BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of: PUGET SOUND ENERGY, INC. for (i) Approval of a Special Contract for Liquefied Natural Gas Fuel Service with Totem Ocean Trailer Express, Inc. and (ii) a Declaratory Order Approving the Methodology for Allocating Costs Between Regulated and Non-regulated Liquefied Natural Gas Services	DOCKET NO. UG-151663

RESPONSE BRIEF OF PUBLIC COUNSEL

FIRST PHASE – BIFURCATED PROCEEDING

May 18, 2016

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I. INTRODUCTION

1. In this phase of the docket, PSE presents a variation on its proposal for a Liquefied Natural Gas (LNG) facility in Tacoma. In its current form this alternative business model has two key elements: (1) the facility would be co-owned by Puget Sound Energy (PSE) and newly-formed Puget LNG, both wholly-owned subsidiaries of Puget Energy; and (2) Puget investors would receive a financial incentive from the regulated company for their investment in the enterprise.

2. The proposal raises two foundational questions which the parties have agreed to address in this round of briefing. The first is whether the Commission should waive the Merger Order's prohibition on Puget Energy's ownership of any subsidiary other than PSE. The second is whether the incentive proposal is consistent with the Merger Order and ratemaking law and policy.

3. In this brief, Public Counsel recommends that the Commission deny both PSE requests. The Merger Order and Commitments do not prohibit Puget from forming an unregulated subsidiary for this project, but it must be done above the Puget Energy level to maintain the ring-fencing structure originally created to keep risk remote from the regulated utility. PSE has not explained why it chose not to pursue this path.

4. Nor should the Commission approve PSE's request for what it terms "sharing" of the transaction's asserted benefits. The request disregards the basic premise of lowest reasonable cost resource acquisition. It also effectively creates an improper "equity bonus" for investors above the authorized return. PSE has failed to show any valid statutory, legal, or policy basis for

allowing such a payment. Moreover, the incentive constitutes a cross-subsidy expressly prohibited under the Merger Commitments.

5. In the event the Commission is inclined to consider either of the Company proposals, it should do so on a conditional basis only, reserving a final decision for a more fully developed record in the next phase of the proceeding.

II. ISSUE 1: PSE SHOULD NOT BE GRANTED A WAIVER OF THE MERGER COMMITMENTS

A. Overview of the PSE Private Equity Acquisition (Merger).

6. On December 30, 2008, the Commission approved the acquisition of PSE and its parent, Puget Energy, Inc., by a group of private equity investors, consisting of Macquarie Infrastructure Partners, Macquarie Capital Group, Ltd., Macquarie FSS Infrastructure Trust, Canada Pension Plan Investment Board, British Columbia Investment Management Corporation, and Alberta Investment Management (the Investor Consortium).[1] The proposal to transform PSE from a publicly traded company to private equity ownership was "distinguished by the fact that there [was] substantial public opposition to the transaction evident from the considerable volume of written public comments and the high attendance and predominant testimony at the four public comment hearings the Commission conducted throughout PSE's service territory."[2] In addition to this public opposition, other parties, including Commission Staff, the Industrial Customers of NW Utilities (ICNU), and Public Counsel, filed testimony in the case raising significant concerns about the increased risk to ratepayers and to PSE's financial integrity posed by the

[1] *In the Matter of the Joint Application of Puget Holdings, L.L.C. and Puget Sound Energy, Inc., For An Order Authorizing Proposed Transaction*, Docket U-072375, Order 08 (Merger Order). The investors are described in ¶¶ 39-49.

[2] Merger Order, ¶ 5.

transfer of control.[3] Ultimately, Staff and other intervenors negotiated a settlement with a broad range of Transaction Commitments (Commitments or Merger Commitments) intended to address their concerns with the acquisition. A Multiparty Settlement Stipulation (Stipulation or Merger Stipulation) incorporating the Commitments was filed with the Commission recommending approval of the transaction conditioned upon Commission acceptance of the Commitments.[4]

7. Public Counsel did not join the Stipulation and continued to oppose approval of the acquisition of PSE at the evidentiary hearing and on brief. In its final order, a majority of the Commission reviewed the Commitments contained in the Merger Stipulation and concluded that "the Settlement Commitments, as further conditioned by this Order, are sufficient to protect PSE's customers and the public interest from risks of harm associated with the change of control transaction."[5] Commissioner Philip Jones dissented, recommending against approval of the Merger Stipulation based on "the risks in the current and future markets of the financial leverage embedded in the proposal, and the risks arising from the lack of transparency and complexity of the structure of the investor consortium."[6]

8. In reviewing PSE's request for a waiver of the Merger Commitments in this docket, the Commission's statements in the Merger Order provide an essential context regarding the purpose and importance of the Commitments. Throughout the Order, the majority dismisses the concerns of Public Counsel and Commissioner Jones, finding the issues were fully addressed by the array of protections agreed to by the acquiring entities:

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[3] Merger Order, ¶ 35.

[4] *Id.* ¶ 37 and Attachment C. Appendix A to the Multiparty Settlement Stipulation contains the Transaction Commitments.

[5] Merger Order, ¶ 292.

[6] Merger Order, Dissent, ¶ 4. Commissioner Jones' dissent also expressed concern about the adequacy of the record.

> We again return to the supreme irony of the dissent's and Public Counsel's position is that [*sic*] the Settlement's ring-fencing and other commitments actually *strengthen* the Commission's powers to *prevent* the kind of harm that can arise from financial distress among major owners of PSE under the *status quo*. As previously discussed, commitments related to minimum equity levels, limitations on dividends, credit rating separations, enhanced disclosure of credit rating-related information to the Commission, disclosure of ring-fencing and non-consolidation opinions to lenders, and bankruptcy protections for PSE all combine to reduce financial risks from what they are under the *status quo*. These are real, substantive public benefits associated with the transaction that the dissent and Public Counsel prefer to reject out of fear of something that might happen over which we would have no control in any event.[7]

9. PSE and the Commission majority relied on these Commitments to show that the acquisition transaction was in the public interest. It is surprising, given the vigor of those earlier assertions, that PSE now seeks to discard some of the same key Commitments in order to pursue a new business opportunity. This is not a sufficient justification for a waiver. Looking ahead at the time of the merger, it was clearly anticipated that the new Investor Consortium, through PSE or its parent companies, might seek to pursue new business opportunities that could expose the Company and its customers to increased financial risk. It was precisely for this reason that many of the protections in the Stipulation and Merger Order were adopted.

