

EXHIBIT NO. _____ (WAG-6)
DOCKET NO. _____
2003 POWER COST ONLY RATE CASE
WITNESS: WILLIAM A. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

Docket No. _____

v.

PUGET SOUND ENERGY, INC.,

Respondent.

DIRECT TESTIMONY OF
WILLIAM A. GAINES
ON BEHALF OF PUGET SOUND ENERGY, INC.

MEMORANDUM



TO: Energy Resources Committee
FROM: George Pohndorf
DATE: May 27, 2002
SUBJECT: WUTC Prudence Standard

Through a series of orders and a Notice of Inquiry process, the Washington Utilities and Transportation Commission (WUTC) has enunciated the standard by which it expects to judge the Company's demonstration of the prudence of its management decisions regarding energy supply acquisitions. The commissioners and their staff have continually informed the state's investor-owned utilities that recovery of resource costs are subject to a finding of prudence and have applied that standard recently to Pacificorp in their 2000 general rate proceedings. Further, in January 2001, Chairwoman Showalter testified to the House Technology, Telecommunications and Energy Committee regarding the duty of the WUTC to apply this standard. She also provided a broad description of the standard.

This memorandum provides a summary of the WUTC precedent that articulates this prudence standard and a series of guidelines that can be followed in assembling proper documentation to meet the standard.

WUTC Prudence Standard

The prudence standard followed by the WUTC is discussed in the following decisions and documents:

- Cause No. U-83-26, a Washington Water Power proceeding involving the prudence of the Kettle Falls project;
- Cause No. U-83-54, a Puget general rate proceeding in which one issue was the treatment of the abandoned Skagit/Hanford nuclear project;
- Docket No. UE-921262, Eleventh Supplemental Order, Puget's general rate case order;
- Docket No. UE-921262, Nineteenth Supplemental Order, Puget's 1993-94 prudence proceeding;
- Docket No. UE-940932, WUTC Notice of Inquiry; and

- Docket No. UE-991832, PacifiCorp general rate case proceeding, stipulation.
- 1. **Kettle Falls case, WUTC v. The Washington Water Power Co., Cause No. U-83-26 (issued January 19, 1984)**

In that proceeding, the Commission concluded that the initiation of the Kettle Falls project was prudent but that WaterPower had not demonstrated that it was prudent in continuing the project in January 1982. In reaching its decision, the Commission stated the following standard to be applied in determining the prudence of a utility's actions:

In this case, the focus is on a project which has been completed and will be in-service. To address whether or not such a project was prudently constructed requires three decisions: (1) was the initiation of the project prudent? (2) was the continued construction of the project prudent? and (3) were the construction expenses prudently incurred?

To test whether the initiation of the project was prudent, one would ask: what would a reasonable board of directors decide given the facts and circumstances known to them or which reasonably should have been known to them at the time the decision was made.

To determine whether continued construction of the project after initiation was prudent and the expenses incurred in that continued construction were prudently incurred, one uses essentially the same test applied at a different point in time and necessarily premised on a reevaluation of the project.

As with all issues, the company bears the burden to prove initiation, construction and continuation of the project was prudent.

- 2. **Skagit/Hanford, WUTC v. Puget Sound Power & Light Company, Cause No. U-83-54, Fourth Supplemental Order (Issued September 28, 1984)**

The Commission reiterated its prudence standard less than nine months later in a Puget general rate proceeding. An issue in that proceeding was the prudence of the Company's decision to proceed with the Skagit/Hanford nuclear plant, and the timing of the Company's decision to abandon the project. The standard applied by the Commission was as follows:

In evaluating prudence it is generally conceded that one cannot use the advantage of hindsight. The test this Commission applies to measure prudence is what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made a decision. This test applies both the question of need and the appropriateness of expenditures.

Applying this test, the Commission determined that a finding of imprudence was warranted:

The most credible evidence in this record supports a finding that such a study [an in-depth cost-effectiveness study of the project] would have demonstrated the futility of continuing the licensing process on a new Hanford site. Such a study was not performed, however, and no one can state unequivocally, that abandonment would have been recommended by mid-year 1980. However, the responsibility for this absence of proof rests squarely on Puget's executive officers and directors. They elected to preserve the option of building a nuclear plant without a full review of the economic consequences of that action. It is the Commission's conclusion that a full review would have shown the nuclear project to be uneconomic when compared to the coal alternative. It follows at all costs incurred on the Skagit/Hanford project after the point in time when a complete cost-effectiveness study would have been available, but be deemed imprudent and disallowed. (Pages 32-33)

3. Puget general rate case and prudence case, Docket No. UE-921262, Eleventh Supplemental Order (general rate case order) and Nineteenth Supplemental Order (prudence review order)

In the general rate case order, the Commission reiterated its position that prudence reviews are undertaken only in general rate cases and that Puget had not carried its burden to demonstrate prudence in the general rate case:

The Commission has stated consistently that the prudence review of new resource acquisitions would be conducted in general rate cases only. The Commission in its PRAM 1 Order¹ specifically rejected Puget's request that the evaluation of new contracts included in that proceeding be defined as the final prudence review of those contracts.

