BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DOCKET NOs. UE-072300 and UG-072301

DIRECT TESTIMONY OF LEE SMITH (LS-1T)

ON BEHALF OF

PUBLIC COUNSEL

MAY 30, 2008

NON-CONFIDENTIAL

DIRECT TESTIMONY OF LEE SMITH (LS-1T)
DOCKET NOs. UE-072300 AND UG-072301

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DIRECT TESTIMONY OF LEE SMITH (LS-1T)
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LEE SMITH'S EXHIBIT LIST

Exhibit No. ___ (LS-2)	Resume of Lee Smith
Exhibit No. ___ (LS-3)	Gross PSC Roll Forward & Sharing Provision; PCA Results without PCORC Filings

1 **I. INTRODUCTION**

2 **Q: What is your name and business address?**

3 A: My name is Lee Smith, and I work for La Capra Associates, 20 Winthrop Square,
4 Boston, Massachusetts.

5 **Q: On whose behalf are you testifying in this proceeding?**

6 A: I am testifying on behalf of the Public Counsel Section of the Washington State
7 Attorney General's Office (Public Counsel).

8 **Q: Please describe your background and experience.**

9 A: I am a Managing Consultant and Senior Economist at La Capra Associates. I
10 have been with this energy planning and regulatory economics firm for 24 years.
11 I have prepared testimony on rates and cost allocation regarding more than 50
12 utilities in 18 states and before the Federal Energy Regulatory Commission. Prior
13 to my employment at La Capra Associates, I was Director of Rates and Research,
14 in charge of gas, electric, and water rates, at the Massachusetts Department of
15 Public Utilities. Prior to that period, I taught economics at the college level. My
16 resume is attached as Exhibit No. ____ (LS-2).

17 **Q: Please describe your educational background.**

18 A: I have a bachelor's degree with honors in International Relations and Economics
19 from Brown University. I have completed all requirements for a Ph.D. in
20 economics except the dissertation from Tufts University.

21 **Q: What is the purpose of your testimony in this proceeding?**

22 A: La Capra Associates has been retained by the Public Counsel to review Puget

1 Sound Energy's (PSE's) power costs and power cost collection mechanisms.

2 **Q: Please summarize your conclusions.**

3 A: I have concluded that the non-traditional way in which PSE's rates are currently
4 set through multiple overlapping mechanisms is unnecessarily cumbersome and
5 expensive. More importantly, the Power Cost Only Rate Case (PCORC) allowed
6 for PSE distorts the operation of the Power Cost Adjustment (PCA) mechanism.
7 Moreover, the PCORC increases rate instability, increases regulatory costs and
8 burden and provides no public benefits to justify its continued existence. I
9 recommend that the PCORC mechanism be eliminated.

10 11 12
II. TRADITIONAL RATEMAKING AND PSE'S CURRENT RATEMAKING SCHEME

13 **Q: Is the ratemaking framework which is currently in place for PSE different**
14 **from traditional cost-of-service based ratemaking?**

15 A: Yes, it is. Cost-of-service ratemaking, as it has existed since the beginning of
16 regulated ratemaking, sets utility rates in a rate case, in which it reviews utility
17 costs for a specified test year. Typically, this has been a historic year, adjusted for
18 known and measureable changes, which results in a consistent view of a utility's
19 costs and revenues. These costs include fuel, variable operating and maintenance
20 expenses, and other expenses, including depreciation. Costs also include
21 shareholder profits, which are calculated as a return on the utility's rate base.
22 Typically, when a utility makes major investments, such as in a new generating

23

plant, it may need to file a rate case to request that investment be recognized in rates.

Traditional rate case ratemaking allows a thorough and consistent review of all costs and revenues, affords the utility an opportunity to earn a reasonable rate of return, and provides the utility with an incentive to minimize costs between rate cases. The utility's built-in incentive to try to minimize costs (including power costs) in between rate cases is a significant benefit of traditional ratemaking.

In contrast, single issue ratemaking is normally not permitted because it presents an unbalanced view of utility costs and revenues. It is improper because it fails to take a comprehensive look at all company costs and revenues. A single issue case focuses on a single cost or category of costs – always rising costs – and seeks recovery on that basis alone. I am not aware of any single issue case that was filed because of declining costs. Subsequent to the setting of rates, if the utility experiences load and revenue growth, it can earn its allowed rate of return even if expenses increase.

The rate case process does take time. The utility must prepare the rate case, and regulatory rules normally specify a period of time for deliberation. The lag between when the case is filed and when the Commission allows new rates, if it does, might be a problem to the utility when costs are increasing, but this can be offset by the allowed adjustments to historic costs and by growth in revenues. Moreover, when utilities are over-earning, they benefit from regulatory lag.

1 Regulators or customer representatives must recognize the overearnings and
2 initiate a proceeding to reduce rates. Rate reduction proceedings normally take
3 just as long as rate increase proceedings.
4 PSE describes its test year as primarily historic, with pro forma
5 adjustments. However, it estimates power costs for the rate year – in this case
6 November 2008 through October 2009 – and then proforms these power costs
7 back to the test year by applying the estimated rate year cost per kWh to the test
8 year billing determinants. This treatment minimizes any regulatory lag problem
9 that might exist with respect to power costs.
10 **Q: Are there other common ratemaking mechanisms that are found in most**
11 **states?**
12 A: Yes. Most states now have some type of adjustment mechanism that tracks fuel
13 and usually also purchased power costs. Power cost adjustment mechanisms were
14 generally adopted in addition to traditional ratemaking during times of significant
15 changes in fuel and power costs. These have been allowed where it has been
16 found that the utilities have little control over such costs
17 **Q: How does the ratemaking scheme under which PSE is currently operating**
18 **differ from the standard approach that you have described above?**
19 A: PSE's rates can be modified, not only through traditional rate cases and regular
20 adjustments for fuel and purchased power costs, but also by an additional
21 ratemaking mechanism. In total there are three mechanisms through which it can
22 modify its rates:

1) A General Rate Case (GRC) which must be filed within three months of the rate change authorized by a PCORC (see below) or which can be filed whenever the utility chooses;

2) A Power Cost Only Rate Case (PCORC), which adjusts all costs related only to power, and which can be filed whenever the utility chooses.