B. PSE's Proposal is Prohibited by the Commission Merger Order and the Merger Stipulation.

1. Commitment 56 establishes a level of business "remoteness" to protect PSE from risk.

10. Commitment 56 states in clear and unambiguous language: "Puget Energy shall not own or operate any business other than PSE."[8]

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[7] Merger Order, ¶ 255 (emphasis in original).
[8] Merger Order, ¶ 64.

11. PSE acknowledges that this provision directly prohibits the transaction it is currently proposing in this case and that it must, therefore, obtain a waiver or exemption from the restriction.[9] The Commission separately referenced this Commitment in the Merger Order and noted that under the *status quo* there was no such limitation on PSE.[10] This limitation, then, is one of the "real substantive public benefits" created by the transaction that the Merger Order points to as a justification for approval because it "strengthen[s] the Commission's powers" and "reduce[s] financial risk" compared with the *status quo* pre-merger.[11]

12. Commitment 56 serves an important purpose. Fundamentally, it helps to insulate PSE and protects the Company and its customers from any additional risk that would result from PSE's parent, Puget Energy, engaging in other business activities, particularly unregulated business ventures. Responding to the concerns regarding the complexity of the corporate structure raised by Public Counsel and Commissioner Jones, the Merger Order explains:

> First, we address the concern that the corporate structure of Puget Holdings and the Investor Consortium is so complex and opaque that it threatens harm. In fact, the relevant corporate ownership structure is not complicated, particularly as it relates to our principal focus of concern, Puget Holdings. *PSE will be wholly owned by Puget Energy and will be Puget Energy's only business asset.*[12]

13. By requiring any affiliated interest business activity to be further away in the corporate structure, business risk to PSE is reduced. The Commission order describes the ownership structure that creates this insulation, continuing:

> Puget Energy's stock will be wholly owned by Equico which will be held by Puget Intermediate. Puget Intermediate, in turn, will be held by Puget Holdings. Equico, which will be debt free and own only Puget Energy stock, was created at the request of parties who initially opposed the transaction *for the specific*

[9] Brief of Puget Sound Energy (PSE Brief), ¶¶ 37, 42 (April 15, 2016).
[10] Merger Order, ¶ 64.
[11] Merger Order, ¶ 255.
[12] Merger Order, ¶ 251 (emphasis added).

> *purpose of making PSE bankruptcy remote from Puget Holdings. Puget Intermediate, while allowing for structural flexibility for future corporate transactions such as the acquisition of another business, provides another level of protection*[13]

It is apparent that the prohibition on Puget Energy owning any other entity besides PSE is an integral part of the structural protections created by the Merger Order and Stipulation.

14. In its brief in the acquisition proceeding, PSE cited Commitment 56 as part of the extensive structure of ring-fencing that protected PSE customers from debt at the Puget Energy level:

> The Joint Applicants have instituted state of the art ring fencing provisions consistent with previous Commission orders that protect PSE's customers from any risks that might result from the debt located at Puget Energy.[footnote citing Commitment 56 *inter alia*] Such ring fencing provisions include maintenance of separate books and records, *prohibitions against loans or pledges of utility assets, commitment to hold PSE customers harmless from any business and financial risk exposures associated with unregulated affiliates, various dividend restrictions, and prohibitions against cross-subsidization by PSE customers of unregulated activities.* Given the separation of PSE through ring fencing commitments, there is no basis for Public Counsel's claim that the debt at Puget Energy creates risks for PSE customers.[14]

15. It is also important to note that, as the quoted language above reflects, Puget Holdings entities are not completely barred by the Merger Commitments from the "acquisition of another business." An entity such as Puget LNG or other subsidiary could be acquired by Puget Holdings, or other Puget entity above the level of Puget Energy. Mr. Roger Garratt's Declaration does not indicate that this was one of the options considered, however. PSE does not

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[13] *Id.* The conclusion in the PSE Brief that the Merger Order and other relevant documents do not "provide a rationale for the prohibition" is therefore incorrect. Indeed, PSE acknowledges that "[p]resumably, the rationale for such prohibition is to limit Puget Energy's risk profile." PSE Brief, ¶ 42.

[14] Brief of Puget Holdings LLC and Puget Sound Energy, Inc., In Support of The Proposed Transaction, Docket U-072375, ¶ 74 (September 24, 2008) (emphasis added).

explain in its brief why the Company has chosen to establish a subsidiary in a prohibited manner, rather than by taking the path permitted by the Merger Order and Stipulation.

2. Commitment 58 limits the use of Puget Energy credit facilities.

16. Commitment 58 restricts the use of future capital expenditure and credit facilities to financing for PSE, providing as follows:

> Joint Applicants commit that the current and *any future capital expenditure credit facilities will by their terms limit the use of such funds only for financing PSE capital expenditures.* Quarterly officer certificates under each of the credit facilities of Puget Energy and PSE will be made available to the Commission and other interested parties, upon request and subject to the protective order in Docket No. U-072375.[15]

17. The purpose of this provision is to prevent the new owners of PSE from using Puget Energy's credit to finance risky business ventures, particularly unregulated business activities. Such ventures could impair Puget Energy's credit, which would be detrimental to PSE and its ratepayers. The Merger Order notes, after describing Commitment 58, that "[u]nder the *status quo* there is no limitation on Puget Energy issuing debt and no limitation on the use of funds derived from any such debt."[16] Again, as with Commitment 56, this restriction provides "real substantive public benefits," "strengthen[s] the Commission's powers," and "reduce[s] financial risk" compared with the *status quo* pre-merger.[17] It was relied upon by the Commission to support a conclusion that the acquisition, when conditioned upon the Commitments, is in the public interest.[18]

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[15] Merger Order, ¶ 66 (emphasis added).
[16] *Id.*
[17] Merger Order, ¶ 255.
[18] PSE suggests that this provision may no longer be operative, and only applied to initial capital financing. This is not supported by the plain language of the Commitment itself, and PSE cites no statement to that effect in the Commission order.

