BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of	)	DOCKET NO. UE-041570
PUGET SOUND ENERGY, INC.,	)	RESPONSE OF THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES REGARDING PCA PERIOD 2 TENASKA COSTS
For Approval of its 2004 Power Cost Adjustment Mechanism Report.	)	

INTRODUCTION

1 The Industrial Customers of Northwest Utilities ("ICNU") respectfully submits this Response Regarding Power Cost Adjustment ("PCA") Period 2 Tenaska Costs in Docket No. UE-041570. ICNU urges the Washington Utilities and Transportation Commission ("WUTC" or the "Commission") to reject Puget Sound Energy's ("PSE" or the "Company") request to earn a full return on the Tenaska regulatory asset for the period July 1, 2003, to May 23, 2004. Likewise, the Commission should reject Staff's proposal to allow PSE to earn a full return on the Tenaska regulatory asset from July 1, 2003, to December 31, 2003.

2 The Commission should apply the Tenaska benchmark mechanism adopted in the Power Cost Only Rate Case ("PCORC") to the entire PCA Period 2 for the following reasons:

- Staff's recommendation and PSE's request are inconsistent with the Commission's PCORC orders deciding the recovery of the return on the Tenaska regulatory asset. The Commission determined in the PCORC that the Tenaska benchmark mechanism "achieves an appropriate balance of shareholder and ratepayer concerns[.]"[1/] The piecemeal approach to application of the mechanism advocated by PSE and Staff would upset that balance;

[1/] Re PSE, WUTC Docket No. UE-031725, Order No. 14 at ¶ 96 (May 13, 2004).

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- The PCORC orders deferred the questions of the appropriate disallowance for the first 10½ months of PCA Period 2. Therefore, the appropriate disallowance for PCA Period 2 has yet to be resolved;

- The Commission has concluded that PSE's past imprudence has impacted the cost of the Tenaska contract for its entire term, and PSE's Tenaska costs in PCA Period 2 exceeded the benchmark set by the 1992 contract by over $30 million. Allowing PSE to recover all of the return on the Tenaska regulatory asset under these circumstances would not be just and reasonable and is inconsistent with the PCORC orders;

- PSE and Staff offer no legitimate reason to allow PSE to reverse the $10.9 million earnings reduction already reported by the Company based on the assumption that the benchmark mechanism applied to all of PCA Period 2. PSE's proposal is a thinly-veiled attempt to boost earnings that defies the logic of the PCORC orders; and

- PSE and Staff have not put forth a rational basis to create a 10½ month gap in the prudence disallowance embodied in the Tenaska benchmark mechanism;

3 ICNU recommends that the Commission apply the benchmark mechanism for determining future disallowances on the Tenaska regulatory asset to the entire PCA Period 2. Neither PSE nor Staff has stated a valid basis to interrupt the application of the Tenaska benchmark mechanism for the period July 1, 2003, through May 23, 2004.

BACKGROUND

4 In determining how to treat the costs of the Tenaska regulatory asset for PCA Period 2, it is important to understand the context in which those costs were incurred. In 1997, the Commission approved an arrangement whereby PSE bought out a long-term gas contract related to its 1992 Tenaska power purchase, and allowed PSE to create a $215 million regulatory asset related to the buyout.[2/] PSE justified the creation of the regulatory asset based on its claim

[2/] WUTC Docket No. UE-031725, Order No. 14 at ¶ 33.

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that lower gas prices would produce significant savings for ratepayers, even after payment of a return of and a return on the regulatory asset.[3/]