The Commission again clearly stated that the prudence of resource contracts would be decided in the context of the general rate case in the First Supplemental Order in the PRAM 2 proceeding (Docket No. UE-920630, September 24, 1992). Puget had ample notice of its responsibility to demonstrate prudence in this proceeding.

(11th Supplemental Order, pp. 22-23.) The Commission added in its Order on Clarification and Reconsideration that "the company was repeatedly and

¹"The Commission reserves the right to conduct prudence reviews of new contracts in future proceedings, although the contracts may be included in rates for the first time in a PRAM proceeding. In a subsequent general rate case, the Commission may review contracts and the company's experience under the contracts, to determine proper ratemaking treatment and to examine items which may be disallowed for ratemaking purposes. Initial review of contracts included in a PRAM proceeding does not foreclose the Commission's later full review in a general rate case." (First Supplemental Order, Docket No. UE-910626, p. 7)

consistently told to justify the prudence of its resource acquisitions in its general rate proceedings.” (15th Supplemental Order, p. 18.)

Puget must make an affirmative showing of the reasonableness and prudence of the expenses under review. This is true even in the absence of a challenge by another party. The Commission concludes that Puget has not carried its burden of demonstrating that its new resource acquisitions were prudent. (11th Supplemental Order, p. 19.)

The Eleventh Supplemental Order then directed Puget to demonstrate the prudence of its resource acquisitions in a prudence proceeding under the same docket. In its decision in the prudence proceeding, the Commission described its prudence standard as a “reasonableness test”:

The Commission relies upon a reasonableness standard. The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made. (19th Supplemental Order, p. 10)

The Commission went on to describe how this standard is applied:

The prudence standard adopted in prior Commission orders is easily applied to any resource decision, whether it is to build or to purchase. The utility must first determine whether new resources are necessary. Once a need has been identified, the utility must determine how to fill that need in a cost effective manner. When a utility is considering purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself. (19th Supplemental Order, p. 11)

Other excerpts from the Order were more specific as to how a utility must conduct its evaluation of alternatives:

When a company seeks to acquire resources, the Commission requires it to analyze any resource alternative under consideration utilizing up to date information, and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning has disclosed need specific analysis at the time of a purchase decision. (19th Supplemental Order, p. 2)

In an increasingly competitive environment, Puget will need to be more sophisticated in its evaluation of its choices and aggressive in its negotiations. . . . It only represents common sense to observe that Puget cannot negotiate from an appropriate base of knowledge if it does not have a clear understanding of what it

would cost to build plants itself, and of the costs and benefits of both building and purchasing. (19th Supplemental Order, p. 37)

The Commission also commented on what it perceived as a lack of participation by Puget's Board of Directors in the resource acquisition process:

For acquisitions of this cumulative magnitude, [\$6.5 billion over 23 years], we would expect the Puget Board of Directors in the future to be better informed about resource acquisitions and their costs, and more involved in the decision process. (19th Supplemental Order, p. 37)

Puget in the future should keep its Board of Directors better informed about resource acquisitions of significant magnitude and their costs. The company should maintain all documents related to its decisions to enter into specific contracts. (19th Supplemental Order, p. 46)

In the prudence review, the Commission was very critical of the Company's documentation of its decisionmaking process with respect to the resources at issue in that proceeding. According to the Commission's decision:

No written record of its decision-making process survives. The company's lack of contemporaneous evaluation and documentation is, at best, poor management practice. (19th Supplemental Order, p. 15)

It is still almost beyond the Commission's comprehension that Puget, which was recipient of the Commission's order in the Skagit proceeding, and was aware of the Kettle Falls order, did not have a file on each of these projects in which it tracked its progress in its decision making, and the studies made to support decisions. It appeared that many of the decisions were made on an ad hoc basis, with little or no structured analysis. (19th Supplemental Order, p. 16.)

The company should also improve its model for estimating power costs. Puget should specifically analyze any resource alternative it is considering for acquisition, using up to date information and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning process and common practice have disclosed need specific analysis at the time of a purchase decision. In addition to making an adequate study at the time, Puget must keep a record of its decision-making process which will allow the Commission to evaluate its decisions. (19th Supplemental Order, p. 46)

Finally, the Commission's order imposed a "contemporaneous documentation" requirement for the decisionmaking process followed in certain utility decisions.

