

**EXHIBIT NO. \_\_\_\_ (SPR-1T)**  
**DOCKET NO. UE-04\_\_\_\_/UG-04\_\_\_\_**  
**2004 PSE GENERAL RATE CASE**  
**WITNESS: STEPHEN P. REYNOLDS**

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

**WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,**

**Complainant,**

**v.**

**PUGET SOUND ENERGY, INC.,**

**Respondent.**

**Docket No. UE-04\_\_\_\_**  
**Docket No. UG-04\_\_\_\_**

**PREFILED DIRECT TESTIMONY OF  
STEPHEN P. REYNOLDS (NONCONFIDENTIAL)  
ON BEHALF OF PUGET SOUND ENERGY, INC.**

**APRIL 5, 2004**

1

**PUGET SOUND ENERGY, INC.**

2

**PREFILED DIRECT TESTIMONY OF STEPHEN P. REYNOLDS**

3

**CONTENTS**

4 **I. INTRODUCTION.....2**

5 **II. SUMMARY OF THE REASONS AND NEED FOR THE**

6 **COMPANY'S PROPOSED RATE RELIEF .....3**

7 **III. STEPS THE COMPANY IS TAKING TO ADDRESS THE**

8 **CHALLENGES IT IS FACING .....5**

9 **IV. REQUEST FOR RATE RELIEF .....8**

10 **V. OTHER WITNESSES .....12**

1

**PUGET SOUND ENERGY, INC.**

2

**PREFILED DIRECT TESTIMONY OF STEPHEN P. REYNOLDS**

3

**I. INTRODUCTION**

4

**Q. Will you please state your name, business address, and position with Puget Sound Energy, Inc.?**

5

6

A. My name is Stephen P. Reynolds. My business address is 10885 N.E. Fourth St., Bellevue, Washington, 98004. I am President and Chief Executive Officer of Puget Sound Energy, Inc. ("PSE" or "the Company"). I also serve on the Company's Board of Directors.

7

8

9

10

**Q. Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?**

11

12

A. Yes, I have. It is Exhibit No. \_\_\_\_ (SPR-2).

13

**Q. What are your responsibilities as President and Chief Executive Officer of PSE?**

14

15

A. I have overall management responsibility for the Company. In consultation with our executive team and Board of Directors, I set the Company's strategic business goals and direct our efforts to achieve those goals.

16

17

18

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

1 A. My testimony provides (i) a summary of the reasons and need for the Company's  
2 proposed rate relief, (ii) a discussion of the steps the Company has taken to  
3 address the challenges it is facing prior to requesting regulatory relief, and (iii) a  
4 description of the rate relief the Company is proposing in this case and how such  
5 relief will better position the Company to meet its obligations to customers and  
6 shareholders. I conclude by listing the other Company witnesses who will  
7 provide more detailed explanations of the case's underlying elements.

8 **II. SUMMARY OF THE REASONS AND NEED FOR THE**  
9 **COMPANY'S PROPOSED RATE RELIEF**

10 **Q. Please explain why the Company needs the proposed rate relief.**

11 A. The Company's mission, first and foremost, is to provide customers with high-  
12 quality service at reasonable rates. In addition, the Company has a responsibility  
13 to protect the interests of its investors. These two core obligations are not, I  
14 believe, at cross-purposes. On the contrary, they are complementary. In the  
15 capital-intensive energy business, only a financially strong utility capable of  
16 serving its investors' interests can have the financial wherewithal, over the long-  
17 term, to effectively serve its customers' interests.

18 The Company has committed to its identity and future as a fully regulated,  
19 vertically integrated utility. PSE firmly believes this path presents the best  
20 opportunity to fulfill its obligations and commitments to customers and  
21 shareholders alike. For the Company to succeed under a regulated, vertically

1 integrated business model, certain key things must happen. Above all, the  
2 Company's financial health must continue to improve. More specifically, the  
3 Company's credit rating must improve and its balance sheet strengthen. With an  
4 improved financial condition, the Company will be in a better position to make  
5 cost-effective energy resource investments for its customers and the substantial  
6 investments necessary to build and maintain reliable delivery infrastructure.

7 The Company has made significant progress over the past two years to improve  
8 its financial standing. The 2002 settlement of the Company's last general rate  
9 case, achieved with the extraordinary efforts of Commission Staff, Public  
10 Counsel, ICNU, NWIGU and other parties to that proceeding, contained several  
11 important provisions key to helping the Company begin to rebuild its financial  
12 health. The settlement's Power Cost Adjustment ("PCA") Mechanism, with its  
13 \$40 million overall cap on PSE's exposure to power costs in excess of amounts  
14 recovered in rates, and the acceptance of a proforma capital structure, are  
15 examples of some of the provisions that have assisted the Company.