3. PSE does not address other Merger Commitments that are designed to protect customers from risky business ventures pursued by the Investor Consortium.

18. PSE's Brief states that Commitments 56 and 58 are the "only two" Merger Commitments implicated by the proposed alternative business model.[19] PSE's list is incomplete, however.

19. Commitments 9 and 26 are also directly called into play by PSE's request. Commitment 9 states, in part, "PSE will … (iii) generally hold PSE customers harmless from any business and financial risk exposure associated with Puget Energy, Puget Holdings, and its other affiliates." Commitment 26, adopted in furtherance of Commitment 9, states in pertinent part, "PSE Holdings and PSE commit that PSE's customers will be held harmless from the liabilities of any non-regulated activity of PSE or Puget Holdings."[20]

20. PSE acknowledges that its proposal to enter into an unregulated LNG business through a Puget Energy subsidiary introduces both new business risk and new financial risk into the corporate structure.[21] This is in fact the reason given for PSE's representation that it will not pursue the LNG project absent the requested waivers or incentive. The amount of additional business and financial risk involved is sufficiently great that PSE argues it must be shared with the regulated company or else the project cannot go forward. This is a barely-veiled admission that additional business and financial risk must be borne by the regulated company and its customers. PSE's statement that customers will continue to be protected from risk by the Merger

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[19] PSE Brief, ¶ 37.

[20] Commitment 26 also states: "Any new non-regulated subsidiary will be established as a subsidiary of either Puget Holdings, Puget Intermediate Holdings Inc., or Puget Energy rather than as a subsidiary of PSE." Commitment 56, however directly and expressly prohibits Puget Energy from owning or operating "any business other than PSE." The apparent conflict is resolved by reading Commitment 56 as the more specific rule, while Commitment 26 is permissive and phrased in the alternative. PSE's request for a waiver assumes that Commitment 56 is a prohibition.

[21] PSE Brief, ¶ 3; Roger Garratt Affidavit, ¶ 12.

Commitments[22] is directly inconsistent with the premise of the ultimatum. It makes no sense to say the regulated company must share the new and increased risks, while simultaneously saying that customers will continue to be protected from risk.

21. An additional Merger Commitment is implicated by PSE's request for a financial incentive to pursue the LNG project. Commitment 20 states, "PSE agrees … (iii) that there will be no cross-subsidization by PSE customers of unregulated activities." This Commitment is discussed below in Section IV of the brief addressing the incentive request.

C. PSE's Request for a Waiver Should not be Granted.

1. The standard is whether waiver is in the public interest viewed in the context of the original Merger Order and Stipulation.

22. In this phase of the proceeding, PSE is asking to unilaterally change commitments it made to other parties and upon which the Commission based approval of the acquisition by the Investor Consortium. None of the signatories to the Stipulation are supporting the change and it is Public Counsel's understanding that other parties may oppose waiver of the Commitments on brief.

23. PSE does not specifically identify the applicable standard it believes the Commission should use to determine whether a waiver or exemption of the Merger Commitments is appropriate. The Merger Agreement does not itself provide any mechanism for or appear to contemplate later modification on the request of one or more parties. Public Counsel

[22] *See, e.g.*, PSE Brief, ¶ 37.

recommends that the Commission apply a standard based on the standard applied to review the original acquisition – whether the proposed modification is in the public interest.[23]

24. The Commitments at issue were agreed to by the acquiring parties, Staff and intervenors, and approved by the Commission for the express purpose of ensuring that the transaction would meet the public interest test for approval. Accordingly, any modification of Commitments should be considered in that light, and should not have the effect of weakening or negating provisions deemed necessary to protect the public interest.

2. PSE's proposal is not in the public interest because it undermines the customer protection provisions of the merger.

a. The proposed project creates new business and financial risks for PSE.

25. PSE readily admits that the LNG project is a risky venture. Puget Energy would be "*assuming greater business and financial risk* through investing in a facility that will be used to make non-regulated sales and for which *greater than one-quarter of the non-regulated capacity remains unsubscribed.*"[24] So risky is the enterprise that PSE states emphatically that it will not embark upon these risky waters unless PSE's customers also climb into the boat along with the company to share the risks. PSE states: "[a]bsent the assumption of such greater business and financial risk, the Tacoma LNG Facility will not be built[.]"[25] Clearly, PSE's customers are

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[23] For merger commitments drawn from multiparty stipulations, the UTC has approved a settlement agreement where the merger-settlement parties had agreed to a one-time exception. *Advanced Telecom, Inc. v. Qwest Corp.*, Docket UT-111254, Order 06, ¶ 13. In Docket UT-100820, CenturyLink was granted a waiver of a merger Commitment that restricted it from filing an AFOR plan no sooner than three years and no later than four years from the transaction closing date of its merger with Qwest. *Joint Application of Qwest Commc'ns Int'l & CenturyTel*, Docket UT-100820, Order 20, ¶¶ 1-5. The UTC allowed this waiver primarily because the FCC had issued orders that caused substantial market changes, such that it was favorable for CenturyLink to accelerate its AFOR plan. Order 20, ¶¶ 27-28. The UTC also noted that the merger order explicitly allowed for modification of the timeline.

[24] PSE Brief, ¶¶ 3, 66 (emphasis added).

[25] *Id.*

being asked to assume some of the project risks. These "greater business and financial risks" are the flip-side of the benefits which PSE represents will flow from the project. Benefits may result, but they are not guaranteed, and losses may also result, consistent with the nature of business and financial risk.

