EXHIBIT NO. ___(JHS-7CT)
DOCKET NO. UG-040640, *et al.* (consolidated)
2004 PSE GENERAL RATE CASE
WITNESS: JOHN H. STORY

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	Docket No. UG-040640 Docket No. UE-040641 (*consolidated*)
In the Matter of the Petition of PUGET SOUND ENERGY, INC. 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 PUGET SOUND ENERGY, INC. 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
JOHN H. STORY (CONFIDENTIAL)
ON BEHALF OF PUGET SOUND ENERGY, INC.**

NOVEMBER 3, 2004

**REDACTED
VERSION**

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF JOHN H. STORY

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PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY OF JOHN H. STORY

I. INTRODUCTION

Q. Are you the same John H. Story 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. My rebuttal testimony will discuss the various electric proforma and restating adjustments that the Company is proposing in rebuttal. First, I will discuss the adjustments proposed by Commission Staff and other parties that the Company agrees with and has incorporated in its updated electric revenue requirement determination. Second, I will discuss adjustments proposed by Commission Staff and other parties that are inappropriate and with which the Company disagrees.

Based on the proforma and restating adjustments proposed by the Company and presented in Exhibit No. ___(JHS-8), I will show the revenue deficiency of $103,302,198 after allocation of $133,376 to wholesale customers. This would represent an average 7.3% rate increase.

Finally, I will present revised exhibits for the Company's Power Cost Adjustment Mechanism, which reflect the production related costs in the Company's revenue requirement. These exhibits represent the Company's proposed Power Cost Baseline rate that will be in effect commencing with the rate year.

II. COMPARISON BETWEEN THE COMPANY'S SUPPLEMENTAL FILING REVENUE DEFICIENCY AND COMMISSION STAFF REVENUE DEFICIENCY

Q. Have you prepared a reconciliation between the revenue deficiency filed by the Company in its supplemental filing and that filed by Commission Staff?

A. Yes. The following table highlights the differences between the Company's and the Commission Staff's electric revenue deficiency after allocation to wholesale customers.

PSE Supplemental Filing Revenue Deficiency	$82,662,094
Cost of Equity (11.75% vs. 9%)	(49,332,234)
Beginning Rate Base	(11,948,864)
Capital Structure and Debt Cost	(10,384,180)
Property Taxes	(4,051,963)
White River	(2,339,246)
Bad Debt Percentage	(1,798,164)
Wage Increase	(1,423,753)
Property and Liability Insurance	(1,187,185)
Miscellaneous Adjustments (less than $1 million each)	(827,543)

Tax Benefit of Proforma Interest	2,185,161
Power Costs	19,773,742
Commission Staff Revenue Deficiency	$21,327,865

Q. Would the adjustments proposed by Commission Staff enable the Company to meet the financial criteria discussed by Mr. Valdman and Mr. Gaines?

A. No. Although the Company agrees with some of the Commission Staff's adjustments, their proposal is in essence a power cost adjustment. Out of the $21.4 million increase recommended by Commission Staff, $19.8 million is an adjustment to the PCA Baseline. All of the power cost changes the Commission Staff proposes would eventually have been adjusted for in the normal course of the PCA mechanism without a general rate case filing. As Ms. Ryan discusses in her testimony, it is important to update rates for this updates information about PSE's anticipated power costs. However, adoption of the Commission Staff's proposal to virtually reject an increase in electric rates for costs other than power costs, plus set the Company's return on equity at one of the lowest utility rates in the Country, would have a severe impact on the Company's financial integrity, as discussed by Mr. Valdman, Mr. Gaines and Dr. Cicchetti.

III. THE COMPANY AGREES THAT THE FOLLOWING ADJUSTMENTS SHOULD BE MADE TO ITS SUPPLEMENTAL FILED REVENUE REQUIREMENT

Q. Have you prepared an exhibit which details the updated restating and pro forma adjustments that the Company is proposing?

A. Yes. Exhibit No. ___(JHS-8) summarizes the Company's restating and pro forma adjustments. This exhibit is presented in the same format as my Exhibit No. ___(JHS-E3) and Mr. Russell's Exhibit No. ___(JMR-3).

Q. Would you please discuss the Commission Staff adjustment that reduces rate base for certain deferred taxes?

A. The Commission Staff proposes to reduce the test year rate base for $72 million deferred tax balance related to a new method of determining overhead deductions that would previously have been capitalized. The Company agrees that such an adjustment could be appropriate, provided that if any such deductions are subsequently disallowed by the Internal Revenue Service ("IRS"), the Company will then be able to immediately adjust rates to recover any revenue loss, including any assessed interest that might result from such disallowance.

Q. Please explain how this deferred tax balance arose.

A. This deferred tax balance was created by the Company taking advantage of a tax deduction proposed to us by Deloitte & Touche. Deloitte advised the Company that, based on Deloitte's research and informal discussions with the IRS, the rules that were adopted as a result of the 1986 Tax Act for the allocation of internal labor and overheads between self constructed assets and products held for sale would also apply to utility companies. Deloitte developed a methodology for reviewing a company's capitalization policy to determine whether a company could allocate more costs to energy production and less to self-constructed assets. This allocation methodology would only apply for income tax purposes and would not affect capitalization for accounting purposes. Based on Deloitte's analysis of PSE's books and records, Deloitte determined that application of its methodology would enable the Company to deduct a one time catch-up adjustment of approximately $163 million and take a current deduction of $23 million on the Company's 2001 tax return (which was filed in the fall of 2002). In addition, the Company applied Deloitte's methodology to deduct approximately $20 million for calendar year 2002.

