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August 26, 1994

Steve McLellan, Secretary
Washington Utilities and
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Re: WUTC v. Puget Sound Power & Light Co.
Docket Nos. UE-920433, UE-920499 and
UE-921262 - Prudence Review

Dear Mr. McLellan:

Enclosed please find the original and nineteen copies of the Brief of Commission Staff in the above-referenced case. Please accept the same for filing.

Very truly yours,

ROBERT D. CEDARBAUM
Assistant Attorney General

RDC:ss
Enclosure

cc: All Parties

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

PETITION OF PUGET SOUND POWER & LIGHT COMPANY FOR AN ORDER REGARDING THE ACCOUNTING TREATMENT OF RESIDENTIAL EXCHANGE BENEFITS	DOCKET NO. UE-920433
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY, Respondent.	DOCKET NO. UE-920499
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND POWER & LIGHT COMPANY Respondent.	DOCKET NO. UE-921262

BRIEF OF THE STAFF OF THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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I.

INTRODUCTION

From 1988-1991, Puget Sound Power & Light Company ("Puget" or "The Company") executed purchased power contracts at a total nominal cost of $5.75 billion over the lives of the contracts. Three of these contracts - Tenaska Cogeneration, March Point Phase II and Sumas Energy - account for $3.72 billion of that total and were acquired outside of the competitive bidding process. (Ex. 2221 at 2.)

The Company now comes before the Washington Utilities and Transportation Commission ("WUTC") proposing the that entire cost of these resource acquisitions be included in rates because the contracts provide "adequate, reliable power at a reasonable cost." (Ex. T-2241 at 1; Ex. 2111, Data Request No. 5307; Ex. T-2001 at 8.) The Company does not claim that the purchased power contracts provide electricity at "least cost." (Ex. 2229, Data Request No. 5388.) The term "least cost" is conspicuously absent from the Company's presentation in this case. (Ex. T-2155 at 32; Tr. 5851.)

The Commission's rules establishing resource acquisition guidelines, however, require each electric utility to meet its load with a "least cost," not a "reasonable cost," mix of generating resources. WAC 480-100-251. If Puget had wished to modify adherence to the least cost standard, it was required to first justify such departure <u>before</u> applying its new standard. It has never directly sought permission to modify the least cost standard,

however. It should not now be allowed to unilaterally adopt its new standard in measuring its actions with regard to the current purchased power contracts.

Moreover, "reasonable cost" is used by the Company as justification for its laxidasical and biased decision-making process in order to expand the range of acceptable outcomes beyond least cost. The Company's decision-making process amounted to nothing more than "robust discussions" which arrived at "consensus decisions" about which Puget "felt comfortable" and had "good feelings." (Ex. 2110 at 10; Ex. 2111, Data Request Nos. 5303 and 5333; Tr. 5006, 5017-5018, 6318.) There were no well-defined guidelines or criteria for evaluating and ranking the various characteristics of particular resource alternatives. (Ex. 2110 at 11, 27; Ex. 2111, Data Request Nos. 5024, 5303, 5304, 5310, 5322, 5748, 5753, 5763.) There was only the Company's "subjective judgment." (Ex. 2110 at 11.) There was no direction to document the Company's evaluation of particular resource alternatives. (Tr. 5220, 5224, 5235.) There were only claims of "no close calls" and "lost opportunities." (Ex. 2110 at 11.)

Whether applied retrospectively to the Company's recent acquisitions, as the Company is attempting to apply, or to new acquisitions, Staff opposes the "reasonable cost" standard. Resources should be least cost, considering price and other factors of a resource affecting its direct cost to the Company and to the public. These may include impacts on the Company's financial

structure, dispatchability, risk, and environmental impacts. Staff also recognizes that there may be factors regarding a resource's development and operation which do not directly affect the costs borne by the Company that should also be considered as part of the acquisition decision. These may include costs borne by the public or factors not readily translated into a cost. (Ex. 2073 at 2126.)

Nonetheless, in both instances, any tradeoff between these factors and the lower costs of other resources should be done in a considered manner and documented completely before, not after, the fact. This tradeoff of the Company's cost with public and non-cost factors could be considered a "best cost" result, even if it is not the lowest cost. In any case, determining a least cost or best cost would not provide the latitude the Company seeks in offering its "reasonable cost" standard. It is, however, of vital importance if ratepayers can reasonably expect to benefit from the Company's decisions and if the Commission is to be able to satisfy its statutory mandate to set rates on the basis of prudent costs. (RCW 80.28.010.)

II.

STATEMENT OF THE CASE

A. The Commission's Eleventh Supplemental Order.

In its Eleventh Supplemental Order, the Commission directed the Company to file a power supply case demonstrating the prudence of its resource acquisitions from Encogen, March Point Phase I and Phase II, Sumas, Koma Kulshan, Montana Power Company, Spokane

Regional Solid Waste Disposal Facility and Snohomish County PUD No. 1 Conservation Transfer. The Company's contract with Tenaska was added to this review by the Commission's Eighteenth Supplemental Order.[1] For each contract, the Company was ordered to describe the resource alternatives available to it at the time the contract was executed. This description was to include, at a minimum, dispatchability, transmission impacts, other bids, building options, and financial and rate impacts. (Eleventh Supplemental Order at 24.)

The Company was directed to make a similar showing regarding the prudence of its four-year energy sale to the Bonneville Power Administration ("BPA"). The Commission stated that Puget could not shift the financial risk of this sale to ratepayers until the Company had demonstrated its prudence. (Id.)

In ordering this further proceeding, the Commission rejected the Company's arguments that the prudence of the purchased power contracts had been demonstrated by virtue of (i) their acquisition through a competitive bidding program; (ii) their consistency with the Company's integrated resource plans ("IRP"); (iii) their being the subject of briefing with the Commission Staff;[2] and (iv) their

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[1] The ten power supply contracts subject to this prudence investigation total 674 aMW. The contracts with Tenaska, March Point Phase II and Sumas are 366 aMW of that total amount. (Ex. 2062.)

[2] In its earlier decision denying a Company Motion for Summary Judgment, the Commission affirmed its legal authority to investigate the prudence of the purchased power contracts despite its prior acceptance of each contract, and despite any prior

costs being less than the equivalent "avoided cost" filing. (Eleventh Supplemental Order at 19-22.)

The Commission was presented with evidence in the original proceeding that these projects were operating as anticipated or, in the case of Tenaska, were expected to be operating very soon, which was not disputed by other parties. (Ex. T-2170 at 8.) Whether or not these projects were operating successfully or were expected to operate successfully was, therefore, not at issue in the Commission's decision to nevertheless order this prudence review.

The Commission also heard argument that the Company's resource acquisitions diversified its power supply portfolio, and brought the Company into resource balance at a time the region was going into deficit. (Ex. 2052.) Again, the Commission was not convinced.

The Commission specifically stated that Puget had not met its burden of proof to demonstrate that rates based on these resource acquisitions are fair, just and reasonable, or that the expenses were prudently incurred. To be prudent, there must be a

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briefings by Puget to Staff. (Tr. 5628-5631.)

Furthermore, any meetings between Puget and Staff only provided limited information to Staff concerning the status of a bidding process, and the selection process to date. (Tr. 5874.) These meetings did not encompass a review of Puget's analysis of the bids or the decision making process employed by Puget to acquire any resources. In fact, no studies or analyses were presented by Puget at these meetings. (Ex. T-2155 at 19-21.) The limited documentation which Puget did circulate was retrieved by the Company when the meetings ended and was later destroyed. (Tr. 5116-5117.) Precisely because of the restricted nature of these meetings, Staff alerted the Company to its positive burden to justify the prudence of its resource acquisitions in this general rate case. (Tr. 5727, 5880; Ex. 2159 at 34.)

demonstration that the selection of a resource was necessary and reasonable, and that the costs of acquisition were appropriate. The test the Commission adopted to measure prudence asked what a reasonable board of directors and Company management would have decided given what they knew or reasonable should have known at the time they made a decision.[3] (Id. at 20.) This is the same test the Commission previously adopted in cases dealing with abandoned nuclear projects (Cause No. U-83-54) and successfully completed generation (Cause No. U-83-26). (Ex. T-2155 at 7-8.)

The Commission has also had prior occasion to consider its role under the competitive bidding rules in Chapter 480-107 WAC. In a complaint proceeding by SESCO, Inc. alleging violations of those rules by Pacific Power & Light Company, the Commission stated:

> The Commission concurs with the Commission Staff's view that the bidding rules establish a framework in which utilities and bidders are to operate, with limited Commission interference. The Commission does not intend to usurp the utility's management function. Nor is the Commission Staff available to any bidder to investigate and take sides on any issue that may arise. In a rate proceeding, if a utility has not behaved in a prudent manner, the Commission will affect the financial consequences of that behavior.

(Fifth Supplemental Order at 13, Docket No. UE-921065 (January 24, 1994).)

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[3] In its Fifteenth Supplemental Order on rehearing and procedural matters, the Commission affirmed its Eleventh Supplemental Order regarding Puget's failure to meet its burden of proof regarding the prudence of its recent resource acquisitions.