26. Additionally there are operational risks to the project. As Mr. Garratt explains in his Declaration: "Puget LNG and PSE would also enter into an Operating Agreement under which PSE would have management responsibility for operating the Tacoma LNG Facility .... PSE would serve as the operator[.]" [26] The operational risks for an LNG facility are illustrated by the 2014 explosion at the Williams Northwest Pipeline facility in Plymouth Washington in which six employees were injured.[27]

27. PSE's brief states that "PSE will continue to remain insulated from the risks of Puget Energy and its affiliate, including Puget LNG."[28] PSE does not explain how removing two key pieces of insulation – the bar to new Puget Energy subsidiaries, and the requirement that credit only be used to finance PSE -- would allow PSE to continue to "remain insulated" from risks. Commitments 56 and 58 are mechanisms specifically designed to protect PSE against business and financial risk created by new ventures of the new private equity owners. Waiving these requirements does not maintain the status quo; it exposes the regulated utility to more risk.

b. The affiliated interest transactions contemplated create inherent risk.

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[26] Garratt Declaration, ¶ 18.

[27] On May 4, 2016, the UTC and federal regulators released their investigation report into the explosion at the Plymouth LNG Peak Shaving Plant. The UTC submitted a violation report to the federal Pipeline and Hazardous Materials Safety Administration (PHMSA) and recommended imposition of a penalty. *Regulators release report into 2014 explosion at liquid natural gas facility,* WUTC Website (May 04, 2016), http://www.utc.wa.gov/aboutUs/Lists/News/DispForm.aspx?ID=392.

[28] PSE Brief, ¶ 37.

28. PSE proposes a business model under which "PSE would co-own the Tacoma LNG Facility as a tenant-in-common with a non-regulated affiliate" tentatively named Puget LNG.[29] These parties would enter into an Ownership Agreement and an Operations Agreement.[30]

29. These transactions and relationships would be subject to the affiliated interest statutes, Chapter 80.16 RCW. Affiliated interest transactions are by their nature a matter of concern:

> The purpose of the affiliated interest statute is to protect ratepayers from cross-subsidization by regulated companies of unregulated affiliates. Because a regulated utility and an affiliate do not engage in arms' length bargaining with each other, the regulated utility has the burden to demonstrate that its transactions with the affiliate are reasonable.[31]

30. The current LNG project proposal therefore creates risk for customers by virtue of its very character as an affiliated interest transaction. As the Commission has recognized:

> The danger in an affiliated interest arrangement is that the pressure for profit creates a risk to ratepayers that management may shift the costs and burdens of company operations so that beneficial aspects flow to the affiliate (while benefitting the same stockholders) and burdensome aspects flow to the regulated company (and ultimately to ratepayers). *Risks of manipulation, intentional or not, are inherent in any arrangement of this sort* and are difficult to discover.[32]

31. While the affiliated interest transactions are not themselves directly before the Commission for approval in this docket, they would be at a later point in time. The structure of the proposal, however, raises concerns now that bear on whether requested waiver or exemption of merger protections should be granted.

32. The relationship between the affiliates is a close one. Puget Energy, PSE's immediate parent, will also be the sole member or shareholder of Puget LNG, a newly-formed and wholly-

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[29] Garratt Declaration, ¶ 8.
[30] Garratt Declaration, ¶¶ 17, 18.
[31] *Wash. Util.'s & Transp. Comm'n v Corp., d/b/a Avista Util.'s,* Docket No. UG-021584, Sixth Supplemental Order Rejecting Benchmark Mechanism Tariff (*Avista Benchmark Order),* ¶ 24.
[32] *Id.* ¶ 7 (emphasis added).

owned subsidiary, and will designate each of the members of the Board of Managers or Board of Directors of Puget LNG. PSE does not provide information about the intended membership of the Puget LNG board.

33. Notably, Puget LNG will have no employees and will have no purpose other than to hold its interests in the Tacoma LNG facility as a co-owner and tenant-in-common with PSE.[33] Puget Energy plans to use its existing credit facilities to finance, in part, the construction of the LNG facility.[34] It appears then the Tacoma LNG operation will be conducted by PSE employees on behalf of both the regulated and unregulated businesses and that PSE will have management responsibility on behalf of both entities.[35] On its face, this will not be an "arms-length" relationship and conducting it as such will be difficult.[36] Commission regulatory oversight may be difficult also. The plant, though operated and managed by PSE, a regulated utility, will be majority-owned by Puget LNG, an entity that would not be subject to Commission jurisdiction.[37]

34. The Commission conducted a careful review of an affiliated interest transaction in the *Avista Gas Benchmark* case. In that case, the Commission was reviewing Avista's use of an affiliated entity, Avista Energy, to conduct natural gas purchasing activities for the regulated company Avista Utilities. The Commission concluded that Avista had not shown adequate

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[33] Garratt Declaration, ¶ 16.

[34] PSE Brief, ¶ 38. Heretofore, Puget Energy's credit facilities have been used exclusively for the benefit of PSE's regulated business and customers. Commitment 58 was intended to preserve that.

[35] Garratt Declaration, ¶ 18.

[36] The ownership as tenants-in-common may pose risks as well. Where tenants-in-common occupy or control different parts of common property, each cotenant is responsible for liabilities arising from defects on the common property, even where control and management is delegated to one cotenant or to a third party. 62 AM. JUR. 2D PREMISES LIABILITY § 24. If PSE is the operator for the entire Tacoma Facility, then it could face tort and regulatory liability for accidents if they arise from PSE's conduct as sole operator.

[37] PSE Brief, ¶ 19.

safeguards or significant measurable benefits for customers. It directed Avista to dismantle the affiliated interest activity and move the unregulated activity back into the utility.[38]

35. Among the Commission's concerns with the arrangement were the failure of Avista to put the arrangement out for competitive bids[39] and the "concern that Avista Utilities and Avista Energy share the same management and the affiliated transaction … results from inherently conflicted negotiations between the two affiliates."[40] These are also concerns with the LNG proposal. PSE's board is negotiating with itself to shift risk from investors to ratepayers. Under an arrangement that would allow PSE to earn an equity adder on top of the cost of a least-cost resource, the Board has an incentive to maximize the regulated ratepayers' contribution towards a subsidy of unregulated activities.