These deductions created a timing difference between the book and tax treatment for this type of cost deduction. These deductions, if ultimately upheld, have created a tax benefit of $72 million. Therefore, the Company in 2002 set up a deferred tax account for approximately $72 million. This is the amount Commission Staff proposes to deduct from test year rate base.

Q. Is the Company guaranteed that the IRS will accept this deduction?

A. No. The Company has a reasonable basis for taking these deductions. However, the IRS is presently reviewing this type of deduction for a number of taxpayers across the country, including the Company. In fact, this type of deduction has the attention of the National Office of the IRS.

Q. Is the IRS review likely to be resolved soon?

A. No. There are other utilities that have taken this same type of deduction. Some of these utilities have taken considerably larger deductions than PSE and this issue may well end up in Tax Court before it is finally resolved. If the IRS were to challenge this deduction and prevail, the companies that have taken this deduction will have to revise their yearly tax filings.

Q. What would be the impact on the Company if this tax deduction were to be disallowed?

A. The Company would have to revise its 2001 tax return, plus any subsequent filed returns, and the deferred tax balance would be eliminated. In addition, the Company would be required to pay the back taxes, plus interest, that would result from this deduction.

Due to the ongoing IRS review of this tax deduction, and the impact that this deduction has on general rates, the Company is requesting that if the Commission accepts the reduction of rate base by the deferred taxes associated with the overhead deduction, and if any such deductions are subsequently disallowed, the Company will be allowed to adjust its rates to recover any revenue lost as a result of applying this deduction for rate making purposes (including any IRS assessed interest that might result from such disallowance) and will be allowed to eliminate the deferred tax reduction of rate base. The Company requests the Commission to include this authorization in its Order for this proceeding.

In this proceeding, the $72 million reduction of rate base for electric rate base is $43.2 million and for gas rate base $$29.7 million. The impact on the revenue requirement is ($5.4) million and ($3.9) million respectively.

Q. Please explain the other adjustments where the Company is in agreement with Commission Staff?

A. The other adjustments and their impact on NOI or rate base are:

Adjustment	NOI	Rate Base
2.01 Temperature Normalization	$4,374,555	
2.02 General Revenues	$116,919,193	
2.05 Federal Income Taxes	($4,651,347)	
2.07 Depreciation/Amortization	($97,252)	($74,810)
2.08 Conservation	$26,189,031	($11,569,864)
2.12 White River	($73,280)	$19,837,623
2.13 Filing Fee	($143,538)	
2.14 D&O Insurance	$5,175	
2.16 Interest on Customer Deposits	($151,631)	
2.17 SFAS 133	$555,963	
2.19 Property Sales	($2,918,307)	
2.21 Pension Plan	($5,565,312)	
2.24 Employee Insurance	($825,326)	
2.26 Storm Damage	$366,405	
2.27 Frederickson Plant	[redacted]	[redacted]
2.28 Low Income Amortization	$3,801,853	
2.29 Regulatory Assets		($46,237,863)

Q. Do any of these adjustments differ from the equivalent adjustment in the Company's supplemental filing?

A. Yes. **Adjustment 2.01, Temperature Normalization**, and **Adjustment 2.02, General Revenues**, are slightly different from the Company's supplemental filing. The Commission Staff and the Company are in agreement on the methodology used to determine temperature normalization and general revenues; however, there is a slight difference resulting from the bad debt percentage used. This bad debt percentage is part of the **Bad Debt, Adjustment 2.09**, which is a contested adjustment. Ms. Luscier discusses the differences between the Company and Commission Staff for this adjustment in her testimony, Exhibit No. ___(BAL-4T). Other than this change, **Adjustment 2.01, Temperature Normalization**, and **Adjustment 2.02, General Revenues** are the same as filed.

Adjustment 2.12, White River, Commission Staff is proposing to not amortize the relicensing and water right costs until more information is known about the disposition of the property associated with the Company's former White River Hydroelectric Project. In addition, the Commission Staff updated the deferral of costs associated with the Company's FERC licensing effort and with securing a water right with payments received from Cascade Water Alliance ($3 million) after the test year. The Company agrees with this change in accounting and to updating the deferred costs. There is a slight difference between the Company's rate base adjustment and Commission Staff's adjustment in that the Company corrected a small math error in Staff's adjustment.

Adjustment 2.21, Pension Plan, the Company agrees with Commission Staff's adjustment, which allocates a portion of these costs below the line based on employee time charged below the line.

Adjustment 2.24, Employee Insurance, Commission Staff proposes using average employee count during the test year to determine this cost. The Company accepts such proposal and has changed its adjustment to reflect this change.

Adjustment 2.26, Storm Damage, does not result in a difference in the net operating income impact between Commission Staff and the Company. However, there is a difference in the understanding of how this adjustment should reflect the Company's original proposal to change the methodology for determining when storm related costs should be deferred, as discussed below.

