agreed to by the parties was to set rates based on a 40 percent equity capitalization ratio, and allow the Company a period of years to actually achieve that level of equity.

Q. What has happened since the 2001 general rate case that created the PCA?

A. Puget has cut its dividend from $1.84 to a more appropriate level of $1.00, which allows for significant retained earnings each year at the allowed rate of return. Puget has issued about 14 million new shares of stock, further enhancing its equity, and meeting the targets set by the equity building mechanism adopted in the 2001 rate case. As a result, the Company's capital structure has strengthened to about 40

percent. Staff witness Mr. Hill discusses the Company current and projected capital structure and rate of return. Finally, the PCA has stabilized the Company's earnings with respect to power cost fluctuations (principally hydro conditions and fuel costs), so the need for equity to protect against power cost earnings variations has diminished significantly.

Q. How has the level of risk that Puget is exposed to by the PCA changed as a result of these changes in the Company's capitalization?

A. The current PCA deadband and sharing bands have not changed, despite significant growth in annual revenues, shareholder equity, and the allowed return. As a result, the "risk" that Puget is exposed to under the PCA is significantly less onerous than when the PCA was adopted.

Q. How can one measure the PCA relative to the size of the Company?

A. The table below compares the amount that Puget is at-risk under the PCA to the Company's Shareholder Equity, Allowed Earnings, and Electric Revenues for 2001 and 2005, with all data taken from the Company's annual reports to shareholders.

Figure 5

Puget Sound Energy PCA Exposure and Financial Strength Indicators

	2001	2005	%
Total Assets	5,446,977	6,609,951	21%
Electric Revenues not including wholesale	1,331,283	1,507,842	13%
Net Income for Common	98,426	155,726	58%
Shareholder's Equity	1,362,724	2,027,047	49%
Total kWh not including wholesale	20,289	22,502	11%
PCA Exposure @ $200 Million	$27,300	27,300	0%

Q. How does this indicate a reduction in the risk exposure under the current PCA?

A. Puget has grown significantly since the PCA was established. Electric revenues are up 32 percent. Net income is up 46 percent. Shareholder equity is up 49 percent. But the risk exposure under the PCA has not changed at all in dollar terms. It poses a much smaller risk, relative to the size of the enterprise, than when it was established. And, it poses that smaller risk to a much healthier enterprise.

Q. How would Puget's proposed changes to the PCA affect the balance of consumer and shareholder interests that was achieved by the PCA stipulation in 2002?

A. The proposed changes would significantly reduce Puget's exposure to earnings variations due to power cost conditions, shifting that risk to consumers. For example, under the current PCA, a power cost increase of $200 million would cause a $27.3 reduction in net income, about $0.25/share. Under the Company's proposal, a $200 million power cost increase would only cause an earnings reduction of $16.9 million, about $0.15/share. At this level, there would be a 40 percent reduction in the risk borne by shareholders under the Company's proposal.

The graphic contained in Exhibit No. ___(Joint-20C) shows the effect on earnings per share of the current PCA mechanism and Puget's proposed changes. The earnings per share under the current PCA structure was computed by Puget, with the Company modeling over 1,000 different combinations of weather and power costs, and measuring how the PCA would work in each example. We modified

Puget's spreadsheet to derive the earnings per share values under the proposed structure using the same scenarios.

