Exh. DCG-5
Dockets UE-260005, UG-260006 and UE-260113
Witness: David C. Gomez

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**DOCKETS UE-260005 & UG-260006**
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Accounting Order Authorizing the Deferred Accounting Treatment for FERC Interest Associated with Mandatory Transmission Network Upgrades**	**DOCKET UE-260113 (Consolidated)**

EXHIBIT TO

TESTIMONY OF

DAVID C. GOMEZ

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

UE-011570, PSE, Direct Testimony of William A. Gaines WAG-1T, 12-03-01

July 28, 2026

EXHIBIT NO. _____ (WAG-1T)
DOCKET NO._____
2001 PSE INTERIM RATE CASE
WITNESS: WILLIAM A. GAINES

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY, INC.

Respondent.

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

DECEMBER 3, 2001

PUGET SOUND ENERGY, INC.

DIRECT TESTIMONY OF WILLIAM A. GAINES

I. INTRODUCTION

Q: Please state your name, business address, and position with Puget Sound Energy, Inc.?

A: My name is William A. Gaines. My business address is 411 108th Avenue N.E., Bellevue, Washington 98004. I am Vice President Energy Supply for Puget Sound Energy, Inc. ("PSE", or the "Company").

Q: Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?

A: Yes, I have. It is Exhibit WAG-2.

Q: What are your duties as Vice President Energy Supply for PSE?

A: My responsibilities include planning and management of the Company's power and natural gas supply portfolios, and associated bulk transmission and transportation arrangements.

II. SUMMARY OF TESTIMONY

Q: Please summarize the contents of your testimony?

A: The following is a description of the organization and content of my testimony:

Section I – Introduction

Section II – Summary of Testimony

Section III – Under-Recovery of PSE Power Costs shows that, due to extraordinary circumstances, the Company is projected to under-recover its power costs by about (i) $63,435,000 in the two-month deferral period of January and February 2002 (as used in this testimony, "Deferral Period") and (ii) $99,649,000 in the

eight-month interim rate relief period of March through October 2002 (as used in this testimony, "Interim Rate Period").

Section IV – Creditworthiness Impacts on Power Supply describes the Company's need to access the power and natural gas markets in connection with providing service to its customers and shows that such access depends upon the Company's financial health as reflected by its creditworthiness.

III. UNDER-RECOVERY OF PSE POWER COSTS

Q: For the period January 1, 2002 through October 31, 2002, are the Company's power costs projected to exceed those power costs reflected in current rates?

A: Yes. I have quantified projected power supply costs of the Company for that period in Exhibit WAG-3. That exhibit calculates Unrecovered Power Costs for that period, the amount by which the Company's projected power costs exceed the power costs reflected in the Company's rates. That exhibit shows Unrecovered Power Costs of (i) $63,435,000 in the Deferral Period and (ii) $99,649,000 in the Interim Rate Period. The rates (after adjustment for revenue-sensitive items) necessary to collect these amounts spread over the projected load for the Interim Rate Period are (i) 5.67 mills per kWh for Unrecovered Power Costs in the Deferral Period and (ii) 8.90 mills per kWh for Unrecovered Power Costs in the Interim Rate Period.

Q: Please describe the circumstances that give rise to this under-recovery.

A: A dramatic change in the wholesale power markets in 2000-2001 (coupled with very poor hydroelectric generating conditions) gave rise to this under-recovery.

(i) In 2000, market power prices rose (and power supply availability in the region tightened) dramatically. Natural gas market prices rose as well, but the increases were not as drastic as the increases in spot market power prices.

(ii) In the summer of 2001, market power prices collapsed even more dramatically. Natural gas market prices also declined.

The cumulative effect of these extraordinary circumstances has been to undermine the Company's ability to offset escalating basic power supply costs with margins from wholesale power sales. Against a backdrop of unprecedented volatility and very poor hydroelectric generating conditions, the Company's basic power supply costs increased substantially (notwithstanding the recent drop in wholesale spot market power prices). This is reflected by the fact that the Company's Projected Power Unit Costs for the January through October 2002 period (see Exhibit WAG-3, Spreadsheet A) are 3.5¢/kWh, whereas the corresponding power costs for a period (July 2000 through June 2001), when the Company was able to use healthy margins in wholesale prices to offset power costs, were 2.3¢/kWh.

The market power prices during the mid-2000 to mid-2001 period enabled the Company to offset these escalating basic power supply costs by allowing the Company to sell surplus power at a healthy margin. More fundamentally, the spark spread was very large during this period. (In general, the spark spread represents the amount by which the spot market power price exceeds the variable operating cost of a natural gas-fired generator.) The large spark spread during this period allowed the Company to economically operate its simple cycle combustion turbines which, because of the high spark spread, could generate electricity at a cost far below the then-prevailing market price. (These simple cycle combustion turbines are an important element of the Company's power resource portfolio and are available to meet extreme peak demand during cold weather and to provide back-up supply in the event of poor hydroelectric conditions.) During the mid-2000 to mid-2001 period, the Company's simple cycle combustion turbines operated at a high capacity factor, and the high spark spread allowed these units to operate at a cost well below the then-prevailing market price and

thereby helped offset the escalation in the Company's basic power supply costs. By contrast, a number of other utilities were forced to seek substantial rate increases during that period, often caused in substantial part by reliance on the spot power markets for a portion of their power supply needs.

Faced with extraordinary volatility and high prices in the wholesale market in the mid-2000 to mid-2001 timeframe, the Company secured several fixed price commitments for natural gas supply for generation the Company needed to have available for its retail loads.