Q. Please explain this difference in understanding regarding Adjustment 2.26.

A. Historically, the "catastrophic storms" events that triggered an accounting deferral were those that affected at least 25% of the Company's electric customers system-wide. The Company proposed to change this 25% test to a $2 million per event test for catastrophic "events" (not just storms). In my direct testimony, I stated that for this proceeding this Adjustment 2.26 should not be impacted by this change in definition.

However, Commission Staff claims there would be "double recovery" under the Company proposal to defer costs associated with catastrophic events that caused more than $2,000,000 damage to Company facilities (Exhibit No. ___(JMR-1T) at 24.). This claim is based on Commission Staff's analysis of historical storm expense and identification of several storms over $2,000,000 that would not have been included in the "Six Year Average Storm Expense" if the new method proposed by the Company had been in effect. It is Commission Staff's position that these expenses need to be removed from the average "normal" storm expense or there is "double recovery." This adjustment is not necessary or appropriate.

There are two parts to the historical "Storm Damage Adjustment." The first part of the adjustment as it has existed does calculate an average storm expense using six years of actual experience. The intent of this calculation is to build into rates a normalized level of storm expense based on a historical record. This is not a methodology to recover these actual historical costs in rates. Instead, it is a method used to estimate rate year expenses for storm damage. This $8,179,748 amount identified by Commission Staff was in fact included by the Company in its filing as part of the normalized storm damage expense to be included in rates.

The second part of Adjustment 2.26 does calculate an amount to be recovered for storm damage costs that were actually deferred for what were called "catastrophic storms." In this part of the adjustment, the deferred costs associated with catastrophic storm activity which have been deferred are totaled and amortized over three years. This second part of the storm damage adjustment does recover actual costs. The Company did not include the $8,179,748 identified by Commission Staff in this part of its storm damage adjustment. Thus, there is no double recovery.

If the Commission Staff's suggestion to remove storm damage costs of $8,179,748 from the storm expense calculation were to be followed through to the proper conclusion, the storm damage costs of $8,179, 748 would now be classified as a catastrophic event and need to be included in the "catastrophic event" calculation. These costs would then be included in the three year amortization calculation instead of the six year normalization calculation. This would decrease net operating income by an additional $1,363,291 and increase the revenue deficiency by a corresponding amount. The Company does not agree that either the storm expense or the catastrophic storm calculation need to be adjusted in this manner. However, if one part of the adjustment is modified, the corresponding adjustment needs to be made to the second part of the storm damage calculation.

As discussed by Ms. McLain, the Company is willing to adopt a modified version of the Commission Staff's proposal for measuring catastrophic events. However, no matter which methodology the Commission would like to adopt to measure a catastrophic event, the expense and amortization determined in the Company's "Storm Damage Adjustment" is a fair measure of this cost for this proceeding.

IV. CONTESTED ADJUSTMENTS

Q. Have you prepared a reconciliation between the Company's revenue deficiency filed in rebuttal and Commission Staff's revenue deficiency?

A. Yes. The following table highlights the differences between the Company's and Commission Staff's electric revenue deficiency.

Commission Staff Revenue Deficiency	21,327,865
Cost of Equity (11.75% vs. 9%)	47,492,476
Power Costs	21,621,611
Capital Structure and Debt Cost	9,999,516
Miscellaneous Operating Expense	2,376,209

Property Taxes	1,337,918
Wage Increase	1,009,651
Tax Benefit of Proforma Interest	384,997
Rate Case Expenses	151,107
Property and Liability Insurance	143,383
Bad Debt Percentage	141,099
White River	(17,652)
Miscellaneous Adjustments (less than $1 million each)	(64,105)
Beginning Rate Base	(2,601,877)
Company Revenue Deficiency	$103,302,198

Ms. Luscier discusses the differences between Commission Staff and the Company for test year rate base and working capital for the electric and natural gas operations. For the test year, the Company's electric rate base, including working capital, is $2,516,697,113 which is $14,983,693 less than Commission Staff's electric rate base shown in Exhibit No. ___(JMR-2C).

A. Power Cost Adjustment 2.03

Q. Is the Company in agreement with the power cost adjustments proposed by Commission Staff and other parties to this proceeding?

A. The Company is agreeing with some, but not all, of the proposed power cost adjustments.

One of the major adjustments is Commission Staff's proposal to change the methodology for projecting rate year natural gas prices by utilizing a three-month rolling average of NYMEX price strips. As explained by Ms. Ryan, Exhibit No. ___(JMR-12T), the Company agrees, in part, with the Commission Staff's proposed methodology for determining rate year natural gas prices but proposes the use of a more recent three-month NYMEX strip. The increase in natural gas prices since the Company's original filing has increased the projected cost of natural gas during the rate year by $43.2 million. The calculation of the Company's rebuttal rate year normalized power costs are discussed in Ms. Ryan's rebuttal testimony, Exhibit No. ___(JMR-12T), and the changes from the Company's supplemental filing power costs are shown in Exhibit No. ___(JMR-22). This adjustment and the Sales for Resale – Secondary Adjustment, 2.04, are calculated using 50-year water pursuant to Commission Staff's proposal, as discussed by Ms. Ryan and Dr. Dubin. Power costs are $3.2 million less due to this adjustment.