3) A Power Cost Adjustment (PCA), filed annually, which compares actual fuel and power supply costs (Net Power Costs) to a baseline projection of these costs; rates change only if the difference between actual Net Power Costs and the normal (baseline) Net Power Costs allowed in the PCA have been greater than specified amount. The PCA baseline rate can be reset by a GRC or a PCORC filing.

Q: Without specific mechanisms such as the PCORC, how do utilities recover the cost of new investment?

A: Utilities make investments almost continually. The costs of new investments can be recovered through depreciation expenses and through revenues from load growth when such revenue growth exceeds increases in expenses. Historically, when utilities make large investments, they file rate cases in order to get recovery of new capital costs. Even the dollars spent on plant construction prior to a rate case can be recovered by capitalizing them and including them, together with an allowance for the cost of funds used during construction, in the new rate base.

1 **III. BACKGROUND OF THE PCA AND PCORC**

2 **Q: When was the PCA adopted for Puget Sound Energy?**

3 A: In 2001, the major means by which PSE could adjust its rates was a general rate
4 case. The Company filed a General Rate Case, Docket Nos. UE-011570,
5 UG-011571, requesting a rate increase, recovery of uncollected power costs, and a
6 new rate adjustment mechanism such that rates would either track changes in
7 power costs or customers would pay a higher amount for power costs that did not
8 vary. The Company argued that it was experiencing some financial difficulties
9 and that it had not been recovering increased fuel costs, due to the turmoil in the
10 Western power markets. This case was resolved by a multipart Settlement
11 Agreement. A Power Cost Adjustment collaborative group developed Settlement
12 Terms for the Power Cost Adjustment Mechanism resulting in the PCA
13 Settlement Agreement,[1] approved June 20, 2002.

14 **Q: How did the Power Cost Only Rate Case (PCORC) get introduced into Puget**
15 **Sound Energy's ratemaking methodology?**

16 A: The 2002 PCA Settlement that adopted the PCA also allowed the utility to file a
17 Power Cost Only Rate Case (PCORC), "a periodic proceeding specific to power
18 costs that would true up the Power Cost Rate to all power costs identified in the
19 Power Cost Rate."[2] It allowed the Company to initiate such cases to add new
20

[1] *WUTC v. PSE*, Docket Nos. UE-011570 and UG-011571, PCA Settlement.
[2] *WUTC v. PSE*, Docket Nos. UE-011570 and UG-011571, PCA Settlement, p. 5.

1 resources and to reflect other changes in power costs. The PCA Settlement
2 contemplated that PCORC proceedings would be completed within four months.
3 According to the Settlement, one objective of the PCORC was to have a rate
4 change by the time the new resource would go into service.

5 **Q: What appears to have been the basis for the introduction of the PCORC for**
6 **Puget Sound?**

7 A: While the PCA mechanism addressed short-run power cost changes, the PCORC
8 evidently was introduced because of PSE's expressed "need to deal with
9 increased costs associated with adding new resources for growth or replacing old
10 low-cost resources."[3] The Company testimony on the PCA Settlement describes
11 the PCORC mechanism as necessary for "PSE to revitalize its resource planning
12 process and to make decisions about longer term supply resources," as the
13 PCORC reviews "would provide for timely inclusion of new resource costs in
14 rates." [4]

15 **Q: Do you have any comments about the adoption of the PCORC and the PCA?**

16 A: Yes. The theoretical justification for allowing the PCORC is less clear than the
17 justification for the PCA. The testimony supporting the PCA Settlement portrays
18 the justification for the PCORC only in terms of the introduction of the cost of
19 new resources into rates. It does not appear that any Settlement testimony
20 provides an explanation as to why a PCORC might be needed in the absence of

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[3] *WUTC v. PSE,* Docket No. UE-011570, Exhibit No. ___ (MRL-2T), p. 13.
[4] *WUTC v. PSE,* Docket No. UE-011570, Exhibit No ___ (WAG-10T), p. 5.

1 the introduction of new resources, although the Settlement allowed PCORC
2 filings to address changes in Net Power Costs even if new resources were not
3 being introduced. General Rate Case proceedings also can, and do, introduce new
4 resources, reflect changes in all types of power costs, and reset the baseline PCA
5 level.
6 The PCA mechanism, on the other hand, was designed to reflect
7 significant changes in what the mechanism calls Net Power Costs, which consist
8 primarily of the utility's variable power costs.
9 **Q: Didn't Public Counsel agree to the adoption of the PCORC in the UE-011570**
10 **Settlement?**
11 A: Yes, it did. However, after six years of experience and four PCORC filings,
12 questions have developed regarding the propriety and efficacy of the mechanism.
13 In the last PCORC, Docket UE-070565, the Commission approved a Settlement
14 Agreement which included an agreement to establish a stakeholder review of the
15 PCORC process. This review was to consider the scope and timing of the
16 PCORC process and whether the mechanism should continue. After meeting
17 numerous times in the fall of 2007, the parties were unable to come to agreement
18 about whether the PCORC should be changed or eliminated. Public Counsel
19 retained me to review the operation of the PCORC and to recommend whether it
20 should be retained.
21

IV. SIGNIFICANT PROBLEMS HAVE EMERGED WITH THE PCORC THAT WARRANT ITS ELIMINATION

Q: Please summarize your findings with regard to the PCORC filings.

