Agenda Date:	February 23, 2005
Item No.:	A1
Docket:	**UE-041570**
Company Name:	Puget Sound Energy
Staff:	Roger Braden, Assistant Director-Energy Hank McIntosh, Regulatory Analyst Roland Martin, Regulatory Analyst Thomas Schooley, Regulatory Analyst Shannon Smith, Assistant AG

Recommendation

PSE's request to include an additional $10.9 million of the return on the Tenaska regulatory asset in allowed power costs in PCA Period 2 should be partially granted in the amount of $6,074,927, resulting in a revised customer portion of the power cost deferral of $5,163,266, including accrued interest.

The Company's amended 2004 PCA Report as filed should be rejected, but PSE should be authorized to refile its report consistent with the Commission's Order and the Commission should approve a properly modified report by letter from the Commission's executive secretary.

Background

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

PSE filed the first of such reports on August 28, 2003, in Docket No. UE-031389 (PCA 1). The interested parties in that docket identified certain issues and exceptions to the initial report and agreed to necessary corrections and true-up methodologies that would impact the first report and future annual PCA reports. The parties reached a settlement that the Commission approved in Order No. 4 on January 14, 2004. That Order resolved all issues in that proceeding except for one, the fuel cost issue for the Tenaska and Encogen cogeneration projects.

The Commission addressed the fuel cost issue (along with other issues) in the then pending Power Cost Only Rate Case ("PCORC"), Docket No. UE-031725. In Order No. 14 in that docket, the Commission determined that approximately $25.6 million of costs representing the revenue requirement impact of the return on the Tenaska regulatory asset should be disallowed from the PCA 1 deferral account balance.

The Commission also established a method to determine potential future Tenaska cost recovery disallowances. The Commission's Order Nos. 14 and 15 in UE-031725 established a benchmark to determine an appropriate level of total cost for the Tenaska power contract. If the total costs of the Tenaska contract exceed the benchmark, the return on the Tenaska regulatory asset will be reduced by one-half of the excess over the benchmark. The Commission clarified in Order No. 15 that the rules for future recovery of prudent Tenaska costs apply to PCA 3 and future review periods, but deferred the question of applicability of the rules to that portion of PCA 2 prior to the effective date of Order No. 14 until the Commission reviewed the Company's PCA 2 report.[1]

The Company's PCA 2 report summarizes the results of the cost sharing mechanism, including the balance of the ratepayers' share of those costs deferred for future recovery in rates. It also contains the supporting exhibits detailing the regular elements of the power cost adjustments, plus the effect of the Tenaska benchmark mechanism as ordered in UE-031725.

In its petition, PSE also asks the Commission to determine that the Tenaska benchmark methodology will not be applied to PCA 2 during the period July 1, 2003, through May 23, 2004. A Commission ruling favorable to the Company would increase the imbalance for sharing by approximately $10.9 million over the amount included in the petition as originally filed. As discussed below, Staff recommends that the Commission allow an additional return on the regulatory asset of $6,074,927 rather than the requested $10.9 million.

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[1] PCORC Order No. 15, ¶ 53.

General Features of the PCA mechanism

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

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

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

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

PCA Period 2 Summary and Discussion

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

adjustments, plus the effect of the Tenaska benchmark mechanism as ordered in UE-031725.

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

Staff's audit of the cost elements covered in the PCA revealed a number of relatively minor issues and mathematical errors related to the calculation of the imbalance for sharing and implementation of the PCA mechanism. Puget and Staff resolved these issues, which are reflected in PSE's revised PCA 2 report filed February 8, 2005. The only remaining disagreement relates to the Tenaska disallowance issue discussed below.

PCA 2 Tenaska Disallowance Issue

The total Tenaska costs exceeded the benchmark for the PCA 2 period by about $31,421,000. The total amount of authorized return on the Tenaska regulatory asset for the PCA 2 period is $24,299,707; therefore the 50% disallowance ordered by the Commission, if applied over the entire PCA 2 period would be $12,149,853. As noted above, PSE posted this amount as an adjustment to the actual power costs in its PCA 2 filing (Schedule B, line 30) and in its financial statements in accordance with applicable accounting standards but now seeks permission to include approximately $10.9 million of that amount in allowable power costs under the PCA.

PSE's request is based on its view that the Tenaska benchmark mechanism established in Order No. 14 in Docket UE-031725 should only apply from the date of the Order going forward, not for the entirety of PCA 2 and on the Commission's characterization of the disallowance of costs in earlier periods as a "one-time" amount. Granting the request would allow PSE to record the full return on the Tenaska regulatory asset for the first 10.5 months of the PCA 2 period, amounting to approximately $10,876,000. (Using the effective date of Order No. 14, May 24, 2004, as the cut-off date.) In

accordance with financial accounting standards (FASB 71), PSE in its original PCA 2 filing recognized this approximately $10.9 million earnings reduction, but now seeks this amount be included in the allowed power costs based on its arguments regarding Order Nos. 14 and 15 in the PCORC.

Staff 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. Staff believes that the better interpretation of the Tenaska benchmark mechanism would apply any disallowance over the entire PCA 2 period, as reflected in the PCA 2 report originally filed by the Company. Staff acknowledges, however, that PSE's position is not without merit and consequently Staff proposes to resolve the uncertainty surrounding Order Nos. 14 and 15 in the manner set forth below.

The Commission has not received any comments or other filings on Docket No. UE-041570 from the public or any of the stakeholders who were parties in Docket No. UE-031725.

Proposed Resolution of the Benchmark Issue

After giving due consideration to the differences in interpretation of the Commission's orders on the Tenaska issue by Staff and the Company, Staff is of the opinion that the best solution is to propose an outcome that seeks to balance interests and equities. Accordingly, Staff recommends that the Commission adopt January 1, 2004, as the commencement date for application of the Tenaska benchmark mechanism to PCA 2. Therefore, the Tenaska benchmark mechanism is not applied during the six-month period July 1, 2003 through December 31, 2003.

Staff's proposal gives consideration to the long history of the Tenaska issue, the lack of clear guidance in the Commission's PCORC orders, and to the Staff's and Company's respective interpretations of the general intent of the benchmark mechanism developed by the Commission. Staff believes that its recommendation is a fair, just, and reasonable solution to this issue.

If the Staff's recommendation is approved the total under-recovered power costs would be $5,101,727 and the associated accrued interest would be $61,539 for a revised total customer deferral balance of $5,163,266.

Conclusion

Staff recommends the Commission approve the inclusion of $6,074,927 of the Company's requested $10.9 million in allowed power costs for the PCA 2 period. Staff further recommends that the Commission reject PSE's 2004 PCA Report, as filed on February 8, 2005, and authorize the Company to refile its report in accordance with the Commission's order granting Staff's recommendation.