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BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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| 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 |
| | NINETEENTH SUPPLEMENTAL ORDER |

## *SUMMARY*

**PROCEEDINGS**: In its Eleventh Supplemental Order in these consolidated proceedings, the Commission directed Puget to file a power supply case demonstrating the prudence of eight power purchase contracts. The Commission also directed the company to make a similar showing regarding the prudence of its four-year energy sale to the Bonneville Power Administration.

In its Eighteenth Supplemental Order entered April 20, 1994, the Commission expanded the scope of this review to include the prudence of Puget's contract with Tenaska.

**HEARINGS**: The Commission held ten days of hearings in the prudence review phase of this case. Hearings were held in Olympia and Bellevue to take testimony from members of the public. The hearings were held before Chairman Sharon L. Nelson and Commissioner Richard Hemstad, and Administrative Law Judge Alice L. Haenle of the Office of Administrative Hearings.

**PARTIES**: Puget Sound Power & Light Company (Puget) was represented by James M. Van Nostrand and Steven C. Marshall, attorneys, Bellevue. The Staff of the Washington Utilities and Transportation Commission (Commission Staff) was represented by Robert D. Cedarbaum and Sally G. Johnston, assistant attorneys general, Olympia. Robert F. Manifold and Charles F. Adams, assistant attorneys general, Seattle, appeared as Public Counsel. Intervenor Washington Industrial Committee for Fair Utility Rates (WICFUR) was represented by Mark P. Trinchero, attorney, Portland, Oregon. Intervenor Bonneville Power Administration (BPA) was represented by Barry Bennett, attorney, Portland, Oregon. Intervenor PacifiCorp, d/b/a Pacific Power & Light Company (PacifiCorp), was represented by James C. Paine, attorney, Portland, Oregon.

**COMMISSION**: The Commission finds Puget has mismanaged its contract selection and evaluation process. The Commission also finds Puget has not demonstrated the prudence of its four-year sales agreement with BPA.

The Commission will disallow 1.2% of the costs of the Tenaska contract, and 3% of the costs of the March Point Phase II contract. These disallowances have a net present value of approximately $16.8 million. This yields a disallowance of approximately $1,538,700 during the PRAM 4 period. For the BPA contract, the Commission will require that ratepayers be held harmless.

When the company seeks to acquire resources, the Commission requires it to analyze any resource alternative under consideration utilizing up to date information, and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning has disclosed need specific analysis at the time of a purchase decision. In addition to making an adequate study at the time, Puget must keep a record of its decision making process which will allow the Commission to evaluate its adequacy.

# I. SCOPE OF PROCEEDINGS

## A. Procedural History

In its Eleventh Supplemental Order in these consolidated proceedings, entered September 21, 1993, the Commission ordered Puget to file by November 1, 1993, a power supply case which demonstrates the prudence of its resource acquisitions since the previous general rate proceeding. On October 18, 1993, Puget filed testimony and exhibits in this prudence review.

The Commission ordered this proceeding to allow Puget another opportunity to demonstrate the prudence of its resource acquisitions because Puget did not make this demonstration in its general rate case. Rather than ordering a total disallowance in the general rate case, the Commission allowed $86 million as a temporary rate, subject to refund. These rates were initially included in the PRAM 3 rates. In its Fifteenth Supplemental Order entered December 15, 1993, recovery of the temporary rates was shifted from the PRAM to general rates.

A prehearing conference was held on October 28, 1993. Parties were directed to supply as prefiled materials any materials from other cases -- including portions of these consolidated dockets occurring before the prehearing conference -- on which they intended to rely in this prudence review.

By its Eighteenth Supplemental Order, the Commission granted a joint motion of Public Counsel and the Commission Staff to expand the issues to consider also the prudence of Puget's contract with Tenaska.

The Commission held hearings on March 21 and 22; June 10 and 17; July 13; and August 1 through 4, 1994. The hearings on June 10 in Olympia and on June 17 in Bellevue were held for the purpose of taking testimony from members of the public.

After hearing oral argument on July 13, the Commission denied a Puget motion for partial summary judgment. On the same date, the Commission granted a motion by Public Counsel to strike certain prefiled materials from company witnesses Donald E. Gaines and Charles E. Olson.

Briefs were filed on August 26, 1994.

**B. Issues Presented**

The company was directed to file a power supply case demonstrating the prudence of the following contracts: Snohomish conservation power sales agreement; Montana Power Company firm power purchase; Koma Kulshan hydro; March Point Phase I; March Point Phase II; Sumas Energy; Encogen Cogeneration; and Spokane Municipal Solid Waste Disposal Facility (Spokane MSW). The company was also directed to demonstrate the prudence of Puget's four-year firm energy sale to BPA. The Commission expanded the scope of this proceeding to include the prudence of Puget's Tenaska contract. For these contracts, Puget must demonstrate that it prudently entered into the contracts, and that the price it paid was appropriate. Puget is proposing to charge ratepayers $6.5 Billion, over 23 years, for the March Point Phase I, March Point Phase II, Montana, Tenaska, Sumas, Encogen and Spokane MSW contracts.[1]

If the company fails to demonstrate the prudence of some or all of these contracts, then the Commission must determine whether some or all of the costs of those contracts should be disallowed for ratemaking purposes.

In addition, the Commission will determine whether certain actions should be taken in future resource acquisition processes.

**C. Summary of the Parties' Recommendations**

Puget recommends the contracts be found prudent and none of the costs be disallowed.

The Commission Staff recommends the Commission find Puget has failed to carry its burden to prove that the selection of its resources was reasonable and prudent, and that the costs of acquisition were appropriate. The Commission Staff also recommends that Puget be ordered to bear the risk of any negative results of the BPA sale, because the company did not properly evaluate the financial risk of that sale. The Commission Staff recommends adjustment of power supply expenses associated with the Tenaska, March Point Phase II, and Sumas contracts, totaling a disallowance of $103 million net present value. To the extent the BPA sale results in a cumulative increase in Puget's net power supply expense, Commission Staff recommends an offsetting adjustment in future cases.

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[1] The price of these contracts is challenged in this proceeding. The cumulative contract amounts in nominal dollars are found in Exhibit 2221.

Public Counsel recommends the Commission find Puget has failed to demonstrate the prudence of seven of its nine resource selections. Public Counsel recommends the Commission find Puget agreed to pay too much for the following contracts: Spokane MSW, March Point Phase I, Montana Power, Encogen, March Point Phase II, Tenaska, and Sumas. Public Counsel recommends no adjustments to the Koma Kulshan and Snohomish PUD contracts. It takes no position on the BPA contract. Public Counsel calculates a disallowance of approximately $500 million net present value, and recommends valuing contracts for future ratemaking purposes by disallowing the percentage of each contract that is found to be unreasonable.

WICFUR recommends that Puget's actions consistent with its Demand and Resource Evaluation (DARE) process be given "some presumption of regularity in resource acquisition." WICFUR does not elaborate on brief how that should be done.

## *BACKGROUND*

This is a continuation of Puget's general rate increase request in Docket Nos. UE-920433, UE-920499 and UE-921262. The Commission entered a final order, the Eleventh Supplemental Order, on September 21, 1993, which granted Puget a rate increase. In that order, the Commission examined Puget's new resource acquisitions since its previous general rate case. It ruled on the appropriate burden of proof for new resources, and found that Puget had not proven that its new resource acquisitions were prudent. The burden of proof conclusion in its final order was not appealed, and is now the law of the case.

The Commission's ruling was:

> Puget must make an affirmative showing of the reasonableness and prudence of the expenses under review. This is true even in the absence of a challenge by another party. The Commission concludes that Puget has not carried its burden of demonstrating that its new resource acquisitions were prudent. (See Order at Page 19.)
>
> Puget should not use different assumptions regarding resource impacts on cost of capital in the planning and acquisition stages than it uses in the ratemaking process. If Puget attempts to raise cost issues not considered in the least cost planning process in order to recover those costs in rates, it must explicitly explain and justify these deviations. Puget should not attempt to justify a resource as least cost based on the least cost plan and then alter the cost of the resource for rate recovery.

The Commission sees no reason to deviate from the traditional prudence standard recited above, and we concur with Commission Staff that the review should include dispatchability, transmission impacts, other bids, building options, and financial and rate impacts. (See Order at Page 22.)

The Commission has stated consistently that the prudence review of new resource acquisitions would be conducted in general rate cases only[2]. The Commission in its PRAM 1 Order[3] specifically rejected Puget's request that the evaluation of new contracts included in that proceeding be defined as the final prudence review of those contracts. (See Order at Page 22.)

The Commission again clearly stated that the prudence of resource contracts would be decided in the context of the general rate case in the First Supplemental Order in the PRAM 2 proceeding (Docket No. UE-920630, September 24, 1992). Puget had ample notice of its responsibility to demonstrate prudence in this proceeding. (See Order at Page 23.)