3. PSE's arguments fail to show that waiver of key Merger Commitments is in the public interest.

a. The uncertain financial benefits are not a basis for granting the waiver.

36. Much of PSE's argument seems to be based on the implicit suggestion that the Merger Commitments should be waived because $98 million in benefits is too good an opportunity to pass up. However, the $98 million cited by PSE is not tied to actual dollars that can be allocated between regulated and unregulated activities, as discussed below, but rather is an estimated portfolio benefit calculation, one of many scenarios calculated in PSE's 2015 Integrated Resource Plan (IRP) analysis. This analysis cannot be used to derive a dollar value that would be made as a payment from ratepayers to shareholders. IRP analysis does not project with certainty the value of potential outcomes. PSE acknowledges that its modeling is not reliable for

[38] *Avista Benchmark Order,* ¶ 9.
[39] *Id.* ¶ 33, n.40.
[40] *Id.* ¶ 33.

this purpose. In the 2015 IRP, the Company describes its Optimization Analysis tools as follows:

> While the deterministic linear programming approach used in this analysis is a helpful analytical tool, it is important to acknowledge this technique provides the model with "perfect foresight" – meaning that its theoretical results may not be achievable. For example, the model knows the exact load and price for every day throughout a winter period, and can therefore minimize cost in a way that is not possible in the real world. Numerous critical factors about the future will always be uncertain; therefore we rely on linear programming analysis to help *inform* decisions, not to *make* them.[41]

37. Moreover, there is no single "portfolio benefit" that should be relied on alone. The IRP considers numerous scenarios and analyzes various sensitivities, allowing for numerous possible futures, each with a different portfolio benefit calculation. As PSE states in its 2015 IRP,

> Scenario analysis allows the company to understand how different resources perform across a variety of economic and regulatory Commitments that may occur in the future. Scenario analysis also clarifies the robustness of a particular resource strategy. In other words, it helps determine if a particular strategy is reasonable under a wide range of possible circumstances.[42]

In its brief, however, PSE routinely cites the portfolio benefits results of only one scenario—the Base Case—at $98 million. By contrast, in PSE's 2015 IRP, the 20 year portfolio benefit for the LNG project was analyzed across 11 scenarios, varying from $8.379 million to $103.794 million depending on which possible future is utilized.[43] The exact dollar benefit of the resource decision is uncertain, at best. Moreover, if the cost of an equity adder[44] were built into the cost of the plant, the Tacoma LNG plant may not continue to be cost-effective in every scenario modeled in the IRP.

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[41] PSE 2015 Electric and Natural Gas Integrated Resource Plan (IRP), Dockets UG-141169 & UE-141170 at 7-4 (emphasis in original).

[42] 2015 IRP at 7-5.

[43] 2015 IRP, Figure 7-26: Scenario Portfolio Benefit of the PSE LNG Project at 7-40.

[44] PSE seeks an equal share of the benefit it estimates at $98 million. PSE Brief, ¶ 65.

38. The portfolio benefit is highly dependent on the assumptions that are built into the portfolio analysis, particularly the generic alternative pipeline cost comparison.[45] It is possible that if PSE's assumptions are not accurate, the portfolio "benefit" could in fact be a "cost" in multiple scenarios. The outcome of the IRP analysis can vary greatly considering the data and assumptions utilized. The point here is that PSE's assertions regarding the $98 million benefit of the transaction should not be accepted as fact and relied upon to show that it is "worth" waiving the Merger Commitments.[46]

b. PSE's environmental policy arguments are misplaced.

39. PSE argues that the waiver (and its entire request) should be granted because it would encourage the availability of LNG as an alternative fuel with resulting environmental benefits. This argument is misdirected however. This case is not about whether LNG fuels are beneficial for the environment as compared with other fuels. No party disputes that general proposition. There is also no dispute that there are multiple entities capable of providing LNG in Washington. PSE did not assert as a basis for regulatory jurisdiction earlier in this docket that its LNG marine fuel service has the characteristics of a monopoly. PSE's filing in this docket includes a "Market

[45] Notably, in its acknowledgement letter of PSE's 2015 IRP, the Commission stated that there was no analysis in the IRP to support the conclusion that PSE cannot rely on spot market supplies at Sumas to meet peak loads, and concluded that the IRP does not contain sufficient information to allow the Commission to evaluate the availability of pipeline capacity on the West Coast. 2015 IRP Acknowledgement Letter, Attachment at 15, Docket UG-141169.

[46] For example, PSE conducted a limited analysis of the alternative of building a "stand-alone" facility for the targeted purpose of meeting the regulated utility's peaking needs. PSE Response to Staff Data Request No. 19. However, PSE's 2015 IRP did not consider a stand-alone peaking facility as one of the Storage and Peaking Capacity Alternatives listed in Chapter 7. *See,* PSE 2015 IRP at 7-24 through 7-25. Thus, there is no portfolio benefit comparison between the LNG project and a stand-alone peaking facility.

Assessment of Liquefied Natural Gas as a Distributed Fuel in Washington State,"[47] which *inter alia*, examines the competitive conditions in the market area.[48]

40. It is also significant that PSE participated in competitive bidding to obtain the Totem Ocean Trailer Express, Inc. (TOTE) Special Contract. This fact alone is strong evidence of competition for the service, indicating that from the point of view of one major customer/purchaser, TOTE, competitive alternatives were available in the market.[49]

41. In summary, there is no evidence that LNG fuel will be unavailable to marine or motor vehicle purchasers if PSE's petition for a waiver or a financial incentive is not granted in this case. The focus in this case should remain on the questions presented by the parties in the petition for bifurcation: should there be a waiver of the applicable Merger Commitments or provision of an incentive? That in turn requires a focus on the central purpose of those Commitments – the protection of PSE and its ratepayers from improper financial and business risk, and the prohibition of cross-subsidization.

c. Supply diversity can be provided in multiple ways other than the proposed project.