The Commission has consistently stated in this and prior cases, that the proper forum which could affect the financial consequences of these particular resource acquisitions by Puget, is the current rate proceeding.[4]

B. Summary of Staff Position.

1. Prudence.

The Commission Staff conducted an in-depth review of the Company's direct and rebuttal cases, Company responses to all data requests, and twenty boxes of additional documents which the Company agrees demonstrates the decision making process actually undertaken by Puget in acquiring the resources under review.[5] (Tr. 5223.) Staff concluded that the information provided by the Company does not demonstrate the prudence of its purchased power

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[4] See, Tr. 5628-5631; Eleventh Supplemental Order at 22; Seventh Supplemental Order at 2, Cause No. U-85-87 (June 1, 1992).

[5] The Company claims that the twenty boxes of documents contain the "good stuff" concerning its evaluation of the projects subject to this prudence review. (Tr. 5222.) The documents, however, were in such disarray that they provided disturbing insight into the Company's decision making process. (Tr. 5884-5886; Ex. 2159 at 113.) The documents often contained multiple copies of the same item and even included a copy of a Commission transportation rulemaking. (Tr. 5911.) The documents also did not contain interim evaluations and other ancillary items which were not kept when Company personnel changed jobs or left Company employment. (Ex. 2229, Data Request No. 5383.)

More important, the emphasis of the documents was upon ensuring the development of those projects the Company had already selected, rather than a systematic review of the evaluation criteria and characteristics of all competing bids and Company build options prior to the selection of a resource. (Tr. 5885, 6002.) Even the Company agrees that more explicit documentation of decisions made and issues evaluated would enhance the record. (Tr. 6323; Ex. 2229, Data Request No. 5383.)

contracts in three categories:

* Projects Selected from Responses to the 1989 Request for Proposals (RFP): Encogen

* Projects Selected After the 1989 RFP But Outside the Competitive Bidding Process: Tenaska, March Point Phase II and Sumas

* Projects Selected Prior to the 1989 RFP But Not Associated with a Qualifying Facility: Montana Power[6]

In fact, Staff's review demonstrates just the opposite: the Company's process for evaluating its resource acquisitions, including what it considered, how it performed the evaluation, and how it documented its process, was inadequate and unsatisfactory especially considering the financial magnitude of the ensuing decisions. (Ex. T-2155 at 17; Ex. T-2170 at 2 and 5.)

More specifically, there was no direct comparison between the Company's own options for constructing new resources and the power contracts being offered. (Tr. 5929, 5931.) The comparison of build options and purchased power options was limited exclusively to a simple application of the Company's filed avoided cost which the Commission had already found unacceptable. (Ex. 2010 at 14-15.) This comparison is contained in Exhibit 2259 which merely

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[6] Staff does not take issue with a fourth category of resource acquisitions: Qualifying Facility agreements executed prior to Puget's first competitive bid in 1989. (Ex. T-2155 at 14.) These contracts were executed during the period when avoided costs were administratively determined under Chapter 480-105 WAC. These contracts are the purchases with Koma Kulshan, March Point Phase I and Spokane Regional Solid Waste Disposal.

calculates the levelized contract rate and avoided cost for each disputed contract without adjustments for the various characteristics of each contract, including dispatchability, and financial and rate impacts. (Tr. 5758, 5932, 5981.) Furthermore, with the exception of Sumas, the avoided cost calculation utilized a coal plant as a proxy resource, not a combined cycle combustion turbine ("CCCT"). (Exs. 2013.) The Company did not incorporate the costs of a CCCT into its avoided cost filings until after the Tenaska, Sumas and March Point Phase II contracts had been executed. (Tr. 5929, 5931.)

Second, the Company's evaluation process did not provide for meaningful and appropriate consideration of characteristics affecting the long-term value of a resource. (Ex. 2110 at 9.) Puget failed to adopt a formal system for ranking the value of various resource characteristics or providing weight to each class of characteristics. (Ex. 2111, Data Request Nos. 5303, 5304, 5307, 5310 and 5322; Tr. 5994-5998.) Lacking a comprehensive evaluation system, Puget was unable to document why one purchased power option was selected instead of another or one of its own build options.[7]

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[7] The Company instead relied upon brief, after-the-fact summaries of the characteristics of each resource, but failed to demonstrate how it evaluated these characteristics or directly considered them in reaching a resource ranking. (Ex. 2022, 2043, 2032, 2037.) An exchange between Company counsel and Mr. Winterfeld concerning developer reliability is representative:

> Q. So you're stating it was made after the fact even though...the final results of the RFP states that "Enserch Development Corporation and affiliated companies including Ebasco have

Instead, the Company's process was a proverbial "black box": resource attributes go in and a ranking and selection come out. (Ex. T-2170 at 24.)

> completed many similar generation projects. They have demonstrated an understanding of licensing and environmental issues which a project this type can raise." Is that the sort of after the fact explanation you were referring to?
>
> A. Exactly. That is exactly it, because that statement could have been made about any one of the developers and there's no way to indicate to what extent that the particulars of those developers weighted any more in favor of that particular project than another name like Bechtel or Fluor would have weighted in favor of another development. The question is was there a ranking of developers that said specifically this developer was given the highest rank as the most reliable of the developers and therefore had the highest probability of success through a ranking of those developers that were lower ranked because they lacked experience and therefore had a lower probability of successfully developing the project. And having had that ranking how that ranking then bore on a specific decision to select one developer over another given all the factors that might be similar or different between them.

(Tr. 5994-5995.)

The Company also failed to quantify and document the specific cost impacts of many items such as dispatchability, transmission losses, and other non-price factors. While the Company purports to have "considered" these items in its evaluation, they were not converted into an increase or decrease in the estimated cost or equivalent value of a particular purchased power option.[8] Leaving the inclusion of these factors to judgmental consideration by the individuals involved in the internal discussions, assured that the Commission and other parties can never know which factors were actually considered and, even if they were, whether they were given too much or too little weight, or were even considered at all. (Ex. T-2170 at 6.)

Third, the Company provided no substantial support - prepared either before or after the fact - for key presumptions that were apparently relied upon in making several resource decisions. Examples of these largely unsupported presumptions are: (i) that an increase in the price of available resources was imminent in

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[8] The Company made several ad hoc calculations of dispatchability savings. Mr. Lauckhart refers to an estimate of approximately 2 mills/kWh for dispatchability savings in 1994. (Ex. T-2010 at 38.) This estimate, however, was prepared by the Company in November 1993. Puget also provided an estimate prepared in May 1991 showing the savings from displacement varying from 4.72 mills/kWh to 0.03 mills/kWh during the period 1993-2100. (Ex. T-2170 at 15.)

Both analyses occurred after the evaluation of the 1989 bids and the 1990 supplemental bids. (Ex. 2168, Attachment 1 at 3; Ex. 2224; Tr. 5233, 5238-5234, 5715 and 5721.) Again, the Company did not adjust its equivalent avoided cost for the differential effects of dispatchability in evaluating its purchased power options. (Tr. 5758, 5932, 5981.)

1990 and early 1991; (ii) that a power purchase must be backed by a firm fuel supply, even if it required firm prices and significant minimum take requirements; and (iii) that a provision in certain contracts for a 50/50 sharing of savings from displacement was appropriate when providing a smaller share to the project owner would have provided greater benefits to ratepayers.[9] (Ex. T-2170 at 7; Tr. 6394.)

2. Ratemaking Treatment.

Given the Company's failure to adequately support the prudency and reasonableness of its resource acquisitions, Staff was necessarily required to focus upon ratemaking consequences so that ratepayers would be held harmless. (Ex. T-2155 at 5; Tr. 5984.) Staff presented two methods to determine the amount of expenses to be disallowed from rates associated with these resource acquisitions. Both methods were based upon an estimation of the value of the power in relation to its cost. (Ex. T-2170 at 2.)

The first method equated the value of the power purchases with the lowest cost build option(s) that Puget estimated it could put into operation within a comparable time frame and that would produce power with similar characteristics. Based upon information and cost ranking provided in two then-contemporary resource planning documents - the 1989 and 1991 Integrated Resource Plans

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[9] For example, when the Company negotiated its contract with Encogen it insisted upon the 50/50 sharing of displacement savings now specified in the contract even though Encogen offered a 90/10 split favoring ratepayers. (Tr. 5052.)

(Exs. 2005 and 2006, respectively) - and the Company's 1991 Avoided Cost filing, the costs of a combined cycle combustion turbine ("CCCT") was the lowest cost comparable alternative for power available to the Company during the 1989-1992 time period.[10] (Tr. 5922, 5926.)

Based upon data from these same documents, Staff incorporated the cost of a CCCT, and adjusted for dispatchability (using BPA estimates published in its January 1991 RFP), capital structure impacts, and end-effects of the purchased power agreements on Puget's overall rate of return, to calculate either a 1989 or 1991 base-year equivalent generation cost associated with the Montana

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[10] Appendix D, Table 2 of the Company's 1989 IRP provides a ranking of resource options based on their levelized revenue requirements. The four highest ranked resources are small hydroelectric projects which, due to their size, output and limited availability, cannot be considered alternatives to the fossil fuel-fired projects being purchased by Puget. The resource option with the next highest ranking was a CCCT which had a levelized cost of 64 mills/kWh versus 71 mills/kWh for a coal fired steam turbine (both in nominal dollars with a 1989 in-service date). The scenario analyses presented in the 1989 IRP also confirm that a CCCT was the lower cost option as compared to coal-fired generation for capacity additions made prior to the year 2000. For example, under the "Boom" scenario, about 1000 aMW of CCCT capacity is added through 1999, but no coal-fired capacity is added until after 1999. (Ex. T-2170 at 11.)