A: The PCORC mechanism has resulted in some fundamental ratemaking problems:

1) The PCORC filings have essentially prevented the PCA from accomplishing most of the objectives for which it was designed;
2) The regulatory burden on all parties and the Commission has been increased.

Q: What were the objectives of the PCA with which the PCORC has interfered?

A: The PCA was created with various provisions that were intended to achieve four main objectives; 1) avoid frequent rate changes, 2) incent the Company to hold down its costs, 3) treat customers and the Company symmetrically, and 4) prevent the Company from incurring large shortfalls in income that could strain its ability to provide safe, efficient, and reliable service due to changes in costs that were out of their control. The PCORC filings have interfered with, if not totally negated, all except the last objective, that of preventing the Company from experiencing large income shortfalls.

Q: What is the basis for your understanding that these were among the primary objectives of the PCA?

A: These four objectives were all expressed in testimony on the PCA Settlement by witnesses for PSE, for the Staff, and for Public Counsel.

1 PSE witness William A. Gaines listed the following characteristics of the
2 PCA:[5]
3 1) Balance between providing customers with certainty and rate stability**;**
4 2) Provide proper incentives to the Company to manage its resource
5 portfolio;
6 3) Equitably share power cost variances between shareholders and
7 ratepayers; and
8 4) Gives the Company some level of protection from extreme variances in its
9 energy supply costs.
10 Staff witness Merton Lott's rationale for supporting the PCA included the
11 following desirable characteristics:[6]
12 1) Rate payers should not be faced with constant frequent changes in power
13 costs:
14 2) The PCA reflects short run costs, and leaves PSE at risk for a substantial
15 portion of variable power supply risks;
16 3) PSE remains partially at risk in all situations for at least a portion of
17 increased power supply costs; and
18 4) The mechanism protects the Company from extreme events.
19

[5] *WUTC v. PSE,* Docket No. UE-011570, Exhibit No ___ (WAG-10T), p. 2.
[6] *WUTC v. PSE*, Docket No. UE-011570, Exhibit No. ___ (MRL-2T), pp.12-13.

1 Public Counsel witness, James Lazar supported the PCA because it:[7]

2 1) Should not result in frequent rate changes;

3 2) It provides a significant incentive for the Company to minimize power
4 supply costs;

5 3) It shares risk between the Company and ratepayers; and

6 4) It provides Puget with a measure of security in the event of multiple "bad"
7 years in a row through the deferral and sharing mechanism.

8 **A. How The PCA Objectives Have Been Distorted**

9 **Q: Please summarize how the PCA mechanism operates.**

10 A: As noted earlier, the PCA mechanism does not exactly match power revenues and
11 power costs. Rather, it compares actual power costs to PCA allowable costs,
12 which result from PCA "baseline" per kwh amounts that have been set in a rate
13 proceeding. A fundamental characteristic of the PCA is that not all of the
14 differences between actual and allowable Net Power Costs are either collected or
15 returned. If actual power costs are greater or less than the PCA allowable power
16 costs, there are several constraining sharing bands that determine customer and
17 Company responsibility.

18 If the annual difference between actual and baseline allowable costs is
19 within plus or minus $20 million (the "deadband"), the difference, either positive
20 or negative, is booked as 100 percent Company responsibility. If the annual
21

[7] *WUTC v. PSE*, Docket No. UE-011570, Exhibit No. ___ (JL-1T), pp.1- 4.

1 difference is between $20 million and $40 million, the second sharing band
2 requires that the difference over $20 million be split equally between the
3 Company and ratepayers. In the third sharing band, from $40 million to $120
4 million, only 10 percent is to be booked to the Company, and 90 percent to
5 ratepayers. In the final band, for any difference over $120 million, the Company
6 would be responsible for only 5 percent of the power cost. A surcharge can be
7 triggered when the Company projects that the increase in the deferral balance will
8 be over $30 million in the next 12 month period. The PCA Settlement Order also
9 requires the Company to file for a rate credit and allows the Company to file for a
10 surcharge when its accumulated deferred balance rises above either positive or
11 negative $30 million[8]. Despite significant growth in Company revenues since
12 2001, these sharing bands have not been adjusted.

13 **Q: How does this PCA design help achieve the objectives listed above through its**
14 **cost deferral and sharing mechanisms?**

15 A: The PCA provisions implement the first three objectives in the following manner:

16 1) Avoid frequent rate changes – these constraints should prevent rates
17 from changing frequently, as the designated deferral amounts must be
18 reached before surcharges or credits are imposed.

19 2) Incent efficiency – the Company's exposure to a limited amount of
20

[8] *WUTC v. PSE*, Docket Nos. UE-011570 and UG-011571, PCA Settlement, p. 2.

1 increased costs is an incentive to try to keep costs to the PCA
2 allowable amount.
3 3) Share risk – customers are at risk of paying more of increased costs,
4 and the Company is at risk for not getting full recovery of increased
5 costs; the Company can also retain some benefits if costs are below
6 the PCA allowable amount.
7 The fourth objective is implemented through the Company's ability to
8 collect a surcharge when the customer portion of the deferred power costs
9 cumulatively exceeds allowable costs by more than $30 million.[9]

10 **Q: How has the PCORC distorted the operation of the PCA?**

11 A: In the PCA, Company cost deferral balances can only result in a rate changes if
12 the utility share of the divergence from the baseline power cost is fairly large. The
13 sharing bands and the allowable trigger for rate changes can prevent rates from
14 changing often; they also share risks between the Company and ratepayers; and
15 the increases in costs that will not be recovered are clearly a strong incentive to
16 try to keep any annual increase in power costs low. When the PCORC resets the
17 baseline, however, rates change when the PCA alone would not have allowed a
18 rate change.

