

BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

DOCKET NOs. UE-072300 and UG-072301

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR. (MJM-1T)

ON BEHALF OF

PUBLIC COUNSEL

May 30, 2008

**NON-CONFIDENTIAL**

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR. (MM-1T)  
DOCKET NOS. UE-072300 AND UG-072301  
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DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR. (MJM-1T)  
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**TABLES**

Table 1.	PSE Executive Compensation – Total	<u>PAGE</u> 23
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**MICHAEL J. MAJOROS, JR. EXHIBIT LIST**

Exhibit No. ____ (MJM-2)	Summary of Qualifications and Experience
Exhibit No. ____ (MJM-3)	Appearances as an Expert Witness before State and Federal Regulatory Agencies
Exhibit No. ____ (MJM-4)	Public Counsel Recommendations and Adjustments
Exhibit No. ____ (MJM-5)	Confidential – Puget Energy and Affiliated Companies Consolidated Tax Adjustment
Exhibit No. ____ (MJM-6)	Summary Compensation Table - Puget Sound Energy 2007 Form 10-K



1 A: Yes, Exhibit No.\_\_\_\_ (MJM-2) is a summary of my qualifications and experience. Exhibit  
2 No.\_\_\_\_ (MJM-3) contains a tabulation of my appearances as an expert witness before  
3 state and federal regulatory agencies.

4 **Q: For whom are you appearing in this proceeding?**

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

7 **Q: Do you have any specific experience in the public utility field?**

8 A: Yes, I have been in the field of public utility regulation since the late 1970s. My  
9 testimony has encompassed numerous complex revenue requirement issues.  
10 Furthermore, I and other members of my firm specialize in the field of public utility  
11 depreciation. We have appeared as expert witnesses on this subject before the regulatory  
12 commissions of almost every state in the country.

13 **Q: Does your experience specifically include electric and gas utilities?**

14 A: Yes, I have appeared as an expert in several electric and gas utility proceedings.

15 **II. SUBJECT AND PURPOSE OF TESTIMONY**

16 **Q: What is the subject of your testimony?**

17 A: This case involves Puget Sound Energy, Inc.'s (PSE or the Company) 2007 general rate  
18 case filing. My testimony addresses the Company's revenue requirement.

19 **Q: What is the purpose of your testimony?**

20 A: I have reviewed the Company's filing. Based upon my findings and the input of others, I  
21 am recommending monetary adjustments to the Company's filed request.

22 **III. SUMMARY OF COMPANY'S FILING**

23 **Q: Summarize the Company's filing.**

1 A: The Company filed a case based on a revenue requirement model reflecting a test-year  
2 ending September 30, 2007. The Company made several adjustments to the test-year  
3 book numbers. These adjustments stretched into 2009 in some cases. Overall the  
4 Company is requesting a \$179.7 million electric revenue increase and a \$58.1 million gas  
5 increase for a total of \$237.8 million.

6 **IV. PSE'S RATIONALIZATION OF INCREASE**

7 **Q: How does the Company rationalize its requested electric revenue increase?**

8 A: According to PSE Witness, John H. Story, eight principle factors drive the electric  
9 increase:<sup>1</sup>

- 10 1. \$55.1 million for power costs expenses relating to the rate year;
- 11 2. \$10.7 million for production expenses relating to new plant additions;
- 12 3. \$8.5 million for transmission and distribution partially explained by increased  
13 tree trimming and storm damage expense;
- 14 4. \$19.9 million for amortization of property losses including storm damage  
15 amortization relating to the December 2006 storm;
- 16 5. \$9.5 million for salaries, outside service, and insurance;
- 17 6. \$12.8 million for increased depreciation including the \$8 million relating to a  
18 new depreciation study;
- 19 7. \$6.8 million of additional amortization for capital additions for software  
20 closings; and,

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<sup>1</sup> This information was provided by the Company in its original filing on December 3, 2007. (*See* Direct Testimony of John H. Story, Exhibit No.\_\_\_\_ (JHS-1TC), pp. 6:18 - 7:18.) PSE provided a supplemental filing on April 11, 2008 that updated and added to its original request, however, in his supplemental testimony, Mr. Story did not provide a similar detailed summary of the factors driving the rate increase.

1           8. \$38.0 million for increased rate base, of which \$12.2 million results from the  
2           requested rate of return change.

3 **Q:    How does the Company rationalize its requested gas revenue increase?**

4 A:    According PSE Witness, Karl R. Karzmar, six principle factors drive the gas increase:<sup>2</sup>

- 5           1. \$7.0 million increase to distribution operating expense;
- 6           2. \$1.5 million increase to customer accounting expense;
- 7           3. \$18.9 million depreciation expense increase, of which \$13.7 million emanates  
8           from a new depreciation study;
- 9           4. \$2.3 million amortization expense increase;
- 10          5. \$20.5 million relating to rate base increases, of which \$5.0 million is caused  
11          by a requested rate of return change; and,
- 12          6. \$4.2 million for Everett Delta adjustment.

13 **Q:    What are the results of your investigation of the Company's rate request?**

14 A:    We have propounded numerous data requests related to the Company's rate request. We  
15       also participated in a conference call regarding certain Towers Perrin studies underlying  
16       PSE's executive compensation requests. As a result of this investigation and in  
17       combination with the recommendations of Public Counsel witnesses, Stephen Hill,  
18       Barbara Alexander, and Charles King, I recommend that the Company's base rates be  
19       increased by \$4.3 million for electric, as shown on Exhibit No.\_\_\_\_ (MJM-4) Schedule  
20       1(E), and by \$7.0 million for natural gas as shown on Exhibit No.\_\_\_\_(MJM-4) Schedule

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<sup>2</sup> This information was provided by the Company in its original filing on December 3, 2007. (*See* Direct Testimony of Karl R. Karzmar, Exhibit No.\_\_\_\_(KRK-1T), pp. 15:17 – 16:9.) PSE provided a supplemental filing on April 11, 2008 that updated and added to its original request, however, in his supplemental testimony, Mr. Karzmar did not provide a similar detailed summary of the factors driving the rate increase.

1 1(G), which together amounts to \$11.3 million overall.

2 **V. PUBLIC COUNSEL ADJUSTMENTS**

3 **Q: Do you have individual adjustments to the Company's filed cost of service?**

4 A: Yes. I will discuss each adjustment below. My discussions will cite to any exhibits  
5 necessary for an understanding of the adjustments. However, all of the actual  
6 adjustments are incorporated as Schedules to Exhibit No.\_\_\_\_ (MJM-4). My adjustment  
7 explanations contain two designations: (E) electric and (G) gas.

8 **A. Adjustment No. 1(E) and (G) – Reclassify SFAS No. 143 Regulatory Liability**

9 **Q: Please explain this adjustment.**

10 A: In this case, there are two important issues related to PSE's collections for future cost of  
11 removal. One issue is the Company's \$137.9 million over-collection for future cost of  
12 removal, which the Company recognized as a regulatory liability for Generally Accepted  
13 Accounting Principles (GAAP) reporting purposes.<sup>3</sup> The other issue is the Company's  
14 excessive cost of removal collections in its going-forward depreciation rates. I am  
15 addressing the regulatory liability issue in my testimony. Mr. King addresses the going-  
16 forward depreciation rates in his testimony.

17 **Q: Please explain the regulatory liability issue.**

18 A: The Financial Accounting Standards Board's (FASB) Statement of Financial Accounting  
19 Standard No. 143 (SFAS No. 143) addresses asset retirement obligations associated with  
20 long-lived plant. SFAS No. 143 was implemented by the Federal Energy Regulatory  
21 Commission's (FERC) in Order No. 631. Both SFAS No. 143 and FERC Order No. 631  
22 identify and highlight utilities' prior excess collections for future cost of removal.

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<sup>3</sup> PSE Response to Public Counsel Data Request No. 241.

1           When a company has a legal asset retirement obligation, SFAS No. 143 requires  
2           capitalization of the discounted fair value of the liability and depreciation as a component  
3           of the original asset cost. If it is determined, upon implementation that a regulated utility  
4           has already collected too much depreciation relating to the asset retirement obligation, the  
5           utility must report the excess as a regulatory liability.<sup>4</sup> If a utility does not have a legal  
6           obligation to incur asset retirement costs for which it has previously collected money in  
7           the form of future cost of removal embedded in depreciation rates, SFAS No. 143 and the  
8           SEC still require reporting the excess as a regulatory liability.<sup>5</sup> In other words, if a  
9           regulated utility has collected for future cost of removal in its depreciation rates, but does  
10          not, and never had, a legal obligation to spend the money, it must segregate these  
11          excesses and report them as a regulatory liability.<sup>6</sup>

12          FERC identified such amounts as “non-legal” asset retirement obligations,  
13          meaning that utilities do not have an actual legal obligation to incur these costs in the  
14          future. However, even though current GAAP and SEC accounting rules require reporting  
15          these excess collections as regulatory liabilities, FERC Order No. 631 does not have the  
16          same requirement. FERC Order No. 631 merely requires separate identification and  
17          reporting within account No. 108-Accumulated Depreciation. Consequently, even  
18          though SFAS No. 143 and the SEC require that excess collections amounts be reported as  
19          a regulatory liability, PSE continues to include these amounts in accumulated  
20          depreciation for regulatory accounting and ratemaking purposes.

21   **Q:    How does GAAP define a regulatory liability?**

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<sup>4</sup> SFAS No. 143.

<sup>5</sup> *Id.*, ¶ B.73.

<sup>6</sup> *Id.*, ¶ B.73.

1 A: SFAS No. 71 – Accounting for the Effects of Certain Types of Regulation defines  
2 regulatory liabilities from a GAAP perspective. I have summarized paragraph 11 below.  
3 It provides the GAAP definition of a regulatory liability. Please note paragraphs 11 and  
4 11.b.

5 **SFAS No. 71 – Regulatory Liabilities**<sup>7</sup>

6 11. Rate actions of a regulator can impose a liability on a  
7 regulated enterprise. Such liabilities are usually obligations to  
8 the enterprise’s customers. The following are the usual ways  
9 in which liabilities can be imposed and the resulting  
10 accounting:

11  
12 a. A regulator may require refunds to customers . . . .