The 1991 IRP also ranked a CCCT as the lowest cost option among non-hydro resources. The levelized cost of power from a CCCT was estimated at 55 mills/kWh versus 77 mills/kWh for a coal-fired steam turbine (both in nominal dollars with a 1991 in-service date). The Company's 1991 Avoided Cost filing also assumed development of a CCCT, rather than a coal-fired steam turbine, and used many of the same data contained in the 1991 IRP. (Id. at 12.)

Power, Encogen, March Point Phase II, Sumas, and Tenaska contracts.[11] (Exs. 2192 and 2193.) The equivalent generation cost was then compared to the levelized contract rate of each purchased power contract. (Ex. 2191.) This comparison demonstrated that the cost of the March Point Phase II, Sumas and Tenaska contracts exceeded their value by a considerable margin: $103 million combined net present value over the lives of the contracts. (Ex. 2191, column (b) versus (d); Ex. 2197, column (c).) No adjustment was calculated for Montana Power since its levelized contract rate was less than the 1989 equivalent cost of generation. (Ex. 2191, column (b) versus (c).) Nor was an adjustment made for Encogen since its levelized contract rate was close to the 1989 equivalent generation cost and it was acquired during a pilot competitive bidding process of Chapter 480-107 WAC. (Ex. T-2155 at 15; Ex. 2191, column (b) versus (c).)

The second method proposed by Staff utilized the proposals received by the Company in response to its 1991 RFP to estimate the

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[11] The 1989 base-year equivalent generation cost incorporates the cost of a CCCT with a start-up date of 1996. (Ex. 2172 and 2173.) The analysis also includes the energy and capacity prices contained in the Company's May 1989 forecast of avoided cost for the years 1989-1995. Sumas was not analyzed using the 1989 base year consistent with Puget's analysis of that contract using the 1991 avoided cost filing. (Ex. T-2188 at 6.)

The 1991 base-year equivalent generation cost is consistent with the 1989 analysis as to the costs of a CCCT, and dispatchability and end effect adjustments. The energy and capacity costs for 1989-1992 come from the Company's 1991 avoided cost filing. The BPA New Resource rate was used for the years 1993-1995. (Ex. T-2188 at 12.)

value of Puget's 1990 purchases of Tenaska, March Point Phase II and Sumas outside the Commission's formal competitive bidding process. This method is appropriate given Puget's failure to demonstrate why it was reasonable and in ratepayers' best interests to acquire resources outside the competitive bidding process, rather than waiting to evaluate proposals that would be offered in its 1991 solicitation.[12]

The cost of the 1991 RFP proposals could be based on the second least expensive of those proposals that provided power of similar quality and similar characteristics. This option results in a ratemaking adjustment of $315 million net present value over the life of the Tenaska, March Point Phase II and Sumas contracts. (Ex. 2191, column (f); Ex. 2197, column (g).) Alternatively, the cost of the 1991 RFP proposals could be based upon an average of the proposals, again, providing power of similar quality and

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[12] The Company's summary of the initial 1991 competitive bid results indicate that twelve medium and large sized gas-fired cogeneration or gas-fired Independent Power Producer projects were short-listed by Puget. (Ex. C-2194.) Most of those projects exhibited similar, favorable characteristics to the Company's 1990 purchases outside the formal competitive bidding process including an established developer, good steam hosts, fixed rates, no front-loading, little on no wheeling concerns, adequate security and West-side location. (Tr. 6064; Ex. T-2188 at 15.) All were rejected by the Company, however, even though many were offered at 60 percent of the Company's avoided cost. (Tr. 5728, 5854, 5896.) Size was the principal negative characteristic given for Puget's rejection of eleven of the twelve projects which, therefore, could have been purchased had the Company not acquired Tenaska, March Point Phase II and Sumas. (Ex. 2168, Attachment 4 at 2; Ex. 2072, Attachment at 4; Ex. T-2188 at 11 and 14; Tr. 5778, 5877.) In fact, the Company's 1990 purchases outside the formal competitive bidding process limited its 1991 RFP to resources under 70 aMW. (Tr. 5122.)

characteristics. This results in a ratemaking adjustment of $199 million net present value over the life of these same three contracts. (Ex. 2191, column (e); Ex. 2197, column (e).)

Of the two options presented, Staff recommends adjusting the March Point Phase II, Tenaska and Sumas contracts on the basis of the estimated 1991 base-year equivalent generation cost. (Ex. 2191, column (d); Ex. 2197, column (c).) This approach results in the lowest disallowance of power supply expense presented by Staff ($103 million net present value). It also addresses Staff's concerns that the Company acquired resources outside the competitive bidding process without supporting its claim of a limited "window of opportunity" in which to make advantageous purchases of "lost opportunities," and without a formal and documented process for evaluating its resource acquisitions, including the calculation of the equivalent cost of generation to be used in such an evaluation. This approach also eliminates or minimizes the effect of applying information retroactively since it is based upon documents and data available to Puget at the time it made its resource decisions. (Tr. 5803, 5942, 5362, Ex. 2174 at 7, 22, 27, 30 and 46.)

3. BPA Sale.

The Company also failed to demonstrate the prudence of its sales agreement with BPA. The Company failed to present any evaluation--prepared either before or after the fact--as to the extent of the financial risks that may be associated with the sale

due to changes in Puget's retail load, hydro conditions, gas prices, and other relevant factors. (Ex. T-2170 at 9-10.) Ratepayers should, therefore, be held harmless with respect to any adverse impacts of the sale on the Company's rates. To the extent it can be shown in future general rate cases or PRAMs that the BPA sale has or will result in a cumulative increase in Puget's net power supply expenses, an offsetting adjustment should be made to negate that impact.

C. Burden of Proof.

In prior orders the Commission clearly, correctly and repeatedly reminded the Company of its affirmative burden to prove the reasonableness and prudence of its purchased power contracts in this docket. (Eleventh Supplemental Order at 18-19; Fifteenth Supplemental Order at 18-19; Tr. 5055.) The Commission flatly rejected the Company's argument that the Company enjoys a presumption that its resource acquisitions were reasonable and that such presumption alone is sufficient to satisfy its burden of proof unless an opposing party raises serious doubts about an expenditure. (Tr. 6221.) The Commission also flatly rejected the Company's standard that the prudence of a competitively bid purchased power contract comes into question only when the Company acts in bad faith or mismanages a contract's selection, evaluation or enforcement. (Tr. 6222.)

Staff, therefore, hoped that the Company had finally understood that the burden of proof rests solely and squarely upon

Puget even in the absence of a challenge by another party. We were wrong. Despite the Commission's prior admonitions, the Company presented the testimony of Dr. O'Connor to evaluate Puget's decision-making process and gave him specific instructions to discuss and apply the exact standards concerning burden of proof which the Commission had already rejected in no uncertain terms. (Tr. 6224-6225.) Dr. O'Connor's "Independent Evaluation," therefore, presumed that the Company's decisions were reasonable and prudent which alone was sufficient to satisfy the Company's burden of proof. Dr. O'Connor's "Independent Evaluation" also required a showing <u>by other parties</u> of bad faith or mismanagement by Puget in order to conclude that the Company had been imprudent. (Tr. 6220.)

The Company's refusal to acknowledge its burden of proof in this case does end here. Having performed his evaluation on the basis of certain guidelines which Dr. O'Connor and the Company knew had already been rejected by the Commission (Tr. 6221-6222), Dr. O'Connor then concluded that process is unimportant because the "results being considered in this case are, by any objective standard, quite good" even "excellent."[13] (Ex. T-2226 at 5-6.)

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[13] Dr. O'Connor, therefore, echoed the Company's sentiments that the Commission should not be concerned with prudence since the projects have not failed and are operating as expected. According to Puget, its decision making process is a secondary concern and, then, only if the results of its resource acquisition program are bad. (Tr. 5055.)

Again, the Commission's establishment of the prudence review despite its prior knowledge of the successful operation of the projects, demonstrates its rejection of this Company standard as

Dr. O'Connor's "objective standard," however, again is one the Commission had already warned is inadequate; namely, that the contracts were acquired at less than Puget's avoided cost, and the projects were completed on a timely basis and are operating reliably. (Ex. 2229, Data Request Nos. 5373 and 5374.)

Furthermore, Dr. O'Connor's "Independent Evaluation" was based upon interviews with Company officers and Company staff, many of them already witnesses in this case, and did not begin until mid-May, after Staff and Public Counsel had filed their cases challenging the Company's resource acquisitions. (Tr. 6222-6223.) Dr. O'Connor did not interview anyone on Commission Staff even though much of his testimony vehemently accused Staff of ambushing the Company after various meetings between Puget and Staff concerning certain resource acquisitions. Under such circumstances, Dr. O'Connor's decision to review only written notes taken by Staff during these meetings is the epitome of bias, not independence.