The company should file, by November 1, 1993, a power supply case which demonstrates the prudence of its resource acquisitions since the last general proceeding. For each contract, the company must describe the resource stack available to it at the time the contract was entered into and describe, at a minimum, dispatchability, transmission impacts, other bids, building options, and financial and rate impacts. In addition, Puget is directed in the future to maintain all documents related to its decisions to enter into specific contracts. Any cost disallowances resulting from the prudence proceeding will be trued up against the PRAM 3 projection.

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[2] See, Seventh Supplemental Order, Docket No. U-85-87 (June 1, 1992). Footnote in original.

[3] "The Commission reserves the right to conduct prudence reviews of new contracts in future proceedings, although the contracts may be included in rates for the first time in a PRAM proceeding. In a subsequent general rate case, the Commission may review contracts and the company's experience under the contracts, to determine proper ratemaking treatment and to examine items which may be disallowed for ratemaking purposes. Initial review of contracts included in a PRAM proceeding does not foreclose the Commission's later full review in a general rate case." (First Supplemental Order, Docket No. UE-910626, September 25, 1991, p. 7.) Footnote in original.

The Commission has similar concerns regarding the prudence of Puget's four-year firm energy sale to the Bonneville Power Administration. Puget has not shown the net benefits of the sale under a reasonable range of market and resource conditions that could be expected to occur. When asked by Commission Staff to demonstrate the prudence of the sale, Puget did not provide any documents describing or quantifying the financial risk associated with the BPA sale. Puget should include the BPA sale in the PRAM 3 projection; the company may not shift the risks of this sale to ratepayers in general rates until it has demonstrated its prudence in the November 1 prudence filing ordered above. (See Order at Page 24.)

On reconsideration, the Commission explained:

The company persists in its allegation that a "new" test of prudence is being applied by the Commission. As noted in the [Eleventh Supplemental] Order, and in the Fourteenth Supplemental Order, the Commission is applying the same standard of prudence it has consistently applied to the company's resource acquisitions. Furthermore, the company was repeatedly and consistently told to justify the prudence of its resource acquisitions in its general rate proceedings.

When the company failed to make this demonstration in its prefiled general rate case materials, the Commission required it to file supplemental direct testimony on this and other unaddressed issues.[4] The [Eleventh Supplemental] Order adopted the same standard of prudence applied in the Pebble Springs and Skagit/Hanford cases, which relies upon a review of the company's decisions based upon facts reasonably available to it at the time the decisions were made.

Puget's failure to make this demonstration has imposed notable burdens on the Commission, and the parties to this proceeding, who must now dedicate scarce resources to a task which should have been completed much earlier. Counsel for the company continue to search out obscure, out-of-state "authority" which they claim excuses their failure to present a prima facie case. They have yet to acknowledge the existence of the Washington statute and Commission decisions to which Puget was a party. Other Commission precedent applies the same standard to the

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[4] See, Exhibit 2153. Footnote not in original.

> other electric utilities in the state.[5] This inadequate legal strategy undermines the company's credibility. Proving the prudence of the company's conduct should be simple and straightforward. The task should be accomplished promptly. Fifteenth Supplemental Order, pages 18-19.

## *II. DID PUGET ESTABLISH THE PRUDENCE OF ITS RESOURCE ACQUISITIONS?*

### A. Burden of Proof

RCW 80.04.130(2) addresses burden of proof in rate cases. It provides:

> At any hearing involving any change in any schedule, classification, rule or regulation the effect of which is to increase any rate, charge, rental or toll theretofore charged, the burden of proof to show that such increase is just and reasonable shall be upon the public service company.

Consolidated Docket Nos. UE-920433, UE-920499 and UE-921262 involve requested rate increases. This prudence review is a further step in those consolidated cases.

Despite the Commission's comprehensive discussion and ruling on burden of proof in the first stage of this proceeding, Puget continues to argue for a different standard. In addition to extensive briefing, Puget also instructed its rebuttal witness, Dr. Phillip O'Connor, to address burden of proof. Commission Staff on brief challenges Dr. O'Connor's "independent evaluation"[6] because it starts with the wrong burden of proof: the rebuttable presumption. Puget gave Dr. O'Connor specific instructions to address burden of proof in this evaluation[7].

Dr. O'Connor supports a rebuttable presumption of prudence.[8] Dr. O'Connor attempts to distinguish prior Commission orders on the basis that they deal with disallowance of nuclear

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[5] See, for example, WUTC v. The Washington Water Power Company, Docket No. U-83-26, Fifth Supplemental Order, (January 19, 1984), pages 11-16.

[6] Exhibit 2228

[7] Transcript Page 6225.

[8] Exhibit T-2226 Pages 9-10.

plants.[9] He supports a less stringent standard for evaluating purchased power contracts, because the purchased power contract results are "quite good", and claims that Puget's contract analysis was "adequate". While chastising the Commission Staff and Public Counsel for using hindsight in their evaluations, Dr. O'Connor would base the strictness of his recommended standard of review on the actual results achieved. Because Dr. O'Connor's study was based on a burden of proof standard already rejected by the Commission, it provided no assistance to the Commission as trier of fact. Dr. O'Connor's study results are therefore rejected, and the company is instructed not to seek recovery of its cost.

Puget argues, at page 36 of its brief, that even if the "extreme" proof requirements the Commission Staff advocates are applicable in nuclear cases, they are not appropriate in this context. "[T]he standard of care expected is commensurate with the degree of risk." Puget is proposing to charge ratepayers $6.5 Billion, over 23 years, for the March Point Phase I, March Point Phase II, Montana, Tenaska, Sumas, Encogen and Spokane MSW contracts. Although the pass through of these costs in the PRAM may appear to protect Puget from any risk associated with these contracts, their fiscal impact on ratepayers is equivalent to the cost of a nuclear plant. As the electric power industry moves into a more competitive future, purchased power costs must be managed, both for the benefit of the ratepayers and for the benefit of the shareholders. We reject any contention that, on a relative scale, these costs were not extremely important.

Puget also claims, at page 44 of its brief, that the Commission Staff is attempting to apply a more stringent "compelling" standard of evidence than is appropriate for this proceeding. This contention may be based on Commission Staff witness Ken Elgin's responses to cross-examination, where he characterizes the company's presentations of various aspects as not being "compelling new evidence".[10] The company is correct that the proper standard in administrative proceedings is proof by a preponderance of the evidence. The Commission understands Mr. Elgin's testimony to be that the company did not present anything new in the prudence portion of this case that it had not presented in the general rate case portion. That conclusion does not imply or require any new standard of proof. In making its decision, the Commission will apply the preponderance of the evidence standard.

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[9] Kettle Falls, however, is not a nuclear plant. It is also a completed, operating plant.

[10] Transcript Page 5705.

The Commission is also disturbed by Puget's contention on brief that "...no party has submitted **any** evidence to contradict the Company's prima facie case."[11] This is completely false. In the general phase of the case, Public Counsel presented evidence about dispatchability and other evaluation factors. In the prudence review phase of this case, witnesses for Commission Staff and Public Counsel presented detailed adjustments based on their evaluations of the company's decision-making process. Although Puget may not agree with this evidence, substantial evidence that Puget did not evaluate its contracts properly and may have paid too much for them is in the record of this proceeding.

The Commission relies upon a reasonableness standard. The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made. Prior Commission rulings established that this standard applied to both abandoned projects[12] and successfully completed projects[13].

The company, at page 34 of its brief, cites the Commission's reasonableness standard. At the top of page 35, it then alleges:

> With respect to purchased power contracts, this means that "[o]nly when a utility acts in bad faith or mismanages the contract selection, evaluation or enforcement process would one expect the Commission to question the prudence of a competitively bid purchased power contract." [citation omitted]

While this is a less strict standard than the Commission applies, the Commission concludes that Puget has violated this less strict standard. As discussed below, Puget has mismanaged its contract selection and evaluation process.

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[11] Puget brief page 47, bold in the original.

[12] Second Supplemental Order, Docket No. U-85-53, May 16, 1986. A portion of the order disallowed certain costs of the abandoned Skagit Nuclear project, because the company did not adequately study the likelihood that the project would be successfully completed after the Three Mile Island incident raised national questions about nuclear plant safety.

[13] Fifth Supplemental Order, Docket No. U-83-26, January 19, 1984. One section of the order disallowed certain cost over-runs of the Kettle Falls power plant, because the company did not adequately study whether it should complete the plant, once the cost over-runs were known.

The prudence standard adopted in prior Commission orders is easily applied to any resource decision, whether it is to build or to purchase. The utility must first determine whether new resources are necessary. Once a need has been identified, the utility must determine how to fill that need in a cost effective manner. When a utility is considering purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself. Specific factors which must be included in its analysis are included in the Public Utility Regulatory Policies Act of 1978 (PURPA),[14] and in Commission rules. Other factors will be identified in the company's least cost plan.[15] The factors identified by the National Energy Policy Act of 1992 will need to be considered in purchases made after its adoption. Contrary to Puget's arguments, the prudence standard applied by the Commission has not changed. It is only the company that has argued for a new standard.

