Exhibit No. __ (DCG-1HCT)
Docket UE-121373
Witness: David C. Gomez
REDACTED VERSION

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Petition of PUGET SOUND ENERGY, INC. for Approval of a Power Purchase Agreement for Acquisition of Coal Transition Power, as Defined in RCW 80.80.010, and the Recovery of Related Acquisition Costs	DOCKET UE-121373

TESTIMONY OF

David C. Gomez

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Coal Transition Power Purchase Agreement: Equity component; Deferral of certain costs with interest and Prudency

November 2, 2012

HIGHLY CONFIDENTIAL PER PROTECTIVE ORDER
Redacted Version

TABLE OF CONTENTS

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is David C. Gomez. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission (Commission) as an Assistant Power Supply Manager, Energy Regulation.

Q. How long have you been employed by the Commission?

A. I have been employed by the Commission since May 2007.

Q. Would you please state your educational and professional background?

A. I hold an undergraduate degree in Business from Hamline University and a master's degree in Business Administration from the University of Saint Thomas; both are located in Saint Paul, Minnesota. Before joining the Commission in May of 2007, my relevant professional experience consisted of 22 years in a variety of fields, including management, contracting, supply chain, procurement, operations and engineering. I have received professional certifications from the Institute for Supply Management (ISM); APICS - The Association for Operations Management; Universal Public Procurement Council (UPPC) and QAI Global Institute (Software Testing).

While employed at the Commission, I have performed accounting and financial analysis of regulated utility and transportation companies as well as legislative and policy analysis.

II. SUMMARY

Q. What is the purpose of this testimony?

A. This testimony responds to Puget Sound Energy, Inc.'s (PSE or Company) August 20, 2012, petition[1] requesting that the Commission issue an order approving the Coal Transition Power Purchase and Sale Agreement (PPA or Agreement) by and between TransAlta Centralia Generation LLC (TransAlta) and PSE. This petition was made pursuant to RCW 80.04.570(1).[2]

PSE requests an order: (1) approving the PPA with specific Commission determinations and findings described in Section VI of its Petition;[3] (2) approving recovery of the equity component of the PPA described in Section IV of its Petition;[4] (3) approving deferral of certain PPA costs for the entire term of the Agreement including later volume and pricing changes;[5] and (4) finding the PPA prudent,[6] regardless of whether the PPA terminates as planned on December 31, 2025, or any time before then.

[1] In the matter of Puget Sound Energy, Inc., Petition for Approval of a Power Purchase Agreement for Acquisition of Coal Transition Power, as defined in RCW 80.80.010, and Recovery of Related Costs, Docket UE-121373 (August 20, 2012). "Petition"
[2] Engrossed Second Substitute Senate Bill 5769, Chapter 180, Laws of 2011.
[3] Petition at pages 17 to 19.
[4] Id. at pages 12 to 14.
[5] Id. at pages 14 to 16.
[6] Id. at pages 7 to 11.

Q. What is the scope of Staff's analysis?

A. Staff's testimony in this case addresses the PPA, associated costs proposed by PSE for recovery from ratepayers, and the treatment of the equity adder. Staff's recommendation concerning the PPA is confined to providing analysis and recommendations to support a decision by the Commission to either approve or disapprove the PPA based on:

1. Whether the terms of the Agreement provide adequate protection to ratepayers and PSE throughout the life of the contract (commencing on December 1, 2014, and expiring on December 31, 2025) or in the event of early termination; and
2. The long-term economic risks and benefits of the PPA are equitably shared between PSE and its ratepayers.

Q. What is Staff's position on the approval of PSE's Petition?

A. Staff recommends approval of the Petition with conditions. Staff stipulates that the PPA is needed by PSE to serve its ratepayers over the term of the contract, and that the PPA meets this need in a cost-effective manner.

However, Staff recommends the Commission condition its approval of the PPA by requiring the establishment of adequate protections for ratepayers. Staff further finds that some of the associated costs proposed for recovery from ratepayers by PSE are not reasonable. Finally, Staff recommends an appropriate equity adder, applied only to the output from the Centralia Coal Transition Facility (CCTF).