The Company rested the credibility of its decision-making process largely upon Dr. O'Connor's "Independent Evaluation." That evaluation, however, was tailored to reach the desired conclusion that the Company's decisions were reasonable and prudent. Dr. O'Connor's evaluation and conclusions should be flatly rejected.

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well.

III.

ARGUMENT.

A. The Company Once Again Failed to Demonstrate the Prudence of Its Resource Acquisitions.

1. The Company's "Successful Operation" Standard is Useless in Determining the Prudence of a Resource Acquisition.

Staff used two benchmarks to test whether any adjustment to the allowable costs of each contract should be made. In fairness to the Company, both benchmarks were developed in order to eliminate or minimize the retroactive application of information. (Tr. 5803, 5942, 5362; Ex. 2174 at 7, 22, 27, 30 and 46.) The Company, however, seeks to twist information retroactively in its favor when it argues that its acquisitions should be given greater value because they are all operating successfully. (Tr. 5005.) There are several obvious flaws in the Company's argument that successful operation should be used by the Commission in judging the prudence of resource acquisitions.

First, if successful operation is to be used in judging prudence, then the issue of prudence could only be determined at the end of the resource's life. Under the Company's "successful operation" approach, the resource would lose value and may ultimately be determined imprudent if the life turned out to be less than expected or the costs were higher than expected toward the end of its life. Like a day of reckoning, the Company would never know what, if any, financial penalty it may suffer until the final kW and kWh was produced by the resource. Obviously, Puget

would not advocate this "day of reckoning" approach. Instead, it seeks to create a hybrid of its own advantage, a partial retrospective approach: look at the relative success of a resource's operation beyond the decision to acquire the resource, but only up through the first general rate case.

Regardless of whether or not use of retrospective information is fair to the Company from the standpoint of ratemaking, it is useless from the standpoint of judging the prudence of a resource decision. No one will know whether or not the proposals rejected by the Company could or would have been successfully developed.

The Company's case insinuates that since these rejected projects are not now operating, while the ones it selected are operating, the Company somehow made the right choice. With Exhibit 2014, the Company more directly tries to show that there are vast odds against the successful development of a Qualifying Facility or Independent Power Producer. Looking past the large numbers intended to hold the reader's attention, the exhibit, in fact, shows just the opposite from what the Company would have us believe. Of projects initially selected by a utility, only 21 percent, or about 1 in 5, had not been developed. (Tr. 6082.) Further, of those not developed, there is no indication in the exhibit how many may have been unsuccessful simply because the utility delayed negotiations or canceled the project entirely. (Id.)

Finally, the Company's touting of the successful operation of its selected resources must be tempered by the realities. It is clear that one project, Sumas, would likely not have successfully operated, or operated at all, without the Company's agreeing to major revisions to the original contract, thereby allowing the developer to expand by more than two-fold the capacity of the original project.[14]

2. The Company Confuses the Description of a Characteristic With the Evaluation of a Characteristic.

The Company attempted to show on cross-examination of Staff using a "check-off" system, that it had considered the factors cited by the Commission, such as financial and rate impacts, dispatchability, and transmission losses. Staff did not argue, however, that these factors were never considered by the Company. Instead, Staff argued that (i) the Company did not document how these factors were considered in ranking resources (i.e., how they were evaluated and how much weight was given one factor versus another), and (ii) the extent of the undocumented, qualitative consideration given most of these factors by the Company had already been made known to the Commission prior to its Eleventh Supplemental Order and found unpersuasive. (Ex. T-2155 at 4 and 11; Ex. 2159 at 81-88.) Therefore, Staff concluded that the brief summary of the qualitative attributes of each resource acquisition

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[14] The initial Sumas project was a 50 MW wood waste project that encountered financing difficulties. The developer, therefore, increased the output to the 110 MW cogeneration facility purchased by Puget. (Ex. T-2155 at 26.)

provided in Mr. Lauckhart's Exhibits 2022, 2032, 2037 and 2043 did not go substantially further than the Commission had already seen, and, although perhaps better organized, did not respond to the Commission's concerns as to how both price and non-price factors were evaluated in resource rankings.

Furthermore, the Company's "check-off" process confuses the description of characteristics with the evaluation of characteristics. (Tr. 5888, 5898, 5900.) The Company described the characteristics of each resource, but did not show how it evaluated these characteristics or directly considered them in reaching a resource ranking. Moreover, the admission that the ranking of resource was done through nothing more than a "robust discussion" reveals almost certain lack of uniformity in their consideration, since there were no guidelines provided to the participants in the internal discussion as to how the resource characteristics were to be used in the ranking process. (Tr. 5024.)

The Company's response to the issue of dispatchability is representative. The Company argues that dispatchability was "considered" along with all the other characteristics that went into the hopper of "robust discussion," but that it simply was not considered to be very valuable. (Ex. T-2010 at 38.) Puget cannot claim, however, after-the-fact that there was little value to dispatchability based on analysis also clearly done after-the-

fact[15] in an effort to justify the before-the-fact shortcomings of its ranking process. Staff showed that information from BPA indicated that the benefit of dispatchability can be substantial. (Ex. 2173.) If it had prepared its own analysis and supported its assumptions and methodology, Puget could have justified a different conclusion prior to or as part of its resource evaluation. The fact is, however, that the Company is now caught like the school boy having failed to do his homework and trying to explain to the teacher why he doesn't have a paper to turn in, while the rest of the class has come prepared. Analysis and explanation prepared after-the-fact are inevitably and justifiably marred with the suspicion of self-service and should not be considered as part of the evidence supporting the prudence of the Company's decisions, for much the same reason that other information received or developed retrospectively should be rejected.

3. Conditions of the Natural Gas Industry in the Pacific Northwest Disfavored the Company's Purchases of Tenaska, March Point Phase II and Sumas.

The Company claims that it would have been imprudent to wait to receive offers from its 1991 RFP, rather than purchasing the Tenaska, March Point Phase II, and Sumas resources, given conditions in the natural gas industry at the time these decisions were made.[16] The Company also states that the pricing terms of the

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[15] See, supra at f.n. 8.

[16] The Company refers to pipeline constraints, shrinking gas supplies and rising gas prices. (Ex. T-2241 at 8 and 9.) However, when asked for all documents, studies and analyses which

contracts for these same resources shift the risks of fuel price increases from its ratepayers to the project developers which represents a value that should be recognized. (Ex. T-2241 at 5 and 9.)

That value, of course, comes at a cost to ratepayers which the Company did not document as to how it was considered in the ranking process, if, indeed, it was considered at all. (Tr. 5994-5995.) Furthermore, there is no evidence to suggest that Puget pursued, or even evaluated, its own acquisition of firm gas supplies, even though it had similar opportunities as the project developers to do so. (Tr. 5707, 5883.)

The evidence only demonstrates that Puget admitted grossly inadequate knowledge of and experience with the natural gas industry which caused it to blindly rely on project developers for the acquisition of gas supplies. (Tr. 5785, 5805, 6225-6226.) The Company was, therefore, forced to employ the services of Mr. Premo to provide after-the-fact testimony regarding conditions in the natural gas industry about which the Company admitted ignorance at the time it made its resource acquisition decisions.

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demonstrate that pipeline constraints existed or were expected to exist at the time these resource acquisition decisions were made, the Company merely provided a copy of an article from "Clearing Up." (Ex. 2245, Data Request No. 5397; Tr. 6297.) When asked for all studies, documents and analyses which support the proposition that natural gas was in short supply in the Pacific Northwest when Puget was considering acquiring these resources, the Company confirmed that its testimony only discusses expectations for events which would occur <u>when</u> gas shortages exist, <u>not</u> that gas shortages actually did or were expected to exist. (<u>Id.</u> at Data Request No. 5395.)

Mr. Premo's testimony, however, is not helpful to the Company's case. In fact, Mr. Premo agreed that Puget could have pursued its own gas supplies, rather than relying on project developers. (Tr. 6286.) He also admits that the Company should have been aware of conditions in the natural gas industry at the time it made its resource decisions. (Tr. 6264.)

Furthermore, Mr. Premo could not testify either to the extent of the Company's knowledge of the natural gas industry, or how any such knowledge was used by Puget at the time it made its resource decisions. Mr. Premo did not review all of the documents made available by the Company to demonstrate the decision-making process it employed. (Tr. 6264-6265.) When specifically asked to provide documentation as to how Puget factored the information included in his testimony in the Company's decision-making process, Mr. Premo gave no response. (Tr. 6266.) Mr. Premo did not begin working on the natural gas issues related to the March Point Phase II, Tenaska and Sumas resources until May 28, 1994, and did not communicate any of the information contained in his testimony to Puget prior to that date. (Tr. 6266-6267.) Nor did Mr. Premo, his present firm or his prior firm conduct other work in connection with the resource acquisitions subject to this prudence investigation. (Tr. 6277-6279.)