[9] The Settlement also provided for more relief to the Company (until July 2006) if cumulative deferrals rose to a cap of $40 million. In its final Order in PSE's 2006 General Rate Case the Commission addressed the removal of this cap. The Commission stated that the $40 million cap had been approved to "temporarily mitigate risk to the Company so that it could improve its financial condition…" (*WUTC v. PSC*, Docket UE-060266, Order 8, p. 10) and that this cap tilted the balance in PSE's favor. The Order allowed the cap to expire.

1 Without the intervention of PCORCs, as I will demonstrate, there would
2 have been larger Company positive and negative deferrals, but fewer rate
3 changes. The PCA would determine, according to its original design, when the
4 mismatches between revenues and costs resulted in surcharges or credits. The
5 PCA baseline would still have been adjusted, but only at the time of a GRC,
6 which would provide rate stability for customers, allow the PCA to work as
7 planned, and afford intervenors and the Commission more time and opportunity to
8 review power cost related rate requests and data.

9 **Q: Can you illustrate how Company and customer deferral balances determined**
10 **by the PCA would have been different were it not for the PCORC?**

11 A: Yes. I have performed an analysis to estimate how Company and customer
12 deferrals would have been different if PCORCs had not been allowed and
13 therefore had not modified the baseline PCA amounts. This is an estimate, as we
14 cannot know how the exact timing and result of GRCs would have differed if
15 there were no PCORCs. I make an assumption that in periods when actual costs
16 were significantly above PCA allowable costs, the Company would have filed
17 GRCs much earlier than they actually did.

18 **Q: Please describe this analysis.**

19 A: My analysis was based on modifying the spreadsheet provided in PSE's response
20 to Public Counsel Data Request No. 546. The worksheet I developed is attached
21 as Exhibit No. ___ (LS-3). Page 1 of this exhibit is the first sheet of the PSE
22 response. Page 2 is my adjusted worksheet. This computation begins each PCA

1 period with the difference between actual and PCA allowable power costs by
2 month. These monthly amounts are accumulated through the PCA period. The
3 worksheet then splits the deferral balance into the various sharing bands, and then
4 calculates customer and Company amounts according to the various sharing
5 bands. Positive balances mean that power costs were greater than the PCA
6 allowable costs, while negative balances mean the opposite. Until July 2006, the
7 total Company deferral was computed to identify when the amount reached $40
8 million, as until this date, the total Company deferral (over all previous PCA
9 periods) was capped at $40 million.[10]
10 To estimate the results if there had been no PCORC, I identified the
11 months in which a PCORC order resulted in a change in the baseline PCA rate
12 from its previous level. Using the PCA kwh sales reported in annual PCA filings,
13 I calculated how much more or less would have been collected each month if the
14 PCORC filing had not modified the PCA, at least until the next GRC rate change.
15 Obviously, if a PCA baseline increase did not happen, the deferral balance would
16 have been greater. In periods when the deferral balance was positive, it would
17 have still have been positive, though a different magnitude. In periods when the
18 deferral balance was negative, removing an increase would have made the balance
19 less negative, possibly even turning it positive.

[10]This was not an absolute cap, but once the balance reached $40 million, the Company's share of additional deferrals decreased to 1 percent.

1 I eliminated each PCORC-related adjustment to the PCA baseline for only
2 four months after its initiation. In other words, I assumed the prior PCA baseline
3 remained in effect four months longer than it actually did. I made the assumption
4 that, had there been no PCORC mechanism, PSE would have instead filed a GRC
5 at the time of each PCORC filing. Based on a review of the history of rate
6 proceedings, it appears that a GRC case filed at the same time as the PCORC case
7 could have changed the baseline PCA rate within four months after the PCORC
8 would have changed rates. I further assumed that the change in the baseline
9 resulting from a GRC would have been "accurate" – that is, that the resulting
10 PCA revenues would have equaled actual costs until the next date on which a
11 GRC change actually occurred.

12 **Q: Please describe how your analysis identified differences between the actual**
13 **PCORC/PCA effects and an alternative scenario without the PCORC.**

14 A: Four changes in the PCA baseline amount resulting from PCORC filings have
15 occurred, and were removed in this analysis. In June 2004, November 2005, and
16 September 2007, the baseline was increased as a result of a PCORC order. In
17 July 2006, the result of a PCORC case that was required to switch the PCA period
18 to a calendar year, the PCA baseline was decreased, indicating that the November
19 2005 increase had been too large. Table 1 below shows the total deferral
20 amounts, i.e. the differences between actual costs and PCA allowable costs, by
21 each PCA period. The third column shows what total PCA deferrals would have
22 been by period if PSE had filed a GRC instead of a PCORC.

1 **Table 1:**

2 **TOTAL PCA DEFERRALS**

PCA Period	Actual Deferral In Period with PCORC (millions)	Estimated Deferral In Period Without PCORC
1 – Year ending 6/03	$2.6	$2.6
2 – Year ending 6/04	$30.2	$33.6
3 – Year ending 6/05	$10.2	$13.2
4 – Year ending 6/06	-$10.5	$42.8
5 – 6 mo. ending 2/06	-$0.06	-$16
6 – Year ending 12/07	-$26.6	-$3.4

3

4 **Q. Does Table 1 address customer cost responsibility under the deferrals?**

5 **A.** No. I have prepared Table 2 below to address that issue. Table 2 shows the
6 actual accumulated customer deferral balances versus an estimate of the
7 accumulated balances that would have occurred absent the PCORC. This yields
8 an estimate of how much more customers have paid because of the PCORC-
9 driven baseline changes, as compared to what would have been paid if only the
10 PCA had been in place and GRCs had been filed.