In addition to making an adequate study at the time, Puget must keep adequate contemporaneous records of its decision process which will allow the

Commission subsequently to evaluate its decisions. This is the minimum standard to which a regulated utility should be held. (19th Supplemental Order, p. 37)

The parties and the Commission therefore should be able to follow the company's decision-making process, knowing what elements the company used, and the manner in which the company valued those elements. Such a process should certainly be documented. (19th Supplemental Order, p. 6)

In addition to making an adequate study at the time, Puget must keep a record of its decision making process which will allow the Commission to evaluate its adequacy. (19th Supplemental Order, p. 2)

4. WUTC Notice of Inquiry into least-cost planning and prudence

Throughout the prudence case, the Company expressed a number of concerns with the application of the prudence standard and encouraged the Commission to provide further clarity through a generic proceeding:

Several of the parties make recommendations about instructions which should be given to the company for the future. Puget recommends that any Commission concerns in these areas, including the link between least cost planning and resource acquisitions, be addressed in a generic, forward-looking proceeding that would allow all interested parties to participate. (19th Supplemental Order, p. 36)

In response, the Commission commenced Docket No. UE-940932:

The Commission intends to issue a Notice of Inquiry exploring the interaction of the least cost planning process with competitive bidding and prudence review. . . . The inquiry will consider generically many of the issues litigated in this proceeding including, among others, the relationships between and among least cost planning, resource acquisitions, and prudence reviews; and alternatives to traditional prudence review, including performance-based and other alternative forms of regulation. (19th Supplemental Order, p. 36)

The Order in the Notice of Inquiry docket states as follows with respect to the process of a prudence review:

Each of the IOUs bears the burden of demonstrating the prudence of new resource acquisitions to the Commission. A demonstration of prudence includes a showing that (1) the selection of each resource was necessary and reasonable, (2) the costs of acquisition were appropriate based upon what a reasonable board of directors and company management decided given what they knew or reasonably should have known to be true at the time the decision was made, and (3) the costs were regularly evaluated. The prudence review is currently conducted by the Commission exclusively in general rate increase cases.

Among other things, Puget stressed that the Commission should adopt a preapproval process for resource decisions. At that time, the Commission declined in that Inquiry to implement such a process:

The Commission continues to believe that prudence evaluation remains an important tool to ensure that utilities are not indifferent to cost or to the consequences of poor decision-making. General rate increase proceedings were established as the forum in which to evaluate prudence, because issues pertaining to the need and price of a resource acquisition can only be determined in a forum where each decision can be viewed in conjunction with all other of the company's resource decisions.

The Commission believes there is no other currently available forum, sufficient in both rigor and scope, within which to make this determination. For that reason, the Commission does not believe preapproval of particular resource acquisitions is appropriate, as this would inappropriately shift the risk of those decisions from utility management to ratepayers.

(Notice of Termination of Notice of Inquiry, Docket No. UE-940932, April 1998.)

The statements in Docket No. UE-940932, following a generic investigation of the prudence issue, represent the most recent source of the general prudence standard. From those statements, the requirements are as follows:

- (a) prudence reviews are conducted in general rate proceedings;
- (b) the utility bears the burden of demonstrating the prudence of new resource acquisitions to the Commission, and
- (c) a demonstration of prudence includes a showing that (i) the selection of each resource was necessary and reasonable, (ii) the costs of acquisition were appropriate based upon what a reasonable board of directors and company management decided given what they knew or reasonably should have known to be true at the time the decision was made, and (iii) the costs were regularly evaluated.

5. PacifiCorp general rate proceeding, Docket No. UE-991832, stipulation

The WUTC investigated the prudence of PacifiCorp's resource decisions in its most recent general rate case. As part of that case, PacifiCorp and other parties provided a stipulation that included a prudence process and standard to be applied. That standard is more general in nature, relying upon the Skagit/Hanford decision and the statements in the Notice of Inquiry:

b. Standard. The standards applied by the Commission to measure prudence are generally as follows:

[W]hat would a reasonable board of directors and company management have decided given what they know or reasonably should have known to be true at the time they made a decision. This test applies both to the question of need and the appropriateness of the expenditures. (Cause No. U-83-54, Fourth Supplemental Order, p.p. 32-33)

Each of the IOUs bears the burden of demonstrating the prudence of new resource acquisitions to the Commission. A demonstration of prudence includes a showing that (1) the selection of each resource was necessary and reasonable, (2) the costs of acquisition were appropriate based upon what a reasonable board of directors and company management decided given what they knew or reasonably should have known to be true at the time the decision was made, and (3) the costs were regularly evaluated. (*Notice of Termination of Notice of Inquiry*, Docket No. UE-940932, April 1998)

Nothing in this Stipulation prevents any Party from asserting any other consistent and applicable Commission precedent. The Company will be required to make an affirmative showing in the direct testimony and exhibits of its next general rate proceeding demonstrating the prudence of those resources acquired since its previous general rate case (Cause No. U-86-02) which it proposes to include in rates in such proceeding.