Most important, Mr. Premo's testimony fails to take into account conditions of the natural gas industry that were unique to the Pacific Northwest at the time the Company made its resource

acquisition decisions. First, in June 1988, Northwest Pipeline Corporation ("Northwest") accepted a blanket certificate to provide unbundled interstate transportation. That event allowed Northwest's customers an unlimited opportunity to convert sales service to transportation service. Northwest shed 1,163,567 MMBTu's/day of firm gas sales as a result of that conversion. (Tr. 6268-6269.) Northwest shed an additional 76,832 MMBTu's/day in sales service when its customers' service agreements expired in October 1989 and allowed those customers another opportunity to convert from sales to transportation. (Tr. 6269-6272.)

Consequently, by the end of 1989, gas producers, who had previously committed supplies to Northwest possessed 1,240,399 MMBTu's/day of additional supplies to sell to any market they could find, including markets in the Pacific Northwest that could only be served through Northwest. (Tr. 6271-6272.)

Second, when Northwest's customers renewed their service agreements after October 1989, Northwest lost approximately 168,000 MMBTu's/day in combined sales and transportation daily demand. (Tr. 6273.) That released capacity could have been used by Northwest to provide sales or transportation service to local distribution companies or other end-users in the Pacific Northwest. (Tr. 6273.)

Third, in February 1990 Northwest conducted an "open season" in which it asked its shippers to identify their needs for additional firm capacity so that any system expansion undertaken by

Northwest would meet the needs of the market. (Ex. 2245, Data Request No. 5397 at 2.) Northwest also indicated its willingness to execute minimum ten year firm transportation agreements with any shipper consistent with the shipper's stated needs. (Id., Data Request No. 5397 at 3.) As a result of this "open season," Northwest expanded its system by 25 percent. (Tr. 6300.)

These significant developments enhanced the Company's ability to acquire firm gas supplies and transportation capacity for operation of Company owned gas-fired generation. They also should have given the Company reason to pause and fully evaluate waiting until the 1991 RFP, rather than rushing into the purchases of Tenaska, March Point Phase II and Sumas with nothing more than unsupported feelings of anxiety and urgency. (Ex. T-2155 at 25.) These developments are not, however, mentioned by Mr. Premo.

Mr. Premo's testimony, therefore, paints a picture of conditions of the natural gas industry which not only comes after-the-fact, but which also is grossly incomplete. His testimony should be given little, if any, weight by the Commission.

4. The 1990 "Supplemental Bidding Competition" Was Far From Competitive.

In 1990, Puget acquired the Tenaska and March Point Phase II resources outside the Commission's formal competitive bidding process contained in Chapter 480-107 WAC. The Company seeks to gloss over this fact by characterizing these events as a "supplemental bidding competition." (Ex. T-2010 at 52.)

There is little, if anything, about the supplemental bid which was truly competitive. First, there are many important differences between the Company's supplemental bid and the formal process of competitive bidding under Commission rule. Under WAC 480-107-010, the Company must submit its long-run prototype contracts. The Company must also file its RFP and stream of avoided costs for Commission review to ensure consistency with the resource needs identified in the Company's most recent IRP. (WAC 480-107-040, and .050.) The filing of the RFP is then subject to public comment and review before a determination is made by the Commission that the RFP is consistent with the public interest. (WAC 480-107-060.) None of these processes occurred in the Company's decision to acquire Tenaska and March Point Phase II. (Tr. 5161, 5736, 5742-5743, 5894, 5896.)

Second, the Company's supplemental bid solicited proposals only from bidders who had been unsuccessful in the 1989 RFP and from certain other project developers familiar to Puget. The Company did not solicit bids from a broader, perhaps national, pool of potential developers. (Tr. 5093-5094, 5161.)

Third, the price Puget was willing to pay for a new resource was pegged to a crude, out-dated estimate of avoided cost. Puget merely informed developers that it would accept proposals no higher than 92.5 percent of the Company's 1989 avoided cost which utilized a coal facility as a proxy resource. (Tr. 5751; Ex. C-2246; Ex. T-2155 at 23.) Puget did not, however, recalculate its avoided cost

to ensure that it was an accurate and contemporaneous measurement of its incremental cost of alternative energy. There is, therefore, no basis upon which to conclude that the 92.5 percent target served as an appropriate ceiling for consideration by project developers, let alone an appropriate benchmark for acquiring more power under take-and-pay contracts with limited dispatchability benefits. In fact, decreasing interest rates and increasing opportunities to secure stably priced fuel should have suggested to Puget that the 92.5 percent target was excessive.[17] (Ex. 2159 at 90-91.)

The Commission's competitive bidding rules do not preclude a company from acquiring resources outside the formal processes established by those rules. The Company, however, simply decided to acquire additional resources outside those processes even though it admitted that it could have waited until its 1991 formal bidding cycle. (Tr. 5121.) This decision was made without any reasoned evaluation that ratepayers would clearly benefit, and without any reasoned assessment of the impact that decision might have on the

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[17] The Company insinuates that the supplemental bid was competitive because no bidders complained to the Commission that the 92.5 percent ceiling was too low. (Ex. 2159 at 103.) As Mr. Elgin explained, however, silence by the bidders, if anything, implies that the price Puget was willing to pay was too high. (Id.) This is indirectly confirmed by the fact that the supplemental bid nearly doubled the amount of power offered in the 1989 RFP from 1200 aMW to over 2200 aMW. (Ex. T-2241 at 17.)

integrity of the upcoming 1991 RFP and the future development of a competitive market for electric generation in Washington.[18]

B. The Company's Power Contracts Should Be Adjusted for Ratemaking Purposes According to Equivalent Cost of Generation Methodology Proposed by Staff.

1. Staff's Use of a CCCT in Determining the Equivalent Cost of Generation Was Valid.

The Company assumes that it is Staff's position that the Company should have built a CCCT, instead of acquiring its purchased power contracts. (Ex. T-2226 at 18.) The Company then devotes the majority of its rebuttal case to an effort to rebut the position it claims Staff had taken.

The Company's assumption, however, is a gross mischaracterization of the Staff case. (Tr. 5796, 5936-5937.) Staff does not believe the Company was imprudent because it did not construct a CCCT. Staff only utilizes the costs of a CCCT to calculate a ratemaking disallowance after concluding that the Company had failed to present evidence supporting the prudence of its decisions. (Ex. 2159 at 20.)

Furthermore, Staff's use of the costs of a CCCT for ratemaking purposes was the only logical and supportable option available. First, according to the Company's 1989 and 1991 IRPs, and its 1991 Avoided Cost filing, a CCCT was the lowest cost, comparable alternative for power available to Puget. (See, supra at f.n. 10.)

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[18] In fact, the purchases which resulted from the 1990 supplemental bid precluded Puget from evaluating several equally attractive, but less expensive, large gas-fired cogeneration projects offered in the 1991 RFP. See, supra at f.n. 12.

Second, the Company's planning documents assume the addition of CCCTs over coal-fired generation. For example, the 1989 IRP relies upon a CCCT for all scenarios except the "Economic Bust" scenario. (Ex. 2005 at Chapter 5: Tr. 5134-5135.) The most efficient CCCT was 50 percent less costly than a coal plant according to the same IRP. (Tr. 5137.)

The 1989 IRP also calls for the Company "to pursue cost effective natural gas supply for use in combustion turbine generating stations on a firm and non-firm basis." (Ex. 2005 at 49.) The Company concluded that natural gas supplies and transmission capacity are sufficient to support 1000 aMW of new CCCT baseload generation, which then became a part of the Company's Action Plan. (Id. at 20, 49 and 53; Tr. 5952-5953.)

In 1990, the Commission Staff recognized that the Company had done a sufficient job of accounting for any uncertainties in natural gas pricing and availability in its planning assumption to create 1000 aMW of new CCCT capacity. (Ex. 2165 at 71.) Staff's incorporation of the costs of a CCCT in its ratemaking disallowance in this case is, therefore, entirely consistent with that prior position. (Tr. 5951-5955.)

2. Staff's Use of BPA Estimates of Dispatchability is Valid.

Both Staff and Public Counsel propose adjustments based on estimates of dispatchability calculated in 1990 and contained in a BPA RFP published in January 1991. (Ex. 2173, column (a); Ex. 2175; Tr. 5957.) The BPA estimates were utilized by Staff because

they were issued contemporaneously with Puget's resource acquisition decisions, and they provided a reasonable measurement of the benefits of dispatchability given the Company's failure to timely perform its own measurement of those benefits. (Tr. 5959, 5962.) The specific estimate of dispatchability incorporated by Staff was 4.5 mills/kWh based on variable costs of 20 mills/kWh.[19] (Ex. 2175.)

The Company claims that BPA's estimates cannot accurately be compared with Puget's relative benefits. (Ex. T-2247 at 6.) The Commission, therefore, must judge whether or not the analysis of BPA is of a sufficient and appropriate level of accuracy to substitute for the analysis which Puget failed on its own to perform regarding dispatchability. Staff and Public Counsel have obviously determined that it is. This leaves the Commission with four alternatives: (i) accept the Company's criticism of the application of BPA's analysis and reject any dispatchability adjustment; (ii) accept the modification of the dispatchability adjustment as presented by Mr. Litchfield in rebuttal; (iii) accept

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[19] The values of dispatchability estimated by BPA was based on variable costs ranging from 5 to 35 mills/kWh. The stream of annual adjustments calculated by Staff is based on variable costs of 20 mills/kWh in levelized, 1990 dollars, or about 39 mills/kWh in levelized, nominal dollars. This is comparable to the estimated fuel cost for a CCCT of 41 mills/kWh in the Company's 1990-1991 DARE report, and the 36 mills/kWh in the Company's 1992-1993 IRP and 1991 Avoided Cost filing. (Ex. T-2170 at 17.)