42. PSE argues that one of the benefits of the proposed project is diversity of natural gas supply. While there is certainly value in supply diversity as a general principle, the current PSE proposal, which includes uncontracted capacity and the associated risk, is not the only way to achieve it. The same diversity would be provided if: (1) PSE built a stand-alone peaking facility

[47] Melissa F. Bartos, Exh. Nos. MFB-3C and MFB-4C.

[48] On this issue, see generally Public Counsel Memorandum of Law Regarding Jurisdiction (Confidential) ¶¶ 37-42, filed in this docket on November 24, 2015. The confidential information and conclusions regarding competition are summarized in the Public Counsel Memorandum and detailed in the report.

[49] Public Counsel Memorandum of Law Regarding Jurisdiction (Confidential), ¶ 41.

as part of its regulated service; (2) PSE built a smaller facility;[50] or (3) PSE built the facility under an allowed ownership structure (e.g. with Puget LNG as a subsidiary of Puget Holdings and subject to affiliated transaction rules). The diversity of supply argument should not be given weight as a determinative factor on either of the two issues currently before the Commission.

D. If any waiver or exemption is granted, it should be preliminary and conditional.

43. If the Commission decides to allow a waiver or exemption to Merger Commitments 56 and 58, or other applicable Commitments, it should do so subject to the requirements of the affiliated interest statutes.[51] The details of the relationship between PSE and Puget LNG are not well fleshed out. The record at this time contains only high-level descriptions of the planned affiliate transactions in the PSE Brief and Garratt Declaration. Puget LNG has not been formed. The Ownership and Operating Agreements do not yet exist. The transactions ultimately contemplated will be subject to the affiliated interest statutes in chapter 80.16 RCW. The Order should be clear that any waiver does not pre-approve or pre-judge any affiliated interest or prudence issue regarding the transaction, including cost-allocation.[52]

III. THE COMMISSION SHOULD DENY PSE'S REQUEST FOR A LEAST-COST RESOURCE ACQUISITION PREMIUM

A. PSE's Requested Incentive Runs Afoul of Merger Commitment 20 Which Prohibits Cross-Subsidization.

44. Commitment 20 states, "PSE agrees … (iii) that there will be no cross-subsidization by PSE customers of unregulated activities."

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[50] Garratt Declaration, ¶ 7.

[51] Ch. 80.16 RCW.

[52] PSE's Brief and Declaration include detailed references to specific cost allocations. These should be treated as illustrative and not approved in this phase of the case. Cost allocations have not yet been presented for decision in the docket and are not currently before the Commission. Although the initial petition sought approval of a cost allocation methodology, no agreement was reached and the first issue brought to the Commission was the threshold question of jurisdiction. The current issues before the Commission are waiver and incentive.

45. There can be no clearer example of the cross-subsidization by PSE customers of "unregulated activities" than payment of a premium or incentive for the acquisition of the LNG resource under the arrangement proposed. PSE estimates the cost of the incentive to be approximately $49 million. PSE (effectively Puget Energy) now states that it will not enter into this new risky business venture with Puget LNG unless PSE ratepayers share in the risks and unless Puget LNG receives a $49 million subsidy (share of the benefits) from PSE ratepayers. Such an arrangement is prohibited by Commitment 20, and PSE would need to receive a waiver or exemption from this Commitment also.[53]

B. Allowing the Utility to Receive an Incentive Payment is not Consistent with the Obligation of Utility Managers to Prudently Acquire Resources at the Lowest-Reasonable Cost.

1. Regulated Utilities Have an Obligation to Prudently Acquire Resources at the Lowest-Reasonable Cost.

46. It is a basic expectation that a regulated utility, its management, and its board will acquire resources to serve their customers at the lowest-reasonable cost. In keeping with this expectation, the Commission's integrated resource planning rules require that "each natural gas utility regulated by the Commission has the responsibility to meet system demand with the least cost mix of natural gas supply and conservation."[54] Consistent with this, the Commission's prudence standards require that the utility must determine how to fill its resource needs in a cost-

[53] Commitment 24 is arguably also implicated by the proposed transaction. It states: "Puget Holdings and PSE will not advocate for a higher cost of debt or equity capital as compared to what PSE's cost of debt or equity capital would have been absent Puget Holding's ownership." The incentive proposal in this case effectively creates an "equity adder" by generating revenue that would yield an additional return for the Investor Consortium on its investment in Puget LNG. Prior to the acquisition no affiliated Puget Energy subsidiaries existed to whom an incentive could be paid, nor did PSE generally have an incentive ROR in place for natural gas infrastructure investments.

[54] WAC 480-90-238.

effective manner.[55] It is not contemplated in this calculation that investors should be awarded an additional bonus for performing this basic function. Regulation already provides an incentive for investors by authorizing a return on equity and a profit on the shareholders' investment.[56]

47. In testimony filed in this docket on August 11, 2015, PSE stated that the Tacoma LNG facility was selected in both the 2013 and draft 2015 IRPs as a resource in the least-cost portfolio.[57] Significantly, PSE's initial proposal for the LNG project in this docket did not contain any "adder" request above the allocated cost of the facility. It is only now at this stage of the docket, that PSE states that it will not proceed with what it says is a least-cost resource without an additional equity adder for shareholders that will increase the cost to customers by millions of dollars. PSE refers to this benefit sharing "as an incentive to develop the facility."[58] PSE does not explain why it was earlier willing to go forward with a regulated/non-regulated proposal without benefit of an incentive payment.

48. PSE's proposal sets a dangerous precedent for future utility resource acquisitions in Washington. Most, if not all, utility resource acquisitions involve a comparison process in an effort to identify the lowest reasonable cost resource that meets the utility's needs. In nearly every case there will be one or more non-selected resources that were more expensive than the

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[55] *Wash. Util.'s & Transp. Comm'n v. Puget Sound Power & Light Co.*, Docket No. UE-921262, Nineteenth Supplemental Order at 11 ("Once a need has been identified, the utility must determine how to fill that need in a cost-effective manner.")