The power costs as shown in the Company's rebuttal case do not reflect the change in the CanWest contract discussed by Mr. Markell (Exhibit No. ___(EMM-6CT). As of the time of its rebuttal filing, the Company has not received a response on its Accounting Petition regarding the CanWest contract, Docket No. UE-041846. If this Accounting Petition were to be approved, the cost of this contract change would add $1,232,000 dollars to the power costs for the rate year. The Company proposes to incorporate the results of the Accounting

Petition in its compliance filing for this general rate case.

This adjustment reduces net operating income by ($58,398,870).

Q. Mr. Schoenbeck characterizes the Company's adjustment for power costs in developing the PCA baseline as not being "normalize costs." Do you agree?

A. Mr. Schoenbeck mischaracterizes the normalization of power costs. The Company does normalize the amount of electricity projected to be consumed during the rate year. This is done by modeling normal load and water availability. In addition, the Company uses plant availability based on historical plant factors (calculated under a methodology approved by the Commission in prior cases) for modeling the generation available to project the source and cost of MWh's available for the rate year. Thus, Mr. Schoenbeck's hypothetical, which assumes that the Company builds in plant availability based on unusual but known events, rests on a flawed premise.

In more general terms, Mr. Schoenbeck's argument rests on the premise that all power costs should be normalized rather than just electric usage and as and hydro generation. This was not the intent of the PCA settlement. The intent of the PCA was to set a baseline power cost using the expected commodity usage levels (normalized electric loads served and normalized natural gas and hydroelectric usage to generate electricity). The costs for purchasing or generating power to serve this normalized usage would be based on the best information available; for example, (i) coal contract prices for Colstrip and not a national average or historical average coal price; and (ii) spot market rates priced at Mid-Columbia and not a southwest hub price. PSE's use of forward market information to price the normalized electricity projected to be used during the rate year is exactly what the PCA requires.

B. Sales for Resale, Adjustment 2.04

Q. Please explain the difference between the proposals of Commission Staff and the Company for Adjustment 2.04, Sales for Resale?

A. This adjustment is based on the results of an AURORA run and is dependent on the assumptions used in that model. Based on the Company's updated rebuttal power costs, the sales for resale are projected to be $27,538,643. This adjustment decreases net operating income $113,651,741.

C. Tax Benefit of Proforma Interest, Adjustment 2.06

Q. Please continue with your discussion of contested adjustments.

A. **Adjustment 2.06, Tax Benefit of Proforma Interest**, is a function of the allowed rate base (as determined by other adjustments), and the effective interest rate as determined by the capital structure. The difference between the proposed Adjustment 2.06 of the Company and Commission Staff reflects the difference between rate base and the weighted cost of debt rate used. This adjustment lowers net operating income by $9,377,425.

D. Bad Debts, Adjustment 2.09

The difference between Commission Staff and the Company proposal for **Adjustment 2.09, Bad Debts**, is discussed by Ms. Luscier. As she indicates, the Company proposes using a three-year average based on five years of experience and removing the high and low years from the calculation. This adjustment increases electric net operating income by $961,153.

E. Miscellaneous Operating Expenses, Adjustment 2.10

Q. Please continue with your discussion of contested adjustments.

1. Incentive/ Merit Pay and Payroll Taxes Associated with Merit Pay

The Company's adjustments related to Incentive/Merit Pay and Payroll Taxes Associated with Merit Pay in **Adjustment 2.10, Miscellaneous Operating Expenses**, is also discussed by Ms. Luscier. The impact of the adjustment, as discussed by Ms. Luscier, is to lower expense by $273,367.

2. Tree Watch

The Company agrees with the Commission Staff's Tree Watch adjustment. As explained by Mr. Russell, Exhibit No. ___(JMR-1T) at 28-29, the Company has been deferring these costs and amortizing the deferred balance over five years. If the Commission were to accept the Tree Watch adjustment as proposed by Commission Staff, the Company will cease deferring this type of cost concurrent with the effective date of new rates in this proceeding and finalize the amortization schedule for the costs that have been deferred prior to the date of such Commission order. The impact of the adjustment is to increase expense by $2,000,000.

3. Deloitte Consulting Fee

The Company does not agree with Commission Staff's proposed removal of the $812,196 paid to Deloitte during the test year as shown in Exhibit No. ___(JMR-3C), at 12. In the normal course of business, the Company hires outside experts to examine ways to cut its tax burden. This is an appropriate business practice because tax law and regulatory interpretations are constantly subject to change. Hiring outside experts allows the Company to gain the benefit of their extensive staffs and experience.

Commission Staff tries to justify the proposed disallowance of the Deloitte consulting fee by pointing to a restating adjustment the Company made for a one-time Montana Corporate License Tax refund that Commission Staff characterizes as resulting from the "retroactive restatement of the tax basis of PSE's assets" (Exhibit No. ___(JMR-3C). This "retroactive restatement of the tax basis of PSE's assets" is actually related to the $72 million dollar reduction to rate base that Mr. Russell discusses on page 6, lines 10 through 16, and is the same deferred tax issue that I discussed earlier in my testimony. The work done by Deloitte resulted in this $72 million potential tax benefit. This potential tax benefit results in a combined revenue requirement savings to the Company's electric and gas customers of approximately $10 million in the current rate proceeding. If this tax deduction is finally resolved in the Company's favor, then customers will continue to get a benefit over the next twenty years as these deferred taxes turn around. As discussed above, the Company is continuing to deduct current overheads, and customers will continue to receive these benefits in future rate proceedings if the tax deduction is resolved in the Company's favor.