Staff's adjustment; or (iv) accept Public Counsel's adjustment.

a. The Company's Criticism of BPA's Analysis Should Be Rejected.

The Company argued that the results of the BPA evaluation were inappropriate for Puget because (i) BPA controlled much more of the region's surplus; (ii) BPA controlled much more of the region's transmission system and did not have to make payment to another party for its use to sell surplus; and (iii) Puget's access to regional surplus was further limited by the preference given to publicly owned utilities in BPA's marketing. (Ex. T-2247 at 6-8; Ex. T-2250 at 4-5.) On cross examination, however, Mr. Winterfeld and Dr. Blackmon argued that the first two factors did not change their judgement as to the applicability of the BPA results. They argued that ownership of the surplus being generated was not significant to the analysis; rather, it was the price of non-firm energy sold to the Northwest and California bulk markets, since this price set the value of energy to both sellers and buyers. (Tr. 5972-5974.)

As to the second issue, the cost of transmission to market surplus, Mr. Winterfeld correctly noted that the fact that Puget may have to pay transmission charges to BPA to market its own surplus energy actually increased the value of dispatchability relative to BPA, since the transmission charges reduced the net price received by Puget for off-system sales to California within a given market condition, thereby increasing the value received from dispatchability and increasing the frequency with which it

would be used. (Tr. 5975.) Of course, when purchasing from the vast surplus being marketed, in Puget's caricature, by BPA, transmission costs are not an issue since Puget is directly connected with BPA.[20] (Tr. 5974.)

As to the third issue, BPA's preference given to publicly owned utilities, there is no evidence that the public preference in marketing of surplus by BPA has any significant impact on the amount of surplus accessible to Puget. BPA's past records show that little non-firm energy has been sold to Northwest publicly owned utility systems. Of the non-firm energy sold by BPA between 1988 and 1993, investor owned utilities purchased more than 94

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[20] The Company's case insinuates that the value of dispatchability depends on the difference between the acquisition price of surplus energy and the variable cost of operating a resource. That is, if BPA generates most of the region's surplus at an acquisition cost of zero (since extra water through a turbine has no variable cost), it receives more value from dispatchability than a utility that has no or, little surplus energy. This is not the case, however, as a moment's reasoning will show. Suppose BPA and utility PNW each are operating their own 200 MW combustion turbines having variable cost of 20 mills/kWh. Also, suppose that BPA has 200 MW of surplus energy to dispose of in an hour and PNW has none, but the price of non-firm energy in the market in that hour is 19 mills/kWh. If BPA chooses to sell its surplus to PNW, the value of dispatchability to PNW for its CCCT is the difference between the variable cost of operating its CCCT and the market price of non-firm energy, or 1 mill/kWh. Likewise, if BPA chooses not to sell its surplus, but instead shuts down its CCCT, the value of dispatchability to BPA is still 1 mill/kWh, the difference between the variable cost of its CCCT and the market price of non-firm energy, since by shutting down the CCCT 20 mills/kWh (in savings) is received versus the 19 mills per kwh of revenue it would have received by selling to PNW. The 19 mills/kWh that BPA receives by either selling the surplus in the non-firm market or using the surplus to displace its CCCT, is the value of the surplus itself, and should not be confused with the value of dispatchability of the CCCT.

percent of the total sold within the Pacific Northwest, and more than 73 percent of total non-firm energy sold by BPA. (Tr. 6376.) Therefore, preference to surplus energy would have a minor impact, if any, on the analysis of dispatchability.

b. Mr. Litchfield's Modification of the BPA Dispatchability Analysis Should Be Rejected.

The modification of the BPA dispatchability analysis presented by Mr. Litchfield on rebuttal is severely flawed in at least two regards. First, Mr. Litchfield admitted that his analysis showed the incremental value of dispatchability of 200 MW of CCCT capacity after 2400 MW of CCCT capacity was already added to the region. Inspection of the 20 percent decrease in his calculated dispatchability value before and after the addition of the 2400 MW reveals a significant impact of this assumption. (Tr. 6346-6350, 6352-6353.)

Second, Mr. Litchfield admitted to incorrectly calculating the adjustment of the levelized value of dispatchability from 1997 dollars to 1990 dollars by using the discount rate, rather than the inflation rate. This lead to another understatement of dispatchability benefits of at least 20 percent.[21] (Tr. 6352.)

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[21] Mr. Litchfield's 2.4 mills/kWh estimate of dispatchability was based on levelized 15-year values, stated in 1990 dollars, of 2.37 mills/kWh for a combined cycle combustion turbine displaced after other CCCTs, and 2.43 mills/kWh for a combined cycle combustion turbine displaced before other CCCTs. (Tr. 6345.) Correcting his calculations to exclude the discount rate results in dispatchability estimates of 2.92 mills/kWh and 2.99 mills/kWh, respectively. (Tr. 6352.)

If these two flaws were corrected, Mr. Litchfield's estimate of dispatchability benefits would increase from 2.4 mills/kWh to over 3.5 mills/kWh, levelized in 1990 dollars. (2.4 X 1.20 X 1.22). While this is still less than calculated by BPA in 1990 (which was between 4.1 and 4.5 mills per kWh for a variable cost of 20 mills per kWh), it is far closer than the 2.4 mills per kWh presented in Mr. Litchfield's rebuttal testimony.[22] The difference between Mr. Litchfield's corrected figure of 3.5 mills and BPA's figure is still not surprising given that Mr. Litchfield used the Regional Council's data files for the analysis and that he did not know what specific differences there may be between the Council's data files and those used by BPA. (Tr. 6338, 6341-6342.)

Mr. Litchfield also argued that Staff's use of a projection of variable cost for a CCCT of 20 mills/kWh, levelized in 1990 dollars, was too high and that a figure of 15 mills/kWh was more appropriate. (Ex. T-2247 at 9 and 14.) On cross examination, however, Mr, Litchfield did not know if his 15 mill figure was consistent with projections used by Puget at the time the resource acquisitions were being considered and admitted that his recommended figure in this case was <u>far</u> below the figure used by

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[22] Again, the 4.5 mill figure is the estimate used by Staff. The 4.1 mills/kWh comes from an amendment to BPA's estimate that Staff specifically did not use because it had not yet been published by BPA at the time the Company decided to acquire its purchased power resources. (Tr. 5962; Ex. 2176.)

the Regional Council in 1991 when Mr. Litchfield was the technical director of its staff.[23] (Tr. 6333, 6353.)

While Mr. Litchfield tried to cast doubt on the veracity of the BPA analysis used by Staff because of the current lack of documentation (Ex. T-2247 at 12-13; Tr. 6338, 6341-6342), it is grasping at proverbial straws to cast doubts on an analysis due to lack of documentation after Mr. Litchfield himself waited four years to request the backup for a study.[24] He admitted that had Puget or the Regional Council approached BPA staff in 1990 or 1991, when studies were being performed supporting the dispatchability estimates used in BPA's RFP, the backup for those studies could have been produced for their inspection. (Tr. 6335.) He also admitted that, had Puget approached the Regional Council in 1989 or 1990 to perform such an analysis of dispatchability, there would have been no technical reason why the Council Staff could not have assisted Puget. (Tr. 6334.)

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[23] The Regional Council's 1991 plan used a fuel cost of $3.16 per MMBtu, and all of it variable. Mr. Litchfield's recommended figure in this case is based on a variable fuel cost of $1.64 per MMBtu. (Tr. 6353, 6367.)

[24] The Company also tried to cast doubts on Staff's use of BPA's estimate of dispatchability by asking Staff to provide details concerning the assumptions and data used by BPA. (Ex. 2186.) This is exactly the type of information one would have expected Puget to follow up on at the time it acquired its resources had it then been attempting to evaluate dispatchability. (Tr. 5972.)

c. Conclusion On Dispatchability.

Staff believes that its adjustment for dispatchability is appropriate because the adjustment is based on information available to Puget at the time the Company made the resource decisions that are at issue in this proceeding. While not perfect, Staff believes it is sufficiently accurate to apply, given that the alternative is to apply no adjustment or to use a corrected version of Mr. Litchfield's calculation which still suffers from much of the same potential criticisms regarding unknowns and validation of input assumptions as were leveled by the Company regarding the BPA calculation. To choose no adjustment because of lack of perfection would, in effect, reward the Company for its lack of effort.

3. Staff's Adjustment for "End Effects" Should Be Accepted.

Given differences in the estimated useful life of the Company's equivalent generating units and the term of a purchased power agreement, as well as the differences in the initial date of power delivery, the capital costs associated with the Company's build option must be adjusted. Since most of the purchased power options have the shorter term, the effect of the adjustment is to decrease the capital costs of the Company's build option in order to make it comparable to the value represented by a purchased power option. This was done by Staff by using a non-levelized stream of annual costs that escalates with inflation. (Ex. 2171, column (c).)