**B. Relevance of Avoided Costs and Least Cost Plans**

PURPA was adopted in 1978. The Commission was required to consider and make recommendations with respect to standards contained in the act. It did so in Docket No. U-78-05. In its order entered October 29, 1980, the Commission noted the following purposes of PURPA:

> The purposes of PURPA are set forth in the Act and are:
>
> (1) Conservation of energy supplied by electric utilities
>
> (2) The optimization of efficiency of use of facilities and resources of electric utilities and
>
> (3) Providing equitable rates to electric consumers. (See order at page 3.)

Since the Skagit and Kettle Falls decisions, two significant changes have occurred in utility resource acquisition in this state. First, beginning with Docket No. U-85-53, Puget has been ordered by the Commission to engage in least cost planning. The planning requirement has since been applied to all electric utilities subject to Commission regulation, and codified as WAC 480-100-251.

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[14] 16 USC § 2601, et seq.

[15] The phrase "least cost plan" is used in the Commission's rule. WAC 480-100-251. We consider the phrase synonymous with "integrated resource plan".

The second development is the effect of PURPA on electric generation suppliers. The state and region have moved from large utility built, coal or nuclear base load plants to wholesale competition between supply and demand side resources to provide electricity service to consumers. Companies now must decide whether to build or buy in an increasingly competitive wholesale market.

The state implementation of PURPA requirements was codified first as chapter 480-105 WAC, which was replaced in 1989 by chapter 480-107 WAC. Key to the implementation of PURPA is the company's calculation of avoided cost; Puget is not required to acquire qualifying facility (QF) resources that cost more than its avoided cost.[16] The National Energy Policy Act of 1992 required State regulatory authorities to consider adopting generic standards for certain aspects of utility purchase of long-term wholesale power supplies. The Commission performed its analysis in Docket No. UE-930537,[17] and concluded after hearing that no new standards were required. Power purchase decisions will continue to grow in importance to Puget, ratepayers, and shareholders.

The issues involved in Puget's purchase of the wholesale power contracts which are examined in this portion of its general rate proceeding are framed, in part, by the dialogue between the Commission, Puget and other parties in these forums. The Commission's prior policy regarding proof of the prudence of company-built resources continues to be relevant in an environment where a utility chooses to purchase its power, rather than to build, and to own, production facilities.

The Eleventh Supplemental Order also addressed the proper forum for prudence review, and the interplay of least-cost plans and avoided cost filings. The Commission re-affirms the following elements:

> Although a least-cost plan may contain information helpful in determining the prudence of resource selection, this is only one consideration in the evaluation. Additional information is required to prove prudence, as indicated in the least-cost planning rule itself. The Commission's acceptance of a company's least-cost plan does not represent a finding of prudence of a particular resource. The least-cost planning process is not sufficiently rigorous or specific to support an independent finding of prudence. (See Order at page 21.)

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[16] "Avoided costs" means the incremental costs to an electric utility of electric energy or capacity or both which, but for the purchase from the qualifying facility or qualifying facilities, the utility would generate itself or purchase from another source. WAC 480-105-010(1); WAC 480-107-010(1).

[17] Second Supplemental Order, October 18, 1993.

This conclusion is now the law of the case.

The Commission has deliberately adopted a flexible planning rule. The rule is intended to encourage companies to take responsibility for their resource planning and to pursue opportunities for least cost resources. Some states have chosen a more prescriptive approach to planning. Their planning process involves specific resource choices.[18] Prescriptive planning is more burdensome at the outset, but it results in "pre-approval" of resource decisions. The Commission's more flexible approach gives a company more management discretion in making its decisions, and the capability to seize unplanned opportunities, should the market develop in unexpected ways. Those specific resource decisions are then reviewed in an after-the-fact prudence review.

The use of a flexible, general plan also requires the company, prior to resource decisions, to tie down planning estimates with specific analysis of its own costs to build, and to evaluate possible purchases against that standard, as well as making a relevant comparison of the different purchase options.

Puget files its estimate of avoided costs in Schedule 91. The avoided cost tariff establishes an avoided cost for small projects of one megawatt or less. In an informational filing accompanying the tariff, the company describes in general terms the data and methodology which are used to calculate avoided costs for larger projects. These general avoided costs are to be adjusted to provide for an even comparison of the costs and benefits of different resource options as compared to Puget's avoided resource.

As the Commission stated in its ruling on Puget's partial summary judgment motion:

> The filed avoided costs to which Puget refers are only estimated forecast costs intended for consideration as only one of many factors required to be considered in determining a reasonable rate to pay a QF ["Qualifying Facility" under PURPA]. The estimated avoided costs are indeed filed with the Commission, and reviewed by the Commission pursuant to WAC 480-105-050. However, as can be seen by a plain reading of WAC 480-105-050, these numbers or data are then used along with several other factors to calculate the rate for purchase. Thus, as Public Counsel argues, the central issue in this case is determining the appropriate avoided cost adjusted for the above factors that a prudent utility manager would have paid for each contract.[19]

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[18] Nevada and Connecticut are examples of states with a more prescriptive approach.

[19] Transcript Pages 5628-29.

Puget rebuttal witness James Litchfield, gave persuasive testimony that unadjusted planning numbers should not be used to evaluate specific resource decisions.

> . . . I think it's a very important point for me as a planner and having spent a long time with the Northwest Power Planning Council working on this, the process that I described of coming up with gas price assumptions and how that's largely a political process and how far away as a planner you are from the real world of actually developing resources, I think that planning has great value, and I am very committed to the overall process, but I think it will absolutely stifle that process if every number in there can later be extracted and used for some purpose not anticipated by the planners and not representing or understanding how much uncertainty there was and how much the collaborative process actually shapes a lot of the analysis and numbers that go into this.[20]

Puget criticizes other parties for using planning numbers inappropriately, but we find that Puget itself has used them inappropriately. This record shows that Puget did not adequately study, using up-to-date information, its specific resource acquisition decisions. If Puget had made an appropriate analysis of its resource options at the time of purchase, instead of relying on planning numbers, we would not face the need to find a usable proxy. Instead, it relied on a mere comparison to its least cost plan, or to an unadjusted "informational" avoided cost. Our prior orders in the Skagit and Kettle Falls cases made it clear that adequate study of specific new resources was required. This is what Puget failed to do.

### C. Puget Mismanaged Its Resource Acquisition Process

In its Eleventh Supplemental Order, the Commission indicated the evidence provided by Puget in that proceeding was not sufficient to demonstrate prudence. The Commission found insufficient Puget's evidence that the resources are consistent with its least-cost plan, that the resources were priced below avoided cost, that the resources were acquired through competitive bidding, and that Puget had briefed the Commission Staff prior to acquisition on its decision to acquire new resources.

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[20] Transcript Page 6369.

The Commission agreed with the Commission Staff and Public Counsel that, although many of the factors presented by Puget could appropriately be considered, by themselves those factors were not sufficient to demonstrate prudence of the new resources. The Commission specifically stated that "... the review should include at a minimum dispatchability, transmission impacts, other bids, building options, and financial rate impacts."[21]

As discussed in the previous section, Puget's least cost plans and informational avoided cost schedule established only general planning data for Puget. The least-cost planning rule was carefully crafted to define a planning process, as opposed to a process that utility management relies upon to acquire specific resources. Both the original PURPA rule (chapter 480-105 WAC) and the competitive bidding rule (chapter 480-107 WAC) require the filing of avoided cost data and methodology, for information purposes only, for projects larger than one megawatt.[22] This informational filing must then be adjusted for several different factors so that it is relevant for comparison with specific resources being acquired. This is distinguished from another part of the filing which establishes a fixed avoided cost for projects under one megawatt.

Puget did adjust its avoided cost to account for factors such as "capacity and energy components, seasonality, maintenance schedule, firm vs. non-firm, and starting and ending dates."[23] However, in calculating a project-specific avoided cost or build option, Puget did not take into account the value of dispatchability or the capital cost effect, which it had identified as relevant in its planning documents. Nor did Puget make an end effects adjustment for projects with a shorter life than its alternative resource. No written record of its decision-making process survives. The company's lack of contemporaneous evaluation and documentation is, at best, poor management practice.

Each time the Commission told Puget it would have to demonstrate the prudence of its resource acquisitions in this general rate case, we assumed that a reasoned analysis existed. When we gave Puget a second chance to demonstrate prudence in this additional phase of the case, the Commission still assumed that a reasoned analysis existed -- we merely believed that Puget had not listened to the message that it must come forward with

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[21] Eleventh Supplemental Order Page 22.

[22] Exhibit 2154.