11 / /

12 / / /

13 / / / /

14 / / / / /

1 **Table 2:**

2 **CUSTOMER RESPONSIBILITY WITH AND WITHOUT PCORC**
3 **(In millions)**
4

PCA Period	Actual Accumulated Customer Deferral Under PCORC (a)	Estimated Accumulated Customer Deferral Without PCORC (b)	Customer Payments Under PCORC Due To Earlier Baseline Changes (c)
1	$0	$0	$0
2	$5.1	$6.7	$3.3
3	$5.1	$6.7	$10.5
4	$5.1	$42.2[11]	$27.1
5	$5.1	$0	$0
6	$1.8	$-3.6	$22.1
TOTAL			$63.0

5 (a) Exhibit No. ___ (LS-3), p. 1, Column P
6 (b) Exhibit No. ___ (LS-3), p. 2, Column S
7 (c) Exhibit No. ___ (LS-3), p. 2, Column I
8
9 **Q. Wouldn't the PCA have allowed the Company to impose a surcharge based**
10 **on the level of customer deferrals in period 4?**

11 **A.** Yes. Without the PCORC, the accumulated customer deferral in period 4 of
12 $42.2 million would have allowed the company to impose a surcharge.[12]

[11] The period 4 estimated customer deferral balance is quite high because PCORC revenues of over $6 million per month were removed for 4 months.
[12] This would have been the case unless its GRC filings would have resulted in higher revenues than I assumed.

1 However, as shown in Table 2, customers paid $63 million as a result of the
2 PCORC-driven changes to the PCA baseline.
3 **Q: What does your analysis indicate with regard to the impact of the PCORC on**
4 **the objectives of the PCA?**
5 A: The analysis shows that without the PCORC there would have been more rate
6 stability, more incentive for the Company to contain their power costs, and more
7 sharing of risk. On the latter point, it appears that the baseline updates under the
8 PCORCs virtually nullify the effect of the deadband in the PCA, with the result
9 that additional power cost risk is shifted to customers. PSE might have filed
10 GRCs earlier than it actually did, at about the same date the PCORCs were filed.
11 PSE would have probably received more revenues through a PCA-generated
12 surcharge than it actually did, however, overall customers would have paid
13 somewhat less. The Company would not have suffered major financial losses.
14 **Q: If it took longer than 4 months for a GRC to change the baseline rate, or if**
15 **the next GRC did not result in rates that eliminate monthly deferrals, how**
16 **would the results have changed?**
17 A: It is not possible to determine this with any accuracy. The answer depends not
18 only on when the baseline rate changed, but by how much. We can not know
19 either exactly when or by how much the baseline rate would have changed.
20 In actuality, there has been only one small rate change due to a PCA filing.
21 The changes in deferral balances have been kept below levels that would justify
22 surcharges or credits, at least partly as a result of PCORCs. As noted, the

1 PCORC mechanism appears to have essentially subsumed the PCA with the effect
2 of shifting increased power cost responsibility to ratepayers.

3 **Q: How does the Company appear to have responded to the possibility that**
4 **actual power costs might be greater than PCA allowable power costs?**

5 A: The Company appears to have responded in several ways. It has filed for and
6 been allowed numerous changes in its PCA baseline power costs through both the
7 PCORC and its GRCs. There is clearly less pressure to contain power costs if the
8 allowable amount of power costs can be easily modified.

9 In addition, it has modified its hedging policy several times, reducing its
10 exposure to changes in power costs by hedging fuel and market power costs.
11 PSE's hedging in 2002 was essentially a dollar cost averaging approach that
12 purchased or sold power to reduce its uncovered position.[13] In 2003 and again in
13 2004 the Company modified its hedge strategy to aim at reducing its dollar risk.
14 It appears from the highly confidential PSE Response to Public Counsel Data
15 Request No. 543 that PSE hedges enough to protect themselves from significant
16 risk even in fairly negative circumstances[14].

17 While hedging is not necessarily a bad thing, it will have costs. Hedging
18 can avoid the need to purchase expensive power, but it can also preclude the
19 possibility of purchasing inexpensive power, when costs go down. Many of
20 PSE's hedging costs have been and are reflected in the costs that it has projected

[13] *WUTC v. PSE*, Docket No. UE-070565, Exhibit No. ___ (DEM-3C), Redacted, p. 4.
[14] The response references the PSE Response to ICNU Data Request No. 02.15.

1 in each PCORC and GRC filing, so hedging may increase costs, but we do not
2 know how much this hedging plan costs customers, except for the cost of the
3 credit line that PSE has in order to support its hedging transactions which is now
4 incorporated in the PCA. According to PSE's response to Public Counsel Data
5 Request No. 634, PSE "has as not performed specific analyses of what power
6 costs would have been without hedging."

7 **Q. How has the PCORC contributed to frequent rate changes and resulting rate**
8 **instability?**

9 A. Since April 2004, there have been 6 separate rate changes, and we are now
10 reviewing a request for a seventh. (One rate change was due primarily to revising
11 the time period for PCA accounting from July to June years to calendar years.)
12 Five of these changes were rate increases and one of these changes was a rate
13 decrease[15]. If there had been no PCORC, it is likely that there would have been
14 3-4 changes due to GRCs, one very small surcharge and one larger surcharge
15 resulting from PCA deferrals reaching the level necessary to change rates.