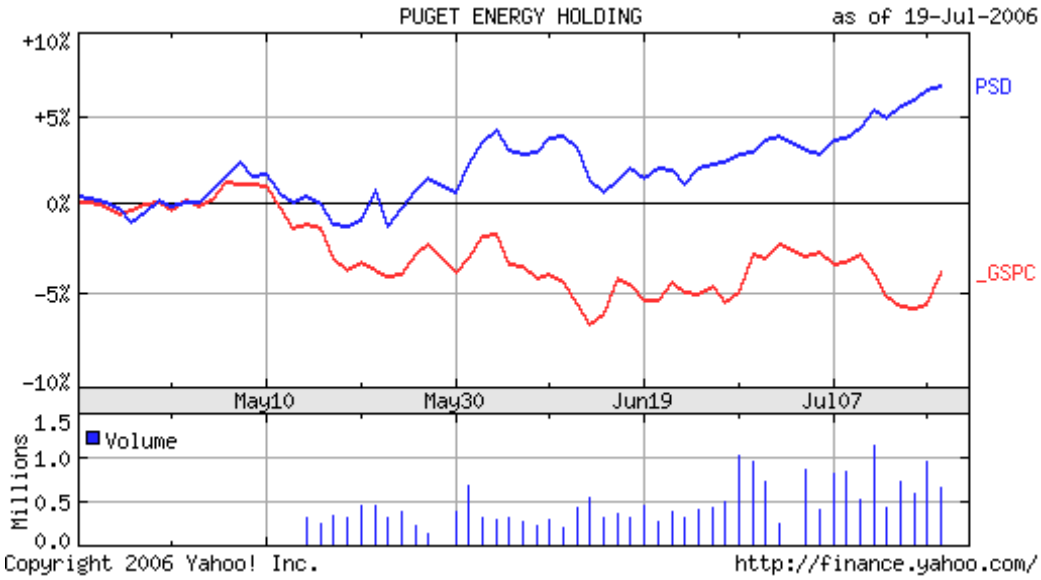
Q. What do these modeling results show?

A. These impacts are described in Exhibit No. __ (Joint-20C), but it is very clear that Puget's earnings per share risk is substantially reduced under the proposed structure.

Q. Has the market recognized Puget as a healthier company?

A. Yes. Just the last three months, as this proceeding has been underway, Puget has significantly outperformed the market. The graphic below compares the price of Puget Energy stock to the S&P 500 Index over the same period. It is quite evident that the market is looking at Puget favorably.

Figure 6



VII. MOST OF PUGET'S PROPOSED CHANGES ARE CONTRARY TO THE PUBLIC INTEREST AND SHOULD BE REJECTED

Q. What are Puget's proposed changes to the PCA?

A. The Company is proposing to eliminate the deadband, and to impose a smaller sharing requirement so that electric consumers bear a much larger share of the power cost risk. As shown in Figure 8, below, the proposal shifts about half the risk it now bears to electric consumers. The Company is also proposing to eliminate the Exhibit E in the original PCA, which limits increases in power contracts from flowing through to the PCA without a Power Cost Only Rate Case. Finally, the Company is proposing that a new category of costs, for hedging power supply costs, be allowable as a PCA expense.

Q. Do you support any of these changes?

A. Yes. We support the inclusion of hedging costs as an allowable PCA expense. The purpose of hedging is to manage the exact categories of cost that the PCA was designed to track. If the hedging program is successful, it will ultimately reduce fuel expenses. Requiring the Company to track the fuel cost savings through the PCA, but not allow it to track the hedging expenses through the PCA would be asymmetrical. However, we note that the hedging program greatly reduces the amount of risk the Company is exposed to – there is a decreased likelihood that it will experience the magnitude of power cost variations anticipated when the PCA was designed. This reduces shareholder risk, and ultimately this should be reflected in the cost of capital. Because the majority of the risk shift will affect the "high-cost" years when ratepayers will bear 90 percent or more of the costs, and because it is our

understanding that Puget will be presenting another general rate case to the Commission within the next 18 months, we are not recommending any specific recognition of this risk shift associated with the hedging program at this time.

Q. Why are the remaining Puget proposed changes inappropriate?

A. Puget is in a much better position to manage power cost risk than electric consumers are. The Company can buy long-term fixed-price resources. It can structure purchased power contracts to shape costs to the advantage of shareholders. It can hedge its fuel costs. It can maintain its power plants so they are reliable. Consumers do not have the ability to manage these types of risks.

Q. What is Puget's justification for eliminating the existing Exhibit E?

A. Mr. Story testifies that because the contracts have been approved by the Commission, any increase in the contract price should be included in the PCA.