III. ANALYSIS

Q. How have you organized your testimony?

A. My testimony is organized roughly in the same manner as PSE's Petition.

Q. What is included in PSE's Petition?

A. The Company's Petition requests an order from the Commission approving the PPA with numerous determinations and findings, including:

1. The PPA is a long-term financial commitment for the purchase of coal transition power as defined in RCW 80.80.010(16) and RCW 80.80.010(5) respectively;
2. The terms of the PPA provide adequate protection to ratepayers and PSE for the duration of the agreement or in the event of early termination;
3. When included as part of PSE's resource portfolio, the total cost of the PPA (contract price and equity component) represents the lowest cost mix of generating, conservation and efficiency resources as defined in RCW 19.280.020(11);[7]
4. The PPA resource is needed by the electrical company to serve its ratepayers;
5. The PPA's end dates comply with the dates in RCW 80.80.040(3)(c);
6. Subject to review and approval by the Commission, the PPA allows for modification of terms if new or revised emission or performance standards or

[7] "PSE estimates that starting in December 2014 the proposed PPA will result in a first-year rate increase of $40.4 million or about 2% based on rates set in PSE's 2011 General Rate Case." Exhibit No. __ (RG-8HC), page 40, paragraph 2.

other operational or financial requirements or limitations on greenhouse gas emissions are imposed by law;

7. The cost of an equivalent plant used in calculating the equity return is $215 million amortized over the 133 month term of the PPA (December 1, 2014, through December 31, 2025);

8. PSE will earn a pre-tax weighted average cost of equity return of 7.24 percent throughout the term of the PPA even if the Agreement is terminated prior to its planned expiration date of December 31, 2025. The requested equity return totals $98.1 million ($8.8 million annually or $2.92 for each MWh of electricity contracted for in the Agreement);

9. PSE's entry into the PPA is prudent and the associated costs are reasonable for recovery in rates as a new resource through the Power Cost Adjustment (PCA) mechanism approved by the Commission in Dockets UE-011570 and UG-011571; and

10. PSE will defer costs associated with the PPA including both the contracted purchase price and the costs of the equity return component. Additionally, PSE would accrue interest on the deferred amounts, at PSE's net of tax rate of return for the period, currently 6.71 percent.

Q. Does the PPA meet the definitions of a "long-term financial commitment" for the purchase of "coal transition power" as defined in statute, namely, RCW 80.80.010(16) and RCW 80.80.010(5)?

A. Yes.

Q. Do the terms of the PPA provide adequate protection to ratepayers and PSE for the duration of the agreement or in the event of early termination, as required by RCW 80.04.570(4)?

A. No. Section 3.2 (b) of the Agreement (Page 17 of 51, Exhibit No. __ RG-3C) allows TransAlta to provide power from any source or sources if, for any reason, the output from the Centralia Coal Transition Facility (CCTF) is reduced or curtailed. Nothing in the Agreement prevents TransAlta from cutting back on CCTF power production, delivering to PSE lower cost power from other sources, and then benefiting from the price arbitrage. The CCTF represents 67 percent of TransAlta's total U.S. power plant capacity, and this Agreement apparently acts as TransAlta's strong hedge against lower power prices. PSE benefits by considering the Agreement as protection against rising power costs, with the added benefit of a guaranteed return of $2.92 for each MWh of electricity it sells to ratepayers. In other words, ratepayers are assuming most if not all of the risk with this Agreement as written.

Q. Do the fixed price terms of the PPA provide adequate protection to ratepayers as required by RCW 80.04.570(4)?

A. No. Staff examined the PPA contract prices and equity adder, expressed in both nominal and levelized dollars per MWh, against nominal and levelized forecasted Mid-C Energy prices[8] to evaluate whether the PPA is at or below PSE's nominal Avoided Costs (Exhibit No. __ (RG-5), page 59). Exhibit No. __ (DCG-2HC) and Exhibit No. __ (DCG-3HC) illustrate the results of Staff's analysis, which shows that

[8] As determined by the Aurora dispatch model.

PPA contract prices, with or without an equity adder, are significantly above nominal Mid-C price forecasts[9] through 2019. Staff used PSE's updated nominal Mid-C forecasts from April 2012, and Northwest Power and Conservation Council's preliminary forecasts for October 2012.