(Docket No. UE-991832, Stipulation)

While Puget still remains subject to the directives of earlier Commission orders, this Stipulation can allow the Company to argue that it should be afforded some latitude in meeting these broad requirements.

6. Showalter testimony before the Washington State House Technology, Telecommunications and Energy Committee, January 24, 2001

This Wednesday, both Chairwoman Showalter and I testified before the Washington State House Technology, Telecommunications and Energy Committee. The purpose of the hearing was to investigate barriers to new resource acquisition by utilities. Showalter discussed the prudence issue generally, making the following comments:

- The regulatory compact means that utilities have an obligation to serve customers through acquiring resources, and, in return for that, have an opportunity to earn a reasonable return on prudent investments.
- The WUTC conducts a general and specific review of resources.
- Utilities are required to file least cost plans, but it is important to note that these plans are not approved by the WUTC.
- The specific review of resources comes through the prudency review process. A number of issues are examined in that process, including:

- Was it a reasonable idea to acquire the resource? Was it needed and was the selection reasonable given the alternatives?
- Did the utility execute reasonably?
- Were conservation investments properly considered as an alternative?
- What was the Avoided Cost of the investment versus the alternatives?
- Was there proper documentation of the decisions?
- What was the nature of the resource (e.g., peak vs. energy)?
- This review process is conducted only in general rate cases which may occur years after the resource decisions are made. A rate case is the forum where utilities seek to recover resource costs and it is a very complex process, so this is the appropriate place to review prudence.
- This process might be changed to incorporate early approval of some elements of the resource decisions. This may provide utilities with greater certainty but may include a number of downsides such as delay in resource acquisition and a movement away from the WUTC's traditional role in providing "hands-off" regulation.
- Through the prudence review process, the WUTC should not judge someone's actions today by a later standard, applying hindsight, but it is really difficult not to do so.

These overtures by the Chairwoman were matched the next day by HB 1440 being submitted by Governor Locke. This bill states:

At any time prior to a general rate proceeding, an electrical company may file with the commission information concerning any decision made by the company to acquire electricity generation resources. The commission shall by rule adopt standards governing the filing of such information by electrical companies under this section. The commission shall consider the information in subsequent rate-making proceedings, as well as any other information deemed relevant to the proceedings. Nothing in this section relieves the company of its burden to prove, based on this or other information, that its acquisitions of electricity generation resources are reasonable and prudent for rate-making purposes. For the purposes of this section, "electricity generation resources" includes resources acquired by the company either by contract or ownership. (HB1440)

Specific Guidelines for Documentation of Management Decisionmaking

Given these directives, documentation of significant actions by PSE management should, at a minimum, include the following:

- A description and analysis of **need**. The Company should show why the expenditure or action is necessary, and what objective is being advanced by its decision. In other words, the context for the decision should be established.
- A considered set of **alternatives**. The Company should identify all reasonable alternative courses of action and demonstrate that all such alternatives were considered. In the case of power supply acquisitions, for instance, the WUTC requires at a minimum that the utility evaluate various alternatives for the both buying and building to meet the resource need.
- A consistent and thorough **analysis** of those alternatives taking into account all appropriate factors in order to make the decision. The Company must show that it did a fair and competent analysis of all factors which bear on the business decision being made, including regulatory requirements. The factors need not be limited to those which can be quantified, but should include qualitative criteria as well.²
- **Selection** of the best alternative. The Company should identify the factors it considered in its analysis and be able to explain how those factors were applied in choosing a particular course of action over the alternatives available. The Company should be prepared to explain the basis for rejecting each of the alternatives not chosen.
- **Contemporaneous** documentation. Documentation should be created at the time these processes are underway, not after the fact.
- **Ongoing reevaluation** of the decision, as appropriate. It is not sufficient to document only the initial decision. As circumstances change, it may be appropriate to revisit the original analysis and update the factors considered to reflect new information.

² Given WUTC practice, the factors the Commission would expect to be considered in evaluating the alternatives would include price, fuel source, reliability, location, fuel diversity, developer qualifications, transmission constraints, fuel price risk, impact on capital costs, dispatchability, and environmental impacts.