Q. Why is this inappropriate?

A. This was a part of a very careful compromise in the original PCA. The return on rate base associated with Company-owned generation tends to decrease over time, as the investment is depreciated. The PCA holds these constant between general rate cases or Power Cost Only Rate Cases. This simplifies the mechanism, but benefits the Company to the detriment of consumers. The quid pro quo is that certain costs are not allowed to rise between rate cases. The purchased power costs are held to no more than the system average costs as a part of this package. The package was

negotiated in order to keep rates for consumers stable, while providing the Company two mechanisms (Power Cost Only Rate Cases or General Rate Cases) should rising power supply contract costs overwhelm declining power supply investment costs. The Company proposal addresses only one part of the package, to the benefit of the Company.

Q. Is the issue originally being addressed here still relevant?

A. Yes, and in fact more relevant. The resources that were originally fixed were the coal plants, which had very significant investment costs that are subject to decline, but also have significant fuel and O&M costs that may rise. Since then, Puget has acquired two wind farms, both with very large investment costs subject to decline over time, but without the fuel costs of the coal plants that are subject to increase. Basically, the Company's owned resources are subject to greater decline over time, but the Company is proposing to leave the coal plants unadjusted, while permitting additional purchased power costs that are subject to increases to flow into the PCA mechanism. This is asymmetrical and should be rejected.

Q. What about hydro conditions and fuel costs. Doesn't the Company have less ability to control these types of costs?

A. Hydro conditions are indeed variable, and the Commission has long held that hydro variations are an appropriate basis for a power cost mechanism. The current PCA addresses hydro risk, and whenever there are significant cost variations due to hydro system output changes, the current PCA provides for the deferral and amortization of

these variations. Fuel cost variation is handled by the PCA in the same manner as hydro cost variation, but it is a cost that the Company can manage through various strategies. Basically, the current mechanism protects the Company from serious earnings attrition due to either of these factors, even though the Company has some ability to manage this risk.

Q. Has Puget taken these types of steps to manage risk?

A. Yes. The Company's Least Cost Plan has guided it in choosing resources like wind energy, which reduce exposure to volatile fuel costs. It has initiated a fuel hedging program, and the costs of that hedging program are included in its power supply cost (and proposed to be included in the PCA adjustment). Under the current PCA mechanism, with a specific performance requirement for the coal-fired units, PSE has a very strong incentive to maintain reliability, and those units have performed well under this incentive mechanism.

Q. Would it benefit consumers to have this risk shifted to them?

A. No. Consumers are not in a position to manage the Company's power supply costs. Frankly, they have little power to do anything but pay their electric bills, and if that is unaffordable, change their usage through conservation or curtailment. Even this type of change is difficult and/or painful in the short-run, the time frame when power cost adjustments would take effect. Simply stated, these are risks that the utility can best manage.

Q. How do Puget's proposed changes fit with the direction the Commission has given in recent proceedings involving power cost mechanisms?

A. Puget has proposed to eliminate the deadband and to narrow the sharing bands. The most recent proceeding is the Avista ERM modifications. In that case, as we have discussed earlier, the Commission approved a deadband that is proportionate to the current Puget PCA deadband, and sharing bands that are approximately of the same magnitude as the current Puget PCA sharing bands.

The immediately previous proceeding, involving Pacific Power & Light Company, resulted in specific Commission direction on the form of power cost mechanisms. One specific finding was that a power cost mechanism should contain a deadband:

> Deadbands and sharing bands are useful mechanisms, not only to allocate risk, but to motivate management to effectively manage or even reduce power costs.[7]

The Commission also reiterated the need for a cost of capital adjustment as part of any power cost mechanism.[8] Puget has proposed a reduction of its risk in the proposed PCA modifications, but a higher return on equity and a higher cost capital structure (i.e., increasing the allowed ROE to over 11 percent, and increasing the equity component from 43 percent to 45 percent) in this filing.

Simply stated, Puget's proposed modifications are directly in conflict with recent guidance provided by the Commission.

[7]Docket No. UE-050684, Order No. 04 at ¶ 96 (April 17, 2006).
[8]Docket No. UE-050684, Order No. 04 at ¶ 91 (April 17, 2006).