[56] The shareholders' return is set at a level sufficient to attract capital investment – in other words, to provide an incentive for shareholders to invest. *POWER v., Wash. Util.'s & Transp. Comm'n* 104 Wash. 2d 798, 809-810, 711 P.2d 319 (1985). In *Wash. Util.'s & Transp. Comm'n v. Avista Utilities,* Dockets UE-991606 & UG-991607, Third Supplemental Order, ¶¶ 382-387 (*Avista 1999 GRC)*, the Commission rejected a request for a "bonus for innovative management and strategic initiative" and stated: "The Commission sets a reasonable return in a rate proceeding. Once a reasonable return is set, management should seek to earn any "bonus" through efficient operation of the business." *Id.* ¶ 387.

[57] Prefiled Direct Testimony of Clay Riding, Exh. No. CR-1CT at 5-6. Public Counsel accepts the IRP analysis on the reasonableness of the Tacoma LNG project, the IRP models, or the assumptions used, for purpose of argument only. The IRP process does not establish prudence or constitute pre-approval of specific resources.

[58] PSE Brief, ¶ 66.

resource actually selected. The difference between the selected least-cost resource and the next most expensive resource – the "portfolio benefit" -- is what PSE wishes to share with its investors. If PSE's request for an "incentive" payment is granted in this case, it is likely that every Washington utility would want to make the same request for its own resource acquisitions. It is not clear what rational basis there would be for the Commission to deny similar requests from other companies. This would effectively put an end to least-cost resource acquisition in any meaningful sense.

C. There is No Statutory Authority Authorizing the Commission to Approve the Requested Incentive.

49. Nothing in the plain text of Title 80 or elsewhere in Washington statute authorizes the incentive requested by PSE in this case. In its argument in favor of the incentive, PSE casts a wide net, stretching the meaning of statutes, regulatory mechanisms, and unrelated policies and programs to find support, but falls short in its effort.

1. The CNG and LNG provisions in 80.28.280 and .290 do not authorize an LNG incentive.

50. RCW 80.28.280 and RCW 80.28.290 address compressed natural gas (CNG) and LNG. The provisions were originally enacted in 1991 as part of broad air pollution control legislation,[59] referencing CNG only, and declaring that CNG fueling stations were "in the public interest." In addition, the 1991 Legislature authorized the Commission to consider "rate incentives to encourage natural gas companies to invest in the infrastructure required by such [CNG] refueling stations."[60] In 2014, as part of a broad revision of motor fuel taxation to achieve more equitable

[59] Chapter 199, Laws of 1991 (Air Pollution Reduction) §§ 216, 217.

[60] RCW 80.28.290. Public Counsel is not aware whether any rate incentives for CNG fueling stations have been adopted under this section. The term "rate incentive" is not defined.

treatment of CNG and LNG,[61] the legislature added LNG to the legislative declaration so that RCW 80.28.280 now provides that both LNG and CNG refueling stations are in the public interest. The legislature, however, did not take the opportunity to amend the rate incentive provision in RCW 80.28.290 to include LNG and the provision remains limited solely to CNG. Given the context of the 2014 amendments, it is reasonable to interpret the failure to amend the incentive provision as reflecting legislative intent to not extend rate incentives for LNG. Finally, RCW 80.28.280 states that it "is not intended to alter the regulatory practices of the commission or allow the subsidization of one rate class by another." The resource acquisition practices of the Commission do not ordinarily allow the utility to add a premium paid by ratepayers in addition to the lowest reasonable cost for a resource.

2. RCW 80.28.024 and .025 do not authorize an LNG incentive.

51. PSE cites RCW 80.28.024 as one of a number of statutes creating the "authority and duty" to give utilities an incentive to invest in natural gas resources, and therefore authorizing the LNG incentive that it now proposes.[62] RCW 80.28.024 is a general legislative finding passed over 20 years ago that specifically encourages "conservation measures … and the use of renewable resources." There is no mention of liquefied natural gas fuel, which is not a renewable resource, nor a conservation measure. The statute makes no direct mention of the Commission and simply opines that incentives "would be of great benefit … by encouraging efficient energy use and … renewable energy resources." General findings of this type are an expression of legislative policy but do not create specific statutory authority or duties.

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[61] Chapter 216, Laws of 2014.
[62] PSE Brief, ¶ 70.

52. PSE also cites RCW 80.28.025 to similar effect but again relies on a provision that is inapplicable to this proposal. As the statutory language quoted in PSE's brief reflects, the statute is expressly addressing "meeting or reducing energy demand through cogeneration … measures which improve the efficiency of energy end use, and new projects which produce or generate energy from renewable resources …." This has no application to LNG vehicle fuel.[63]

53. PSE mischaracterizes both these provisions as general authorization for the Commission to adopt incentives, when in fact, both provisions are targeted to specific types of resources (conservation, renewables, co-generation). The fact that incentives are authorized by statute only in specific circumstances, moreover, underlines that such incentives are not otherwise permissible for the reasons argued elsewhere in this brief. There is no generic or inherent Commission authority to provide financial incentives to utility owners over and above recovery of costs and a reasonable profit, unless expressly provided by legislation.

3. PSE's review of Washington energy policy has no direct relevance to the specific issues in this case.

54. PSE catalogs a wide range of legislative and executive energy policies designed to support clean energy, as well as UTC decisions and mechanisms in various areas.[64] There is no dispute that these kinds of initiatives are being undertaken, or that they pursue important public interest goals. General policy direction of this type, however, and decisions taken out of context, do not translate into the kind of specific legal authority that PSE suggests.

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[63] PSE also fails to point out that the incentive rate of return mentioned in the statute only applied to projects begun before January 1, 1990. *See, e.g. Avista 1999 GRC,* Third Supplemental Order, ¶¶ 396-398 (Commission rejected Avista's request under the statute for an incentive rate of return on the Kettle Falls Plant as untimely).