Q. What was the Montana Corporate License Tax refund?

A. Montana corporate license taxes are dependent on the Company's federal income taxes paid. As discussed above, the Company was able to deduct a one time catch-up adjustment for federal income taxes of approximately $163 million and take a current deduction of $23 million on its 2001 federal income tax return (which was filed in the fall of 2002) as a result of the consulting work performed by Deloitte. The benefit of this retroactive federal income tax catch-up adjustment was reflected in the Montana corporate license tax calculation. This resulted in a one-time Montana corporate license tax credit of $1.9 million. The Company removed the Montana corporate income tax credit from the test year as a restating adjustment and pro formed in a normal level of deduction for federal income taxes and Montana corporate income taxes.

In other words, the Deloitte consulting work resulted in a current $10 million revenue benefit to customers and a continuing benefit on both Montana corporate license tax and federal income tax, provided that the Company's deductions are ultimately upheld. The Company should continue to recover in its rates sufficient funds to engage consultants, such as Deloitte, in the future, and Commission

Staff's proposed adjustment should be rejected.

F. Property Taxes, Adjustment 2.11

Q. Will you please continue your discussion of contested adjustments with Adjustment 2.11, Property Taxes.

A. As Mr. Parvinen discusses in his testimony, Exhibit No. ___(MPP-1T), the Company used an estimate of levy rates to calculate property taxes in its initial filing. This adjustment updates that estimate for current levy rates. Commission Staff and the Company are in agreement on this part of the adjustment.

In addition, Commission Staff removed a payment to the Oregon Department of Revenue related to property taxes for 1995 through 2001 on the 3rd AC transmission line. The Company had proposed, and is proposing, to amortize the payment of this assessment over three years.

Q. Why didn't the Company remove this payment on the 3rd AC as a restating adjustment?

A. The Company was never billed by the Oregon Department of Revenue for property taxes on the 3rd AC prior to the fall of 2002. These taxes were the subject of litigation for several years by one of the parties with an interest in the 3rd AC. The issue was whether the Oregon Department of Revenue had the right to assess property taxes on a non-federal party with an interest under contract in the 3rd AC. In late 2002, the Company entered into settlement discussions with the Oregon Department of Revenue following an adverse ruling by the Oregon Supreme Court. The Oregon Department of Revenue billed the Company back for property taxes in late 2002, which was the first time that Company was actually assessed for the taxes. The Company was able to reach a settlement with Oregon, and the amount that the Company is seeking to recover is the tax settlement amount (which is 75% of the original amount assessed for the 1995 through 2001 tax periods). The Company should not be penalized for protesting and contesting questionable tax assessments, particularly when the taxing authority had not even billed the Company until the fall of 2002, which is part of the test year. The impact of this adjustment is to lower income by $1,277,761 and NOI by $830,545 more than Commission Staff's adjustment.

The Company does not believe the Montana Corporate License Tax refund of $1,892,000 described above and the payment of the Oregon property tax are similar. However, if Commission decides they are the same type of test period activity, the appropriate adjustment would be to offset (net) the Montana Corporate License Tax and the Oregon property tax assessment. The net of these two items is $1,941,282 in expense, which amortized over three years would be a $420,611 reduction of net operating income.

G. Montana Energy Tax, Adjustment 2.15

Q. What is the difference between the Company and Commission Staff proposals with respect to Adjustment 2.15, Montana Energy Tax?

A. **Adjustment 2.15, Montana Energy Tax**, is based on the number of hours that the Colstrip plants are projected in the AURORA model to run during the rate year. The difference between the parties' proposed adjustments reflects different assumptions in the AURORA model run. This adjustment lowers net operating income by $107,925.

H. Rate Case Expenses, Adjustment 2.18

Q. What is the difference between the Company and Commission Staff proposals with respect to Adjustment 2.18, Rate Case Expenses?

A. There are several differences between the Company and Commission Staff with respect to **Adjustment 2.18, Rate Case Expenses**. However, I would like to point out an agreed portion of the adjustment where the Company and the Commission Staff are in agreement. The Commission Staff proposes that the PCORC legal expenses be a normalizing adjustment that would reflect $650,000 per year in expenses to handle this type of filing in the future. The Company agrees with this adjustment and has reflected the same calculation in its updated revenue requirement.

As to the contested portion of the adjustment, the Company has, consistent with prior rate proceedings, updated its projection of costs associated with this general rate case proceeding. Commission Staff is actually proposing a change from the treatment in prior rate proceedings in proposing only to allow the costs incurred through August 2004 to be deferred and amortized and to allow a "normalized" amount for the remaining 2004 rate case costs. (*See* Exhibit No. ___(JMR-1T) at 22-23.) The Company feels that this part of the Commission Staff adjustment is inappropriate.