Staff's Exhibit No. __ (DCG-2HC) also includes an estimate of CCTF's variable costs over the life of the PPA.[10] When levelized, PPA power costs (less equity adder) are $15.57 MWh higher than CCTF's $36.42 MWh estimated levelized variable costs.[11] Staff compared these estimates to data contained in PSE's response to Public Counsel's Data Request No. 56 which included a November 11, 2011, offer from TransAlta in response to PSE's 2011 RFP.[12] As a result, Staff's final estimate of the levelized cost structure of the PPA is: [redacted][13] for Variable Costs (almost entirely fuel); [redacted][14] for Fixed Costs; and [redacted][15] as a Capacity Charge (covers return of and on the capital invested in the facility).

As worded in the PPA, power prices are to remain firm and fixed throughout the term with a pre-determined escalation. This rather simplistic approach fails to take advantage of any index or benchmark of market prices for coal and market power that can be used to hedge ratepayers' risk of paying too much for power. The PPA may exceed the cost of market power over the term of this agreement by amounts in the range of $100 to $150 million. However, the PPA placed first in the RFP when compared to the other offered resources. Staff believes that certain terms

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[9] Id.

[10] SNL Energy, Centralia Plant Financials, 2011.

[11] This amounts to $523 million (29.1 percent) of total purchased power costs over the full term of the PPA.

[12] Docket 121373 PSE Resp PC DR 056_Attach (HC) 2011 RFP TransAlta Bid 1.

[13] Id.

[14] Id.

[15] Id.

of the PPA may be unfair to customers. Specifically, the firm/fixed pricing terms in Article 3, Energy Obligations, Section 3.1[16] should be periodically reviewed against market conditions.

Q. Does the PPA define "resupply" in a manner that provides adequate protection to ratepayers as required by RCW 80.04.570(4)?

A. No, it does not define "resupply" at all. Staff believes that the proper interpretation of "resupply," as it relates to a power purchase agreement for the acquisition of coal transition power, is a seller's right to substitute the source of energy in the event of an abnormal circumstance of limited duration that prevents delivery from the CCTF. This definition should be added to the PPA to provide adequate protection to ratepayers as required in RCW 80.04.570(4). The PPA should further include notice to PSE concerning when "resupply" conditions are invoked for purposes of applying the equity adder.

Q. Is the energy to be provided by the PPA needed by PSE to serve its ratepayers, as required by RCW 80.04.570(4)?

A. Yes. The step increase in power delivered to PSE fits PSE's needs for power over the contract life.

Q. When included as part of PSE's resource portfolio, does the total cost of the PPA (contract price and equity component) represent the "lowest reasonable

[16] Exhibit No. __ (RG-3C) at 16.

cost," meaning the lowest cost mix of generating, conservation and efficiency resources, as defined in RCW 19.280.020?

A. Yes.

Q. Do the PPA's end dates comply with the dates in RCW 80.80.040(3)(c)?

A. Yes, but the requirement in the statute cited in the Company's petition does not address coal transition power purchase agreements but instead has to do with compliance with specific emission standards for one of the two CCTF boilers by December 31, 2020, and the other by December 31, 2025.

Q. Does the PPA allow for modification of terms if new or revised emission or performance standards or other operational or financial requirements or limitations on greenhouse gas emissions are imposed by law, as required by RCW 80.04.570(2)?

A. Yes. Staff has also reviewed the requirements contained in RCW 80.04.570(2) that relate to the modification of terms of any coal transition power purchase agreement in the event of new or revised Greenhouse Gas Standards. In Staff's opinion, the language in Article 10, Section 10.1 of the PPA meets these requirements.[17]

Q. Does the $215 million used by PSE in calculating the equity return in the PPA represent the least cost purchased or self-built electric generation plant with equivalent capacity?

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[17] Exhibit No. __ (RG-3C) at 30.

A. No. PSE arrived at $215 million by multiplying a resource requirement of [redacted][18](#11103-r or Company-proposed) by PSE in the final phase of its 2011 RFP. PSE claims that the selection of the Company-proposed resource is appropriate because it has the next lowest capital cost of ownership available in the marketplace. The Company excluded the [redacted][19] project (#11119-r or Alternative) saying it no longer qualified since it was also chosen in the RFP along with the PPA. Staff does not agree with the Company's logic. For one, the Alternative plant was not chosen until after the selection of the CCTF. The Alternative plant offer should not be disqualified as a benchmark resource for the calculation of the equity return for the PPA solely because of its later selection for purchase by PSE. There is no logical, statutory or legal basis for this disqualification. Furthermore, the Company-proposed resource does not meet either the capacity or the least cost criteria for selection as a resource from which to calculate the equity return component of the PPA.[20]