[23] Exhibit T-2254 Page 12.

the evidence. When the Commission Staff received a briefing from Puget on its new contracts, the Commission Staff presumed that a reasoned analysis existed.[24] It is still almost beyond the Commission's comprehension that Puget, which was the recipient of the Commission's order in the Skagit proceeding,[25] and was aware of the Kettle Falls order,[26] did not have a file on each of these projects in which it tracked its progress in its decision making, and the studies made to support decisions. It appears that many of the decisions were made on an ad hoc basis, with little or no structured analysis. The Commission is constrained to conclude that Puget has mismanaged its resource acquisition process.

As the Commission Staff correctly highlights, the company's resource mix is required to be "least cost" under WAC 480-100-251. This test is not fulfilled by Puget's claim that it acquired these resources at "reasonable" cost. If Puget had bargained more strenuously and sent out proper signals about its alternatives, Puget might well have obtained the resources under these same contracts at lower prices. But because Puget was satisfied with a general, unadjusted estimate of avoided cost as a ceiling, and because it failed to document its decision-making process, we cannot know what price Puget could have obtained if it had followed a prudent course.

The company's "robust discussions" about various resources, with "a consensus" on the decisions, are not sufficient to demonstrate prudence.[27] The Commission Staff has challenged Puget's process as not documented and not susceptible of replication. Puget sets up the word "replicate" as a straw man--saying that it means that Puget must reproduce in minute detail each decision making process--then knocks the straw man down. Commission Staff made it clear that this is not what it meant by "replicate". These contracts will bind the company and its ratepayers to pay $6.5 billion over the next 23 years. The parties and the Commission therefore should be able to follow the company's decision-making process, knowing what elements the company used, and the manner in which the company valued those elements. Such a process should certainly be documented.

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[24] Exhibit T-2155 Page 22.

[25] Second Supplemental Order, Docket No. U-85-53, May 16, 1986.

[26] Fifth Supplemental Order, Docket No. U-83-26, January 19, 1984.

[27] Exhibit 2110 Page 10.

**D. The Resources at Issue**

There are ten separate projects subject to a prudence review in this proceeding. The contracts can be separated into four general categories.

**1. RESOURCES PURCHASED UNDER CHAPTER 480-105 WAC**

First, there are three contracts that Puget entered into during the period that chapter 480-105 WAC was in effect. These contracts are the power purchases from Koma Kulshan, March Point Phase I, and Spokane MSW.[28] The Commission Staff recommends that the contracts acquired pursuant to these rules be accepted by the Commission for ratemaking purposes. Public Counsel recommends a dispatchability adjustment to the March Point Phase I and Spokane MSW contracts. No adjustments have been proposed to rate recovery of the costs of the Koma Kulshan project.

These three contracts are for purchase of power from qualifying facilities. Puget used 1989 avoided cost values which were based on the BPA's new resources rate, and the cost to build a coal plant.

Chapter 480-105 WAC was adopted in January 1981 as the state's implementation of section 210 of PURPA. These rules required electric utilities to establish an avoided cost, and to purchase electricity from qualifying facilities sized one megawatt or less whose one-year charge for energy was less than the filed avoided cost. The rules were intended to encourage development of small, incremental projects which could postpone or eliminate the future need for building large, baseload units. The avoided cost applied to both supply and demand side resources, and was a first step in encouraging utilities to purchase conservation.

The Commission decision in Docket No. U-86-119,[29] involving the Washington Water Power Company's avoided cost tariff, illustrates the Commission's concern that small, incremental projects should be encouraged. The Commission in that docket disapproved a Water Power tariff proposal which would have based its avoided cost calculation on 0% inflation. An end effects adjustment, proposed for the first time on rebuttal, was opposed by the Commission Staff because Water Power did not apply the adjustment in its analysis of company owned, supply side resources.

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[28] The Koma Kulshan contract was signed in February 1986, Spokane Regional Solid Waste in July 1988, and March Point I in June 1989.

[29] Second Supplemental Order, April 27, 1987.

Puget PURPA tariffs were filed in its Schedule 91, while chapter 480-105 WAC was in effect.[30] In addition to the PURPA rate established for projects of one megawatt or less, Puget's Schedules 91 contained data and a methodology which indicated, in general, what Puget would pay for projects larger than one megawatt. WAC 480-105-030(2) defined the data which each utility was to make available ". . . from which avoided costs may be derived. . ." WAC 480-105-050(6) outlined specific factors which the utility was to use in determining the rates for purchase. One of the identified factors was the data provided pursuant to WAC 480-05-030(2). Another was dispatchability.

A two-step process was contemplated: First, the company was to maintain general data from which avoided costs could be derived. WAC 480-05-030(2). These data were published in Schedule 91 of Puget's tariff. Then, when a specific purchase of a resource larger than one megawatt was contemplated, the general data in the tariff were one portion of the information which was to be analyzed, along with the other factors listed in WAC 480-105-050(6), in order to determine the rates for purchase. The outcome would be a purchase-specific avoided cost.

Public Counsel bases its proposed adjustments to the Spokane MSW and March Point Phase I contracts on an argument that Puget did not appropriately analyze and adjust for dispatchability when it analyzed rates for the purchases. The Commission Staff does not propose any adjustments to these contracts.

The Commission will not adjust the prices paid for the Spokane MSW or March Point Phase I contracts. Although WAC 480-105-050(6) identifies dispatchability as a factor to be considered, no study of dispatchability based on a coal plant has been presented. A coal plant was Puget's, and the region's, proxy resource at the time these contracts were executed. The BPA study, on which Public Counsel witness Dr. Blackmon bases his recommended adjustment, is based on a Combined Cycle Combustion Turbine (CCCT).

### 2. RESOURCE PURCHASED UNDER PILOT BID AS CHAPTER 480-107 WAC WAS BEING FORMULATED

#### a. <u>The Pilot Bid</u>

Experience with PURPA in other jurisdictions, most notably California, disclosed problems with what has become known as administratively determined avoided costs as the means of implementing PURPA, and with sending the appropriate contract rate signals to qualifying facilities or independent power producers. The initial PURPA regulations required that utilities

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[30] January 1981 to July 1989.

purchase all resources offered to them that are priced under their avoided cost. Therefore in some states prices were established for alternative resources higher than the market demanded. The result was that a flood of supply far larger than needed was offered, and utilities had to purchase it. As it observed this phenomenon, this Commission decided to inject a market test into its PURPA requirements by establishing bidding rules.[31] The hope was that healthy competition between PURPA developers would result in bids that were lower than administratively determined avoided cost, and would allow the utilities to purchase only the supply of resources needed.

Consequently, in 1989, the Commission replaced chapter 480-105 WAC with chapter 480-107 WAC. WAC 480-107-005(1) contains the same definition of avoided cost as WAC 480-105-005(1). The test is still avoided cost -- an accurate assessment of the utility's own cost to build is essential in judging whether bid resources actually avoid any utility costs.

Puget was actively involved in the Commission's design and implementation of chapter 480-107 WAC. As the Commission was developing the new rules, Puget used a pilot bid to test the efficacy of the then-proposed rules. Its pilot bid project limited to 100 megawatts the amount of power Puget was willing to purchase and tested the bidding process proposed in the rule. Both Commission Staff and Public Counsel commented on the 1989 pilot RFP, and the Commission approved it. The Encogen bid was selected from the bid resources and, after successful negotiations, Puget executed the Encogen contract in September 1990. Public Counsel has proposed both an end effects and a dispatchability adjustment to this contract. The Commission Staff analyzed Encogen but proposed no adjustment, finding that the price paid for Encogen was slightly below its recommended standard for determining prudence in this proceeding -- "equivalent generation cost."[32]

Although not technically under the bidding rule, the Encogen pilot project was done in cooperation with the Commission as a test of its proposed bidding rule. Even if the Commission were to use the Public Counsel-sponsored dispatchability study, with variable costs at the level accepted by the Commission, it would not result in any adjustment to the Encogen price.[33] Commission Staff found the project to be favorably priced when compared with the build option. Therefore, the Commission will not disallow any of the costs of the Encogen project.

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[31] See, Transcript Page 5471.

[32] Exhibit T-2188 Page 8.

[33] See, infra. Pages 32-33.

**b. The 1991 Bid**

Chapter 480-107 WAC includes a competitive bidding process so that marketplace forces can be used to achieve a least cost mix of supply-side and demand-side resources to meet the current and future needs of the utility and ratepayers. At the same time, the concept of avoided cost, adjusted for current information and relevant factors continues to play a large role in both the company's evaluation of resources and the Commission's review of the acquired resources.

Puget conducted a bidding competition under the new rule in 1991. Twelve large and medium sized cogeneration and Independent Power Producer projects were short listed by the company. Most of those offers exhibited similar favorable characteristics to the March Point Phase II, Sumas, or Tenaska projects, but all were rejected by Puget. The principle reason for rejection for 11 of the 12 projects was their size.[34]

The market prices bid by the rejected project developers were, in some cases, 60% below the administratively determined avoided cost.[35] Puget did not purchase any of the large, relatively inexpensive resources offered. It had already purchased Tenaska, March Point Phase II, and Sumas outside of the bidding process. Thus, it did not need the power.

