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| Item No.: | A1 |

**Docket:** **UE-041570**

Company Name: Puget Sound Energy

Staff: Hank McIntosh, Regulatory Analyst
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**Recommendation**

Grant PSE's petition for approval of its 2004 Power Cost Adjustment (PCA) Report, as revised to incorporate Staff's corrections. Deny PSE's request to reinstate approximately $10.9 million to the PCA 2 imbalance for sharing.

**Background**

On August 31, 2004, PSE filed a petition for review and approval of its 2004 Power Cost Adjustment Report for the twelve-month period ending June 30, 2004 ("PCA 2"). The petition is filed in accordance with the annual reporting requirement of the PCA mechanism approved in the Twelfth Supplemental Order in Docket No. UE-011570. PSE filed testimony and exhibits in support of its petition.

PSE filed the first of such reports on August 28, 2003, in Docket UE-031389. The interested parties in that docket identified certain issues and exceptions to the initial report and agreed to necessary corrections and true-up methodologies that would impact the first report and future annual PCA reports. The parties reached a settlement that the Commission approved in Order No. 4 on January 14, 2004. The Order resolved all issues in that proceeding except for one, the fuel cost issue for the Tenaska and Encogen cogeneration projects.

The Commission addressed the fuel cost issue (along with other issues) in the then pending Power Cost Only Rate Case ("PCORC") Docket No. UE-031725. In Supplemental Order No. 14 in that docket, the Commission determined that approximately $25.6 million of costs representing the revenue requirement impact of the return on the Tenaska regulatory asset should be disallowed from the PCA 1 deferral account balance. The Commission also established a method to determine potential Tenaska cost recovery disallowances. In response to a Motion for Reconsideration of Order No. 14 filed by the Company, the Commission clarified in Order No. 15 that it would address the question of whether the benchmark mechanism set forth in Order No. 14 would apply to the entirety of PCA 2 within the context of the PCA 2 review and approval proceeding.

The Company's PCA 2 report summarizes the results of the cost sharing mechanism, including the balance of ratepayers' share deferred for future recovery in rates. It also contains the

supporting exhibits detailing the regular elements of the power cost adjustments, plus the effect of the Tenaska benchmark mechanism as ordered in
UE-031725.

In its petition, PSE also asks the Commission to determine that the Tenaska benchmark methodology will not be applied to PCA 2 during the period July 1, 2003, through May 23, 2004. As discussed below, Staff recommends that the Commission deny this request.

**General Features of the PCA mechanism**

The PCA compares allowed dollars produced by a "baseline" PCA rate in dollars per megawatt-hour multiplied by the actual megawatt-hours (MWH) with a "modified actual" level of power cost expenditures over the twelve month PCA period which begins on July 1 and continues through June 30. The allowable power costs that are subject to certain integral adjustments, less the baseline power cost, will determine an "imbalance for sharing." This imbalance is shared between ratepayers and shareholders by predetermined percentages applied to each of four bands of power cost variances. Puget shareholders' share is capped at $40 million over the four-year period July 1, 2002, through June 30, 2006. If the cap is reached, the ratepayers pay 99% of the costs in excess of the cap.

The power cost baseline rate used to calculate the baseline power costs is set during a general rate case (GRC) or in a power cost only rate case (PCORC). Variable and fixed energy production-related costs are the basic components of the baseline rate.

Production-related fixed costs as established in the latest GRC or PCORC are held at the same levels for determining the actual expenses eligible for sharing until modified in a subsequent proceeding. These are shown as the "(a)" items in Exhibit A-1 of the power cost rate. The goal is to allow the Company to recover its production-related fixed costs at a minimized risk of under- or over-recovery due to variations in Mwh sales.

Variable power costs are also determined in a GRC or PCORC. A variable rate per MWH is calculated at the normalized level of sales for the test year involved. To determine the imbalance for sharing, the actual variable power costs are compared to the variable rate multiplied by the actual megawatt-hours. This comparison allows the Company to recover variations due to price changes, but insulates ratepayers from cost changes due to variations in sales volumes.