Staff's non-levelized representation of capital costs is at odds with the Company's method of calculating its avoided costs. This is no reason, however, to reject Staff's end-effects adjustment. Based in part on Staff testimony supporting the concept, the Commission in its Second Supplemental Order in Cause No. U-86-119 directed The Washington Water Power Company to adopt levelized, annual capital related costs in its avoided cost filing without any additional adjustment for the difference between plant life and contract term. Puget then adopted this practice in its own subsequent avoided cost filings. Puget now relies exclusively on this practice, rather than its own analysis to determine the appropriateness of its resource acquisitions. (Ex. T-2170 at 13.)

There should be a clear distinction, however, between a policy decision made with respect to an avoided cost filing by Water Power and the methodology used by Puget to evaluate the estimated cost of equivalent generation vis-a-vis the costs offered through a purchased power agreement. Avoided costs are available only to generation from small, renewable resources and from cogeneration projects (Qualifying Facilities). Moreover, the requirement of electric utilities to purchase from QFs at "avoided costs" is based on public policy established by a combination of regulations and decisions of this Commission, the Federal Energy Regulatory Commission, and, ultimately, federal statute. Chapter 480-107 WAC; 18 C.F.R. Part 292; 16 U.S.C. Section 824a-3. Therefore, the process of setting avoided costs is unique, and decisions reached

by this Commission with respect to the development of avoided costs of another electric utility should not have been relied on exclusively by Puget for determining the appropriateness of its own resource acquisitions.[25]

In the context of comparing a power purchase with the alternative cost of its own build option, not adjusting capital costs for the difference in plant life and contract term meant that the Company was, very simply, at risk of paying more for power under the contracts than it is worth.

4. Staff's Adjustment for Capital Structure Impacts Should Be Accepted.

Staff's calculation of an equivalent cost of generation also includes an adjustment for the effect of the Company's purchased power contracts on its capital structure.[26] (Ex. 2173, column

[25] The Commission as much recognized this point when it stated in the Water Power order that the methodology for calculating avoided costs would not always be based upon the costs of a coal plant or any other particular proxy resource. Instead, the best forecasts and best assumptions possible must be used in order to arrive at the best estimate of avoided costs. Even that estimate only establishes a ceiling for the cost of QF power purchases. It does not determine the measure of what the power will actually cost. (Second Supplemental Order at 14-15, Cause No. U-86-119 (April 23, 1987).)

[26] The adjustment for capital structure proposed by Staff was calculated based on increasing the common equity component of the Company's capital structure by 5 percent and making a corresponding decrease in the long-term debt component. The resulting change in overall rate of return was then used to calculate a new fixed charge rate. The new, higher overall rate of return and fixed charge were then substituted in the calculation of the total cost of equivalent generation for a CCCT, as shown in Exhibit 2172. The difference in total costs calculated using the higher common equity component is represented in the stream of annual adjustments shown in Exhibit 2173, column (b).

(b).) The Company argued that there should be no adjustment for capital structure impacts in evaluating its resource decisions because (i) it has not apparently received such an adjustment from the Commission; (ii) some have argued that, even in theory, no adjustment would occur because any needed decrease in leverage would be offset by a compensating decrease in the cost of equity with no resulting change in revenue requirement;[27] and (iii) the information needed to make a capital structure adjustment was unknown to Puget at the time because the rating agencies did not publish their quantification of the effects of purchased power until after the Company acquired its resources. (Ex. T-2265 at 3-9.)

Whether or not the Company has yet to (or may ever) receive a specific adjustment for the cost of capital impacts of power purchases, Staff argues that Puget has reduced the leverage in its capital structure at the same time it was making these additional power purchases, thus, affecting the cost of capital impact irrespective of any Commission decision. (Ex. T-2155 at 29-30.) Moreover, the Company has not disputed that in citing cost of capital impacts in its recent DARE reports, it had the clear expectation that purchased power resources would increase the

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[27] Apparently, this argument is the Company's attempt to comply with the Commission's order to explain and justify the difference between the assumptions Puget used regarding resource impacts on cost of capital in the resource planning process than it used in the rate setting process. (Eleventh Supplemental Order at 22.)

Company's overall rate of return.[28] (Tr. 5991-5992.) That expectation was certainly the basis for an aggressive presentation in the general rate case, now apparently shunned by Puget, regarding the impact of purchased power on its financial profile. (Ex. T-2155 at 29; Ex. 2159 at 6.)

Irrespective of the underlying factors, therefore, over the last four years, Puget has increased the relative amount of common equity in its capital structure. Accordingly, in comparing purchased power and its own build options, it would have been appropriate for Puget to consider these impacts on its capital structure, overall rate of return, and, ultimately, revenue requirement.

Staff also does not believe that the arguments made in the last rate proceeding by one intervenor witness, opposed at the time but now cited by Puget, regarding an offsetting decrease in the cost of equity is sound. To accept this argument would deny the almost universally held concept of an optimal capital structure which minimizes the overall capital related costs of a firm. (Tr.

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[28] Puget stated in its 1992-93 IRP that rating agencies had expressed concern about the effect of significant amounts of purchased power on an electric utility's credit rating. (Ex. 2006 at 13; See also, Tr. 5879.) In the 1990-91 DARE report, the Company assumed a capital structure having 40 percent common equity. In the 1992-93 IRP, the assumed capital structure had shifted to 41.5 percent common equity. (Ex. T-2170 at 18.) In its most recent rate adjustment, the Company argued for and received a capital structure having a 45 percent common equity component, contending that rating agencies required this higher ratio due, in part, to its purchased power obligation. (Eleventh Supplemental Order at 27.)

5822, 5863.) Moreover, there is no specific reference in the Commission's Eleventh Supplemental Order that it necessarily agreed with the theoretical argument of offsetting effects. Certainly, the decision as to cost of equity does not appear to offset the decreased leverage of Puget when the impacts of income taxes on capital related costs are accounted for and result in an increase to the Company's revenue requirement even when the overall cost of capital remains constant.[29] (Tr. 5827, 5864; Ex. 2159 at 14.)

Finally, the Company acknowledges that, in assigning credit quality, rating agencies had considered the impacts of purchased power long before the Company's resource acquisitions were made. (Ex. T-2265 at 5.) Therefore, although Puget was fully aware of the negative exposure to its credit quality that purchased power created, the Company made no attempt to evaluate these impacts merely because the rating agencies had not yet quantified them. This is but another example of the Company's failure to carefully consider the financial impacts of its decisions to purchase power.

The Company did not specifically account for capital structure impacts in its evaluation of the 1989 bid responses or the 1990 supplemental bid responses. (Ex. T-2170 at 18.) Such an

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[29] For example, if the equity ratio is increased from 40 to 45 percent, and the overall cost of capital remains 8.94 percent, revenue requirement increases by $4.7 million. (Ex. 2167 at 1.) Alternatively, when the cost of equity is increased from 10.5 to 11 percent and the overall cost of capital, again, remains 8.94 percent revenue requirement increases by $6.9 million. (Id. at 2.)

adjustment as proposed by Staff, however, is appropriate.[30]

5. Staff's Recommended Disallowance is the Most Conservative of All Options Analyzed By Staff.

The Company cross-examined Staff using another "check-off" system designed to show that Staff did not specifically quantify the value of various characteristics of the purchased power contracts, such as option terms, take-and-pay term, developer reliability, location, resource diversification, and others. Admittedly, Staff did not directly quantify a value for each of these project characteristics. That is the Company's burden. (Ex. 2159 at 22-23.)

Furthermore, any such analysis by Staff would have been hampered by much the same reason the Company failed to demonstrate prudence in the first instance: a lack of information and evaluation by the Company itself of the value of these same characteristics. Staff, therefore, was required to follow the Company's lead. (Tr. 5986, 6034-6049, 6079.) The Company should not now be heard to criticize Staff for any lack of rigor the Company itself did not pursue before, or after, it decided to purchase these resources.

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[30] In fact, Staff's adjustment is a conservative estimate of capital structure impacts because the 5 percent adjustment to the common equity component is applied only to the cost of equivalent generation. Based on the 630 aMW available from the purchased power contracts being reviewed, the adjustment amounts to about $5 million annually. Had the 5 percent adjustment in the common equity component, instead, been applied to the Company's total capital structure, an $8.8 million annual decrease in total revenue requirements would result. (Ex. T-2170 at 19: Ex. 2158.)

Staff's recommended ratemaking adjustment is, nevertheless, the most generous to Puget of all the options Staff considered. First, having concluded that the Company had failed to demonstrate the prudence of its resource acquisitions, Staff could have ended its analysis and recommended a disallowance of all costs related to the Tenaska, March Point Phase II, Sumas, Encogen and Montana Power contracts. Staff, instead, recognized that the power the Company had purchased from these projects is valuable. The issue for Staff was to calculate a reasonable estimate of that value in relation to its cost.

Second, at $103 million net present value, the Staff recommendation is significantly lower than either reasonable proposal based upon projects offered in the Company's 1991 RFP.