Q. Please summarize the Company's understanding of treatment of rate case costs in prior proceedings.

A. For at least two decades, the Commission has permitted such costs to be deferred, updated to actual in the Company's compliance filing, and amortized for recovery over a multi-year period. The Commission's Fifth Supplemental Order in Cause No. U-80-10 at page 15 states as follows:

> Staff proposes amortizing the expenses of the present proceeding over 24 months; the company [sic] proposes a 12 month period, resulting in a difference of $42,525 less than the staff's approach for test period pro forma net operating income. The company's proposal is more realistic in light of the increased frequency of general rate filings each year for the foreseeable future...

The Commission's Sixth Supplemental Order in Docket No. U-81-41 states the following:

> The Commission notes that it has on rare occasions authorized the recovery of past expense in instances where doing so is consistent with the public interest and sound regulatory theory. Expensing of investment in abandoned

> plant, for example, amortization of rate case expense; legal fees; recovery of extraordinary weather-related expenses, and similar matters are approved by the commission and others.

The Commission's Eleventh Supplemental Order in Docket No. UE-921262 states as follows with respect to rate case costs:

> The appropriate level of costs should be amortized over three years, which is the cycle of general rate case filings the Commission has herein ordered.

Each of these Commission orders provided for the deferral and amortization of rate case costs over a period of years. In addition, parties to prior rate proceedings before the Commission have included deferred rate case costs in calculations such as working capital, which indicates that they realized the costs had been deferred.

Q. What is the difference between amortization and normalization?

A. There is an accounting and rate making distinction between "normalize" and "amortize." To normalize is to adjust a year to what would be considered normal for recovery in an adjusted test year. For example, the Company normalizes revenues, subtracts or adds revenue, to remove the effects of colder or warmer weather based on a normal standard. The same is done for some power costs. The objective of normalizing the test year is to determine costs and revenues without regard to the impacts of good or bad weather or good or bad water.

Amortization, by contrast, is the reduction of the value of an asset or liability by prorating its cost over a period of years. As noted above, prior Commission orders treat recovery of rate case costs through amortization.

Q. Is the Commission precluded from changing the methodology for recovery of a cost on a going forward basis?

A. No. However, in this particular instance the Company feels that adopting the Commission Staff's proposal is not an appropriate change. Rate case costs can vary greatly from year to year. Obviously, in a year where there is no general rate proceeding, the costs would be minimal. During a test period, there will be some rate case costs as the Company prepares its case. However, the majority of rate case costs fall outside the test period. Under Commission Staff's proposal, the rate year revenues would reflect recovery of rate case costs during the rate year, while such costs are insignificant during the rate year. The variability and unpredictable nature of this type of cost is a reason that it is appropriate for deferral and amortization. Rate case costs are typically incurred over a period greater than a calendar year, which is another valid reason for deferring and amortizing this type of cost.

Q. What about Commission Staff's concern about auditing multi-year rate case cost deferrals during a general rate case?

A. The current rate case cost deferrals are tracked in unique accounts, and the supporting cost data are available for review. The actual rate case costs are recorded and available for audit, which provides an accurate method for reviewing costs rather than determining a "normalized" cost.

Q. Is the Company properly accounting for rate case costs?

A. Yes, the Company is complying with FERC Order 552 and the guidance provided by FERC Staff. FERC Order 552 created Account 182.3, Other Regulatory Assets, which is to be used to record regulatory assets. FERC Staff has indicated that Account 182.3 is the preferred account to record regulatory assets.

Mr. Russell's testimony points out that the definition of Account 928 states it is to reflect the amortization of rate case expenses from Account 186. This does create an apparent conflict between the definition of Account 928 and FERC Order 552, which created Account 182.3 for recording regulatory assets. The reason for this new accounting was to enable outside parties to see what assets the Company has on its books that are a result of regulatory deferral of costs or revenues. FERC staff has indicated in discussions with utility representatives that if a state commission requires the use of Account 186 instead (and there is a ratemaking reason why use of that account is appropriate), then FERC would likely accept that accounting. If this Commission wants the Company to use Account 186 for these costs the Company will transfer the costs. Whether a cost is included in Account 182.3 or Account 186 does not determine whether such cost is included in working capital. It is the Commission that determines whether such cost is included in working capital.

Q. Would you please summarize the Company's position regarding Commission Staff's proposed rate case expense adjustment?

A. The Company has followed prior Commission direction and precedent in the treatment of rate case costs. The Company's adjustment properly matches revenues and expenses associated with this cost, provides an audit trail and should be accepted by the Commission. The Commission Staff's proposed adjustment fails to recognize the variation in rate case expenses from year to year and mismatches revenues and expenses. In addition, the Commission Staff's proposal provides no methodology for future determination of such costs on a normalized basis. For these reasons, the Commission should not accept the Commission Staff's proposed adjustment.

I. Production Adjustment

Q. Please explain the difference between the Commission Staff and Company Adjustment 2.30, Production Adjustment?

A. The production adjustment reflects all the production related expenses and rate base items that have been revised through other adjustments. As with power costs, these items are adjusted from a rate year basis to a test year basis using a production factor. The Company and Commission Staff agree as to the production factor to use. However, because some of the costs are based on adjustments that are contested, the net operating income and rate base amounts will be different. The Company's adjustment increase net operating income $546,675 and lowers rate base $9,748,332.