13  
14 b. A regulator can provide current rates intended to recover  
15 costs that are expected to be incurred in the future with the  
16 understanding that if those costs are not incurred future rates  
17 will be reduced by corresponding amounts. If current rates  
18 are intended to recover such costs and the regulator requires  
19 the enterprise to remain accountable for any amounts charged  
20 pursuant to such rates and not yet expended for the intended  
21 purpose, the enterprise shall not recognize as revenues  
22 amounts charged pursuant to such rates. Those amounts shall  
23 be recognized as liabilities and taken to income only when  
24 associated costs are incurred.

25  
26 c. A regulator can require that a gain or other reduction of net  
27 allowable costs be given to customers over future periods . . . .  
28

29 **Q: Does PSE agree that its collections for non-legal AROs result in a regulatory**  
30 **liability?**

31 A: PSE states that it “has no opinion as to the treatment of legal or non-legal obligations of  
32 costs of removal being treated as regulatory liabilities for rate-making purposes.”<sup>8</sup>

33 **Q: What do you recommend?**

---

<sup>7</sup> SFAS No. 71, ¶ 11. Only the first sentence of each subparagraph is included.

<sup>8</sup> PSE Response to Public Counsel Data Request No. 243.

1 A: The Commission must specifically recognize that PSE has a \$137.9 million regulatory  
2 liability for these amounts.<sup>9</sup> PSE should reclassify this from accumulated depreciation to  
3 Account 254-Other Regulatory Liabilities for regulatory accounting, reporting and  
4 ratemaking purposes. This will result in equivalent GAAP and regulatory accumulated  
5 depreciation and regulatory liability amounts for “non-legal” cost of removal.<sup>10</sup>  
6 Regardless of being included in accumulated depreciation, these amounts are dollars  
7 *already* collected from ratepayers for future cost of removal. There is no reason that the  
8 utility should be entitled to keep these dollars if it turns out they are never spent on future  
9 costs of removal. The funds represent a refundable liability to ratepayers until spent on  
10 their intended purpose. Now that SFAS No. 143 has identified them, they should be  
11 recognized as the regulatory liability they are.

12 Furthermore, \$137.9 million is a substantial amount. By definition, the Company  
13 has collected, but not spent, \$137.9 million for cost of removal. Therefore, the  
14 Commission must protect this amount in Uniform System of Accounts (USOA) account  
15 254-Other Regulatory Liabilities. Without that protection, current and future ratepayers  
16 face the strong possibility of losing substantial prepaid funds they have submitted to the  
17 Company for future cost of removal.

18 **Q: Why is it necessary for the WUTC to protect the \$137.9 million as a regulatory**  
19 **liability?**

---

<sup>9</sup> PSE Response to Public Counsel Data Request No 241.

<sup>10</sup> The phrase “non-legal” emanates from the FERC’s Order No. 631. It is used to distinguish legally required asset retirement obligations from those which lead to the cost of removal regulatory liability discussed above. Importantly, the phrase “non-legal” should not be construed to imply any “illegality.”

1 A: PSE, and virtually all other utilities, consider amounts in accumulated depreciation, even  
2 excessive amounts, to be *their* money, i.e. capital recovery with no refund obligation. It  
3 is certainly fair and reasonable for any Commission to recognize excessive cost of  
4 removal collections as a refundable regulatory liability until the utility spends them on  
5 their intended purpose. The FERC rule to which PSE adheres is insufficient.

6 **Q: Why is FERC Order No. 631 insufficient?**

7 A: The FERC has recognized and identified the amounts involved and requires separate  
8 accounting for those amounts.<sup>11</sup> However, the FERC has deferred recognition of the  
9 regulatory liability to the states. Consequently, until the Commission provides it, there is  
10 no *regulatory* recognition of the liability. Accordingly, there is no provision for a refund  
11 to ratepayers if PSE does not spend the cost of removal amounts they have collected for  
12 the intended purpose. In fact, I can assure the Commission that PSE has actually already  
13 spent that money for things other than cost of removal.<sup>12</sup>

14 In other words, nothing holds PSE directly accountable for these excess  
15 collections from a regulatory standpoint. Regardless of the transparency provided by  
16 FERC, PSE failed to mention the regulatory liability in its depreciation study or in the  
17 rate case in general. This is wrong. Experience indicates that it is highly unlikely that  
18 these amounts will be spent for cost of removal in the magnitude they have been  
19 collected. Furthermore, even if it was highly probable that PSE would spend all this  
20 money for cost of removal, it is fair and reasonable for the Commission to recognize the

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<sup>11</sup> FERC Docket No. RM02-7-000, Order No. 631, ¶ 38.

<sup>12</sup> This is the obvious result since what PSE reports as a regulatory liability is the excess of what they have collected versus what they have spent for non-legal cost of removal.

1 ratepayers' security interest in these monies until spent on their intended purpose.

2 Otherwise, the money is at risk.

3 **Q: Have any other Commissions recognized non-legal asset retirement obligations as**  
4 **regulatory liabilities?**

5 A: Yes. Recently, in Docket No. A.04-12-014, involving Southern California Edison  
6 Company, the California Public Utilities Commission specifically recognized that  
7 Company's non-legal asset retirement obligations collections as a regulatory liability.

8 **Q: Do you have an exhibit showing your recommended reclassification?**

9 A: Yes, on page 8 of Exhibit No.\_\_\_\_ (MJM-4), Adjustments No. 1(E) and 1(G) on Schedule  
10 4, show the reclassification of the SFAS No. 143 Regulatory Liability.

11 **Q: Does this adjustment have any revenue requirement effect?**

12 A: No, it is merely a revenue neutral reclassification of a rate base reduction from one  
13 account to another. However, as I will discuss later, I recommend using a portion of the  
14 regulatory liability to offset storm damages. This will result in a slight increase to rate  
15 base.

16 **B. Adjustment Nos. 2 through 5(E) – Disallow Out of Period Plant from Rate**  
17 **Base**

18  
19 **Q: Describe Adjustment Nos. 2 through 5 (E).**

20 A: These adjustments, shown on pages 9 and 10 of Exhibit No.\_\_\_\_(MJM-4),<sup>13</sup> either reverse  
21 or reduce several of the out of period plant additions PSE proposes to include in its rate  
22 base, and where applicable, implement Mr. King's recommended depreciation rates.

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<sup>13</sup> Adjustments 2(E), 3(E) and 2(G) are straight reversals of PSE's adjustments, with the exception of FIT, which is calculated using my recommended 30.67 percent tax rate. As such I have not included a page in Exhibit No.\_\_\_\_ (MJM-4), Schedule 4 for these adjustments.

1 **Q: Why are these adjustments necessary?**

2 A: Mr. Story attributes much of the electric revenue requirement increase to growth in rate  
3 base. In fact, Mr. Story proposes several plant additions which further increase the rate  
4 base. Most of these, however, are out of period. Although PSE selected a test year  
5 ending September 30, 2007, most of the rate base additions Mr. Story proposes are  
6 estimated to occur in 2008 and some of them will not be booked until 2009. In my  
7 opinion, Mr. Story's approach stretches the known and measurable standard too far.

8 **Q: Are you proposing to disallow any of these additions?**

9 A: Yes. I applied the following standard. I have accepted any project with an anticipated  
10 closing date of October 30, 2008 or sooner. In my opinion, anything beyond that violates  
11 the known and measurable standard.

12 **Q: Does Mr. Story agree with you?**

13 A: No, Mr. Story does not agree with me. PSE's Response to Public Counsel Data Request  
14 No. 318 states, "[f]or further discussion on rate base treatment of known and measurable  
15 proforma adjustments for generating plants, please refer to the prefiled direct Testimony  
16 of John Story Exhibit No.\_\_\_\_ (JHS-1CT)."

17 I went to those pages of Mr. Story's testimony to locate the phrase "known and  
18 measurable" but I did not find it. I *did* find a statement on page 20 that "[t]his pro forma  
19 and restating adjustment includes the estimated cost of Goldendale Generating Station as  
20 of the rate year, November 2008 through October 2009 . . . ." I also found other  
21 references to his so-called "rate year."

22 In an effort to determine how the known and measurable concept relates to "rate  
23 year," I reviewed WAC 480-07-510. I found reference to "restating actual adjustments"

1 (not proforma), and I found reference to “pro-forma adjustments,” however that reference  
2 does not refer to any “rate year” concept. In fact, I found several references to “test  
3 period,” but no references to “rate year.” Consequently, I assume Mr. Story does not  
4 agree with my interpretation of the known and measurable standard.

5 I believe that my interpretation is closer in keeping with the statute than Mr.  
6 Story’s. The intent of any known and measurable standard is to protect ratepayers. The  
7 inclusion of potential expenditures a year beyond the end of a future test (October 2008)  
8 year is speculative and does not provide protection for ratepayers. Instead, it provides a  
9 gift to PSE’s management and major stockholders, particularly given the pending  
10 purchase of the Company.

11 **Q: Have you applied your interpretation of WAC 480-07-510 to PSE’s proposed plant**  
12 **additions?**

13 A: Yes, I have.

14 **Q: What are the results?**

15 A: Based on my interpretation of WAC 480-07-510, I am disallowing the Whitethorn  
16 Generating Station addition,<sup>14</sup> which is not scheduled to be in service until February 2009.

17 **Q: Have you disallowed any of Mr. Story’s other rate base additions?**

18 A: Yes, I have disallowed Mr. Story’s addition for the Goldendale Generating Station.<sup>15</sup>  
19 This adjustment is merely the result of an inconsistent averaging approach Mr. Story  
20 applied to the Goldendale acquisition costs versus the accumulated depreciation balance.  
21 Goldendale was in service for seven months of the test year, for a net book value of

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<sup>14</sup> Adjustment No. 2(E) not included in Schedule 4 see n. 13.

<sup>15</sup> Adjustment No. 3(E) not included in Schedule 4 see n. 13.