The results of the 1991 bidding alternative are the basis for a Commission Staff alternative measure of damages to ratepayer interest which is discussed further below.

**3. RESOURCES PURCHASED FROM OTHER UTILITIES OUTSIDE A BIDDING PROCESS**

The third category of contracts is inter-utility contracts. Included in this group are contracts for power purchases with Montana Power Company and the Snohomish County PUD, and for power sales to the Bonneville Power Administration. The Commission Staff recommends that no adjustments be made to the two power purchase contracts, and that ratepayers be held harmless from any negative consequences of the BPA sales contract. Public Counsel recommends an adjustment to the Montana Power Company contract.

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[34] Exhibit T-2188 Page 11.

[35] Exhibit C-2194.

**a. Montana Power and Snohomish County PUD**

The Snohomish County PUD contract was signed in December 1989. The Snohomish County PUD contract was a demand side purchase of conservation. No party has recommended an adjustment to the Snohomish County PUD contract. The Commission will not disallow any of the costs of the Snohomish County PUD Contract.

The Montana Power contract was signed in October 1989. For the Montana Power (and Snohomish County PUD) contracts, Puget used its 1989 avoided cost forecast. At that time, a coal plant was the regional proxy in avoided cost calculations. This was not a PURPA purchase, but an off-system sale.

The Commission will not disallow any of the costs of the Montana Power contract. No study of dispatchability based on a coal plant has been presented. A coal plant was Puget's, and the region's, proxy resource at the time this contract was executed. The BPA study, on which Public Counsel witness Dr. Blackmon bases his recommended adjustment, is based on a Combined Cycle Combustion Turbine. However, even if we were to use the Public Counsel sponsored dispatchability study, with variable costs at the level accepted by the Commission, no adjustment to the Montana contract would result.

**b. The BPA Sale**

In addition to the power purchases in this proceeding, the Eleventh Supplemental Order also required review of a four year power sale from Puget to the BPA. The contract was signed as a settlement to a lawsuit brought by Puget claiming BPA had breached a contractual provision commonly known as regional preference. The BPA sale is a contract to sell to BPA under two arrangements during the years 1993 through 1997. The contract's two parts include combustion turbine energy and winter energy.

Puget argues that it has analyzed the benefits of its four year sale, as demonstrated by the testimony of Mr. Lauckhart.[36] Mr. Lauckhart's testimony refers to the advantages of the low-load nature of these sales, and compares them to the secondary rates over the preceding four years. Puget also calculates that the contract has provided benefits to the company and ratepayers of over one-half million dollars, to date. The company characterizes the treatment proposed by the Commission Staff as unbalanced. Puget notes that even Commission Staff witness Mr. Winterfeld anticipates benefits from the contract.

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[36] Exhibit 2010 Pages 57-67.

The Commission Staff argues that Puget has provided no analysis of the financial risks of this contract. There are no schedules showing anticipated gains based on particular best-case, worst-case, or "most probable" scenarios. Commission Staff therefore proposes that (on a cumulative basis) ratepayers be held harmless if the contract does not yield net benefits. This position is not based on a belief that the contract will not yield benefits, but rather on the contention that Puget operated imprudently by not evaluating the risks before it entered into the contract. The Commission Staff acknowledges that the treatment is unbalanced, but argues that an unbalanced treatment is an appropriate sanction when a company has not demonstrated prudence.

The Commission finds that Puget did not demonstrate the prudence of the BPA sale. The company should have performed an analysis of the contract terms over a reasonable range of scenarios, to determine the probable future impacts of this sale. Although the company did some analysis of contract terms, such as the advantage of sales during times of low use, the company's analysis does not give an adequate picture of the financial risks that may be associated with the sale, due to changes in Puget's retail load, hydro conditions, gas prices, or other relevant factors.

Ratepayers should therefore be held harmless with regard to any adverse rate impacts. To the extent it can be shown in future cases that the BPA sale has or will result in a cumulative increase in Puget's net power supply expenses, the Commission will allow an appropriate offsetting adjustment. If Puget is correct in its claim that the BPA sale will yield net benefits, it will not be harmed by this treatment.

### 4. COGENERATION PROJECTS PURCHASED OUTSIDE A COMMISSION-APPROVED BID

The fourth category contains three cogeneration contracts which Puget entered into outside a Commission-approved competitive bid setting. Two contracts, Tenaska and March Point Phase II, were acquired pursuant to a "supplemental bid" process not approved by the Commission. The Sumas contract is a natural gas cogeneration plant which was renegotiated from what began as a offer of output from a wood waste plant.

In 1990, as a follow-up to its pilot bid project, Puget conducted what it now calls "Supplemental Bidding". Chapter 480-107 WAC provides for a two year cycle between bids.[37] The rule also provides that bids may be called for more frequently, but that such solicitations "must take the form of an RFP approved by

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[37] WAC 480-107-060(2)(a) read in conjunction with WAC 480-100-251(3).

the Commission."[38] Although chapter 480-107 WAC was in effect, Puget did not follow the rule. The long-run prototype contracts, request for proposals (RFP), and stream of avoided costs required by the rule were not provided.[39] No public comment and review was provided.[40] The supplemental bid was open only to bidders in the pilot bid and other project developers known to Puget.[41] The Commission Staff notified Puget that it must be prepared to justify its decision to purchase new resources outside of the bidding rule.[42]

Thus, the only portions of chapter 480-107 WAC relevant to analysis of these contracts are the definitions in WAC 480-107-005 and WAC 480-07-001(1), which provides:

> . . .
> [t]hese rules do not preclude electric utilities from constructing electric resources, operating conservation programs, purchasing power through negotiated purchase contracts, or otherwise taking action to satisfy their public service obligations. Information about the price and availability of electric power obtained through the bidding procedures described in these rules may be used, in conjunction with other evidence, in general rate cases and other cost recovery proceedings pertaining to resources not acquired through these bidding procedures.

In the "Supplemental Bidding," the price Puget was willing to pay was pegged to an outdated estimate of avoided cost. Puget set a ceiling of 92.5% of its 1989 avoided cost, which used a coal plant as a proxy resource, without analyzing whether it should be modified by the results of the pilot bid, or any other current information.[43] Puget purchased the March Point Phase II and Tenaska projects through this process. The March Point Phase II contract was signed in December 1990; the Tenaska contract was signed in February 1991.

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[38] WAC 480-107-060(2)(a).

[39] WAC 480-107-040 and -050.

[40] See, WAC 480-107-060.

[41] Transcript Pages 5093, 5094, 5161.

[42] Exhibit T-2155 Page 23.

[43] Transcript Page 5751, Exhibit C-2246, Exhibit T-2155 Page 23.

The Sumas project was acquired outside the "supplemental bid" or any other competitive bid process. The Sumas project originated with a February 1989 contract for a 50 megawatt wood-waste plant. Subsequently, Sumas withdrew this project and instead offered Puget a 110 megawatt gas cogeneration project. A contract for the second project was executed in September 1991. Puget's first discussions of the Sumas contract separated it into two separate components, and analyzed them using different avoided cost information. Public Counsel argued that the first Sumas contract was canceled, and that the second contract should be analyzed as a whole based on information from 1991. Puget's brief compares Sumas to the "build" option of its 1991 avoided cost. During this proceeding, Puget negotiated a dispatchability provision in the Sumas contract.

The March Point Phase II, Tenaska, and Sumas resources are all QFs.[44] Thus, Puget should have compared their purchase rates to its avoided cost. All were acquired outside the bidding procedures. Although the Company used a "supplemental bidding" process to acquire March Point Phase II and Tenaska, such a supplemental bidding was not specifically approved by the Commission or reviewed by the parties in the same manner as provided under the rules. Thus, the formal competitive bidding rules and results of Commission-approved bids may provide useful information, but they are not dispositive in determining the reasonableness or prudence of these acquisitions. Other evidence needs to be considered. Other evidence may include the appropriate avoided cost, dispatchability, transmission impacts, building options, and financial and rate impacts, as we stated the Eleventh Supplemental Order. The record shows that the company did not evaluate the contract prices using such evaluation criteria.

The Commission Staff and Public Counsel used the Combined Cycle Combustion Turbine (CCCT) cost in Puget's 1991 avoided cost as their starting point in analyzing Tenaska, March Point Phase II, and Sumas. Puget agrees that the analyses supporting its 1991 avoided cost filing were being performed about the same time that the March Point Phase II and Tenaska contracts were signed and "thus a CCCT represents the 'build option' against which to evaluate these purchases."[45]

The Commission agrees that March Point Phase II, Tenaska, and Sumas should be compared to the costs of a combined-cycle combustion turbine. The information was available to the company at the time these contracts were being negotiated, although the 1991 informational avoided cost had not yet been issued. After consideration of all the evidence, the Commission

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[44] Transcript page 5674; Puget brief page 14.