J. Revenue Deficiency

Q. Would you please explain Exhibit No. ___(JHS-9)?

A. Exhibit No. ___(JHS-9) presents the calculation of the revenue deficiency based on the proforma and restating adjustments discussed above. As shown on page 1 of this Exhibit, based on $2,546,059,451 invested in rate base and $167,990,528 of net operating income the Company would have an electric retail revenue deficiency of $103,302,198 after allocation of $133,376 to wholesale customers

1. Cost of Capital

This schedule, shown on Exhibit No. ___(JHS-9), page 2, reflects the proposed capital structure for the Company during the rate year and the associated costs for each capital category. The capital structure and costs are presented in the testimony of Mr. Donald Gaines, Exhibit No. ___(DEG-9CT). The rate of return is 9.12%.

2. Conversion Factor

The conversion factor, shown on Exhibit No. ___(JHS-9), page 3, is used to adjust the net operating income deficiency by revenue sensitive items and Federal income tax to determine the total revenue requirement. The revenue sensitive items are the Washington State utility tax, Washington WUTC filing fee, and bad debts. The conversion factor used in the revenue requirement calculation, taking into consideration the adjustments discussed earlier, is 62.07738%.

3. Rate Base

The calculation of the test period rate base is shown in Exhibit No. ___(JHS-9), page 4, and is $2,546,059,451. Ms. Luscier discusses the differences between Commission Staff and the Company for test year rate base and working capital for the electric and natural gas operations.

4. Working Capital

The calculation of working capital is shown in Exhibit No. ___(JHS-9), page 5. The purpose of this calculation is to provide a return for the funds the shareholder has invested in the Company, for utility purposes, over and above the investment in plant and other specifically identified ratebase items already earning a rate of return.

The first part of this adjustment calculates the total average invested capital that has been utilized during the test year. From the average invested capital, the operating investment, which is already earning a return, is deducted. A second deduction is made for nonoperating assets and plant not in service. The result is total working capital provided by the shareholder.

This total working capital is then allocated between nonoperating working capital and operating working capital using the method consistent with previous rate cases. The resulting operating working capital represents the shareholder's average investment which is required to provide utility service but which would otherwise not earn a return.

This proforma adjustment is $15,068,558 and is included in the rate base for the test period.

K. Other Contested Adjustments

Q. Please continue with your discussion of contested adjustments.

A. Ms. Luscier discusses the differences between Commission Staff's and the Company's proposal for the following adjustments, which affect both the electric and natural gas requirement. The adjustment, and its impact on electric NOI, are provided below:

Adjustment 2.20, Property & Liability Insurance – decreases net operating income $321,615.

Adjustment 2.21, Pension Plan – decreases net operating income $5,565,312

Adjustment 2.22, Wage Increase – decreases net operating income $2,509,848

Adjustment 2.23, Investment Plan – decreases net operating income $104,205

V. OTHER ADJUSTMENTS

A. Rate Case Legal Costs

Q. Mr. Schoenbeck refers to a Company response to ICNU data request No. 6.12 as an example of how the Company's legal expense for rate case services are becoming "substantial." Is the Company presentation he submitted as Exhibit No. ___(DWS-14C) about rate case legal costs?

A. No. The presentation by PSE's Vice President and General Counsel, Jennifer O'Connor, focused on the efficiencies to be gained from handling more routine legal tasks internally rather than sending them to outside firms. It did not address rate case work. The average hourly rates Mr. Schoenbeck cites from the presentation, $[redacted] per hour figure for outside counsel, is not the rate PSE is paying its counsel for this rate case.

The average hourly billing rate for PSE's outside counsel on this rate case is, in fact, $[redacted] per hour. To the extent Ms. O'Connor's presentation is at all relevant to this topic, that $[redacted] per hour average rate (for services performed in 2004) is below the national law firm average hourly rate of $[redacted] as of 2002. In addition, the $[redacted] per hour rate of the lead Perkins Coie partner on this rate case is at the low end of the range PSE typically is required to pay for outside counsel of the caliber that is required to handle PSE's external representation. *See* Exhibit No. ___(DWS-14C) at 23.

In addition, it is inappropriate to compare the rates PSE pays for outside legal services in any given proceeding with PSE's average hourly cost for PSE's inside counsel. Just as with tax law and its interpretation, many legal matters are more appropriately handled by outside counsel than by PSE's in-house legal team. For those matters, PSE's average hourly cost for in-house attorneys is irrelevant. Instead, the appropriate hourly rate comparison is as between various potential outside counsel who could handle the matter for PSE.

Q. **Has PSE been making efforts to control its legal costs?**

A. Yes. The Company is well aware of and has taken to heart the Commission's admonition in UE-920433 et al. that it was concerned about the Company's legal costs. (*See, e.g.*, Exhibit No. ___(DWS-14C) at 10.) Mr. Schoenbeck's Exhibit No. ___(DWS-14C) is an incomplete version of PSE's Response to ICNU Data Request No. 06.12. In Exhibit No. ___(JHS-10), I provide a more complete version. Exhibit No. ___(JHS-10) demonstrates PSE's efforts in recent years to control its legal costs. Among other things, PSE has:

- increased the size of its internal legal department, including addition of attorneys, paralegals and support staff;
- in-sourced certain work previously undertaken by outside counsel;
- instituted a gatekeeper function with respect to hiring of outside counsel including restrictions on the retention of outside counsel without the approval of an in-house attorney;
- diversified the outside counsel it uses; and
- entered into fixed-fee, retainer and other fee arrangements with outside counsel.