1 approximately \$121 million for each of those months. Mr. Story's internal averaging  
2 calculation reduced the net book value to approximately \$53 million. He then made a  
3 rate base adjustment to write the net book value back up to where it always was to begin  
4 with. This is inappropriate and, in my opinion, lacks credibility. The objective of  
5 averaging is to reflect a rate base reduction given the average rate base during the test  
6 period. Mr. Story's piece-part approach has the same result as no averaging at all.  
7 Accordingly, I propose reversing Mr. Story's entire Goldendale adjustment.

8 **Q: Have you made any other adjustments to Mr. Story's rate base adjustments?**

9 A: Yes, I have adjusted all of Mr. Story's allowed rate base additions to reflect Mr. King's  
10 recommended depreciation rates.<sup>16</sup>

11 **C. Adjustment No. 2(G) – Reverse Everett Delta Lease**

12 **Q: Describe Adjustment No. 2 (G).**

13 A: This adjustment reverses Mr. Karzmar's adjustment No. 9.03 related to the Everett Delta  
14 pipeline lease.

15 **Q: Why have you reversed Mr. Karzmar's adjustment?**

16 A: Mr. Karzmar's adjustment relates to an early transfer of the recovery of the Everett Delta  
17 pipeline expansion from the PGA mechanism into general rates.<sup>17</sup> Mr. Karzmar notes  
18 that, while the proposed adjustment will serve to increase the revenue deficiency in this  
19 case, it will eventually be offset by a reduction in PSE's PGA rates, which are expected  
20 to become effective on October 1, 2009.<sup>18</sup>

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<sup>16</sup> Adjustment Nos. 4(E) and 5(E) on pp. 9-10 of Exhibit No. \_\_\_\_ (MJM-4).

<sup>17</sup> Exhibit No. \_\_\_\_ (KRK-1T), p. 20:9-10.

<sup>18</sup> Exhibit No. \_\_\_\_ (KRK-1T), p. 20:17-21.

1           In my opinion this adjustment is premature. PSE will not take over the Everett  
2 Delta pipeline until 2009, well outside the future test year in this case.<sup>19</sup> The second part  
3 of the equation, which is the change in PGA rates, will also take place outside the future  
4 test year.<sup>20</sup> In fact, I believe I have been generous in my interpretation of the rate base  
5 statutes. In reality, I have used a 2008 future test year. In other words, I have allowed  
6 adjustments for resources expected to be in service by October 2008. As such, I have  
7 reversed Mr. Karzmar's entire adjustment.<sup>21</sup>

8           **D.     Adjustment No. 6(E) – Storm Damage**

9           **Q:     Have you made any adjustments to PSE's storm damage requests?**

10          A:     Yes, as shown on page 11 of Exhibit No.\_\_\_\_ (MJM-4), I am making two monetary  
11 adjustments to PSE's quantification of the storm damage costs. I am also making an  
12 offsetting amortization to eliminate the need for any storm damage increase in this  
13 proceeding.

14          **Q:     What is you first monetary adjustment to PSE's storm damage expense?**

15          A:     My first adjustment holds the level of storms, as defined by the Institute of Electrical &  
16 Electronics Engineers, to the \$7 million limit previously set by the Commission.<sup>22</sup> It is  
17 my understanding that this limit was set so that storm damage costs would be shared  
18 between ratepayers and shareholders. I see no reason to increase it to \$8 million as Mr.  
19 Story proposes.

20          **Q:     What is the second monetary adjustment to PSE's storm damage expense?**

---

<sup>19</sup> Exhibit No. \_\_\_\_ (KRK-1T), p. 19:2-16.

<sup>20</sup> Exhibit No. \_\_\_\_ (KRK-1T), p. 20:21.

<sup>21</sup> See n. 13.

<sup>22</sup> Direct Testimony of John H. Story, Exhibit No.\_\_\_\_ (JHS-1CT), p. 47:3-4.

1 A: The second monetary adjustment reflects Ms. Alexander’s recommendation to disallow  
2 five percent of the Company’s request for recovery related to the December 2006  
3 “Hanukkah Eve” windstorm.

4 **Q: Please explain the offsetting amortization you are proposing.**

5 A: I amortize a portion of PSE’s cost of removal regulatory liability to offset its net storm  
6 damages claim in this proceeding.

7 **Q: What is your rationale for this adjustment?**

8 A: As discussed earlier, PSE has charged and collected excess amounts from ratepayers for  
9 future cost of removal. PSE recognizes this regulatory liability (amount owed to  
10 ratepayers) in its general purpose and SEC financial statements. The \$137.9 million  
11 regulatory liability consists of those collections over and above PSE’s actual expenditures  
12 for cost of removal. In my opinion, it is reasonable and appropriate to use a portion or all  
13 of these amounts to offset the catastrophic storm damages charged to ratepayers.

14 **E. Adjustment Nos. 7(E) and 3(G) – Federal Income Taxes**

15 **Q: Have you made any adjustments to PSE’s federal income tax calculations?**

16 A: Yes, I have made two adjustments. I have reduced income tax expense to reflect PSE’s  
17 effective corporate tax rate. I have also implemented flow-thru tax accounting for storm  
18 damages. My adjustments are shown on page 12 of Exhibit No.\_\_\_\_ (MJM-4).

19 **Q: Explain the tax rate adjustment.**

20 A: My tax rate adjustment reduces PSE’s federal statutory tax rate from 35.00 percent to its  
21 30.67 percent average effective federal tax rate for the years 2004 to 2006.

22 **[Begin Confidential]**

23 **XX** ~~XXXXXXXXXXXXXXXXXXXXXXXXXXXX~~

1 **XX** [REDACTED]

2 [REDACTED]

3 [REDACTED]

4 [REDACTED].<sup>23</sup> [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 [REDACTED].<sup>24</sup> [REDACTED]

8 [REDACTED]

9 [REDACTED].<sup>25</sup> [REDACTED].

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED] **[End Confidential]**

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<sup>23</sup> **[Begin Confidential]** [REDACTED] **[End Confidential]**  
<sup>24</sup> **[Begin Confidential]** [REDACTED] **[End Confidential]**  
<sup>25</sup> **[Begin Confidential]** [REDACTED]. **[End Confidential]**

1 **Q: Please explain your flow-thru adjustment.**

2 A: My next income tax adjustment uses flow-thru (or actual) tax accounting, rather  
3 normalization tax accounting, for the storm damages included in Mr. Story's federal  
4 income tax calculation. Mr. Story's normalization adjustment is reflected in his original  
5 adjustment No. 4.04 and his updated adjustment No. 11.04.<sup>26</sup>

6 **Q: How does Mr. Story justify his normalization adjustment?**

7 A: Mr. Story says that his adjustment "recalculates the test year using expenses and tax  
8 adjustments for the twelve months ending September 30, 2007. Taxable income is shown  
9 as a loss in this adjustment as the electric income includes the current deduction  
10 associated with the storm losses during the latter part of 2006 and beginning of 2007.  
11 The tax benefits of these losses have been normalized and are provided to the customer in  
12 the restating Storm Adjustment. The effect of this adjustment is to decrease net operating  
13 income by \$12,165,039."<sup>27</sup> Mr. Story adjusts the total in his updated adjustment 11.04,  
14 stating that this adjustment "corrects a cell reference in the original filing." This  
15 correction reduces the adjustment to a \$9,826,242 reduction to operating income."<sup>28</sup>

16 **Q: What is the revenue requirement effect of Mr. Story's normalization adjustment?**

17 A: Mr. Story's adjustment No. 4.31 and the updated adjustment No. 11.31 both increase  
18 revenue requirements.

19 **Q: Why are you using flow-thru accounting for this adjustment?**

20

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<sup>26</sup> Exhibit No.\_\_\_\_ (JHS-11).

<sup>27</sup> Direct Testimony of John H. Story, Exhibit No.\_\_\_\_(JHS-1CT), pp. 13:16-14:3.

<sup>28</sup> Exhibit No.\_\_\_\_ (JHS-9T), p. 6:19.

1 A: I am using flow-thru accounting because Mr. Story’s normalization adjustment  
2 unnecessarily increases rates. There is no legal requirement to normalize these tax  
3 benefits. Furthermore, as I explained above, I am proposing an offsetting amortization to  
4 PSE’s storm damage increase. One effect of this offset is to eliminate the need for a tax  
5 adjustment relating to storm damages.

6 **F. Adjustment No. 8(E) – Amortization of Interest associated with Deferral of**  
7 **Unrecovered Residential Exchange benefits Credited to Customers (UTC**  
8 **Docket No. UE-071024**  
9

10 **Q: Please explain Adjustment No. 8(E).**

11 A: Mr. Story’s Miscellaneous Operating Income adjustment No. 4.14 (and updated  
12 adjustment No. 11.4) includes several subcomponents. One of these subcomponents is  
13 the amortization of interest discussed in the description of Adjustment No. 8(E) above. I  
14 am not proposing to disallow this adjustment, but merely to use a different amortization  
15 period. Adjustment No. 8(E) reduces Mr. Story’s proposed amortization expense for this  
16 item to provide for a seven-year amortization period instead of his two-year proposal. A  
17 seven-year amortization period is consistent with the amortization period Mr. Story  
18 proposes for his Summit Building adjustment that is also combined with his  
19 Miscellaneous Operating Income adjustments. My recommendation, shown on page 13  
20 of Exhibit No.\_\_\_\_ (MJM-4), will alleviate the magnitude of the increase to ratepayers in  
21 this proceeding.  
22

1           **G.     Adjustment Nos. 9(E) and 4(G) –Depreciation Expense**

2   **Q:     Please explain Adjustment Nos. 9(E) and 4(G).**

3   A:     These adjustments implement Mr. King’s depreciation rate recommendations. They  
4         appear on page 14 of Exhibit No.\_\_\_\_ (MJM-4).

5           **H.     Adjustment Nos. 10(E) and 5(G) – Executive Compensation**

6   **Q:     Please explain Adjustment Nos. 10(E) and 5(G).**

7   A:     These adjustments, shown on page 15 of Exhibit No.\_\_\_\_ (MJM-4), eliminate a portion of  
8         the Company’s claim relating to executive compensation.