Third, the CCCT costs utilized by Staff are for a new construction site. (Ex. 2179, f.n. 2.) Installing a CCCT on an existing site would be 8 to 16 mills/kWh less because some site preparation and permitting has already been completed. (Id.) If anything, therefore, Staff's estimate overstates the cost of a CCCT which reduces the amount of the adjustment. (Tr. 6065-6066.)

Finally, some of the projects offered in the 1991 RFP involved repowering existing simple cycle combustion turbines into combined cycle combustion turbines. (Id.) These projects reduce the cost of a CCCT, again, because some site preparation and permitting has already occurred. Staff did not, however, adjust its calculation to incorporate these savings. Again, its estimate overstates the

cost of a CCCT which lowers the magnitude of the disallowance.

6. The Company Should Not Be "Rewarded" When It Fulfills Its Statutory Obligations.

The Company insinuated on cross-examination of Staff that Staff's recommended disallowance was asymmetrical because it "penalizes" Puget for contracts priced above Staff's estimate of the equivalent cost of generation, but does not "reward" the Company for contracts priced below that estimate. (Ex. 2159 at 96-99.)

Ratemaking disallowances of any magnitude, of course, are always asymmetrical. (Tr. 6236-6237.) More importantly, it is Staff's position that the Company has failed to demonstrate the prudence of all of the purchased power contracts, except those executed when Chapter 480-105 was in effect, but that an adjustment is unnecessary for two contracts (Encogen and Montana Power) only because the comparison of contract rates and equivalent generation costs happen to favor those two contracts. There should be no reward to the Company under such circumstances.

Moreover, it is management's responsibility to pursue least cost resource options. No reward is due when that responsibility is fulfilled. No regulatory theory or policy exists which rewards management for fulfilling that responsibility. (Tr. 6078.)

C. The Company Has Not Demonstrated the Prudence of Its Sale to BPA.

As with the evaluation of its resource acquisitions, the Company also failed to justify its decision to sell off-peak energy

to BPA or to show that it had carefully considered the financial impacts of the sale in light of uncertainty regarding the availability of its own surplus and the market price for surplus energy. (Ex. T-2170 at 9-10.) While Mr. Gaines claims that the Company performed such analyses, when asked to produce such studies, one finds that there was nothing more than the cursory review previously provided by Mr. Lauckhart which the Commission already found to be inadequate. (Ex. 2253 at Data Request No. 5407.)

As with its resource acquisition process, the Company confuses description of characteristics with evaluation of characteristics. A description, no matter how thorough, cannot be substituted for an evaluation and sensitivity analysis of the financial impacts of the characteristics themselves.

Puget, having demonstrated beyond all doubt, that it did not properly evaluate the financial risk of the BPA sale should be held to bear the risk of any negative results. This action is, indeed, one-sided in favor of the ratepayer and to the disadvantage of the Company. Nonetheless, this is an appropriate and fair method in this instance to recognize the Company's not having met the burden of showing the prudence of its actions. While requiring the Company to bear the risk of any negative outcome could result in a retroactive adjustment, the relative short term of the sale (four years) makes this practical and avoids calculating a prospective adjustment, which is the only legitimate alternative, but may

unnecessarily penalize the Company by being too high or the ratepayers by being too low.

D. Staff's Recommendations to Improve the Resource Planning and Acquisition Processes Should Be Adopted.

Staff also recommends several improvements to the Company's resource planning and acquisition processes that would likely reduce the number and magnitude of any future purchased power expense disallowances. (Ex. T-2170 at 21-25.) First, the IRP process should support the bid evaluation process. Specific estimates, not vague observations, should be made of the value of dispatchability, timing of generation, seasonality and time of use attributes, pricing and delivery requirements for fuel supply. If possible, the same modeling and modeling assumptions used in the IRP process should be used in the bid evaluations.

Second, the IRP process should explicitly and quantitatively incorporate uncertainty in load and resource projections in the derivation of an action plan. This will improve the IRP scenario analysis method which currently indicates what should be done with perfect knowledge of the future, but does little to allow the best decisions that can be made based on uncertainty and imperfect knowledge.

Third, the current planning process has not been successful in providing Puget with specific concerns of Staff and has not fostered give and take among the parties regarding the details of the IRP process. While Staff recognizes Commission budgetary constraints (Tr. 5884), participation of Staff and other parties

should be encouraged at a very detailed and technical level, including access to the IRP modeling tools used by Puget. This participation should not, however, be construed to mean that a party could not later raise objections to the IRP itself or resource acquisitions that result from that process.

Fourth, the current planning models are insufficient and, therefore, are in need of improvement. The PCS model is based on average monthly loads, resources and spot market energy prices. As a result, the model does not distinguish between load surplus or deficiency within a month or within a day, or the significant price differential between on-peak and off-peak hours. (Ex. T-2170 at 16.) The spot market pricing inputs allowed by the model are also relatively crude and do not capture the significant fluctuations in price that do occur due to changes in temperature and water conditions. As a result of these shortcomings, the PCS model does not recognize many opportunities for savings due to dispatchability, especially for resources having relatively high variable costs.

The MIDAS and WUTC Avoided Cost models also lack the ability to represent variations in the availability and price of spot market energy. Neither model includes an optimization routine. Finding a "least cost" plan is, instead, dependent on the insight, luck or persistence of the modeler, not the model.

Fifth, a formal evaluation and ranking system should be adopted for selecting among resource options.[31] At a minimum, the system should specifically rank each factor or characteristic to be considered, and there should be an explicit weight given to each such factor or characteristic based on relative value, to the extent such can be quantified. Such an evaluation system need not be filed as part of the RFP process, but could be developed within current Commission practices as part of the demonstration of the prudence of specific resource decisions.

These improvements to the current IRP process would not require revisions to the Commission's existing rules regarding preparation of IRPs. They would require only revisions to Puget's planning and implementation process in order to emphasize substantive support of the Company's resource decisions.

IV.

CONCLUSION.

During the cross-examination of Staff witnesses, Mr. Winterfeld summarized the weakness in the Company's case when asked whether the Company had cited developer reliability as a reason for selecting a particular resource:

> In the overall documentation I don't recall seeing that specifically, but it doesn't surprise me. I think, though, as Mr. Elgin indicated, that the problem with that is that statement is made after the fact. What we

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[31] In fact, a Lawrence Berkeley Laboratory study cited by Dr. O'Connor contains a discussion of ranking systems and their benefits. (Ex. 2229, Data Request No. 5384 at Chapter 3.)

> need to see, though, and what we were hoping to see in the documentation is some evidence that in fact had occurred in the Company's process. It's a little bit like going out and looking at cars. You go out and examine the cars, and you look at price and you look at reliability and you look at miles per gallon and in the end you come up and decide you're going to take the bright red convertible and you may say, well, you did it based on reliability, but in fact you really liked the color of the paint. Unless you know what process was used to reach that decision, there can be various explanations made after the fact and there's no way to confirm those.

(Tr. 5993-5994.)

The Company has been given multiple opportunities to demonstrate to the Commission and to ratepayers that its recent resource acquisitions were based on a considered and documented evaluation and ranking of project characteristics. The Company, once again, has failed to make that presentation. It has added nothing to this record that was unknown to the Commission at the time this prudence review was ordered. If anything, on rebuttal the Company has contradicted positions previously taken.[32]

The Commission should, therefore, find that the Company has failed to carry its burden to prove that the selection of its resources was reasonable and prudent, and that the costs of

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[32] For example, the Company claims on rebuttal that the risks associated with purchased power do not increase revenue requirement, even though it had previously proposed to have its overall rate of return based upon a higher equity ratio to account for that increased risk. Moreover, the Company now claims that certain assumptions in its IRPs cannot be used to calculate the equivalent cost of generation (Ex. T-2241 at 14), but it previously argued that its resource acquisitions were prudent because they were consistent with its IRPs.

acquisition were appropriate. The Commission should also insure that ratepayers are held harmless from the Company's decisions by accepting Staff's recommendation to adjust power supply expense associated with the Tenaska, March Point Phase II and Sumas contracts.

Respectfully submitted this 26th day of August, 1994.

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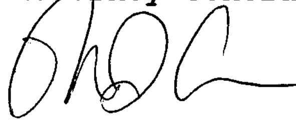

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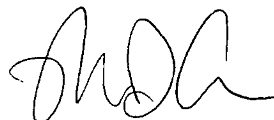
CERTIFICATE OF SERVICE

I hereby certify that I have served one copy of the foregoing document upon James M. Van Nostrand, Attorney at Law, Perkins Coie, Suite 1800, One Bellevue Center, 411 - 108th Avenue NE. Bellevue, WA 98004; Mark P. Trinchero, Attorney at Law, Davis Wright Tremaine, 2300 SW 5th Avenue, Portland, OR, 97201; Barry Bennett, Office of General Counsel, Bonneville Power Administration, 905 NE 11th Street, Portland, OR 97208; Robert Manifold, Assistant Attorney General, Public Counsel Section, 900 Fourth Avenue #2000, Seattle, WA 98164; and James C. Paine, Suite 2300, 900 SW Fifth Avenue, Portland, OR 97204-1268, via U.S. Mail postage prepaid.



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Dated: August 26, 1994.