The resource selected by PSE to calculate the equity return is a combined cycle combustion turbine (CCCT) plant with a capacity of 650 MW. As part of its Phase II Qualitative Risks analysis of the Company-proposed plant offer PSE states that the "[redacted]."[21] The Alternative facility's 280 MW is a closer match for the 327 MW of average energy

[18] Exhibit No. __ (RG-1HCT) at 25, lines 7-8.
[19] Exhibit No. __ (RG-8HC) at 372.
[20] RCW 80.04.570 6 (b) states; "(f)or purposes of determining the equity value, the cost of an equivalent plant is the least cost purchased or self-built electric generation plant with equivalent capacity."
[21] Exhibit No. __ (CB-4HC) at 10,

delivered to PSE from the PPA, and the 221 MW of capacity that was originally envisioned in the 2011 IRP for a self-build SCCT resource addition.

In PSE's Exhibit No. ___ (CB-4HC), page 18, the RFP scoring results for Phase II show the Company-proposed plant offer as having a negative portfolio benefit of $62.4 million, with significantly higher risks associated with the acquisition than the Alternative plant offer with its portfolio benefit of $96.1 million. Staff's Exhibit No. ___ (DCG-4HC) shows a table of purchase price offers for both The Alternative plant and the Company-proposed plant. Staff believes that the Alternative plant's purchase price offer of [redacted][22] is the appropriate resource benchmark for calculating an equity return based on the Alternative plant's capacity and that it is the lowest total cost and lowest risk option for the Company. Staff does not agree with PSE's addition of upgrades to the Alternative plant's purchase price to meet operational standards and for recovery of transaction costs related to the acquisition. These costs are not supported by any data and, in the case of transaction related costs, may already be included in rates.

Staff's Exhibit No. ___ (DCG-5) shows an updated equity return calculation for the PPA using the Alternative plant's purchase price. Staff also corrected an error in PSE's Exhibit No. __ (RG-9) worksheet as revised by the Company on September 19, 2012. The error overstated the monthly MWh equity adder.[23] The revised total equity adder for the PPA at Staff's recommended levels is $33.7 million, compared to the $86.2 million proposed by the Company. Staff

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[22] Exhibit No. __ (RG-8HC) at 372.

[23] The Company's worksheet used 31 days for every month, which overstated the MWh delivered under the PPA and consequently resulted in an erroneous equity adder of $2.92 per MWh. A $2.92 equity adder results in a total equity payment of $98.1 million. The equity return based on a corrected Company equity adder of $2.57 is $86.2 million ($11.8 million difference).

recommends a $1.00 per MWh adder for each MWh delivered under the PPA from power generated at the CCTF.

Q. Should PSE earn a pre-tax weighted average cost of equity return of 7.24 percent throughout the term of the PPA?

A. No. While Staff agrees that the 7.24 percent pre-tax weighted average cost of equity reflects the current return on equity and equity ratio authorized by the Commission in PSE's last general rate proceeding, Staff does not believe the Company should be guaranteed this rate for the full term of the PPA. On page 13, paragraph 25 of the Company's petition, PSE proposes that the Commission freeze the equity return at 7.24 percent for the entire term of the PPA, regardless of what the Commission may allow as an authorized equity ratio or return on equity in future rate proceedings.

The Commission, under general rate-making principles, allows a company to include an acquired asset in rate base and earn a return. The return changes commensurate with the relative amount and cost of both debt and equity as determined in a rate case. Staff does not see any reason why the equity return rate of 7.24 percent should remain the same throughout the term of the PPA, as this would be inconsistent with current practice.

Q. Should PSE earn an equity return even if the PPA is terminated prior to expiration, or if TransAlta provides power from a source other than the CCTF?

A. No. PSE is asking the Commission to allow it to earn the full equity return of almost $90 million even if the PPA is canceled or terminated prior to its full 133 month term, or if power is provided from a source other than the CCTF. Staff's reading of an informal Attorney General's opinion, as it relates to this case,[24] does affirm that PSE is entitled to recover the cost of the power it purchases through the PPA. The real issue here is what happens to the equity adder in the event that TransAlta provides power from a source other than the CCTF, or if the PPA is terminated before December 31, 2025. The informal AG opinion does not directly address either the equity adder, or whether certain conditions in the PPA would provide adequate protection for ratepayers as required by RCW 80.04.570(4).