9   **Q:     Why do you believe executive compensation is of particular concern?**

10  A:     Excessive and escalating levels of executive compensation in general are coming under  
11         increased attention and criticism by many parties: Congress, state Public Service  
12         Commissions, including the UTC, the business community, and company shareholders.  
13         For an unregulated corporation, executive compensation is presumably constrained by  
14         what earnings and shareholders will tolerate. In my opinion, these checks and balances  
15         are not working. Nevertheless, if the shareholders are not happy, they are free to vote on  
16         the issue, or even elect a new executive. As regulated utility, PSE’s situation is unique in  
17         that it can seek to charge ratepayers for whatever levels of compensation it chooses to  
18         pay its executives. The only constraint here is what the Commission will allow as  
19         reasonable.

20  **Q:     What precedents are available regarding executive compensation?**

21  A:     In general, a regulated utility may recover executive compensation from ratepayers to the  
22         extent it is “reasonable” and contributes “to the better management or greater efficiency

1 of the utility.”<sup>29</sup> The Washington State Supreme Court adopted this principle, requiring  
2 utilities to show that compensation is reasonable overall *and* that it provides a benefit to  
3 ratepayers.<sup>30</sup>

4 **Q: Do you have any specific concerns regarding PSE’s executive compensation?**

5 A: Yes. In addition to general concerns over increased executive compensation levels and  
6 the widening gap between what is paid to executives versus non-executives, I have  
7 specific concerns with how PSE determines the compensation it pays its executives.

8 Recently, there has been increased scrutiny regarding the use of consultants hired to assist  
9 companies in setting executive pay levels.<sup>31</sup> PSE has hired Towers Perrin to assist in this  
10 task. Towers Perrin performs two separate functions. First, a Towers Perrin consultant  
11 assists PSE’s Board of Directors’ Compensation Committee in its compensation  
12 decisions. Second, PSE’s compensation levels are influenced heavily by Towers Perrin  
13 compensation studies. As I discuss below, these studies are unreliable because they are  
14 circular, and because they use an inappropriate proxy group in evaluating and making  
15 recommendations on PSE’s compensation levels.

16 **Q: What is the primary concern relating to the use of compensation consultants such as**  
17 **Towers Perrin?**

18 A: The primary concern is possible conflicts of interest. A December 2007 report prepared  
19 for Rep. Henry A. Waxman, the Chairman of the Committee on Oversight and  
20 Government Reform, found widespread conflicts of interest among compensation

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<sup>29</sup> 78 C.J.S. Public Utilities Section 92.

<sup>30</sup> *US West v. UTC*, 134 Wn.2d 74, 125 (1997).

<sup>31</sup> Executive Pay: Conflicts of Interest Among Compensation Consultants, United States House of Representatives, Committee on Oversight and Government Reform, December 2007, Executive Summary.

1 consultants. Many of these consultants provided additional services to companies, and  
2 fees relating to those services often outweighed fees relating to compensation  
3 consulting.<sup>32</sup> In other words, the compensation consultants were not truly independent.  
4 This is similar to the auditor independence issues Sarbanes-Oxley addressed. The  
5 Committee’s report actually found a correlation between the extent of conflict of interest  
6 and the level of CEO pay.

7 **Q: Have you investigated whether or not Towers Perrin provides additional services to**  
8 **PSE?**

9 A: Yes. Public Counsel’s Data Request No. 523 asked for a schedule of all amounts paid to  
10 Towers Perrin for 2004 through 2007. **[Begin Confidential]** **XXXXXXXXXXXXXXXX**  
11 **XX**  
12 **XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. [End Confidential]** However, those  
13 payments were made in 2004 and 2005 and none were made in 2006 and 2007.<sup>33</sup>

14 **Q: Did PSE make any payments to Towers Perrin relating to the proposed sale?**

15 A: Yes, however it appears that those payments are not included in the total for 2007.<sup>34</sup>

16 **Q: Has the UTC addressed the subject of executive compensation and the use of**  
17 **compensation consultants?**

18 A: Yes, the Commission has addressed the issue several times. In its Final Order in  
19 PacifiCorp’s 2005 rate case, the Commission provided its overall strategy regarding  
20 executive compensation, stating:

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<sup>32</sup> *Id.*  
<sup>33</sup> PSE Response to Public Counsel Data Request No. 523.  
<sup>34</sup> *Id.*

1 In determining the reasonableness of executive compensation,  
2 the Commission will *consider compensation as a whole, not*  
3 *limited to whether executive incentive compensation is paid in*  
4 *stock or whether compensation is similar in level or benefits to*  
5 *that of other comparable companies.*<sup>35</sup>  
6

7 In its Final Order for PacifiCorp’s 2006 rate case, the Commission noted the  
8 “increasing attention to and criticism of excessive levels of executive compensation and  
9 bloated severance packages.” The Commission also noted the ongoing investigation into  
10 that matter and the use of compensation consultants by Congress.<sup>36</sup> In sum, the  
11 Commission stated, “we are inclined to be wary of studies by consultants that potentially  
12 are self-serving and may not provide objective information that is useful to us.”<sup>37</sup> In my  
13 opinion, both of these Orders indicate that an “everyone else is doing it” argument is not  
14 persuasive when it comes to executive compensation.

15 **1. Overall Executive Salary Levels**

16 **Q: Given the increased concern over excessive executive compensation, did you**  
17 **specifically look at the compensation of PSE’s CEO and other top executives?**

18 A: Yes, I did. PSE’s top six executives are: Stephen Reynolds (CEO), Bertrand Valdman  
19 (COO), Eric Markell (CFO), Susan McLain (Sr. VP – Operations), Jennifer O’Connor  
20 (General Counsel) and Kimberly Harris (CRO). The total compensation for these  
21 individuals is reported in the Summary Compensation Table included in the PSE’s 10-K.  
22 I have attached the 2007 table as Exhibit No.\_\_\_\_ (MJM-6) to my testimony. To  
23 summarize the table, the executives reported the following compensation in 2006 and  
24

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<sup>35</sup> PacifiCorp GRC, Docket No. UE-050684, Order 04 at ¶ 350 (emphasis added).

<sup>36</sup> Final Order UE-061546 and UE-060817, ¶ 174.

<sup>37</sup> Final Order UE-061546 and UE-060817, ¶ 174.

1 2007, showing an overall 35 percent increase in total compensation:

<u>Executive</u>	<u>2006</u>	<u>2007</u>	<u>Increase</u>	<u>Percent</u>
Reynolds	\$ 3,548,438	\$ 4,817,727	\$ 1,269,289	36%
Valdman	1,070,111	1,514,995	444,884	42%
Markell	766,611	1,118,194	351,583	46%
McLain	803,276	975,133	171,857	21%
O'Connor	745,188	944,088	198,900	27%
Harris	<u>655,101</u>	<u>876,326</u>	<u>221,225</u>	34%
Total	\$ 7,588,725	\$10,246,463	\$ 2,657,738	35%

Source: PSE December 31, 2007 10-K, p. 148.

2

3 **Q: What forms of compensation are included in the above amounts?**

4 A: The amounts above include: (a) salary, (b) stock awards, (c) option awards, (d) non-  
5 equity incentive plan compensation, (e) change in pension value and above market DCP  
6 and (f) other compensation, which includes perquisites and other personal benefits,  
7 registrant contributions to defined contribution plans and the imputed income on life  
8 insurance.<sup>38</sup>

9 **Q: Are all of these components included in the rate case?**

10 A: No. As I will discuss below, not all are included.

11 **Q: If the amounts in the table above are not included in the rate case, why have you**  
12 **included Table 1?**

13 A: I included Table 1 because I wanted the Commission to be fully aware of the total  
14 compensation package for these executives.

<sup>38</sup> PSE December 31, 2007 10-K, pp. 148-149.

1 **Q: Has the Commission expressed any interest in total executive compensation in the**  
2 **past?**

3 A: Yes. The PacifiCorp Order quoted above clearly indicates that the Commission intends  
4 to review executive compensation as a whole, including stock and other forms of  
5 compensation in addition to salaries.<sup>39</sup> Table 1 provides that necessary information.

6 **Q: Do these executives stand to receive additional compensation if the sale is approved?**

7 A: Yes, substantially so. PSE's response to Public Counsel's Data Request No. 530  
8 provides the change in control benefits estimated to be paid if the sale is approved. The  
9 benefits include an automatic "cash severance" payment of \$4.6 million, estimated excise  
10 tax gross-up of \$3.4 million to Mr. Reynolds, and an acceleration of the long term  
11 incentive plan (LTIP) for all the executives amounting to \$22.6 million.<sup>40</sup>

12 However, it should be noted that this answer provides only a narrow discussion of  
13 the compensation that PSE executives will receive if the sale is approved. According to  
14 the Company's February 16, 2008 merger proxy, Mr. Reynolds alone would receive  
15 approximately \$20 million in total compensation by the close of the sale.<sup>41</sup> Other PSE  
16 executives will also gain substantial financial benefits, estimated in the millions of  
17 dollars, as a result of the sale. Additionally, the February 16, 2008 merger proxy also  
18 provides information about the levels of compensation—above and beyond these  
19 additional millions of dollars not mentioned in PSE's response to Public Counsel's Data  
20 Request No. 530—promised to the top executives if they are terminated after the sale.

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<sup>39</sup> PacifiCorp GRC, Docket No. UE-050684, Order 04 at ¶ 350.

<sup>40</sup> PSE Response to Public Counsel Data Request No. 530.

<sup>41</sup> PSE Response to WUTC Staff Data Request No. 1003 in Docket U-072375. The February 16, 2008 merger proxy is also available online at: <http://www.pugetenergy.com/files/reports/ProxyStatement/SpecialProxy.pdf>

1 **Q: Does the fact that Mr. Reynolds’s \$4.6 million sale payday is referred to as a “cash**  
2 **severance” mean that he will be leaving the Company if the sale is consummated?**

3 A: No. Mr. Reynolds will receive that amount regardless.

4 **Q: Were you able to compare the overall 35 percent increase in total compensation**  
5 **received by these executives to the overall increase received by other employees in**  
6 **the Company?**

7 A: No. Public Counsel’s Data Request No. 591 requested the increase in total compensation  
8 for employees broken into union and non-union groups, with the non-union employees  
9 further broken down between the CEO, executives making more than \$150,000, and  
10 employees making less than \$150,000. PSE objected, claiming the groups in question  
11 had different compensation packages and thus, such a comparison was not possible. The  
12 information PSE did provide indicates that, although the percent in base salary increase  
13 received by executives was similar to that received by other employees, the incentive  
14 executives received as a percent of base salary was far higher than the percentage  
15 received by other employees.<sup>42</sup> In other words, in comparing just incentive awards, the  
16 Company’s executives received significantly larger increases.