**PCA Period 2 Summary**

In Puget's PCA 2 report, as filed, the deferred amount representing the ratepayers' portion is $2,145,935, including $16,758 of interest. The allocated Company share is $22,129,177. These figures reflect the effect of the Tenaska disallowances imposed in PCORC Order No. 14, and the

application of the benchmark mechanism established in that proceeding for the entire PCA 2 period

**Discussion**

Staff reviewed the petition and PCA 2 report, and the supporting testimony, exhibits and workpapers. Staff also conducted field audits and met with PSE as necessary during its investigation. Staff reviewed PSE's approaches to power and gas supply during PCA 2. Staff's audit indicates that PSE's methodology, data, and review processes during PCA 2 appear to be reasonable. Staff does not challenge the prudence of PSE's decisions during PCA 2.

Staff's audit of the cost elements covered in the PCA revealed a number of relatively minor issues and mathematical errors related to the calculation of the imbalance for sharing and implementation of the PCA mechanism. Puget and Staff resolved these issues, which are reflected in PSE's revised PCA 2 report. The revised report summary shows the imbalance for sharing at $24,130,983 with the customer portion as $ 2,085,890, including interest.
As a separate but related part of the present petition, PSE requests permission to re-establish a portion of the $12,150,000 Period 2 Tenaska disallowance in its PCA accounts. PSE interprets the Order No. 14 in Docket UE-031725 as applying only from the date of the Order going forward, not for the entirety of PCA 2. Granting the request would allow PSE to record the full return on the Tenaska regulatory asset for about 10.5 months of the PCA 2 period, amounting to approximately $10,876,000. (Using the date of Order No. 15, May 24, 2004, as the cut-off date.) In accordance with financial accounting standards (FASB 71), PSE in the present PCA 2 filing has recognized this approximately $10.9 million earnings reduction, but now seeks to reclaim that reduction based on its interpretation of Order No. 14. For the reasons stated below, Staff opposes PSE's request to reduce the PCA 2 Tenaska disallowance.

**Unresolved Issue: PCA 2 Tenaska Disallowance**

The Commission's Order Nos. 14 and 15 in UE-031725 established a benchmark to determine an appropriate level of total cost for the Tenaska power contract. If the total costs of the Tenaska contract exceed the benchmark, the return on the Tenaska regulatory asset will be reduced by one-half of the excess over the benchmark. The Commission clarified in Order No. 15 that the rules for future recovery of the Tenaska prudent costs apply to the full PCA 3 and future review periods but deferred the question of applicability of the rules to the period in PCA 2 prior to the Order No. 14 tariff effective date until PCA 2 was completed and presented to the Commission for review so that all parties would have an opportunity to present any additional evidence and more thorough arguments on the issue.

The imbalance for sharing in PCA 1 was reduced by the full return on the Tenaska regulatory asset for that period. As stated above, PSE reduced the balance in the PCA account by $25,613,650 to recognize the Commission's order.

The total Tenaska costs exceeded the benchmark for the PCA 2 period by about $31,480,000. The return on the Tenaska regulatory asset for the PCA 2 period is $24,299,712; therefore the disallowance during the PCA 2 period is $12,149,856. As noted above, PSE posted this amount as an adjustment to the actual power costs in its PCA 2 filing (Schedule B, line 30) in accordance with applicable accounting standards but now seeks to have approximately $10.9 million of that amount reinstated.

**Analysis and Evaluation**

Staff recommends that the Commission deny PSE's request to reinstate the $10.9 million applicable to the portion of PCA 2 prior to May 24, 2004. The Tenaska benchmark mechanism should apply to the entire PCA 2 period and the 2004 PCA report, as filed, correctly presents the disallowance. The "disallowance" is in essence a reduction to the interest allowed on the regulatory asset related to the Tenaska plant's fuel supply. It is important to note that this regulatory asset still exists, and it still earns a return notwithstanding the Commission's determination of imprudent corporate actions.

PSE testifies that it attempted to control and moderate its power costs incurred during PCA 2, including management of Tenaska costs. The Company also described its longer-term fuel supply acquisition strategies, detailed the calculation and reflection of the disallowance in the report, and also discussed financial concerns and reactions stemming from the Commission's PCORC Orders 14 and 15. (This perception of financial risk issue is discussed later in this memo.) None of this material speaks to the applicability of the benchmark mechanism.