16 **Q: If the Company did not have a PCORC, could increases in its power costs**
17 **cause it great financial distress?**

18 A: No. It is protected from such a result by the provisions that allow it to file a
19 surcharge when deferrals have or are expected to exceed $30 million, and by its
20 hedging policy.

[15] Although even this was the result of a case (Docket No. UE-060266) in which the Company had requested an increase.

1 Moreover, there is no reason to expect that power costs would exceed
2 allowable PCA costs by amounts that would cause financial distress, since the
3 Company can always file a GRC. Every GRC can provide a new projected level
4 of power costs and will change the baseline PCA from the date of the ordered
5 change in rates.
6 The PCORC has allowed the PCA baseline to be changed quickly and
7 easily. This ability to modify the PCA baseline decreases the incentive to
8 minimize power costs, and negates the impact of the sharing bands.
9 **B. Increased Regulatory Burden**
10 **Q. Why do you think that the existence of PCORC filings increases regulatory**
11 **costs and imposes a regulatory burden on all parties?**
12 A. The most obvious additional burden resulting from the PCORC is that it requires
13 additional cases. Since October 2003 PSE has filed 13 cases – PCAs , PCORCs,
14 and GRCs. Another burden, particularly on parties other than the Company, is
15 that it is difficult to adequately review PCORC filings within four months. The
16 abbreviated schedule of PCORC cases severely limits the ability of intervenors to
17 address the complex issues involved. After each PCORC, the Company then
18 must file a rate case within three months, further straining the resources of the
19 Commission and parties. If PCORC filings did not exist, when changes in power
20 resources increased PSE's revenue requirements, PSE would simply file a rate
21 case. Likewise, if fuel and purchased power costs increased significantly the

1 Company could either file for a surcharge through the PCA or would file a
2 general rate case.

3 **Q. Please discuss the financial cost in more detail.**

4 A. Additional cases impose additional costs on all parties. According to the response
5 to Public Counsel Data Request No. 631, Puget Sound has spent a total of $2.7
6 million on three PCORC cases on outside legal and consulting expenses alone.
7 Other internal Company costs greatly expand the total expenditure on rate cases.
8 The Commission Staff, the Public Counsel, and other intervenors also incur
9 significant expenses associated with PCORC cases but are very constrained in
10 their respective budgets. There is a significant imbalance between what the
11 Company is able to and has spent on all of these proceedings and what the other
12 parties have available to participate in the process.

13 **Q. Is it likely that the parties who signed the PCA Settlement anticipated this**
14 **regulatory effort and the overall impact that the PCORC could have on**
15 **ratemaking?**

16 A. No, it is not. The testimony in Docket No. UE- 011570 indicates all parties'
17 expectations that the addition of new resources would be the major driver behind
18 PCORC filings. This has not proven to be the case. In fact, of the three PCORC
19 cases excluding the one filed to change the PCA period, new large resources
20 accounted for only from 28 percent to 49 percent of the dollars granted, as shown
21 in the table below.
22

1 **TABLE 3:**

2 **NEW RESOURCES AS A PERCENTAGE OF PCORC REQUESTS**
3 (In millions)

PCORC Docket	Amount Associated with New Resource	Total Amount Requested	Percent from New Resource
UE-031725	$18.3*	$64.4	28%
UE- 050870	$38.5**	$101.9	38%
UE- 070565	$31.4***	$64.7	49%

4 * *WUTC v. PSE,* Docket No. UE-031725, Exhibit No. ___ (DWS-1T) p. 6.
5 ** *WUTC v. PSE,* Docket No. UE-050870, Exhibit No. ___ (JHS-4), p. 1.
6 *** *WUTC v. PSE,* Docket No. UE-070565, Order 7, p. 19.
7

8 **Q. The total number of cases filed includes the required follow-up GRCs. What**
9 **is the purpose of the requirement that PSE must file a follow-up GRC?**
10 A. This requirement exists because the PCORC is essentially a single-issue rate case.
11 By its nature, such a case only reflects a subset of costs. It does not recognize
12 other costs changes which may be offsetting. This problem is why the
13 requirement to file a GRC after a PCORC was adopted originally. As the
14 Commission noted in its Order in Docket UE-060266, this provision "provides an
15 important safeguard to ensure an earnings review and a true-up of all costs after
16 the occurrence of a PCORC – a single issue ratemaking mechanism."[16]
17 **Q. Isn't the subsequent rate case filing required by the PCA Settlement?**

[16] *WUTC v. PSE,* Docket No. UE-060266, Order 8, p. 12.

1 A. Yes. The PCA Settlement included terms that would require a general rate case
2 filing to follow PCORC filings. From July 2002 through July 2005, PSE was
3 required to file a rate case within three months of a cumulative rate increase in
4 excess of 5 percent resulting from PCORC cases. After July 1 2005, the
5 Settlement provided that rate cases should be filed within three months of the date
6 of a rate increase resulting from a PCORC order.

7 **Q. May the General Rate Case filed subsequent to any PCORC case be**
8 **simplified by the fact that major power cost issues were addressed in the**
9 **prior PCORC case?**

10 A. It may simplify the General Rate Case for the Company. However, as is evident
11 in the current proceeding, the GRC still contains new estimates and new issues
12 regarding power costs. All of the other issues in a GRC remain: cost of capital,
13 adjustments to O&M expenses and rate base, interclass cost allocation, and rate
14 design. Moreover, as noted earlier, the abbreviated schedule of the PCORC cases
15 severely limits the ability of intervenors to address the complex power cost issues
16 involved in the PCORC. From the standpoint of intervenors, it seems to me that
17 the PCORC is a lose-lose situation.