The ability of the Company to use the high spark spread during the mid-2000 to mid-2001 period to offset escalating base power supply costs was particularly important in light of the merger Rate Plan. The volatility and level of wholesale market prices during that period far exceeded the historic volatility that had been experienced at the time of the agreement of the parties to the Rate Plan and under the Company's merger order in 1997.

The ability of the Company to use surplus sales to offset the escalation of the Company's basic power supply costs unexpectedly changed when wholesale market prices and the spark spread experienced an extraordinary decline in the summer of 2001. The consequences of these events are affecting the Company's power costs to the point where the Company's Underrecovered Power Costs are (i) $63,435,000 in the Deferral Period and (ii) $99,649,000 in the Interim Rate Period.

Q: Please describe the calculation of the Company's Unrecovered Power Costs for those periods?

A: The calculation of Company's Unrecovered Power Costs for those periods is described in Exhibit WAG-3. These power costs consist of purchase and interchanged power, wheeling and non-core gas and other fuel for electric generators, reduced by sales to

other utiltiies. The calculations are based on 40 years of streamflow data, which were analyzed using the Aurora model. This model is described in Exhibit WAG-4.

IV. CREDITWORTHINESS IMPACTS ON POWER SUPPLY

Q: Is there volatility in the Company's energy loads and resources?

A: Yes. For example, the Company's loads are temperature-dependent and its hydroelectric generating resources are weather-dependent. In an average year, the Company's hydroelectric resources provide approximately 7,700,000 MWh of energy (approximately 6,300,000 MWh from long-term purchases from Mid Columbia hydroelectric projects and approximately 1,400,000 MWh from production at PSE's owned Westside hydroelectric resources). However, under very dry or very wet conditions, production from these resources can vary from approximately 5,600,000 to approximately 9,800,000 MWh annually. Moreover, the Company's electric energy load can vary up or down by as much as 1000 MWh in a single day for each one degree change in temperature. The average temperature in the Company's service area for a winter month can vary as much as plus or minus eight degrees, and the average temperature in the Company's service area for a winter day can vary as much as much as plus or minus thirteen degrees. Any deficiency or surplus of power supply must be purchased or disposed of in the wholesale power markets.

Q: What is the effect of this volatility on the Company's need to access the power and natural gas markets?

A: In providing service to its retail customers, the Company must continually balance its resources with its loads. Participation in the power and natural gas markets is an essential element of the Company's ability to achieve that balance and discharge its public service responsibility, in light of the volatile nature of the Company's loads and resources. Participation in such markets is also essential if the Company is to have the ability to hedge risks of market volatility.

Q: Does the Company's access to the power and natural gas markets depend on the Company's financial health, as indicated by its creditworthiness?

A: Yes.

Q: With the continuation of Unrecovered Power Costs, will the Company's access to the power and natural gas markets be impaired?

A. Yes. During the period since the Company's last general rate case, the power and natural gas markets have become much more developed. Counterparties now routinely review a company's financial health, as indicated by its creditworthiness and other indicators, to determine whether and on what terms to enter into transactions, physical or financial, with such company. Satisfaction of such review has become a routine requirement of counterparties in the wholesale markets.

These requirements are reflected in the standardized contracts used in, and in conventions applicable to, the power and natural gas markets. For example, the overwhelming majority of physical power transactions in the Northwest are conducted under the Western Systems Power Pool Agreement ("WSPP"). If a party to a transaction under that agreement suffers any debt downgrade to below investment grade (or further downgrade below investment grade) by at least one rating agency, such party upon request must provide "(1) the posting of a Letter of Credit, (2) a cash prepayment, (3) the posting of other acceptable collateral or security . . . , (4) a Guarantee Agreement executed by a creditworthy entity; or (5) some other mutually agreeable method . . . ." WSPP, Section 27 (Creditworthiness). As a practical matter, the triggering of such requirements for the Company (or any other company) may well require it to make cash payments, post cash collateral up to the amount of its forward obligations or attempt to purchase an expensive letter of credit.

Q: What could happen to the Company's ability to access the wholesale power and natural gas markets if its debt were downgraded to below investment grade?

A: The Company would most probably be precluded from dealing with any number of potential counterparties for wholesale power and natural gas financial and physical transactions. To the extent the Company were able to find counterparties willing to enter into such transactions, required prepayments (or deposit of funds to induce a bank to issue a letter of credit) for transactions could well amount to tens of millions of dollars. Moreover, many existing transactions at the time of the down-rating could be subject to the Company's posting of collateral for, or accelerated payment by the Company of, forward amounts owed by the Company based on the then-current valuation of future obligations under the applicable contract. In short, the Company's power costs would increase, and its ability to enter into market transactions in connection with meeting its loads and in connection with hedging risk could be seriously impaired. The recent events regarding Enron only underscore the importance of creditworthiness in accessing the wholesale power and natural gas markets

Q. Since the Company initiated a request for emergency rate relief in August 2001, have counterparties expressed increased concern about the Company's creditworthiness?

A. Yes. The Company has received inquiries regarding its creditworthiness and has had to provide credit enhancement. In addition to counterparties in the wholesale markets, other parties--for whom the Company's obligations to purchase generating project output provide credit support for project financing--are affected.

Q. How are those other parties affected?

A. A number of generating projects providing power in the Company's portfolio are owned by other parties which sell power under long-term contracts to the Company. The financing for the projects is typically supported by the Company's promise and ability to purchase and pay for the power from those projects. In that regard, the continuation of

Unrecovered Power Costs would make it very difficult to provide credit support necessary for financing new projects.

Q. Does this conclude your testimony?

A. Yes, it does.

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