The PCORC orders established the imprudence of PSE's gas purchases. The Commission adopted the benchmark in order to restore equity for ratepayers for such imprudence. The Commission's benchmark mechanism is of a continuing nature and applies as long as the original Tenaska contract lasts, or until the benchmark is eliminated. Staff sees no logic in allowing a hiatus in the adjustment during the PCA 2.

With respect to periods after PCA 1, the Commission developed a recovery rule for Tenaska fuel costs. If PSE's net Tenaska costs are prudent and fall at or below the benchmark, then PSE will recover fully its Tenaska-related costs. However, if the Tenaska-related costs are prudent, but exceed the benchmark, PSE will receive 50 percent of any portion of the return on the asset that is above the benchmark, along with full recovery of its actual gas costs and return of the asset. In other words, if PSE's costs exceed the benchmark, the Commission will disallow up to 50% of the return on the asset that is above the benchmark.[1]

Staff believes the Commission intended its PCA 1 prudence component (the $25 million "one time" amount) and its benchmark mechanism to be equal parts of a single, flexible, and

[1] PCORC Order No. 14, ¶ 95. The above is a summary of the Commission's Tenaska approach.

continuous remedy. The Commission adjusted the PCA 1 balance and established the benchmark mechanism to address PSE's Tenaska-related costs in light of its history in managing that asset. The Commission also intended that the "one time" adjustment component and benchmark rule component would fit within the PCA mechanism.[2] Staff's proposal to apply the 50% Tenaska disallowance for the entire PCA 2 period better satisfies the Commission's intent to "promptly and fairly [share] risks between ratepayers and shareholders."[3] Because PSE's Tenaska-related costs are prudent, but exceed the benchmark, the Commission should disallow 50% of the return on the Tenaska asset. Because the actual expenditures were not submitted for Commission review prior to the issuance of Order Nos. 14 and 15, the review period and the period for consideration by the benchmark mechanism is the entire 12 months of PCA 2, not just the last six weeks.

**Perception of financial risk**

PSE witness Durga Waite testifies (DDW__ 1-T p. 5 and DDW__4 p. 7 ) that the investment community sees the Tenaska benchmark mechanism as an indicator of regulatory risk. However, the analysts referenced are misinformed about the nature of the PCA.

Witness Waite and the analysts cited believe that one source of regulatory risk is in the uncertainty about the renewal of the PCA mechanism in 2006. However, the PCA Settlement in Docket No. UE-011570 uses the date of June 30, 2006, as the expiration date for the 99% - 1% sharing band, not the PCA mechanism itself.

Although PSE has applied FASB 71 by conservatively booking the results of 12 months application of the benchmark mechanism, it cannot be said that the issue underlies increasing risk or perceived risk: a rational investor will see the decision as a sunk cost, not a future one. As noted above, the "disallowance" is in essence a reduction to the interest allowed on a regulatory asset related to the Tenaska plant's fuel supply. The full nominal value of the regulatory asset plus some return is recovered in rates.

In discussions with Staff, PSE has raised the issue of retroactive ratemaking. Staff believes that the existence of a well-defined, mechanical, mathematical structure for the review of these costs and the existence of a tariff (Schedule 95), which was intended to recover such costs under this structure, precludes any worry about a challenge of retroactive ratemaking in the future. The PCA mechanism and its application in a published schedule make it as secure from challenge as the long-used PGA mechanisms and tariff schedules.

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[2] PCORC Order No. 14, ¶¶ 94, 96, 102.

[3] PCORC Order No. 14, ¶ 103.

Exhibit A to Settlement Stipulation--Settlement Terms for PCA, at 2.

**Conclusion**

Staff recommends the Commission approve PSE's 2004 PCA Report, as revised. Staff further recommends that the Commission deny PSE's request to reinstate $10.9 million to the PCA 2 imbalance for sharing representing the full return on the Tenaska regulatory asset for the period July 1, 2003, through May 23, 2004.