[45] Brief Page 11.

concludes that Puget paid too much for the Tenaska and March Point Phase II contracts. These resources were not purchased through a competitive bid; the clear standard applied to them as qualifying facilities is that they must cost less than Puget's avoided cost. Puget's general avoided cost must be properly adjusted to review the price of the purchased resources. As discussed in the following sections, the properly adjusted avoided cost is lower than the price Puget paid for the contracts.

### E. How Much Were Ratepayers Damaged by Puget's Mismanagement

The Commission Staff and Public Counsel recommended adjustments calculated by recreating what an adequate analysis by Puget, at the time the resources were acquired, would have disclosed. They sponsored adjustments based on dispatchability, end effects, and capital cost effects. The Commission Staff also recommended an alterative method for computing damages. The parties' "damage" estimates range from a present value of $103.4 million to $505.9 million.

The Commission considered the following options for calculating the damages caused by Puget's mismanagement of its contract selection and evaluation process. In our view each of these options is a reasonable alternative to consider in determining how to balance the interests of shareholders and ratepayers when making an adjustment upon a finding of imprudence.

#### 1. PUGET PAID MORE THAN THE MARKET PRICE FOR THE MARCH POINT PHASE II, TENAKSA AND SUMAS CONTRACTS

A Commission Staff alternative measure of damages would use the 1991 bid results as a proxy for what an adequate study by Puget would have disclosed in 1990. Commission Staff showed two alternate means of calculating this adjustment: one using the second lowest price bid and one using the average price bid. Using the second lowest price would give a present value disallowance write-off of about $315 million; using the average would give a present value disallowance write-off amount of about $200 million.

Commission Staff testified that the so-called supplemental bid conducted by Puget in 1990 was not a competitive process. It was not open to all supply and demand side bidders on an equal basis. The price was essentially dictated by Puget's negotiators, rather than using market competition.

This alternative method of measuring damages could have played out in a couple of ways: if Puget had analyzed its costs properly, using information available to it at the time, its avoided cost would have come out lower--thus the price it set would have come out lower--and the "supplemental" bids might have

come in as low as the bids made the following year. If this did not happen, and Puget rejected the bids because they were all higher than its avoided cost of building the projects itself, then Puget might have pursued building a company owned CCCT. If the result of its bids under the bidding rule, in 1991, were lower than its estimated costs to build, it may have chosen to accept some of the 1991 bids. It could then have compared the bids to a correctly calculated avoided cost and decided which were the better options for the company to pursue.

### a. Puget Did Not Properly Evaluate the Natural Gas Market

Puget claimed that it would have been imprudent to wait to receive offers from its 1991 RFP, rather than purchasing the Tenaska and March Point Phase II, and Sumas contracts.[46] It also argued that the contracts shift the risks of fuel price increases from ratepayers to project developers.[47]

The Commission Staff argued that the value of the shift in fuel risk came at a cost to ratepayers; the company did not document how that cost was considered in the ranking process, if at all.[48] It argued, further, that Puget had not even evaluated obtaining its own firm gas supplies.[49]

The Commission Staff claimed that Puget admitted grossly inadequate knowledge of the natural gas industry and blindly relied on developers for the acquisition of gas supplies.[50] The company was forced to hire Mr. Premo to testify in this proceeding because it had not educated itself about the natural gas market at the time it signed the contracts or at the time of rebuttal. Mr. Premo agreed that Puget could have pursued it own gas supplies, and that the company should have been aware of conditions in the natural gas industry at the time it made its resource decisions.[51] The Commission Staff then discussed what Puget could have learned if it had hired Mr. Premo in 1990, instead of waiting to consult experts until this proceeding.

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[46] Exhibit T-2241 Pages 8-9.

[47] Id., Pages 5 and 9.

[48] Transcript Pages 5994-5995.

[49] Transcript Pages 5707, 5883.

[50] Transcript Pages 5785, 5805, 6225-6226.

[51] Transcript Pages 6286 and 6264.

The Commission Staff described developments in the natural gas market in the Northwest, from 1988 to 1990, which opened up the availability of ample space for transporting natural gas.[52] It argued that these significant developments enhanced the company's ability to acquire firm gas supplies and transportation capacity, and 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.[53]

The Commission agrees with the Commission Staff evaluation. The conditions of the natural gas market do not justify Puget's decision to proceed with its "supplemental bidding," rather than waiting for the 1991 RFP.

**b. The So-Called "Supplemental Bid" Was Not 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.[54] The Commission Staff argued that there is little, if anything, about the supplemental bid which was truly competitive. Puget's departures from the bidding rule's requirements have been discussed supra. at page 23.

The Commission Staff noted that the bidding rules do not preclude a company from acquiring resources outside the formal processes established by those rules. It argued, however, that the company's 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 integrity of the upcoming 1991 RFP and the future development of a competitive market for electric generation in Washington.[55]

The Commission agrees that the supplemental bidding was not competitive. The company made no reasoned analysis which supports proceeding with the 1990 supplemental bid, instead of waiting for the 1991 RFP.

The strong advantage of this method for calculating damages is that it shows the price the market set for comparable resources. It establishes a benchmark against which to measure other adjustments for reasonableness. Ascertaining just such a

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[52] See, Transcript Pages 6269-6300.

[53] Commission Staff Brief at Page 28.

[54] Commission Staff Brief Page 28, et seq.

[55] Commission Staff Brief Pages 30-31.

benchmark was one of the Commission's goals when it established the bidding rule. Another advantage is that it does not require the Commission to attempt, after the fact and without a good company study, to determine what an adequate analysis by Puget would have disclosed.

### 2. ADEQUATE STUDY BY PUGET WOULD HAVE SHOWN THAT THE AVOIDED COSTS OF THE CONTRACTS WERE LOWER THAN THE PRICES IT PAID

#### a. An Adjustment Is Appropriate Because of Puget's Failure to Analyze Dispatchability

Puget and the region rely heavily on a hydro-based system. Resource planning is based on a critical water year. This means that when Puget is in resource balance, in an average water year Puget will have surplus power. Notes from the March 5, 1992 meeting at which Puget briefed the Commission Staff on its 1991 bids indicate that with average water, Puget has 200 average megawatts more power available than in a critical water year.[56] In a wet year, it will have even more. A company-owned resource can be fully dispatched[57]: the company may turn it on and off at will, limited by the engineering characteristics of the resource and fuel contracts. When it is turned off, certain fuel and variable operation and maintenance costs can be avoided. It is these savings that Commission Staff and Public Counsel argue that Puget should have studied and deducted from its generic avoided cost in order to more properly compare its "build" and "buy" options.

Puget argues that it analyzed dispatchability, but that the value of dispatchability was so small that it did not differentiate among projects or options. It appears that what Puget did was to compare its various purchase alternatives and to conclude that one was not significantly better than another because of dispatchability. What Puget failed to do was measure the value of the difference between the dispatchability of its build option and that of its purchase options, in order to properly value its purchase options.

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[56] Exhibit 2168.

[57] Longer periods of dispatchability are referred to as displacement. Both are discussed in the testimony and exhibits in this proceeding. Our analysis of dispatchability and displaceability is the same. We have consistently used the word "dispatchability" in this order to refer to both.

No contemporaneous calculation of the value of dispatchability was provided, and no party has argued that Puget made such a calculation. In fact, Public Counsel argues that the record clearly shows, and that the parties all agree, that Puget did not make such an evaluation of dispatchability for these projects at the time resource decisions were being made.

The Commission finds that Puget's failure to evaluate dispatchability when evaluating these resources was a fundamental flaw in the acquisition process and constitutes imprudence. In fact, Puget admits, after the fact, that dispatchability does have value.[58] We must now consider what the appropriate value is and whether a disallowance is warranted.

In its direct case, Puget offered a dispatchability value of 2.3 mills/kWh based upon a study it performed after the fact in 1993. This value was calculated using Puget's Production Costing System model and a current spot price of gas. Both Commission Staff and Public Counsel have provided estimates of the value of dispatchability that Puget could have determined if an appropriate, contemporaneous study had been done. Both argue that the lack of such a study is Puget's fault. They further contend that Puget should not be able to avoid its responsibility for lack of a complete, Puget-specific study by arguing that second-best, but available, proxies are not perfect. On rebuttal, Puget provided another estimate of the value of dispatchability from Mr. Litchfield.

Commission Staff uses a BPA estimate of 4.5 mills/kWh, based on variable costs of 20 mills/kWh in levelized, 1990 dollars. Both Commission Staff and Public Counsel argue that the value of dispatchability for Puget should be similar to that for BPA, since the two systems are interconnected. The company argues that BPA has more transmission access than Puget and, thus, that dispatchability does not have as much value for Puget as it has for BPA. The Commission Staff then notes that the BPA transmission charges may, in fact, increase Puget's opportunities to dispatch.

Public Counsel uses a 1993 BPA study for its proposed adjustment. Public Counsel characterizes the 1993 study as being closest to the kind of study that Puget should have done, because it includes in-month effects. Exhibit C-2209 shows Public Counsel's application of the 1993 BPA study to each of the purchase contracts which are reviewed in this proceeding.