17 **Q: Do you think PSE’s overall executive compensation levels are excessive?**

18 A: Yes. As I will discuss in detail below, PSE’s executive compensation is pegged to the  
19 compensation at much larger companies. This alone would cause PSE’s executive  
20 compensation to be excessive. In addition, the increase in total compensation received by  
21 the top executives is far greater than that received by other employees.  
22

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<sup>42</sup> PSE Response to Public Counsel Data Request Nos. 362 and 591.

1                   **2.     Towers Perrin Studies**

2   **Q:     What are the Towers Perrin compensation studies you mentioned above?**

3   A:     According to PSE witness, Tom M. Hunt, “PSE participates in numerous confidential  
4           salary surveys provided by third-party consulting firms in order to compare PSE’s pay  
5           programs – both base salary and variable pay – to other companies in [PSE’s] labor  
6           markets.”<sup>43</sup> The Company provided a list of the surveys in its response to Staff Data  
7           Request No. 111. Although the list contained surveys from several organizations, the  
8           primary surveys used by PSE appear to be those prepared by Towers Perrin.

9   **Q:     How does PSE use these studies to set compensation levels?**

10  A:     According to its 2007 10-K, the Company “annually compares executive pay to external  
11           market data from similar companies in [its] industry. Base pay and total direct  
12           compensation are targeted to the 50<sup>th</sup> percentile of [PSE’s] comparator group.”<sup>44</sup>  
13           Although the target is the 50<sup>th</sup> percentile, individual compensation is adjusted according  
14           to experience, performance, and responsibilities.<sup>45</sup> In addition, total cash compensation  
15           can reach the 75<sup>th</sup> percentile if PSE exceeds its performance goals.<sup>46</sup> In other words, PSE  
16           selects a comparison group of utility companies and sets its target pay for each executive  
17           to approximately the 50<sup>th</sup> percentile of similar executives in those companies.

18  **Q:     In general, do you see a problem with the use of compensation studies?**

19  A:     Yes. These types of studies are circular in nature. The data included is from companies  
20           that choose to participate by providing their data and in paying for access to the database.

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<sup>43</sup> Exhibit No.\_\_\_\_ (TMH-1T), p. 7:5-6.

<sup>44</sup> PSE’s December 31, 2007 Form 10-K, p. 139.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*, p. 141.

1 A company that does not set compensation levels based on industry data would not have  
2 any incentive to participate. If each participant sets its compensation levels at the 50<sup>th</sup>  
3 percentile or higher, such as PSE does, the average will ratchet up each year.

4 Compensation set in this manner becomes artificial—it will no longer be based on  
5 business factors specific to PSE, only on what is being paid at the next company down  
6 the road. If companies base compensation on data from larger companies such as PSE  
7 does, the database becomes even more skewed.

8 **Q: Were you given access to the studies used by PSE?**

9 A: Public Counsel Data Request No. 517 requested copies of the studies. In response, PSE  
10 stated that it was prohibited from distributing copies of the studies due to confidentiality  
11 constraints and instead would make the studies available for review at its headquarters in  
12 Bellevue.<sup>47</sup> Due to the time and distance involved, my client viewed the studies on my  
13 behalf. PSE also arranged a web presentation on April 24, 2008 to demonstrate how it  
14 uses the Towers Perrin data. In addition, we were provided an MS Excel file entitled  
15 “Towers Perrin Peer Group 2006 Data (C)” and a report dated October 2006 entitled  
16 “2006 CDB Energy Services Industry Executive Compensation Database Puget Energy  
17 Custom Analysis – 2006 Executive Peer Group.” These documents represent PSE’s  
18 custom analysis using the Towers Perrin database and are considered confidential. We  
19 were not provided access to the database itself. In addition, Towers Perrin declined to  
20 allow PSE to perform any analysis on behalf of Public Counsel using its compensation  
21 database.

22 **Q: What did you learn during the presentation?**

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<sup>47</sup> PSE Response to Staff Data Request No. 111.

1 A: During the presentation, I learned that PSE has access to Towers Perrin's online database  
2 of compensation information. After selecting a peer group of energy companies (which  
3 is then approved by PSE's Towers Perrin consultant), PSE is able to perform queries that  
4 provide compensation information by both the highest paid positions and by job type.

5 **Q: How did PSE select its peer group?**

6 A: The peer group selected consisted of utility companies with revenues between \$1.5  
7 billion and \$7.0 billion, and assets between \$4.0 billion and \$10.0 billion.<sup>48</sup>

8 **Q: Do you believe the peer group selected by PSE is a reasonable proxy for PSE?**

9 A: No. In my opinion, PSE has selected a peer group of companies that are in many cases  
10 much larger than PSE in terms of assets, employees, and revenues. As I discussed above,  
11 there are problems inherent in using compensation studies such as the one by Towers  
12 Perrin to set compensation levels. The use of an inappropriate peer group merely adds to  
13 those problems.

14 **Q: What are some specific flaws with PSE's peer group?**

15 A: According to confidential information provided in PSE's response to Public Counsel's  
16 Data Request No. 522, the median 2006 revenue for the peer group was **[Begin**  
17 **Confidential] XXXXXX [End Confidential]**, with the average revenue being **[Begin**  
18 **Confidential] XXXXXX [End Confidential]**. In contrast, PSE's 2006 revenue was only  
19 \$2.91 billion. Based on revenue alone, PSE is smaller than the both the median and  
20 average of the peer group. PSE also is quite a bit smaller when using other metrics as  
21 well. For instance, the median 2006 market capitalization for the peer group was **[Begin**  
22 **Confidential] XXXXXXXXXX [End Confidential]**, with the average being **[Begin**

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<sup>48</sup> PSE's December 31, 2007 10-K, p. 141.

1 **Confidential** [REDACTED] **[End Confidential]**. PSE's 2006 market capitalization was  
2 only \$2.70 billion.<sup>49</sup> Finally, a comparison of the number of employees supervised by  
3 PSE's CEO versus the average number of employees supervised by the CEOs of the peer  
4 companies shows that while Mr. Reynolds supervises **[Begin confidential]** [REDACTED] **[End**  
5 **Confidential]** employees, the CEOs of the peer group supervise **[Begin Confidential]**  
6 [REDACTED] **[End Confidential]** employees on average.<sup>50</sup>

7 **Q: Why is the use of larger companies in the proxy group a problem?**

8 A: Because the peer group companies are so much larger, they are not truly comparable to  
9 PSE. Executive pay may be tied somewhat to the size and complexity of a company. If  
10 PSE sets its executive pay to be comparable with that of larger companies, PSE will  
11 naturally end up paying its executives more than what is a correct market rate for a  
12 company of PSE's size. For instance, as mentioned above, there is an enormous  
13 discrepancy between the numbers of employees Steve Reynolds supervises versus the  
14 average number supervised by the CEOs of the peer group. Based on the data provided  
15 in PSE's response to Public Counsel's Data Request No. 521, the number of employees at  
16 PSE falls between the **[Begin Confidential]** [REDACTED]  
17 [REDACTED] **[End Confidential]**. However, Mr. Reynolds's total direct compensation falls  
18 closer to **[Begin Confidential]** [REDACTED] **[End Confidential]** for the companies.

19 **Q: What parameters should PSE use in selecting a peer group?**

20 A: PSE used a range of \$1.5 billion to \$7.0 billion in revenue to select its peer group, when  
21 its own 2006 revenue was \$2.91 billion. This is a range of 51 percent to 240 percent of

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<sup>49</sup> Confidential PSE Response to Public Counsel Data Request No. 522.  
<sup>50</sup> Confidential PSE Response to Public Counsel Data Request No. 521 Supplemental.

1 PSE's revenue. A more appropriate range would have been between 75 percent and 125  
2 percent of PSE's revenue, in other words, \$2.2 billion to \$3.6 billion. Furthermore,  
3 revenue is not necessarily the best indication of similarities between companies. PSE  
4 should give more weight to other factors such as number of employees, amount of  
5 regulated versus non-regulated business, value of assets, and market capitalization, in  
6 selecting a comparison group.

7 **Q: Did you have the opportunity to select a different proxy group and perform your**  
8 **own compensation analysis using the Towers Perrin database?**

9 A: No. Towers Perrin declined to allow PSE to either provide access to the database or  
10 perform additional analyses using peer groups selected by the intervenors in this case. As  
11 such, the only information I have available is the summary information used by PSE.

12 **Q: What do you recommend regarding PSE's use of compensation studies?**

13 A: I do not recommend setting executive compensation based on what is being done at other  
14 companies. As I have discussed above, I believe the sort of compensation studies PSE  
15 relies upon are circular in nature, and can lead to compensation levels that would  
16 otherwise not occur if normal economic factors were at play. Because PSE has relied  
17 upon compensation levels at much larger companies in determining the compensation for  
18 its own executives, in my opinion PSE's compensation levels are suspect.

19 **3. Executive Compensation Included in Rate Case**

20 **Q: Please explain the components of PSE's executive compensation that have been**  
21 **included in the rate case.**

22 A: Public Counsel's Data Request No. 528 requested the amounts of compensation by  
23 component included in the revenue requirement for the Company's top five executives.

1 According to that response there are four types of executive compensation included in the  
2 rate case: salary, employee insurance, incentive pay, and long term investment plan  
3 (LTIP).

4 **Q: What do the incentive pay and investment plan components represent?**

5 A: The incentive pay portion is the amount related to the Company's 2007 Goals and  
6 Incentive Plan, which I will discuss in depth later in my testimony. The investment plan  
7 amounts appear to be related to PSE's 401(k) plan.