16 Under that settlement, the Company has experienced some positive results. For  
17 example, when the Company filed its last general rate case in November 2001, its  
18 equity ratio was 31.7%. By the end of 2003, the Company had boosted its equity  
19 ratio to 40%. In addition to meeting the equity targets of the 2002 settlement well  
20 ahead of schedule, the Company lowered its overall cost of debt from a rate of  
21 7.4% to 6.74%.

22 Despite these and other tangible signs of progress, the Company has not yet

1 achieved the financial strength, stability and flexibility needed to support its  
2 energy supply and infrastructure requirements. This situation is expensive for  
3 both the Company's customers and shareholders and should be corrected. This  
4 rate case is another important step in that direction.

5 **III. STEPS THE COMPANY IS TAKING TO ADDRESS THE**  
6 **CHALLENGES IT IS FACING**

7 **Q. What are some of the challenges facing the Company?**

8 A. While the region's energy markets have stabilized in the wake of the 2000-01  
9 Western energy crisis, the Company faces a considerable and pressing need for  
10 new power supplies to meet our customers' requirements. This will require large  
11 sums of capital to acquire needed energy resources, in addition to the capital  
12 required to build and maintain reliable energy-delivery systems.

13 In addition, the Company's resource portfolio is subject to significant volatility  
14 and risk that ultimately have a substantial impact on the Company's customers  
15 and shareholders. While the Company has continued to improve its risk  
16 management systems and tools to help reduce the risks and volatility of energy  
17 costs associated with its electric and gas portfolio, the Company's financial  
18 position limits its ability to make use of hedging products. Financial strength is  
19 required to manage energy cost volatility effectively.

20 **Q. What steps has the Company taken to improve its financial condition?**

21 A. The Company has taken significant steps to lower the Company's debt, boost its

1 equity ratio, control costs, and secure a reliable, cost-effective energy supply for  
2 customers. Further steps are planned, but will require regulatory support to be  
3 implemented successfully.

4 In 2003, the Company increased its equity ratio to 40%--two years ahead of the  
5 target set in the 2002 rate case settlement. In this filing, the Company requests  
6 that the Commission base Company earnings on a 45% equity ratio.

7 The Company is also in the midst of a multi-faceted resource acquisition program  
8 to secure long-term energy resources at the least risk and cost possible for  
9 customers. The Company began this effort last fall with the proposed purchase of  
10 a near 50% interest in Frederickson 1, a gas-fired power plant near Tacoma,  
11 Washington. The Company is currently analyzing proposals received under  
12 requests for proposals for wind power and all-generation resources that have been  
13 issued under the Commission's rules.

14 Another key step taken by the Company to strengthening its business is, I believe,  
15 the work we have done toward building better relationships with customers,  
16 policymakers, the Commission, and other government regulators.

17 **Q. What has the Company done to increase its operational efficiency and**  
18 **control costs?**

19 A. Boosting operational efficiency and cutting costs--without sacrificing service  
20 quality--has been a high priority for the Company since the 1997 merger of Puget  
21 Sound Power & Light Co. and Washington Energy Company. The evidence

1 suggests that the Company's efforts have been successful. Our operations &  
2 maintenance ("O&M") costs per customer annually rank among the industry's  
3 lowest. PSE's 2003 O&M costs should place the Company, once again, among  
4 the top ten most efficient utilities in the nation, while consistently maintaining  
5 high marks on Service Quality Index standards.

6 **Q. How would you characterize the Company's quality of service?**

7 A. Judging from customer surveys, a strong majority would agree that the  
8 Company's service is excellent. PSE's annual Service Quality Index data indicate  
9 the Company consistently performs at a high level. The day-to-day reliability of  
10 service is good. For instance, field technicians respond promptly to emergencies,  
11 isolated equipment failures, and basic service appointments. The number and  
12 duration of non-storm power outages is low. And when major storms cause  
13 widespread outages, the Company's restoration efforts are, I believe, as good as  
14 can be found anywhere.

15 While the reliable delivery of basic electric and natural-gas service is the  
16 Company's highest priority, PSE further strives to provide customers with  
17 services for managing their energy use in the most efficient, convenient, and cost-  
18 effective manner possible. The Company's broad-based energy efficiency  
19 program, for instance, is a central element, providing technical assistance, product  
20 rebates, grants, and other services to tens of thousands of customers. PSE steadily  
21 looks for new ways to employ technology to help customers manage their energy  
22 consumption in simple, user-friendly ways. PSE's Web-based, personal energy-



1 tracking tool and interactive bill-information services are a couple of examples.