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[58] See Exhibit T-10, Page 36.

Public Counsel criticizes Puget's Production Costing System study because it set prices at the same level in years with low stream flow as in those with high stream flows, "eliminating the main source of savings from dispatchability, which is to shut down the plant in periods of high stream flow when secondary energy prices are low."[59] Public Counsel also criticizes Puget's use of 1993 gas prices, rather than 1990 gas prices which were higher. Finally, Public Counsel calculated that if Puget's 2.3 mill value were converted to a levelized, nominal amount, it would be 4.55 mills/kWh. Puget did not rebut Public Counsel's analysis of Puget's study.

Public Counsel argues that its dispatchability estimates are better than those of the Commission Staff because Public Counsel's witness analyzed the specific characteristics of each of the contract resources and is, therefore, more accurate. Public Counsel notes, also, that the Staff estimate of variable costs is within 10% of its own.

After Puget amended the Sumas contract during the course of these proceedings to provide for dispatchability, Public Counsel modified its recommendation for a disallowance for Sumas. Public Counsel argues that it correctly treated the Tenaska project as if it could only be dispatched for 80 days per year, based on the limitations on dispatchability discussed in Exhibit C-2220, and the fact that, in light of Exhibit C-2220, no information indicating that a greater amount of dispatchability would be allowed was added to the record by Puget.

Puget argues that both Commission Staff and Public Counsel place an inflated value on dispatchability. The company criticizes Commission Staff and Public Counsel for excerpting fuel cost estimates from the Company's least-cost plans and for assuming that all or most of those fuel costs are variable. Mr. Premo testified that a firm fuel supply would require fixed price components, including minimum take provisions.

Puget also challenges use of BPA estimates by Commission Staff and Public Counsel, arguing that the BPA power system is fundamentally different from Puget's. Puget hired Mr. Litchfield to check BPA's 1991 estimate of the value of dispatchability. His study, using BPA's Systems Analysis Model produced a value of dispatchability of about 2.4 mills/kWh, levelized 1990 dollars. Alternatively, Mr. Litchfield's study, using the Power Marketing Decision Analysis Model, produced an even lower value. Mr. Litchfield concluded, based on both studies, that a reasonable estimate of the value of dispatchability is a range of 0.2 to 2.0 mills/kWh, expressed in real 1990 dollars.

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[59] Public Counsel brief Page 21.

The Commission Staff recommends rejection of Mr. Litchfield's modifications to the study used by the Commission Staff. Commission Staff identifies two errors, each of which made the value of Mr. Litchfield's number 20% lower than it would otherwise have been. Commission Staff argues that the number was 40% too low even before analyzing the appropriate gas cost forecast. The Commission Staff argues that another flaw was Mr. Litchfield's use of a gas price estimate far lower than that used by the Regional Council (whose model he used) in 1991. Staff further argues that if Puget had approached BPA in 1991 to obtain the backup for the study, that backup could have been provided and analyzed. In Staff's opinion, Puget is wrong to criticize the Commission Staff now, because the BPA backup is not now available, because this improperly assigns responsibility for Puget's failure to do an adequate study to the Staff.

The Commission concludes that Puget's failure to fully evaluate dispatchability when acquiring resources was a major flaw in Puget's process. If Puget had done a proper evaluation of dispatchability at that time, the Commission would not have to choose among the offered proxies. The responsibility for the dearth of contemporaneous information rests squarely with Puget. It is difficult to construct an adjustment, using information that was, or should have been, available to Puget at the time these contracts were signed. The Commission rejects Puget's contention that the offered proxies should be discarded because they are not perfect.

The Commission believes that the study presented by Dr. Blackmon is the best alternative because it measures in-month effects. Use of this study is consistent with the Commission's order in the general rate case regarding within-month secondary transactions.[60] It is also consistent with the Commission's decision in the PRAM 4 order, entered contemporaneously with this order.[61] The dispatchability study was based on a CCCT. Thus, the Commission has concluded that the adjustment should only be applied to resources whose avoided proxy resource is a CCCT. Those resources are March Point Phase II, Tenaska, and Sumas.

Although the Commission considers Mr. Blackmon's adjustment to the three contracts reasonable, it has also considered two other alternatives which also are reasonable based on the record. The dispatchability study upon which Mr. Blackmon relied is shown in Exhibit C-2209. The exhibit shows the value of dispatchability at alternative levels of savings. Mr. Blackmon based his recommended adjustment on the column using 25

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[60] Eleventh Supplemental Order, Page 47.

[61] Docket No. UE-940728.

mills/kWh as the variable costs saved per each kiloWatt hour of dispatch. A disallowance based on 25 mills/kWh would equal approximately $12.4 million in the first year; 19.4% of the March Point Phase II contract, 16.6% of the Tenaska contract, and 13.5% of the Sumas contract.

The Commission Staff based its recommended displacement adjustment on variable costs of 20 mills/kWh. A disallowance based on the 20 mill column in Exhibit C-2209 would equal approximately $5.4 million in the first year; 10.1% of the March Point Phase II contract, 7.8% of the Tenaska contract, and 3.6% of the Sumas contract.

Puget rebuttal witness Mr. Litchfield recommended use of a 15 mills levelized real variable cost amount.[62] A disallowance based on the 15 mill column in Exhibit C-2209 would equal approximately $1.0 million in the first year; 3% of the March Point Phase II contract and 1.2% of the Tenaska contract, with no resulting disallowance for Sumas. These disallowances have a net present value of approximately $16.8 million, based on Public Counsel's response to Bench Request No. 2002, Exhibit 2221.

The Commission will revise Dr. Blackmon's calculation of the value of dispatchability by using the 15 mill column of his exhibit. In so doing we are using the best study of dispatchability presented. We are using the most conservative estimate of variable gas costs. These choices mean that we will make an adjustment only to the amount of the cost of the March Point Phase II and Tenaska contracts which may be passed on to ratepayers. These contracts were entered into at a time when the company had gathered the information used to calculate its general 1991 avoided cost. If it had correctly analyzed its avoided costs to purchase rates which properly valued the two specific projects, as compared to a company built CCCT, it would not have agreed to purchase at the prices its paid. Because we have chosen to use Mr. Litchfield's 15 mill gas cost estimate, there is no resulting adjustment to the amount of the Sumas purchase price passed through to ratepayers.

The Commission finds that, for the March Point Phase II and Tenaska contracts, Puget's failure to factor in the value of dispatchability caused Puget to pay too much for the contracts. For ratemaking purposes, the portion of the price the company can recover from ratepayers will be adjusted. Future ratemaking treatment for these contracts should reflect the disallowances as follows for the two contracts: 3% of net contract charge for March Point Phase II, and 1.2% of net contract charge for Tenaska. The net charge is the amount paid to the contractor, Tenaska or March Point, plus any payments for replacement power resulting from economic dispatch.

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[62] Exhibit T-2247 Page 9.

Even though we have not accepted their recommendations, the Commission is grateful to the Commission Staff and Public Counsel for their thorough work in this proceeding. They have brought into focus lessons regulators and the industry must learn as we move into an increasingly competitive future. We are moving into uncharted territory, where the environment will clearly be more competitive than the present or recent past.

A prudence review in this context is inherently a very blunt instrument. It is particularly so in this case, where the company's failure to properly evaluate and document its power purchases requires the use of proxies and estimates to measure disallowances. We must protect monopoly ratepayers from paying rates that are too high because of the company's imprudent actions.

While we conclude that a larger disallowance would be defensible, we also must look ahead. While Puget paid too much the contracts, the use of purchased power will in all likelihood continue to be a major part of Puget's resource acquisition strategy. We think this company's management must do better in the future, not only for the sake of its ratepayers but also to insure its viability in a more competitive environment. However, the Commission took seriously the comments from representatives of various independent power producers in the public hearings. We are mindful that the electric power industry is currently undergoing a major "paradigm shift" and market structure transformation. The region's regulators and policy makers are all struggling to harmonize the continuing relevant goals of PURPA, the Northwest Power Planning and Conservation Act and the new market forces unleashed by the Energy Policy Act of 1992. We have, therefore, chosen the "damages" or disallowance option with the least impact on Puget's bottom line.

## *III. WHAT PUGET SHOULD BE REQUIRED TO DO IN THE FUTURE*

### A. Puget Should Make an End Effects Adjustment

An end effects adjustment is used to correct for the effects of inflation in comparing the value of resources which have different lives. Puget contends it made an adjustment for end effects when it levelized the capital costs of the projects. Puget argues that an end effects adjustment (as defined above) should not be made. Puget cites the Commission's order in Docket U-86-119 (relating to The Washington Water Power Company) as authority for its position. Puget further contends that this position was reinforced in informal consultations with the Commission Staff. Finally, Puget argues that the contracts in this matter grant the company certain rights in the projects beyond the term of the power delivery. Puget did not quantify the value of these rights.