8 **Q: How were the salaries amounts, provided in PSE's Response to Public Counsel's**  
9 **Data Request No. 528, calculated?**

10 A: Based on PSE's response, the salary amounts included in the revenue requirement were  
11 increased by the overall effective increase for salaried employees. I was able to confirm  
12 this using Mr. Story's workpapers. His workpaper "4.25E & 4.18G Wage Increase.xls"  
13 includes the test year salary by employee, which I then multiplied by his overall effective  
14 increase for salaried employees of 4.79 percent. In performing this check I noticed two  
15 issues.

16 **Q: Please explain your findings.**

17 A: First, I noticed discrepancies in the various salary amounts I have been provided by the  
18 Company. The salary amounts included in Mr. Story's workpapers are allegedly test year  
19 amounts. I compared those amounts for the top five executives to the base salary  
20 amounts, labeled as "Actuals from 10-1-06 to 9-30-07", found in PSE's confidential  
21 Response to Public Counsel's Data Request No. 674, which based, on the label, should be  
22 test year amounts as well. There were differences between the two amounts, which calls  
23 into question the validity of the data used.

1           Second, and more importantly, I noticed that 100 percent of Mr. Reynolds' salary  
2 has been charged to O&M, as well as the vast majority of the total salary amounts for the  
3 other top five executives.

4 **Q: Why do you feel that charging Mr. Reynolds' entire salary to ratepayers is an issue?**

5 A: PSE's Response to UTC's Data Request No. 133 provided the percentages of each  
6 executive's salary that were allocated either to utility operations or non-regulated  
7 operations, by month, from January 2001 through December 2007. Per the response, the  
8 source of the data was officer time-sheets and fixed assessment rules applied to each  
9 officer's cost center. With the exception of one officer (Phil Bussey, Director of  
10 Communications), the fixed assessment rules allocate 100 percent of the officer's time to  
11 the regulated utility.

12           Even though Puget Energy does not have a large amount of non-regulated  
13 operations, I believe that some portion of executive pay should be the responsibility of  
14 the shareholders. In any investor-owned utility, one would expect the top executives to  
15 spend at least some of their time on activities that provide no direct benefit to ratepayers.  
16 These activities may include preparing shareholder reports and attending shareholder  
17 meetings, monitoring stock performance, and cost reduction efforts where there is no  
18 accompanying reduction in rates. Other activities might be designed to increase  
19 shareholder value, such as the upcoming sale. In fact, although the executives allocated  
20 100 percent of their time to regulated operations through the test year, I noticed that,  
21 beginning around September 2007, more time was allocated to non-regulated operations.  
22 The Commission should consider the specific duties of each executive and whether they  
23 are actually serving ratepayers.

1 **Q: Were you able to determine the specific duties of each executive?**

2 A: No. Public Counsel’s Data Request No. 529 requested a listing of the common tasks  
3 performed, along with the percentage of time spent on each task for the five top  
4 executives. PSE was not able to provide this information, stating that the Company did  
5 not have job descriptions for the top five executives. Instead, the Company suggested  
6 reviewing the job descriptions of the employees who report to each executive and the  
7 summaries of executive goals as related to the Goals and Incentive Plan.

8 **Q: Did you review these items as suggested?**

9 A: Yes. I found that many of the officer goals provided in PSE’s Response to Public  
10 Counsel’s Data Request No. 31 were not directed towards areas that would provide a  
11 direct benefit to ratepayers. For some officers, such as Phil Bussey (Corporate  
12 Communications), Jennifer O’Connor (Legal), and Bert Valdman (COO), none of the  
13 goals provide a direct benefit to ratepayers.

14 The job descriptions also showed few customer service related responsibilities.  
15 For example, Mr. Bussey’s job summary, “[r]esponsible for leading and overseeing all  
16 external and internal communications strategies, policies and activities supporting the  
17 reputation and identity of Puget Energy, and its primary subsidiary, Puget Sound Energy”  
18 clearly is directed towards shareholder value, not ratepayer benefit.<sup>51</sup> Note that even  
19 though Mr. Bussey’s position provides no direct benefit to ratepayers, he charges 80  
20 percent of his time to regulated operations.<sup>52</sup> According to his job description, Mr.

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<sup>51</sup> PSE Response to Public Counsel Data Request No. 129.

<sup>52</sup> PSE Response to Public Counsel Data Request No. 133.

1 Bussey reports to the CEO.<sup>53</sup> Other job descriptions that are clearly aimed towards  
2 shareholder benefit are the Director Investor Relations and Director Structuring Asset  
3 Optimization and Analytics, all of whom report to the CFO, the Director Federal  
4 Government (reporting to the CRO), and those directors that report to General Counsel.<sup>54</sup>

5 This discussion demonstrates that, despite charging almost all of their time to  
6 regulated operations, PSE's top executives have many responsibilities, some of which do  
7 not provide benefit to the ratepayers.

8 **Q: Do you recommend that a portion of executive pay be disallowed based on your**  
9 **discussion above?**

10 A: Yes. Using the information provided in PSE's Response to Public Counsel's Data  
11 Request No. 528, I have eliminated 50 percent of the base salary included in the revenue  
12 requirement for Mr. Reynolds, Mr. Valdman, Mr. Markell and Ms. O'Connor. I have not  
13 eliminated any of Ms. McLain's base salary due to her position as Vice President of  
14 Operations.

15 **Q: Why have you selected 50 percent as the amount to eliminate?**

16 A: PSE is not able to provide job descriptions for the executives listed above, nor is it able to  
17 provide task breakdowns for the positions. In the past, the UTC has not permitted  
18 companies to charge ratepayers for the entire amount of officer salaries, when it is clear  
19 that the officers spend time on non-regulated activities, or activities that do not provide a  
20 direct benefit to the ratepayers.<sup>55</sup> The preferable method of disallowing a portion of the  
21 salaries would be to use direct assignment, which is not possible. Another preferred

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<sup>53</sup> PSE Response to Public Counsel Data Request No. 129.

<sup>54</sup> *Id.*

<sup>55</sup> Final Order UE-991606 and UE-991607, ¶¶ 244-250.

1 method would be the use of an allocation factor, also not possible in this case. I have  
2 selected 50 percent based on my judgment.

3 **Q: Have you reduced any other executive salaries?**

4 A: Yes. I have eliminated 25 percent of Ms. Kimberly Harris's salary. Ms. Harris is the  
5 Chief Resource Officer. According to PSE's website, Ms. Harris heads Energy  
6 Resources, including project development and contract management, Energy Efficiency  
7 Services, and Federal Government Relations. My 25 percent elimination is related to her  
8 role as head of Federal Government Relations. I would also eliminate the entire salary  
9 for the Director, Federal Government, but do not have the necessary information to do so.  
10 The other salary adjustment I have made related to this issue is to eliminate 100 percent  
11 of Mr. Bussey's salary. As noted above, Mr. Bussey's position as head of Corporate  
12 Communications does not appear to provide any direct benefit to ratepayers.

13 **I. Adjustment Nos. 11(E) and 6(G) – SERP and Deferred Compensation Plan**

14 **Q: Are PSE executives eligible to receive any additional compensation that was not**  
15 **included in the response to Public Counsel's Data Request No. 528, but is included**  
16 **in the revenue requirement?**

17 A: Yes. PSE's executives participate in a Supplemental Executive Retirement Program  
18 (SERP) and a Deferred Compensation Plan. Both of these plans appear to serve the  
19 purpose of allowing PSE to provide retirement contributions to executives that are greater  
20 than those allowed by the Internal Revenue Service (IRS) under normal, tax-qualified  
21 retirement plans.

22 **Q: Please explain the SERP.**

1 A: As described in PSE's 2007 Form 10-K, the SERP is designed to provide executives a  
2 benefit that is coordinated with the tax-qualified PSE Retirement Plan.<sup>56</sup> The plan is open  
3 only to those executives designated by the company. The monthly benefit, available to  
4 the executive at age 62, is equal to "one-twelfth of the participant's highest average  
5 earnings times the participant's years of credited service (not in excess of 15) times 31/3  
6 percent," less the monthly amount payable under the Retirement Plan and the monthly  
7 amount payable under any "pension-type rollover accounts within the Deferred  
8 Compensation Plan."<sup>57</sup>

9 **Q: What is your opinion regarding the SERP?**

10 A: PSE's SERP is an extremely generous retirement program open only to select executives.  
11 It is far more lucrative than the Retirement Plan that PSE's regular salaried employees are  
12 eligible to participate in. For instance, employees participating in the Retirement Plan  
13 accrue a cash balance based on 3 to 8 percent of eligible compensation, up to an IRS  
14 limit. Normal retirement age under that plan is 65 years, not 62 years as for the SERP.<sup>58</sup>  
15 Another indication of the generous nature of the SERP can be found in the schedule of  
16 pension benefits for the Company's top six executives. With the exception of Mr.  
17 Reynolds, who does not participate in the SERP, the total present value of the  
18 accumulated benefit for the Retirement Plan is only 25 percent of the same amount for  
19 the SERP.<sup>59</sup>

20 **Q: Please explain the Deferred Compensation Plan.**

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<sup>56</sup> PSE's December 31, 2007 Form 10-K, p. 145.

<sup>57</sup> *Id.*, p. 154.

<sup>58</sup> *Id.*, p. 153.

<sup>59</sup> *Id.*, p. 152.