2 **IV. REQUEST FOR RATE RELIEF**

3 **Q. Why is the Company filing this rate case?**

4 A. Although the Company has made great strides to improve its financial condition,  
5 we are not where we need to be. To succeed as a vertically integrated utility and  
6 provide customers with first-rate, low-cost service, it is imperative for the  
7 Company to improve its financial health and attain greater financial stability and  
8 flexibility. As PSE is able to establish itself as a competitive investment option  
9 within national investment markets, access to financial tools will improve and  
10 costs decrease. Improved financial strength will also improve the Company's  
11 ability to manage volatility in its power and natural gas portfolio through use of  
12 long-term fuel supply contracts and hedging products. Achievement of these  
13 critical goals requires regulatory assistance.

14 In particular, the Company needs to further increase the percentage of equity in its  
15 capital structure, and have the opportunity to earn an improved return on that  
16 equity, in order to increase its attractiveness to investors and strengthen its credit  
17 rating.

18 PSE has identified several structural aspects of its rates, such as current rate  
19 design, that restrict the Company's ability to actually earn the rate of return that  
20 the Commission has approved. This filing seeks to remove those hurdles and  
21 move the Company farther down the road to recovery.

1 **Q. What are the Company's primary objectives for this filing?**

2 A. Above all, this rate case is designed to help the Company continue improving its  
3 financial condition so that it can meet the long-term interests of customers. To  
4 that end, this rate case has several key objectives:

5 a) obtain additional revenue in rates to pay for increases in costs the  
6 Company incurs to serve its customers;

7 b) authorize a fair and reasonable rate of return on equity of 11.75%, a level  
8 commensurate with the returns expected from peer utilities in states with  
9 similar regulatory standards;

10 c) authorize a capital structure comprised of 45% equity, a ratio the  
11 Company will need to sustain its credit improvement objectives;

12 d) improve the Company's ability to strengthen its corporate credit rating to  
13 BBB+, and thereby allow the Company to access capital markets on  
14 reasonable terms and improve the Company's ability to engage in hedging  
15 activities to reduce the cost volatility in managing its energy portfolio; and

16 e) establish a revised rate structure that reflects customers' changed energy-  
17 usage patterns and allows the Company recovery of its fixed costs.

18 **Q. What level of rate increase is the Company requesting under this case?**

19 A. The overall rate increase sought by this filing is 5.7% for electric customers, and  
20 4.8% for natural gas customers. In terms of revenue, the filing requests an annual

1 increase in electric revenue of \$81.4 million, and in gas revenue of \$49.0 million.

2 Even with the requested increase, customers' rates still would rank among the  
3 lowest in the country. More importantly, by strengthening the Company's  
4 financial profile and enhancing its credit rating, the filing will help keep rates low  
5 over time and stabilize customers' future energy costs. In exchange for this  
6 filing's rate adjustment and cost-recovery provisions, customers will continue to  
7 see greater reliability of service at a stable and reasonable price.

8 **Q. What are the main factors that have increased the Company's costs?**

9 A. The Company's aging infrastructure requires substantial investment to maintain  
10 the reliability and safety of the gas and electric systems. Growth is also a  
11 significant factor driving the steady increases to the Company's cost of service:  
12 growth in the number of customers served and growth in the distribution systems  
13 required to meet their needs.

14 **Q. Are you requesting that the Commission make changes to existing policies or**  
15 **rate structures for Company recovery of costs?**

16 A. Yes, such changes are warranted in two key areas. The first involves improving  
17 recovery of costs associated with major storms and other catastrophic events. The  
18 second addresses the impact of lower revenues due to declining usage per  
19 customer.

20 **Q. Please describe the issue and proposal regarding catastrophic events?**

1 A. Under existing Commission policy, the Company is eligible to seek deferral of  
2 storm related costs for its electric system only from an event in which service was  
3 interrupted to at least 25% of customers. The current definition does not protect  
4 the Company from catastrophic damage caused by non-storm events, such as  
5 earthquakes or terrorism, does not apply to damage to the gas system, and is  
6 restricted by the customer percentage threshold regardless of the financial impact  
7 of the event.

8 The Company is requesting that the Commission authorize deferral of costs  
9 caused to its electric or gas systems based on a financial measure of the damage  
10 caused by such events and extend the current definition to include major events  
11 such as earthquakes or other catastrophic events.

12 **Q. What is the issue with respect to lower usage per customer?**

13 A. The Company recovers its fixed costs for serving customers through rates that are  
14 based on the amount of gas or electricity a customer uses. When customers use  
15 less gas or electricity per household, the Company recovers less in revenues but  
16 still faces the same fixed costs of providing gas and electric service to each  
17 household. The result is an under-recovery of revenues.

18 The Company is proposing some changes to its rate design as well as small  
19 annual increases in gas and electric rates to address this problem, so that it has the  
20 opportunity to actually earn the revenues the Commission has approved in rates.