5 In the PCORC, the Commission found that "PSE failed to develop and implement a gas-purchasing plan that took into account the Company's obligation to manage its gas supply with an eye to securing savings for customers over the longer term."[4/] The evidence in the PCORC demonstrated that PSE failed to take advantage of several opportunities to protect customers from the risk of being caught short on gas, which led the Commission to conclude that "PSE managed gas acquisition for the short-term bottom line for shareholders."[5/] The Commission ultimately concluded that PSE's "mismanagement of gas purchases for Tenaska was imprudent resulting in the incurrence of costs that are not reasonable considering the total costs of gas, return of, and return on the Tenaska regulatory asset."[6/] The Commission determined that, as a result of PSE's imprudence, the cost of the Tenaska contract (including recovery of the return of and on the regulatory asset) was significantly above the "benchmark" of the original contract by the time of the PCORC. The history of the disallowances in the PCORC orders is extremely significant, because it shows that the purpose of those orders was to remedy the impact of PSE's past imprudence on current and future time periods.[7/]

6 The Commission addressed PSE's imprudence through two means. First, the Commission disallowed approximately $25.6 million in costs incurred during PCA Period 1, which represented the revenue requirement impact of the return on the Tenaska regulatory asset

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3/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 33.
4/ Id. at ¶ 88.
5/ Id.
6/ Id. at ¶ 109.
7/ Id. at ¶ 92, 96.

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for this time period.[8] Second, the Commission established a methodology to determine future disallowances of Tenaska costs from the date of the order through the end of the Tenaska contract.[9] The Commission clearly indicated that the order did not address costs incurred between July 1, 2003, and the date of the Order.[10] The Commission's methodology includes a benchmark mechanism to which it compares PSE's total Tenaska costs.[11] If the total costs exceed the benchmark, the Commission will reduce PSE's return on the Tenaska regulatory asset by one-half of the amount in excess of the benchmark.[12] The Commission applied the benchmark mechanism to the time period that covered both the PCORC test period and PCA Period 1 (July 1, 2002, to June 30, 2003), and stated that the Tenaska benchmark mechanism would apply on a going-forward basis to costs incurred after the effective date of the order as well.[13] The effective date of the rates approved in the PCORC was May 24, 2004.

7 On June 7, 2004, the Commission issued its order on reconsideration in the PCORC, restating that the Tenaska benchmark mechanism applied from May 24, 2004 (the effective date of Order No. 14) to PCA periods 3 and beyond. The Commission specifically reserved its decision on the applicability of the Tenaska benchmark mechanism for the period July 1, 2003, to May 24, 2004, finding it "preferable to address [that] question in the context of [the PCA Period 2 review] proceeding."[14] After the Commission issued its order on

[8] WUTC Docket No. UE-031725, Order No. 14 at ¶ 93. PCA Period 1 lasted from July 1, 2002, to June 30, 2003.
[9] Id. at ¶ 95.
[10] Id. at n.104.
[11] Id. at ¶ 95.
[12] Id.
[13] Id. at ¶ 97.
[14] Re PSE, WUTC Docket No. UE-031725, Order No. 15 at ¶ 53 (June 7, 2004).

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reconsideration, PSE recorded a $10.9 million pre-tax disallowance to purchase power expense, which assumed application of the Tenaska benchmark mechanism to all of PCA Period 2.[15/]

8 In PSE's petition requesting approval of its PCA Period 2 report, the Company requested that the Commission not apply the Tenaska benchmark mechanism from July 1, 2003, through May 23, 2004.[16/] PSE acknowledges that the PCORC orders do not compel the Commission to exclude part of PCA Period 2 from application of the benchmark mechanism, but PSE nevertheless requests that the Commission not apply the mechanism in light of the Commission's previous reservation of its decision on that issue.[17/] PSE's proposal would restore recovery of the $10.9 million of the return on the Tenaska regulatory asset that the Company previously wrote off.

9 In the Staff memorandum for the February 9, 2005 open meeting, Staff recommended that the Commission deny PSE's request with respect to the applicability of the Tenaska benchmark mechanism during PCA Period 2. Staff explained its reasoning as follows:

> 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 continuous remedy.
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> 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.'[18/]

15/ Re PSE, WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶ 4 (Feb. 7, 2005).

16/ Re PSE, WUTC Docket No. UE-041570, PSE Petition at ¶ 14 (Aug. 31, 2004).

17/ WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶ 14.