1 A: Like the SERP, the Deferred Compensation Plan is only available to certain executives.  
2 The Plan allows executives to defer up to 100 percent of his or her base salary, annual  
3 incentive compensation, and vested performance shares. The plan also provides  
4 participants with Company contributions designed “to restore benefits not available to  
5 them under PSE’s tax-qualified plans due to limitations imposed by the Internal Revenue  
6 Code.”<sup>60</sup>

7 **Q: Are any additional payments made under the guise of the Deferred Compensation**  
8 **Plan?**

9 A: Yes. PSE’s CEO, Mr. Reynolds, elected not to participate in the SERP. Instead, he  
10 chose to receive “an annual credit of performance-based stock equivalents to his Deferred  
11 Compensation Plan’s stock account.”<sup>61</sup>

12 **Q: What do you recommend regarding the SERP and Deferred Compensation Plan?**

13 A: I recommend that they be removed from the revenue requirement. PSE’s SERP and  
14 Deferred Compensation Plan provide an additional level of compensation to its already  
15 highly-paid executives. The SERP goes far and beyond any Retirement Plan available to  
16 other Company employees, not to mention any retirement programs available to the  
17 majority of its ratepayers. Contributions to the Deferred Compensation Plan appear to  
18 serve the purpose of side-stepping limitations put in place by the IRS to curb excessive  
19 executive compensation. If PSE feels that such programs are necessary then they should  
20 be financed by the Company’s shareholders, not its ratepayers.

21 **Q: Have you seen these types of programs in any other recent cases?**

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<sup>60</sup> PSE’s December 31, 2007 10-K, p. 155.

<sup>61</sup> *Id.*, p. 155.

1 A: Yes. I recently prepared testimony in North Dakota Case No. PU-07-776.<sup>62</sup> In North  
2 Dakota, retirement plans such as the SERP are not included in the revenue requirement.

3 **Q: Have you calculated the amounts to be removed?**

4 A: Yes. According to PSE's pension plan related workpapers, the Company has adjusted its  
5 SERP expense to reach a restated level of \$2,236,061 for electric and \$1,309,865 for gas,  
6 a total of \$3,545,926. I have removed this entire amount from the revenue requirement.<sup>63</sup>  
7 My adjustment is shown on page 16 of Exhibit No.\_\_\_\_ (MJM-4).

8 **J. Adjustment Nos. 12(E) and 7(G) - Remove Incentive Pay**

9 **Q: Explain Adjustment Nos. 12(E) and 7(G).**

10 A: These adjustments remove all amounts related to PSE's Goals and Incentive Plan. They  
11 appear on page 17 of Exhibit No.\_\_\_\_ (MJM-4).

12 **Q: What is PSE's Goals and Incentive Plan?**

13 A: Company witness, Thomas M. Hunt, describes PSE's Goals and Incentive Plan as  
14 providing "all employees with the opportunity for incentive payment based on Company,  
15 team and individual performance."<sup>64</sup> Essentially the plan puts some of each employee's  
16 total compensation at risk – if certain corporate and individual goals are not met, the  
17 incentive bonus is not distributed. The amount of compensation at risk is greater the  
18 higher the position.

19 **Q: How is the overall incentive payout determined?**

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<sup>62</sup> Application of Northern States Power Company, a Minnesota Corporation, for Authority to Increase Rates for Electric Service in North Dakota, Case No. PU-07-776.

<sup>63</sup> We have requested PSE's deferred compensation in Public Counsel Data Request No. 697, however, we have not yet received a response.

<sup>64</sup> Exhibit No.\_\_\_\_ (TMH-1T), p. 16:14-15.

1 A: The total amount of incentive payout to be distributed depends on two factors: earnings  
2 per share (EPS) and Service Quality Index (SQI) goals. Mr. Hunt provides more detail in  
3 his testimony:

4 For any incentive payment to be possible, two threshold  
5 requirements must be met: First, PSE's earnings per share (EPS)  
6 must exceed the "trigger" level (\$1.43/share in 2007). Second, PSE  
7 must meet or exceed its required performance on at least 5 of 11 of  
8 the Service Quality Index (SQI) goals.<sup>65</sup>  
9

10 **Q: What does this indicate about the Goals and Incentive Plan?**

11 A: The fact that Mr. Hunt lists EPS as the first factor involved in computing the incentive  
12 payout indicates that, despite the inclusion of SQI goals in the formula, the primary driver  
13 of *any* incentive payout is PSE's financial performance. In other words, if shareholder  
14 expectations are not met through a certain level of earnings per share, *no incentive is paid*  
15 *out at all.*

16 **Q: How do the SQI goals factor into the equation?**

17 A: Once the Company has determined the total amount of incentive pool available per its  
18 EPS level, that amount is modified up or down based on how many SQI goals the  
19 Company has achieved. In order for 100 percent of the EPS-related pool to be available  
20 for payout, PSE must meet 10 out of 11 of its SQI goals. If the Company meets all 11,  
21 the EPS-based pool is paid out at 120 percent. If it meets 4 or fewer SQI goals, the EPS-  
22 based pool is not paid out at all.<sup>66</sup>

23 While the achievement of SQI goals has the potential to increase or reduce the  
24 incentive pool to be paid out, the actual payment of any incentive is primarily related to

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<sup>65</sup> Exhibit No. \_\_\_\_ (TMH-1T), p. 18: 9-12.

<sup>66</sup> Exhibit No. \_\_\_\_ (TMH-4).

1 the achievement of EPS goals. If PSE meets 5 of its SQI goals, the incentive pool will be  
2 paid out at 50 percent. In other words, PSE need only achieve 45 percent of important  
3 SQI goals in order for a bonus to be paid out. In many situations, 60 percent is  
4 considered a barely passing grade – 45 percent would be considered unacceptable.

5 **Q: Do any other Public Counsel witnesses address the Company’s SQI goals?**

6 A: Yes. Barbara Alexander addresses PSE’s customer service and SQI goals.

7 **Q: How do the individual and team goals factor into the incentive plan?**

8 A: Individual and team goals only help in determining how much of the incentive pool is  
9 paid to an individual employee.<sup>67</sup> The goals have nothing to do with the overall payout  
10 pool as calculated based on EPS and modified by SQI. Goals are nice to have, and they  
11 can serve to direct Company strategy, but they can also be fairly subjective. Regardless,  
12 the goals are not at issue in determining the overall amount to be paid out under the plan.

13 **Q: What is your overall impression of the Goals and Incentive Plan?**

14 A: My overall impression is that the Goals and Incentive Plan is first and foremost tied to  
15 financial performance measures – a shareholder benefit, not a ratepayer benefit. Any  
16 other factors discussed, including SQI and goals, only serve to modify the amount paid,  
17 and not determine the starting point.

18 **Q: Has this Commission or Washington courts provided any guidance on these types of**  
19 **programs?**

20 A: Yes. In PSE’s 1992 rate case, the Commission disallowed a “pay-at-risk” program for  
21 the Company’s officers and directors, referring to the program as a “profit-sharing” plan.

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<sup>67</sup> *Id.*

1 As described in the Commission’s Final Order, the “pay-at-risk” program sounds very  
2 similar to PSE’s current “Goals and Incentive Plan.”<sup>68</sup>

3 Additionally, in a 1997 decision, the Washington State Supreme Court upheld the  
4 Commission’s decision to disallow recovery of U.S. West’s incentive program in rates.  
5 In its Final Order below, the Commission noted that in U.S. West’s incentive plan,  
6 employees could recoup any part of their bonus lost by poor service performance if the  
7 Company’s earnings exceeded a certain level. It disallowed the plan because the  
8 structure allowed financial rewards to eclipse customer service failures.<sup>69</sup>

9 Finally, in its Final Order in Avista’s 1999 general rate case (disallowing recovery  
10 of Avista’s incentive plan), the Commission noted that Avista’s incentive plan suffered  
11 from the same flaws as U.S. West’s plan - Avista would not pay its incentive bonus if  
12 certain earnings goals were not met, even if it exceeded customer service goals.<sup>70</sup>

13 **Q: Does PSE’s plan suffer from the same flaws as U.S. West’s and Avista’s plans?**

14 A: Yes it does. As I have discussed above, the first criteria in determining the bonus payout  
15 is EPS. For 100 percent of the target bonus to be funded, the Company must have an  
16 EPS of \$1.57 and meet 10 out of 11 SQI goals. Using Tables 1 and 2 in Exhibit  
17 No.\_\_\_\_(TMH-4) and assuming PSE reaches \$1.65 EPS (the top of its earnings guidance),  
18 the Company could achieve only 8 out of 11 SQI factors and still fund the bonus pool at  
19 greater than 100 percent of its target. The bonus pool cap is 205 percent of target, which  
20 is tied to an EPS figure of \$1.76. If PSE were to reach that figure, it would still fund over

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<sup>68</sup> Puget Sound Power & Light, Docket No. UE-920499, Eleventh Supplemental Order, at p. 67.

<sup>69</sup> *US West v. UTC*, 134 Wn.2d 74, 125 (1997).

<sup>70</sup> Avista GRC, Docket No. UE-991606, Third Supplemental Order at ¶¶ 244-273.

1 100 percent of its bonus pool while achieving only 5 out of 11 SQI goals! This plan  
2 suffers from the exact flaws as the plans disallowed in the U.S. West and Avista cases.

3 **Q: What do you recommend?**

4 A: Because the program's overall payout is first tied to EPS, a shareholder benefit, I  
5 recommend that shareholders finance the program. As such, I have removed the entire  
6 amount from the revenue requirement. This amounts to \$5.4 million for electric and \$3.1  
7 million for gas.

8 **K. Adjustment Nos. 13(E) and 8(G) - Remove Expenses Related to Shareholders**

9 **Q: Explain Adjustment Nos. 13(E) and 8(G).**

10 A: These adjustments, shown on page 18 of Exhibit No.\_\_\_\_(MJM-4), remove certain  
11 expenses associated with Puget Energy's (PE) status as a public company.

12 **Q: Why have you made these adjustments?**

13 A: PSE is the only subsidiary of PE. PE incurs certain costs brought on solely by its status  
14 as a public company. Included in these costs are: directors' fees and expenses; trustee,  
15 registrar, and transfer agent fees and expenses; stockholder meeting expenses; expenses  
16 related to dividend and other financial notices and printing and mailing dividend checks;  
17 expenses related to publishing and distributing annual reports to stockholders; and,  
18 expenses related to public notices of financial, operating and other data required by  
19 regulatory statutes. Currently, PE's affiliate allocation methodology allocates 100  
20 percent of most of these expenses to its subsidiary, PSE, and from there to its  
21 ratepayers.<sup>71</sup>

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<sup>71</sup> PSE Response to Staff Data Request No. 026, Attachment F.