21 **Q. Would approval of this filing serve the interests of your customers as well as**

1           **shareholders?**

2    A.    Yes. Commission approval of this filing would address the ongoing under-  
3           recovery of costs the Company incurs to serve customers and help to improve the  
4           Company's financial condition. In doing so, we believe the filing will reduce the  
5           Company's cost of capital and lower the ultimate cost of customers' energy, as  
6           well as better enable the Company to invest in the energy resources and  
7           infrastructure needed to provide reliable, cost-effective service to our customers.

8    **V.    OTHER WITNESSES**

9    **Q.    Would you please identify the Company witnesses who will be providing**  
10           **testimony on the issues you have mentioned?**

11   A.    I would be happy to.

12           1.    Mr. Eric Markell, Senior Vice President Energy Resources, discusses in  
13           his testimony, Exhibit No. \_\_\_(EMM-1CT), the Company's current  
14           resource portfolio, the Company's need to acquire additional energy  
15           supply resources over the next several years, and the expected magnitude  
16           of expenditures to acquire such resources.

17           2.    Ms. Julia Ryan, Vice President of Risk Management and Strategic  
18           Planning, discusses in her testimony, Exhibit No. \_\_\_(JMR-1T), the  
19           volatility and risk drivers in the Company's efforts to manage risk and  
20           volatility in its energy supply portfolios and the importance of the  
21           Company's financial strength to these efforts. Ms. Ryan also describes the

1 approach taken by the Company in preparing its projection of normalized  
2 power costs presented in this case.

3 3. Dr. Jeffrey Dubin, Pacific Economics Group L.L.C. and Associate  
4 Professor of Economics at the California Institute of Technology  
5 (Caltech), discusses in his testimony, Exhibit No. \_\_\_(JAD-1T), the  
6 statistical soundness of estimating the Company's future hydroelectric  
7 generation based on the full 60 years of available information (1928-1987)  
8 rather than only the most recent 40 years of information.

9 4. Ms. Susan McLain, Senior Vice President Operations, discusses in her  
10 testimony, Exhibit No. \_\_\_(SML-1CT), the Company's delivery  
11 operations, including the Company's work to control costs while providing  
12 excellent service and reliability. She also describes significant costs the  
13 Company is facing to replace and maintain its aging infrastructure in  
14 addition to expanding that infrastructure to serve new customers.

15 5. Mr. Bertrand Valdman, Senior Vice President Finance and Chief Financial  
16 Officer, discusses in his testimony, Exhibit No. \_\_\_(BAV-1T), the  
17 Company's financial strategy and concerns of its investors. Mr. Valdman  
18 also describes the need for the requested rate relief to improve the  
19 Company's financial strength so that it can acquire the resources it needs  
20 to service customers and manage its resource portfolio on reasonable  
21 terms.

- 1           6.     Mr. Donald Gaines, Vice President Finance and Treasurer, discusses in his  
2                     testimony, Exhibit No. \_\_\_\_ (DEG-1CT), the Company's current credit  
3                     ratings, the steps taken by the Company to strengthen its financial  
4                     condition since its last general rate case, and the Company's requested  
5                     capital structure, cost of capital calculations and overall rate of return.
- 6           7.     Dr. Charles Cicchetti, Pacific Economics Group L.L.C. and Jeffrey J.  
7                     Miller Chair in Government, Business and the Economy at the University  
8                     of Southern California, discusses in his testimony, Exhibit No. \_\_\_\_ (CJC-  
9                     1T), rate relief issues pertaining to the Company and his recommended  
10                    return on equity for the Company.
- 11          8.     Mr. John Story, Director of Cost and Regulation, discusses in his  
12                     testimony, Exhibit No. \_\_\_\_ (JHS-1T), the calculation of the revenue  
13                     requirement for the electric results of operations. Mr. Story also presents  
14                     the updated Power Cost Baseline Rate for the PCA Mechanism.
- 15          9.     Ms. Barbara Luscier, Manager of Revenue Requirements, discusses in her  
16                     testimony, Exhibit No. \_\_\_\_ (BAL-1T), the calculation of the revenue  
17                     requirement for the gas results of operations.
- 18          10.    Ms. Colleen Paulson, Manager of Pricing & Cost of Service, discusses in  
19                     her testimony, Exhibit No. \_\_\_\_ (CEP-1T), the Company's electric and gas  
20                     cost of service studies.
- 21          11.    Mr. James Heidell, PA Consulting Group, Inc., discusses in his testimony,

1 Exhibit No. \_\_\_\_ (JAH-1T), the Company's proposed electric and gas rate  
2 designs and tariffs, including proposed changes to gas and electric rate  
3 structure.

4 **Q. Does this conclude your testimony?**

5 A. Yes it does.

6 [[BA040850.039 / 07771-0089](#)]