Q. Mr. Schoenbeck suggests that it would be appropriate to only allow the Company to recover 50% of its outside legal and consulting rate case expenses. Do you agree?

A. No. Mr. Schoenbeck suggests an inappropriate, arbitrary limit to the Company's recovery of outside legal and consulting rate case expenses. While other parties are free to contest specific rate case costs that they believe are not reasonable, ICNU has not raised such challenges in its testimony in this proceeding.

With respect to any challenges to PSE's legal expenses, it must be recognized that the Company is a regulated entity and provides a basic service to the public. Accordingly, PSE has significant ongoing need for legal counsel, both internal and external, in rate proceedings and in other Company legal matters.

Mr. Schoenbeck asserts that the Company is causing rate proceedings to become more complex and expensive. However, this assertion fails to recognize that the utility industry has itself become more complex, that the Company typically bears the burden of proof in a rate proceeding, and that the Company cannot arbitrarily limit the issues and arguments advanced by other parties to a rate proceeding. In addition, the Company must incur significant consultant and legal expenses in responding to discovery requests.

B. Navigant Expenses

Q. In Exhibit No. ___(DWS-1HCT) at 27, Mr. Schoenbeck states that the bulk of the Navigant expenses appear to be related to a one-time event and were capitalized as part of the resource acquisition program. Is this statement accurate?

A. No. As Mr. Markell discusses, the Company did capitalize $391,157 of the Navigant consulting costs associated with the Frederickson 1 acquisition. It would not have been appropriate for the Company to have capitalized any more of these expenses. The Company must comply with Generally Accepted Accounting Principles (GAAP), and GAAP does not support capitalizing preliminary investigation pre-acquisition or due diligence costs when researching or analyzing new capital asset additions.

Under the provisions of Statement of Accounting Standards No. 67 ("SFAS No. 67") the Company is permitted to capitalize costs directly related to the acquisition of a specific resource, but only after an acquisition is probable. The execution of a detailed letter of intent and term sheet satisfies the requirements of SFAS No. 67 and that is the standard applied by the Company to defer and capitalize transaction-related legal, engineering, environmental and other professional fees. Conversely, expenditures associated with evaluating alternatives and unsuccessful commercial negotiations must be expensed during the period in which they are incurred. The bulk of Navigant's activities were for activities that cannot be capitalized, as discussed by Mr. Markell in his rebuttal testimony.

Additionally, SFAS No. 67 provides that pre-acquisition costs should be expensed in the period incurred unless such costs are directly identifiable to a specific property, in which case, such costs would be capitalized if the property were already acquired, and/or the acquisition is probable. Accordingly, GAAP does not permit the Company to capitalize professional fees pertaining to the Company's resource planning activity, RFP process, or exploratory or unsuccessful commercial negotiations as part of a specific resource acquisition like Fredrickson 1 until a Letter-of-Intent has been signed and the above conditions are met. These conditions were met in the third quarter of 2003 and the appropriate Navigant costs were capitalized during that quarter. The test period reflects this capitalization.

Q. On page 27 of his testimony, Mr. Schoenbeck also recommends that the Commission reduce the amount of Navigant costs to $300,000. Is this an appropriate adjustment?

A. No. Mr. Markell explains why this adjustment is not appropriate, as the Company continues to incur costs in excess of the test year costs for activities similar to those performed by Navigant.

Even without this type of explanation, Mr. Schoenbeck's adjustment is inappropriate. Obviously, there are many costs that are incurred in a test period that will not be incurred again. It is not the purpose of a test period to recover a specific cost. The purpose of the test period is to set a relationship between expenses and revenues that assumes such costs to be representative of costs to be incurred in the future. The Company has a limited amount of dollars for expenses. If the dollars are allocated to a specific program or expenditure in one year they obviously can not be allocated elsewhere. This does not mean that equivalent dollars can not and will not be used next year to cover a different program or expense. However, when a prudently-incurred cost is disallowed for setting new revenues, then all areas of the Company suffer as the dollars are no longer available to allocate to areas of need. This type of adjustment is not appropriate or constructive in setting revenue requirement.

C. PCA Exhibits

Q. Please describe Exhibit No. ___(JHS-11).

A. Exhibit No. ___(JHS-11) presents the adjusted Exhibits for the Power Cost Adjustment mechanism. Page 1 of this exhibit adjusts Exhibit A-1, Power Cost Rate, to reflect the new Power Cost Rate based on the Company's rebuttal revenue requirement calculations. The methodology applied is consistent with that set forth in the PCA Settlement Agreement, under Docket No. UE-011570, and the PCA Compliance Settlement Agreement, under Docket No. UE-031389.

Commission Staff made an adjustment to Exhibit A-1, Power Cost Rate, to separate the Amortization of Regulatory Assets from the production and amortization line shown on Exhibit A-1. The Amortization of Regulatory Assets was actually included in the several variable cost line items. The Company agrees with Commission Staff that this cost should be identified as a separate line item and has done so on lines 23a and 23b of Exhibit A-1.

Q. Does that conclude your testimony?

A. Yes, it does.

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