VIII. APPROPRIATE CHANGES IF THE MECHANISM IS TO BE UPDATED

Q. If the PCA mechanism were to be changed, what elements would be appropriate to update?

A. Because Puget is a larger and healthier utility than when the PCA was established, it would be appropriate to consider increasing the size of the deadband and sharing bands proportionate to that growth. Figure 5, above, presents various indicators showing that Puget has grown by 11 percent (kWh) to 49 percent (shareholder's equity). If the current PCA bands were appropriate four years ago, larger bands would be appropriate today.

Q. Which of the indicators is most appropriate to consider in making changes?

A. The PCA was designed to mitigate the financial risk of power cost variations. Therefore the financial indicators rather than the physical indicators should be primary. Earnings, rather than gross revenues or kilowatt-hours are key.

Q. How should the Commission look at the change in the Company's financial strength in evaluating possible changes?

A. There are several factors. First, the Company's equity has increased. Second, the cost of capital was reduced in the 2004 general rate case proceeding, Docket Nos. UE-040641 and UG-040640, and the Staff recommendation is for a further decrease in this proceeding. These somewhat offset the increased equity in terms of how much the risk the PCA allows relative to the earnings capability of the Company.

Q. Have you computed the increase in the PCA bands that would be appropriate given the changes in the Company's financial situation?

A. Yes. The table below estimates the return on equity that Puget would have achieved at the allowed return applied to its past equity, the currently allowed return on its current equity, and the Staff-proposed return on equity. It shows that at the Staff-proposed ROE, the Company's allowed return has increased by 27 percent since the 2001 general rate case establishing the PCA mechanism. By this measure, the dead band and sharing bands should be increased by at least 27 percent (and up to 39 percent at the current allowed return of 10.3 percent).

Figure 7

Puget Sound Energy PCA Exposure Relative to Earnings Capacity

		2001		2005		%
Shareholder's Equity		1,362,724		2,027,047		49%
Allowed ROE		11.0%		10.3%		
Allowed Return		$ 149,900		$ 208,786		39%
Staff Proposed ROE (this docket)				9.375%		
Allowed Return		$ 149,900		$ 190,036		27%

Q. If the Commission were to update the PCA bands on this basis, what would the changes look like?

A. The table below compares the current PCA bands with increases that would be commensurate with the Company's current equity and the allowed return as proposed by Staff. For simplicity, we have rounded down the 27 percent increase in allowed return at the Staff-recommended ROE to 25 percent in computing the changes to the sharing bands, and rounded up to 33 percent in computing the change to the Trigger. Of course, at a higher ROE (above 9.375 percent), a larger increase in

the bands would be justified, on the order of a 39 percent increase in each band and the trigger at the current allowed ROE of 10.3 percent.

Figure 8

Current PCA Updated for Company Financial Growth

Element	Existing Sharing Band	Updated Sharing Band
Dead Band	$20 million	$25 million
50% Band	$20 million	$25 million
90% Band	$80 million	$100 million
95% Band	Over $120 million	Over $150 million
Trigger	$30 million	$40 million

Q. Are you recommending that these changes be applied at this time?

A. No. Our joint recommendation is that the Commission leave the current mechanism unchanged at this time except for the inclusion of gas hedging costs as an allowable PCA expense. While the risk posed to Puget has declined significantly since the PCA was adopted, due to the growth of the enterprise, we believe the mechanism should be allowed to more fully mature through a range of hydro and power cost conditions.

At this time, we recommend that the Commission direct a study of the financial risk posed by power costs under the current PCA mechanism, from the date of inception to the present, and that this study be presented by the Company at least three months prior to filing its next general rate case as a predicate to updating the sharing bands and trigger threshold. Any changes to the PCA should be deferred until that study is completed and reviewed in the next general rate case. It is our

understanding that PSE will likely come forth with another general rate case within the next 18 months, so the delay will not be significant.

Q. Does this complete your joint testimony on the PCA issues in this proceeding?

A. Yes it does.