18/ Re PSE, WUTC Docket No. UE-041570, Staff Memorandum for the Feb. 9, 2005 Open Meeting at 4-5 (quoting WUTC Docket No. UE-031725, Order No. 14 at ¶ 103).

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Accordingly, Staff saw "no logic in allowing a hiatus in the adjustment during the PCA 2."[19]

10 On February 7, 2005, PSE submitted its Response to Staff's Memorandum for the February 9, 2005 Open Meeting.[20] In its Response, PSE reiterated its request that the Commission not apply the Tenaska benchmark mechanism for the period of PCA Period 2 that occurred prior to the effective date of the rates authorized in the PCORC.[21]

11 After the matter was removed from the February 9, 2005 open meeting agenda, Staff reconsidered its position and revised its recommendation regarding the applicability of the Tenaska benchmark mechanism.[22] Staff states in its memorandum for the February 23, 2005 open meeting that it "does not agree with PSE's interpretation that the Tenaska benchmark mechanism does not apply to the portion of PCA 2 prior to May 24, 2004" and that a "better interpretation of the Tenaska benchmark mechanism would apply any disallowance over the entire PCA 2 period[.]"[23] Nevertheless, Staff states that "PSE's position is not without merit" and proposes to adopt January 1, 2004, as the commencement date for application of the Tenaska benchmark mechanism for PCA Period 2.[24] This would allow PSE to recover approximately $6.0 million of the return on the Tenaska regulatory asset during PCA Period 2.[25]

ARGUMENT

12 As a result of the imprudence found in the PCORC, the Commission should not allow PSE to earn a full return on the Tenaska regulatory asset during PCA Period 2. The Tenaska costs that PSE seeks to recover in PCA Period 2 exceed the benchmark of the original

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[19] Id. at 4.
[20] WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶ 1.
[21] WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶ 14.
[22] Re PSE, WUTC Docket No. UE-041570, Staff Memorandum for the Feb. 23, 2005 Open Meeting at 5-6.
[23] Id. at 5.
[24] Id.
[25] Id. at 1.

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1992 contract by more than $30 million.[26/] Therefore, under the reasoning of the PCORC orders, PSE should not earn a full return on the Tenaska regulatory asset. Since PSE has already written off the amounts it now seeks to recover, adopting either the Staff or PSE proposal would result in an immediate earnings boost for PSE, which would come at the expense of ratepayers who may never be made whole for the costs of PSE's imprudent management of the Tenaska gas supply. The Commission's PCORC orders reflect an intent to establish disallowances related to the impacts of PSE's imprudence on past and future PCA deferrals. Interrupting the application of the Tenaska benchmark mechanism during PCA Period 2 is inconsistent with the Commission's treatment of the costs of the regulatory asset for the remainder of the Tenaska contract.

13 In PSE's Response to the Staff February 9, 2005 Open Meeting Memorandum, the Company puts forth two primary arguments regarding why the Commission should not apply the Tenaska benchmark mechanism to the first 10½ months of PCA Period 2: 1) the Commission should not expand the "one-time" disallowance for the Company's historic imprudence with respect to the Tenaska gas supply by denying $10.9 million in return on the regulatory asset; and 2) application of the benchmark mechanism to the entire PCA Period 2 would be inconsistent with the going-forward incentive created by the Commission in the PCORC orders and would be "needlessly punitive to PSE's current management."[27/] Staff recommends that the Commission allow a full return on the regulatory asset for a portion of PCA Period 2 based on its conclusion that PSE's arguments are "not without merit." All of these arguments are inconsistent with the reasoning in the PCORC orders and the Commission should reject them.

[26/] Id. at 4.
[27/] WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶¶ 14-15.

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A. Application of the Benchmark Mechanism Would Not "Expand" the One-Time Disallowance Ordered for PCA Period 1

14 The Commission reserved ruling on the applicability of the benchmark mechanism to PCA Period 2 until it had the information on the PCA Period 2 costs. PSE's argument that the Commission should not "expand" the one-time disallowance ordered for PCA Period 1 rests on the premise that the one-time disallowance also applies to PCA Period 2. This premise is incorrect. The Commission specifically found that it "cannot make, and has not made, any prudence determination after June 30, 2003, and has established rules only for recovery of prudently incurred costs incurred during periods after that date. "[28/] This illustrates two points. First, the disallowance for PCA Period 1 explicitly does not cover PCA Period 2. Second, the benchmark mechanism reduces the return on the regulatory asset even when PSE's actions within the PCA Period are prudent.

15 In addition, PSE ignores the distinction between the disallowance for PCA Period 1 and the Tenaska benchmark mechanism. The Commission made clear in Order No. 14 that it was adopting a single disallowance for PCA Period 1 because "it [was] not possible to pinpoint either the precise consequences to gas costs that resulted from PSE's failure to manage prudently or the precise consequences to the regulatory investment that should follow."[29/] This single disallowance addressed PSE's past imprudence up to the end of PCA Period 1.

B. The Benchmark Mechanism Applies Regardless of PSE's Prudence in PCA Period 2

16 PSE also argues that application of the mechanism to the first 10½ months of PCA Period 2 is inconsistent with the going-forward incentives created by the Commission. PSE

28/ WUTC Docket No. UE-031725, Order No. 15 at n.29.
29/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 93.

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essentially requests that the Company be let off the hook for application of the benchmark mechanism in the first part of PCA Period 2 because the Company prudently managed its gas costs during this period. This is inconsistent with the benchmark mechanism itself, however, because the 50%/50% sharing embodied in the benchmark mechanism assumes prudence. If the Commission finds imprudence, then PSE is subject to disallowance of "any and all" Tenaska costs.[30/] Moreover, the Tenaska benchmark mechanism was not designed to assess a disallowance based on the prudence of PSE's actions in PCA Period 2 or any other PCA Period. Rather, the benchmark mechanism was intended to quantify a disallowance for the impact of PSE's past imprudent actions on the current PCA Period. As the Staff report points out, the "total Tenaska costs exceeded the benchmark for the PCA 2 period by about $31,421,000."[31/] This is exactly the circumstance in which the benchmark mechanism was intended to result in a disallowance. The only going-forward incentive created by the Tenaska benchmark mechanism is to bring the total Tenaska costs below the benchmark. When that happens, PSE will be allowed to earn its full return on the Tenaska regulatory asset.

17 The PCORC orders demonstrate that the costs of the Tenaska contract (including a return on and a return of the regulatory asset) are expected to substantially exceed the costs of the original contract through at least 2006.[32/] Since PSE's past imprudence continues to impact the costs incurred during PCA Period 2, there is no basis to not apply the benchmark mechanism to determine the appropriate disallowance in this period. The Commission's rationale for adopting the benchmark mechanism supports the application of the mechanism in PCA Period 2.

30/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 95.
31/ WUTC Docket No. UE-041570, Staff Memorandum for the Feb. 23, 2005 Open Meeting at 4.
32/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 92, Figure 1.

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C. The Commission Ordered That the Benchmark Mechanism Should Apply Despite the New Management at PSE

18 PSE's argument that application of the benchmark mechanism for the first 10½ months of PCA Period 2 will be "needlessly punitive to the Company's current management" disregards the fact that the Commission established the benchmark mechanism with full knowledge of PSE's new management.[33/] As described above, the Commission ordered the single disallowance for PCA Period 1 because of the impossibility of precisely determining the cost impact of PSE's imprudence. In addition, for future PCA periods, the benchmark mechanism applies when the benchmark is exceeded, regardless of the prudence of PSE's management during the PCA period at issue.