18 **Q. Could this problem be solved by eliminating the requirement that a GRC be**
19 **filed within a certain period after a PCORC?**

20 A. No. Eliminating the requirement that a GRC must follow a PCORC could reduce
21 the number of rate cases, but it could result in rates being increased when the
22 Company's overall cost and revenue situation did not justify a rate increase.

V. RESPONSE TO COMPANY ARGUMENTS FOR RETAINING THE PCORC

Q: In this case has Company testimony argued for maintaining the PCORC in its current form?

A: Yes it has. Testimonies of Mr. Story, Mr. Markell and Ms. Harris put forth various reasons to continue the PCORC. These arguments are:

1) The Company needs immediate recovery of costs associated with new generating resources and will be harmed if it does not have the PCORC;
2) The Company may not make the optimal resource decision if it does not have the PCORC;
3) The PCORC addresses fundamental ratemaking problems with regulatory lag;
4) There will be a fundamental mismatch between resources and costs reflected in the PCA without the PCORC; and
5) The PCORC provides benefits to ratepayers.

Q: What are the Company's arguments with regard to the PCORC and new generating resources?

A: Ms. Harris testifies that the Company faces a large need for additional generating resources, and that having less than immediate recovery when it introduces new resources creates cash flow problems.[17] PSE admits that even without a PCORC

[17] Exhibit No. ___ (KJH-1HCT), pp. 10, 20.

1 it would not necessarily be denied recovery of any capital costs associated with
2 new resources, since it could request deferral until the next rate case of such costs.
3 Ms. Harris testifies that the PCORC enables the Company to make resource
4 decisions without concern for the timing of recovery.[18] Mr. Story also states that
5 the PCORC allows the Company to "make the most cost effective power
6 decisions." [19]

7 **Q: Please discuss what the Company apparently views as the harm to it that is**
8 **cured by the PCORC.**

9 A: Ms. Harris refers to interim cash flow problems, due to a lag in collecting costs
10 associated with a new unit. [20]

11 **Q: Do you agree with this concern?**

12 A: No. A new owned generating unit will result in increased depreciation and capital
13 costs and will often produce increased revenues from increased retail or wholesale
14 electricity sales. However, the utility will normally receive revenue recovery for
15 the costs and carrying costs associated with the new unit. The utility can request
16 that the Commission grant it deferral of costs incurred after the unit goes on line
17 and before it is included in base rates. The Company assumes that a monthly
18 carrying charge would be applied to the deferred costs of a resource acquisition.[21]
19 It could also request a pro forma adjustment for a unit or contract for which it had

[18] Exhibit No. ___ (KJH-1HCT), p. 21.
[19] Exhibit No. ___ (JHS-1CT), p. 63.
[20] Exhibit No. ___ (KJH-1HCT), pp. 20-21.
[21] PSE Response to Public Counsel Data Request No. 629.

1 provided adequate evidence.[22] Although PSE may argue that the delay between
2 expenditure and recovery is undesirable, the Company can be fully compensated
3 for its costs.

4 **Q. Does it appear that that the additional regulatory lag from filing a GRC**
5 **relative to filing a PCORC should be a significant factor to the Company's**
6 **finances or resource decisions?**

7 A. No, it does not. First, the difference is not that large. In PSE response to Public
8 Counsel Data Request No. 628, the Company provided data on test year, filing
9 dates, and order dates, for three electric rate cases and three PCORC cases. This
10 data shows the average time between filing date and order date was 9.6 months
11 for GRC electric cases, and 6.3 months for PCORC cases. This is only a
12 difference of 3.2 months. This response shows a larger gap from the end of the
13 test year to the dates rates became effective for the GRC cases, but this is because
14 of a longer time between the end of the test year and the date of filing for the
15 GRC cases. This is within the Company's control. In the current case the
16 Company filed the case in less than three months from the end of the test year —
17 a shorter preparation time than for its four PCORCs. From this, I assume that the
18 Company can put together a GRC as expeditiously as a PCORC, and we should
19 focus only on the additional length of the process for a GRC.

[22] In *WUTC v. PSC*, Docket UE-060266, Order 8, the Commission did not allow requested proforma adjustments, not on principle, but because the Company made the requests too late and presented too little evidence.

1 Second, the Company has not provided any specific or even illustrative
2 evidence as to how resource decisions might be biased by the lack of the PCORC
3 decision. In PSE response to Public Counsel Data Request No. 629, the Company
4 said, "regulatory recovery mechanisms that are available to allow recovery of
5 costs, and PSE's ability to finance an acquisition…would be a consideration at the
6 time the decision is being made." It is not convincing that financing a resource
7 for four months after the in-service date, when the Company could receive
8 deferral treatment of such financing costs, would cause the Company to chose an
9 otherwise less preferred generating asset, particularly since the Company agrees
10 that it could recover the carrying costs on a resource that went into service prior to
11 its recognition in rates.

12 **Q. Although the Company has not provided any specific example, could you**
13 **describe how a resource decision might impact the Company if there were no**
14 **PCORC?**

15 A. Yes. A new owned wind resource would result in additional energy being
16 produced at essentially no variable cost. I believe this no-cost energy would
17 reduce the actual Net Power Costs [23] that would be compared to the PCA
18 allowable power costs, and so would reduce any difference between actual and
19 allowable costs, and therefore reduce the Company's deferrals.