Neither the statute nor the informal AG opinion should be interpreted as a guarantee that the Company is entitled to a fixed equity return regardless of the source and cost of the power provided by TransAlta, or if the PPA is terminated early.

Q. What is Staff's proposal for the application of the equity adder to "resupply" power delivered by TransAlta?

A. Staff proposes that the equity adder only is allowed for power generated by coal fuel at the CCTF or under the narrow definition of "resupply". This is in keeping with the law's goal of maintaining employment in affected communities. Laws of 2011, ch. 180, § 101(4). The CCTF is located in Lewis County.

Q. Are the associated transmission costs of the PPA reasonable for recovery in rates?

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[24] Exhibit No. __ (RG-8HC), Attachment I, page 448 through page 459.

A. No. Staff contests the $35.5 million in PPA transmission costs proposed by the Company.[25]

PSE's costs for 100 MW of Point-to-Point transmission includes a $1.74 per MWh (variable portion) for spinning reserves that Staff believes are an unnecessary ancillary cost for the Centralia baseload resource. In addition, the fixed cost component of this transmission was escalated yearly at a rate of 2.5 percent. Staff's analysis of the annual inflation rates being faced by the Company are at two percent.

The remaining 280 MW of transmission required for the PPA will come from capacity already on PSE's system. The Company also included a spinning reserve variable cost adder which Staff proposes be removed. In addition, PSE included an opportunity cost for lost sales on the 280 MW of transmission and a one-time fixed transmission cost of $300,000 to cover its transaction costs related to the PPA.[26] Staff believes both of these costs should also be disallowed which results in a total reduction in transmission costs of $1.06 per MWh.

Q. Should PSE be allowed to defer costs associated with the PPA prior to inclusion in rates in a similar manner as PSE deferred its costs when it acquired the Goldendale Generating Station in Docket UE-070533?

A. No. PSE seeks to defer both the contracted purchase price and the costs of the equity return associated with the Coal Transition PPA prior to those costs being included in rates. Additionally, PSE seeks to accrue interest on the deferred amounts, at PSE's net of tax rate of return for the period, currently 6.71 percent. A similar deferral

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[25] The contested fixed transmission is $4.3 million and the contested variable transmission is $31.2 million.

[26] Staff's rationale is that the personnel resources used to negotiate and close the PPA transaction are likely already in rates.

would also be used to adjust the yearly increases in contracted power and price increases in the PPA.

This situation is not similar to the Goldendale case where PSE had limited control over the timing of the acquisition and was required to immediately borrow the large amount of funds necessary to secure the Goldendale Generating Station opportunity for its customers well in advance of enabling recovery methods.

Here, PSE will not take its first delivery of power for nearly two years. This provides the Company with sufficient time to include the PPA into rates via a Power Cost Only Rate Case (PCORC).

IV. CONCLUSION

Q. What are Staff's recommendations?

A. Staff recommends the Commission approve the PPA under the following conditions:

1. Disallow certain transmission expenses – As explained above, transmission certain expenses for 100 MW of point-to-point transmission and all expenses for 280 MW of existing PSE transmission should not be allowed in determining the cost for customers. This reduces the contract price by $1.06 per MWh.
2. The equity adder is only awarded to PSE from capacity provided by the CCTF or under the narrow definition of "resupply" set forth above – The equity adder should be consistent with the statutory intent to maintain employment in local communities.

3. Equivalent plant – The Commission accept Staff's recommendation that the equivalent capacity plant for calculation of the equity return is $84 million (or $1.00 per MWh) which is estimated to generate an equity adder of $33.7 million over the life of the Agreement.

4. Rate of return - The equity return rate of 7.24 percent used to calculate the equity adder will be adjusted to reflect any new rate of return approved by the Commission in future rate cases.

5. If the memorandum of agreement (MOA) between the State of Washington and TransAlta is terminated then the PPA is terminated - The MOA specifies the obligations required from each party as a result of the Coal Transition Energy Bill, E2SSB 5769. These obligations include annual payments by TransAlta totaling $55.0 million to fund economic and community development in Lewis and South Thurston County.[27] Staff views PSE ratepayers, via the PPA, as a main source of these funds.

Q. Does this conclude your testimony?

A. Yes.

[27] Exhibit No. __ (RG-3C), Article 17, Section 17.3 on page 34 states that PSE (Buyer) may terminate the Agreement if the MOA is cancelled (emphasis added).