19 PSE has not offered any explanation that fits within the reasoning in the PCORC orders for its request that the Commission not apply the benchmark mechanism to all of PCA Period 2. The Commission applied the Tenaska benchmark mechanism to the PCORC test period and PCA Period 1 (July 1, 2002, to June 30, 2003), and it has established the benchmark mechanism to determine disallowances on the return of the Tenaska regulatory asset for the period after May 23, 2004. There is no sound basis to not apply the benchmark mechanism for the period July 1, 2003, to May 23, 2004. As Staff initially stated regarding PSE's proposal, there is "no logic" to a piecemeal application of the benchmark mechanism. To do so would upset the balance of interests between shareholders and customers that the Commission implemented when it adopted the benchmark mechanism.[34/]

33/ WUTC Docket No. UE-041570, PSE's Response to Commission Staff's Open Meeting Memo at ¶ 15.
34/ WUTC Docket No. UE-031725, Order No. 14 at ¶ 96.

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D. Staff's Compromise Resolution Lacks Any Rational Basis

20 The primary reasoning that Staff provides to support its compromise solution is its claim that PSE's position is "not without merit."[35/] Unfortunately, Staff does not explain why PSE's arguments are not without merit. In addition, Staff also states that an outcome that balances the interests and equities is the best solution but does not explain how its proposal is consistent with the benchmark mechanism or the PCORC orders. Ironically, it is the benchmark mechanism that balances interests and equities. Although the Commission could have disallowed all of the return of and return on the regulatory asset, it chose only to disallow 50% of the return on the asset.[36/] Staff's statements that it disagrees with PSE's interpretation about application of the Tenaska benchmark mechanism and that a better interpretation would apply the mechanism throughout PCA Period 2 is at odds with Staff's conclusion that its compromise resolution is the "best solution." In sum, Staff's arguments for applying the benchmark mechanism to the entire PCA Period 2 are well reasoned, but Staff's compromise recommendation is based on conclusionary statements that PSE's request is "not without merit." The Commission should reject Staff's compromise solution.

E. The Commission Has All of the Facts That it Needs to Apply the Benchmark Mechanism to PCA Period 2

21 The Commission need not develop an evidentiary record to reach a decision on the applicability of the benchmark mechanism during PCA Period 2, because the evidentiary record developed in the PCORC is sufficient. The same imprudent conduct that justified a disallowance for PCA Period 1 and after May 23, 2004, justifies a disallowance for PCA Period

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35/ WUTC Docket No. UE-041570, Staff Memorandum for the Feb. 23, 2005 Open Meeting at 5.
36/ See WUTC Docket No. UE-031725, Order No. 15 at ¶¶ 37-38.

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2. The facts described above regarding the creation of the Tenaska regulatory asset and the subsequent imprudent management of the gas supply apply equally to PCA Period 2. The result for customers is the same; they are being asked to pay for a regulatory asset during PCA Period 2 that has little to no benefit.

22 The only debatable question is whether the Commission should disallow all of the return on the regulatory asset for PCA Period 2, as it did for PCA Period 1, or whether it should apply the 50/50 sharing suggested by the benchmark mechanism.[37/] ICNU supports applying the benchmark mechanism because it fairly balances the interests of PSE and customers.

CONCLUSION

23 The Commission should apply the Tenaska benchmark mechanism to all of PCA Period 2. PSE provides no legitimate reason for the Commission to interrupt the application of the mechanism for the period from July 1, 2003, to May 23, 2004. Staff disagrees with PSE's interpretation of the applicability of the mechanism, but comes to the unsupported conclusion that a split-the-difference approach provides the "best solution." Staff's and PSE's recommendations are not supported by sound policy or the reasoning of the PCORC orders and should be rejected. ICNU respectfully requests that the Commission find that the Tenaska benchmark mechanism should be applied for the entire PCA Period 2.

37/ Commissioner Oshie stated in his concurring and dissenting opinion that he was inclined to disallow all of the return on the Tenaska regulatory asset until PSE could demonstrate that the total cost of the asset did not exceed the benchmark. WUTC Docket No. UE-031725, Order No. 14 at ¶ 143 (Oshie, concurring and dissenting).

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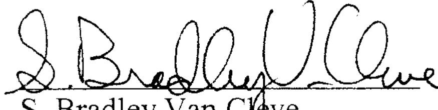
DATED this 22nd day of February, 2005.

Respectfully Submitted,



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