1           In my opinion, shareholders, not ratepayers, should incur these types of expenses.  
2  
3           Furthermore, should PE's proposed sale be approved I would expect that these expenses  
4           would no longer be necessary at all. According to PSE's response to Staff Data Request  
5           No. 026, the Company has not calculated the change in these expenses post-sale.

6   **Q:    What do you recommend?**

7   A:    I recommend the removal of 100 percent of PSE's expenses related to trustee, registrar,  
8           and transfer agent fees, stockholder meetings, dividend and other financial notices, the  
9           printing and mailing dividend checks, the publishing and distribution of annual reports to  
10          stockholders and public notices of financial, operating and other data required by  
11          regulatory statutes. Because I recognize that directors should play a role in the  
12          management of a company, I have split directors' fees and expenses evenly between  
13          shareholders and ratepayers. In total, I have removed \$1.8 million in related expenses  
14          from PSE's electric and gas revenue requirements.

15   **L.    Adjustment Nos. 14(E) and 9(G) - Remove Corporate Aircraft Expense**

16   **Q:    Explain Adjustment Nos. 14(E) and 9(G).**

17   A:    These adjustments remove all amounts related to PSE's corporate airplane and appear on  
18          page 19 of Exhibit No.\_\_\_\_ (MJM-4).

19   **Q:    Why have you made these adjustments?**

20   A:    According to PSE's Response to Public Counsel's Data Request No. 321 PSE owns a  
21          corporate airplane and leases an airport hangar. Test Year amounts related to the aircraft  
22          and hangar include \$472,523 in flight services expenses, \$969,352 net plant included in

1 rate base, \$50,982 in depreciation expense for the test year, and \$186,794 in deferred  
2 federal income tax.<sup>72</sup>

3 Although it is PSE's policy that the aircraft is only used for business purposes, a  
4 review of the flight log indicates that much of its use is merely shuttling executives back  
5 and forth to meetings and other events, including holiday parties. While it may be  
6 convenient for Company executives to travel by private aircraft, it is not a necessity,  
7 given PSE's service territory. Private aircraft travel should be done at shareholders'  
8 expense, not ratepayers'. A corporate aircraft is not essential for the provision of safe,  
9 reliable electric service.

10 **M. Adjustment Nos. 15(E) and 10(G) - Remove Expenses Relating to Athletic**  
11 **Events**

12  
13 **Q: Explain Adjustment Nos. 15(E) and 10(G).**

14 A: These adjustments remove \$17,849 in expenses relating to athletic events. They appear  
15 on page 20 of Exhibit No.\_\_\_\_ (MJM-4).

16 **Q: Why have you made these adjustments?**

17 A: PSE's Response to Public Counsel Data Request No. 598 indicates that the Company  
18 incurred \$207,434 in expenses related to athletic and sporting activities. Of this amount,  
19 \$189,584 was charged below the line, leaving \$17,849 in the rate case. The majority of  
20 the total amount is related to PSE's corporate suite for the Seattle Mariners. The amount  
21 included in the revenue requirement appears to be for various "employee games", which  
22 involve PSE officers, directors and, employees drawn from an employee pool, and are

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<sup>72</sup> PSE Response to Public Counsel's Data Request Nos. 321 and 577. Total flight services expenses in rate case = \$294,039 grand total from Public Counsel Data Request No. 321 plus \$178,484 utility chargeback from Public Counsel Data Request No. 577.

1 meant to serve as team-building exercises.<sup>73</sup> Attendance at athletic events is not essential  
2 to the provision of safe, reliable electric service, and does not benefit ratepayers. If PSE  
3 wishes to reward employees with baseball games viewed from a corporate suite, its  
4 shareholders should foot the bill.

5 **N. Adjustment Nos. 16(E) and 11(G) - Adjust D&O Insurance to Remove**  
6 **Impact of Pending Litigation**

7  
8 **Q: Explain Adjustment Nos. 16(E) and 11(G).**

9 A: These adjustments, shown on page 21 of Exhibit No.\_\_\_\_ (MJM-4), Schedule 4, adjust  
10 Directors' and Officers' (D&O) insurance to remove the impacts of increased premiums  
11 brought on by pending litigation.

12 **Q: Why have you made these adjustments?**

13 A: PSE has increased its D&O insurance by \$35,809 for electric and \$24,618 for gas. Of  
14 PSE's five D&O insurance providers, four reduced their premiums for 2007-2008.  
15 However, one provider, AEGIS, increased its premium by \$112,182. PSE's Response to  
16 Public Counsel Data Request No. 421 cited pending litigation as the cause for the  
17 increased premium.

18 In its confidential Response to Public Counsel Data Request No. 604, PSE  
19 explained that the litigation in question involved **[Begin Confidential]**

20 **XX**

21 **XX**[End

22 **Confidential]** The increase in D&O insurance is clearly related to **[Begin Confidential]**

23

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<sup>73</sup> PSE Response to Public Counsel Data Request No. 598, Attachment B.

1 ~~XXXXXXXXXXXXXXXXXX~~ [End Confidential] and as such should not be borne by  
2 ratepayers.

3 **Q: How did you calculate the adjustment?**

4 A: I used PSE’s D&O workpapers and reduced the premium for AEGIS by \$112,182, which  
5 set the premium to the 2006-2007 level. I did not attempt to reduce the premium further,  
6 even though the other four insurers had reduced their premiums. The formulae in PSE’s  
7 D&O workpapers produced the revised adjustment for electric and gas. My total  
8 adjustment includes the elimination of PSE’s increase, as well as the decrease associated  
9 with the effect of reduced premiums for the other four insurers.

10 **Q: What is the impact of your adjustment?**

11 A: My adjustment results in a decrease in D&O insurance of \$65,799 for electric and  
12 \$45,236 for gas.

13 **O. Adjustment Nos. 17(E) and 12(G) - Remove Airport Parking Expense**

14 **Q: Explain Adjustment Nos. 17(E) and 12(G).**

15 A: These adjustments remove all amounts related to PSE’s lease of six parking spaces at  
16 SeaTac Airport. They are shown on page 22 of Exhibit No.\_\_\_\_ (MJM-4).

17 **Q: Why have you made these adjustments?**

18 A: PSE leases six parking spaces at SeaTac Airport, “to accommodate officers when they  
19 travel to out-of-town meetings.”<sup>74</sup> Rate case expenses related to this perquisite are  
20 \$21,541.<sup>75</sup> As with the use of a private aircraft, while it is certainly convenient for  
21 Company officers to have pre-arranged parking available at the airport to the extent the

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<sup>74</sup> PSE Response to Public Counsel Data Request No. 607.

<sup>75</sup> PSE Response to Public Counsel Data Request No. 433.

1 cost of these leased parking spots exceeds the cost of day-to-day parking, they should be  
2 borne by shareholders, not ratepayers. PSE provided a usage log for the passes related to  
3 the parking spaces, but it is impossible to determine from the log how many days an  
4 individual actually parked at the airport.<sup>76</sup>

5 **P. Adjustment Nos. 18(E) and 13(G) – Interest Synchronization**

6 **Q: Explain your interest synchronization adjustments as shown on Exhibit No.\_\_\_\_**  
7 **(MJM-4), p. 23.**

8 A: Adjustment Nos. 18(E) and 13(G) adjust the interest expense in the income tax  
9 calculation to reflect Mr. Hill’s recommended composite weighted interest rate.

10 **Q. Rate of Return**

11 **Q. Have you implemented Mr. Hill’s recommended rate of return?**

12 A: Yes. I have implemented Mr. Hill’s recommended rate of return in Exhibit  
13 No.\_\_\_\_(MJM-4), Schedules 2(E) and 2(G). This results in a revenue requirement  
14 reduction of \$36.8 million in electric and \$15.1 million in gas.

15 **VI. Summary**

16 **Q: Please summarize your recommendations.**

17 A: In addition to implementing Mr. Hill’s recommended rate of return, I have made 18  
18 adjustments to the Company’s electric revenue requirement proposal and 13 adjustments  
19 to its gas revenue requirement proposal. In summary:

- 20 • I recommend that the UTC specifically recognize that PSE has a \$137.9 million  
21 regulatory liability related to its collection of excess future removal costs. PSE  
22 should be required to reclassify this amount to Account 254-Other Regulatory

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<sup>76</sup> PSE Response to Public Counsel Data Request No. 607.

1 Liabilities for regulatory accounting, reporting, and ratemaking purposes. This  
2 adjustment is a revenue neutral reclassification, however, I recommend it be used  
3 to offset storm expenses.

- 4 • I have disallowed certain out-of-period plant additions for PSE's electric plants,  
5 as well as reversed Mr. Karzmar's premature Everett Delta Lease adjustment.
- 6 • I have made adjustments relating to PSE's storm damage expenses, including  
7 amortizing a portion of its cost of removal regulatory liability to offset its net  
8 storm damage claim.
- 9 • I have adjusted the Company's federal income tax rate to reflect its corporate tax  
10 rate and implemented flow-thru tax accounting for storm damage costs.
- 11 • I have increased the amortization period for interest associated with the deferral of  
12 unrecovered residential exchange benefits credited to customers from PSE's  
13 proposed 2 years to 7 years.
- 14 • I have implemented Mr. King's depreciation rates.
- 15 • I have reduced PSE's requests for executive compensation and directors' fees –  
16 splitting some of those expenses with shareholders. I have also reduced PSE's  
17 requested increase to D&O insurance.
- 18 • I have eliminated PSE's requested amounts relating to its SERP, Goals and  
19 Incentive Plan, shareholder services, corporate aircraft, athletic events, and airport  
20 parking spaces.
- 21 • I have adjusted the interest expense in the income tax calculation to reflect Mr.  
22 Hill's recommended composite weighted interest rate.

1 **Q: What is the impact of your adjustments?**

2 A: My adjustments reduce PSE's calculated revenue deficiency by \$175.4 million for  
3 electric and \$51.0 million for gas. This results in a \$4.3 million electric revenue increase  
4 and a \$7.0 million gas revenue increase.

5 **Q: Does his conclude your testimony?**

6 A: Yes, it does.