[23] Mr. Story testifies that variable costs of a new resource are included in the PCA calculation (Exhibit No. ___ (JHS-1CT), p. 60), unless the variable costs are in excess of the current baseline power cost rate. (PSE Response to Public Counsel Data Request No. 632)

1 **Q. Do you agree that the PCORC "allows" the Company to make cost-effective**
2 **resource decisions?**
3 A. No. The implication of the testimony of Ms. Harris and Mr. Story on this point is
4 that without the four-month deliberation period of the PCORC the Company
5 would make resource decisions that were not cost effective. I do not believe,
6 given its prudency and fiduciary obligations that PSE would not choose the best
7 resource acquisition due to the cash flow issue created by a several month delay in
8 cost recovery of a long-term resource addition. Even in the case of the wind
9 resource that I posited above, the Company's revenues would not be reduced
10 because of the wind energy unless the no-cost energy resulted in a negative
11 deferral large enough to require a credit to customers. It seems highly unlikely
12 that the Company would not file a rate case to reflect the unit if it were large
13 enough to create a credit situation.
14 **Q. What does the Company claim is a fundamental ratemaking problem cured**
15 **by the PCORC?**
16 A. Mr. Markell testifies that without a PCORC "the requested relief does not address
17 the persistent and structural problems inherent with the use of a largely historic
18 test year to set rates for a company whose capital investments and growth in
19 related operations and maintenance are rapidly increasing."[24] Mr. Markell's
20 reference to the Company's test year as largely an historic test year overlooks the
21

[24] Exhibit No. ___ (EEM-1CT) p. 44.

1 fact that the Company bases its power cost estimates on its projection of rate year
2 costs. He presents no evidence regarding the claimed inadequacy of the
3 ratemaking process. When capital investments increase, in the absence of the
4 PCORC, the Company can recover costs through a general rate case if revenue
5 increases resulting from increasing sales were not sufficient to provide adequate
6 revenues.

7 **Q. What is the Company's claim regarding the fundamental mismatch between**
8 **resources and costs reflected in the PCA without the PCORC?**

9 A. Mr. Story states that the PCORC is needed both to update power costs and to
10 bring new resources before the Commission "in a timely fashion."[25] When PSE
11 adds a new resource to its portfolio, no fixed cost recovery is allowed in the PCA
12 mechanism until approved by the Commission.

13 **Q. Is this a unique or very problematic mismatch?**

14 A. No, I do not think so. Utilities across the country have put generating resources
15 into rates through rate cases for many years, even though fuel cost associated with
16 the new units might be reflected in fuel adjustors at different times. Mr. Story
17 goes on to say that the "PCA was designed to compel the Company to come in to
18 change its power costs when its portfolio changes."[26] The new resource could be
19 approved and would change the PCA baseline through a GRC, if no PCORC were
20

[25] Exhibit No. ___ (JHS-1CT) p. 63.
[26] Exhibit No. ___ JHS_1CT) pp. 61- 62.

1 in place. The only difference, as discussed above in my response to Ms. Harris' testimony, is one of timing.

Q. Won't your recommendation of the elimination of the PCORC result in the Company being denied recovery of some power costs?

A. It is important to remember that traditional ratemaking allows an <u>opportunity</u> for the recovery of all costs. The PSE PCA mechanism can result in the Company not collecting all variable power costs in some years, but it may collect more than variable costs in other years; and the this symmetrical treatment is a basic part of the PCA. Eliminating the PCORC will mean that there are times when the Company will have greater uncollected power costs than if it were increase its baseline PCA through the mechanism of a PCORC. It can increase its baseline PCA through a GRC to reflect new generating resources and to reflect increases in power costs. Even if it does not request and receive rate changes simultaneous with the addition of new resources, there are other ways in which costs associated with new resources can be collected (through deferral and inclusion in the next GRC). Potentially deferred costs and credits will still be limited by the structure of the original PCA Settlement terms.

Q. Does the Company claim that the PCORC provides benefits to ratepayers?

1 A. Yes. Mr. Story claims there is customer benefit because the "PCORC uses what would
2 have been growth in revenues associated with production assets to offset power cost
3 increases." [27]
4 **Q: Do you agree that the PCORC provides benefits to ratepayers?**
5 A: No. While allowing for sales growth may be viewed as a benefit compared to a
6 situation where the Company was allowed to present new costs with no
7 recognition of associated revenues, it is not a benefit compared to a GRC which
8 would recognize changes in all costs and revenues. It is only an advantage for
9 consumers compared with a flawed mechanism like the Company's former
10 ECAC, which allowed flow-through of investment-related power supply costs
11 associated with new purchased power resources without recognition of the role of
12 general rates in recovering such costs. That problem was addressed when the
13 PCA was designed.
14 **Q: There also seems to be an implication that the PCORC provides customers a**
15 **benefit through providing a better "price signal." Please comment on this**
16 **implication.**
17 A: I do not think that any "signal" that may be provided by the PCORC is useful or even
18 beneficial to customers. Neither the PCORC nor the PCA provide short-term signals to
19 customers that might guide efficient behavior. To the extent that changes resulting from
20 the PCORC indicate that there is a longer-term increase in power costs, changes resulting
21 from GRCs could and would (if there were no PCORCs) also so inform customers.

[27] Exhibit No. ___ (JHS-1CT). p. 63

1 The existence of PCORC filings has not contributed to price stability.
2 PSE's own consumer survey indicates that customers are interested in price
3 stability. **[Begin Confidential]**
4 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
5 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
6 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
7 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
8 XXXXXXXXXXXXXXXXXXXXXXXXXX. **[End Confidential]**[28] There
9 appear to have been more price changes and less stability because of PCORCs.
10 **Q. Does this conclude your testimony?**
11 A. Yes, it does.

[28] PSE Response to Public Counsel Data Request No. 545.