[64] PSE Brief, ¶¶ 67-81.

55. For example, PSE suggests that the UTC rulemaking order following enactment of the Energy Independence Act (EIA) provides support for its incentive proposal.[65] This Order and the EIA relate to electric power consumption, not natural gas use.[66] The order refers to the incentives authorized by RCW 19.285.060 for meeting and exceeding electric energy conservation or renewable energy targets for electric portfolios. Creating an incentive for LNG fuel sales in Tacoma will not aid PSE's gas conservation efforts with its general customers and has nothing to do with the renewable component of the electric portfolio.

D. PSE Improperly Presents an Ultimatum to the Commission.

56. PSE presents the Commission with what amounts to an ultimatum in this case. PSE begins its brief with the statement that "[w]ithout Commission authorization of an incentive … PSE can no longer proceed with the Tacoma LNG Facility" and ends it by repeating"[w]ithout such an equal sharing, the Tacoma LNG Facility *will* not be built."[67]

57. The Commission has rejected this sort of ultimatum in the past and should do so again in this case. The Commission was presented with a similar demand involving the Lancaster Power Purchase Agreement in the 2009 Avista General Rate Case. Avista sought a prudence determination and recovery in customer rates for the Lancaster PPA although the agreement had not been provided to the Commission and had not even been executed. The Commission observed that: "the Company presents us with the proposed PPA as an ultimatum – it will execute the agreement only if we approve the ratemaking treatment requested as a condition

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[65] *See In re Energy Independence Act*, Docket UE-061895, General Order R-546 at ¶ 44.
[66] *See* RCW 19.285.030; WAC 480-109-007 (defining "conservation" only in reference to electric power).
[67] PSE Brief, ¶¶ 6 and 81 (emphasis added).

precedent."[68] The Commission noted that "the arrangement at issue here is a contract with an affiliated interest, not a third party. The contracting parties are in a practical sense representing the same interest."[69] The Commission declined to be influenced by the ultimatum. It rejected the ratemaking treatment and declined to rule on the proposed contract because it was not available for the Commission to review.[70]

E. Even if an Incentive can be Allowed as a Conceptual Matter, it is Premature to Determine the Amount or Sharing Percentage.

58. Even if the Commission determines in this initial phase of the case that an incentive is permissible as a conceptual matter, there are two key points that will require further consideration in the second phase of the bifurcated proceeding based on material facts yet to be presented.

1. The benefits of the proposal, if any, cannot yet be determined.

59. As discussed earlier in this brief, the amount of the asserted benefits of the LNG facility cannot be determined at this stage of proceedings. Although PSE's advocacy repeats the figure of $98 million throughout its briefing, it is important to recognize that $98 million is not a "real" number. This is only one output from a range of modeling scenarios, with results ranging from $8 million (at low demand) to $130 million. These amounts are portfolio benefit amounts. They are not real dollars that can be used for ratemaking purposes. While PSE uses portfolio benefit analysis as one of numerous tools used in consideration of resources,[71] it is not reasonable to use

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[68] *Wash. Util.'s & Transp. Comm'n v. Avista Util.'s,* Dockets UE-090134/UG-090135, Order 10, ¶¶ 203-207 (*Avista 2009 GRC*). *See also,* ¶ 224, where the Commission expresses concern about the ultimatum, and describes it as "tantamount to making the Commission a contract party."

[69] *Id.* ¶ 225. The case involved assignment of contracts to Avista Utilities from its wholly-owned subsidiary Avista Turbine. *Id.* ¶¶ 173-179.

[70] *Id.* ¶ 214.

the portfolio benefit analysis to attempt to derive a cost that would be passed through to customers in rates, as PSE's proposed equity adder does in this case.

60. One further problem with the asserted portfolio benefit is that it measures the wrong thing. Under the proposal, PSE's board is choosing to take on the additional risk of the larger facility sized to provide fuel to customers besides TOTE.[72] PSE states that it rejected the smaller Tacoma LNG facility because the cost savings associated with reducing the capacity resulted in PSE's core gas customers losing the benefits of the economies of scale.[73] However, the asserted portfolio benefit which is the basis for the incentive is calculated on the difference between the larger plant and *no* plant (i.e. use of incremental pipeline capacity). The relevant "benefit," if any, may be more properly measured as the difference between the large plant and the small plant, or some other resource not considered in the IRP. At this time, however, the record does not contain an analysis of these alternatives.

61. In determining the issues in the case, including whether there should be waiver of Merger Commitment or whether investors should share in benefits, the Commission should not assume any particular level of benefits. The record is not sufficient to do so, and the parties in this round of briefing are addressing only the conceptual issues, not recommending findings of fact.

2. The sharing percentage cannot be determined until the second phase of the case.

62. It is premature for the Commission to adopt a specific sharing percentage as an incentive in the first phase of this case, should it determine sharing is appropriate. Although PSE has

[72] PSE Brief, ¶ 15.
[73] PSE Brief, ¶ 17.

framed the issue as whether "equal sharing" of benefits is appropriate.[74] Public Counsel has not agreed that, if permitted at all, sharing would be 50/50. Public Counsel and other parties reserved the right to argue for a different percentage.[75] Given the state of the record it has not been feasible to address alternate sharing proportions in this phase of the case and would have been premature. Public Counsel requests that the Commission allow parties to present additional evidence in the adjudicative phase on sharing percentages, should the Commission decide it will consider the incentive proposal.

IV. CONCLUSION

63. For the foregoing reasons, Public Counsel recommends that the Commission decline to approve PSE's request for an alternative business model for the Tacoma LNG project as framed in this phase of the docket. The proposal is not consistent with the conditions imposed in the Merger Order and Commitments, it is contrary to law and ratemaking policy, and inappropriately and unnecessarily exposes PSE customers to increased business and financial risk.

64. DATED this 18th day of May, 2016.

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[74] PSE Brief, ¶ 7.
[75] Joint Response to Motion To Establish A Bifurcated Proceeding, ¶ 3 (March 11, 2016).