Commission Staff argues that the capital costs of the company's build option must be adjusted to make it comparable to the value represented by a shorter-lived purchased power option. The Commission Staff made this adjustment by using a non-levelized stream of annual costs that escalates with inflation. The Commission Staff notes that the Commission order in Docket U-86-119 dealt with setting avoided costs for small (1 megawatt or less) renewable resources or cogeneration projects. The Commission Staff contends that order should not control Puget's analysis of larger projects for which an advisory avoided cost filing only provides a ceiling.

Public Counsel agrees with the Commission Staff analysis. Public Counsel also notes that Mr. Litchfield testified that an end effects adjustment would result in more accurate results.[63] Public Counsel agrees that Puget could reasonably have followed the order in Docket No. U-86-119 in 1987 and 1988. Public Counsel argues that responsible utility managers would have begun making the adjustment in 1989, with the advent of competitive bidding and the expectation that supply from non-utility generators would become the norm.

The Commission agrees that Puget arguably could have relied on the order in Docket No. U-86-119 in failing to use end effects adjustments. Although the company characterized the Commission's directive in that order more broadly than we might, we cannot say the company acted unreasonably. This case has, however, persuaded the Commission that end effects adjustments are necessary to accurately compare and contrast resource options with different lives when the company makes a decision to purchase. In the future, the Commission will expect the company to include end effects adjustments as a part of its analysis of the cost of various options.

### B. Puget Should Make a Capital Cost/Capital Structure Adjustment

In the 1993 general rate proceeding, the Commission allowed Puget's return to be set based on Puget's actual capital structure of 45% equity. For ratemaking purposes, Puget's equity percentage had previously been hypothetically assumed to be 39% to recognize the risk-reducing benefits of the PRAM. In its 1990 general rate proceeding, Puget's actual equity percentage had been 41.5%. Puget witnesses testified that the company had increased its equity ratio because of the large percentage of purchased power in its portfolio.

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[63] Transcript Page 6362.

Commission Staff argues that, over the last four years, Puget has increased the relative amount of common equity in its capital structure. In comparing purchased power and its own build options, Puget should have considered these impacts on its capital structure, overall rate of return, and revenue requirement. The Commission Staff contends that Puget was fully aware of the negative exposure to its credit quality that purchased power created, and that its failure to attempt to evaluate that impact, just because the rating agencies had not quantified them, is yet another example of Puget failing to carefully consider the financial impacts of its decisions to purchase power.

Puget opposes the Commission Staff's adjustment for capital structure for several reasons. It claims that it assumes revenue requirements impacts that have not been shown to exist, and that it is premised on information that was not available at the time the resource decisions were made. Puget argues that the Commission Staff presumption that the Commission adopted a 45% equity ratio as a result of the impact of purchased power is not apparent from the Eleventh Supplemental Order, nor does the Order indicate that a revenue requirement impact was associated with this higher common equity ratio. Puget also argues that the Commission Staff adjustment is premised on hindsight, because Puget did not know what the rating agencies would be saying about purchased power when it signed these contracts.

The Commission directed the company in the Eleventh Supplemental Order not to use different assumptions regarding the cost of capital in the planning and acquisition stages of the ratemaking process (page 22). Thus, the proper comparison may be between the two presentations of the company, rather than to the decision of the Commission. Puget was told that if it attempted to raise cost issues not considered in the least-cost planning process in order to recover those costs in rates, it must explicitly explain and justify those deviations. Puget raised its actual equity component to 45%, and argued in the first phase of this proceeding that it needed more equity because it had so much purchased power. The Commission set rates based on Puget's actual capital structure. Puget argues now that the higher equity ratio has not been shown to have an effect on its revenue requirement, based on Dr. Peseau's testimony, and the Commission order. Because of tax effects, there is a revenue requirement increase.

The Commission will not make an adjustment in this prudence review based on capital cost or capital structure. The Commission is persuaded that much of the information about rating agencies' views of purchased power was not available at the time these contracts were signed.

Now that detailed information is available, however, the company in the future should use that information to quantify the impact of future resource acquisitions on capital cost and capital structure. These factors require evaluation during the time the company is making its decisions on resource acquisitions and must be documented thoroughly.

### C. Puget Should Make Better Analyses and Keep Better Records

Several of the parties make recommendations about instructions which should be given to the company for the future. Puget recommends that any Commission concerns in these areas, including the link between least cost planning and resource acquisitions, be addressed in a generic, forward-looking proceeding that would allow all interested parties to participate.

Commission Staff 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. First, the least cost planning process should support the bid evaluation process. Second, the least cost plan should explicitly and quantitatively incorporate uncertainty in load and resource projections in the derivation of an action plan. Third, participation of Commission Staff and other parties should be encouraged at a very detailed and technical level. Fourth, improvements should be ordered in the current planning models, such as Production Costing System, MIDAS, and Washington Utilities and Transportation Commission Avoided Cost. Fifth, a formal evaluation and ranking system should be adopted.

Public Counsel argues that the Commission should go beyond rejecting the Puget dispatchability study and direct Puget to improve its capabilities in this area. The Production Costing System should no longer be considered reliable or acceptable. Public Counsel also recommends that after this proceeding and a period for reflection, Puget should be asked to declare publicly its current thinking on the issue of pre-approval of purchased power contracts.

The Commission intends to issue a Notice of Inquiry exploring the interaction of the least cost planning process with competitive bidding and prudence review. The Commission has held a series of roundtable discussions in recent months on the evolving structure of the electric industry to provide a backdrop for the Notice of Inquiry, which we will issue this Fall. The inquiry will consider generically many of the issues litigated in this proceeding including, among others, the relationships between and among least cost planning, resource acquisitions, and prudence reviews; the competitive bidding and least cost planning rules; and alternatives to traditional prudence review, including performance-based and other alternative forms of regulation.

The Commission is aware that the academic community and our own National Association of Regulatory Utility Commissioners are evaluating concepts like rolling prudence reviews as a means to bring prudence reviews closer in time to the actual decisions by the utilities. In our view, the prudence review remains important to assure that the company is not indifferent to cost. Utility managers are faced with an increasingly competitive future. They must learn skills that their counterparts in the unregulated sector have always observed and succeeded or failed by soon.

It is beyond doubt that the region will see more power supply purchases in the future. In an increasingly competitive environment, Puget will need to be more sophisticated in its evaluation of its choices and aggressive in its negotiations. It should be evaluating options like converting its own combustion turbines to CCCTs, and building turnkey projects. It only represents common sense to observe that Puget cannot negotiate from an appropriate base of knowledge if it does not have a clear understanding of what it would cost to build plants itself, and of the costs and benefits of both building and purchasing.

For acquisitions of this cumulative magnitude, we would expect the Puget Board of Directors in the future to be better informed about resource acquisitions and their costs, and more involved in the decision process. The company was instructed in the Eleventh Supplemental Order to maintain all documents related to its decisions to enter into specific contracts.[64] The company should also improve its model for estimating power costs. There is no reason to wait for a Notice of Inquiry before making the improvements identified in this case as deemed necessary by Puget's management.

Puget is instructed specifically to analyze any resource alternative it is considering, using the most currently available information, and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning and good practice will disclose need specific analysis at the time of an acquisition decision. In addition to making an adequate study at the time, Puget must keep adequate contemporaneous records of its decision process which will allow the Commission subsequently to evaluate its decisions. This is the minimum standard to which a regulated utility should be held.

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[64] Eleventh Supplemental Order Page 24.

# *IV. OTHER ISSUES*

## A. Puget Procedural Challenges

Puget on brief challenged two procedural rulings made by the Commission during the course of this case.

### 1. Did the Commission Err By Striking Testimony

On brief, Puget repeats its arguments that the Commission should not have stricken the pre-filed rebuttal materials of Charles Olson, and part of that of Donald Gaines. Puget argues that the testimony rebutted evidence offered by the Commission Staff. Puget further contends it should have been allowed to argue that the end effect of any write-down would constitute an unconstitutional taking. Puget apparently seeks reconsideration of this decision (although it also argues that the error cannot be cured).

The Commission ruled:

> [T]he Commission reviewed public counsel's motion to strike portions of the testimony of Donald E. Gaines, and all of the testimony of Charles E. Olson, and the motion is granted. The testimony of these witnesses does not address what a reasonable board of directors and management would have decided given what they knew or reasonably should have known to be true at the time these contracts were entered into. The Commission feels that the company submitted prefiled is not proper rebuttal, that is, it's not addressing the same issue that is addressed by public counsel and staff, and that is the focus of this procedure, and it is outside the scope of the prudence review.[65]

The Commission determined that two different, unrelated, cost of capital issues were being presented by the Commission Staff and Public Counsel on the one hand and by Puget on the other. It found relevant the issue of whether cost of capital impacts from the purchased power contracts should have been considered when the contracts were negotiated, and were properly accounted for. It found testimony regarding whether its decision regarding prudence would have a future impact on Puget's cost of capital to be addressing a different concept. Puget's testimony was addressed to future impacts, which were outside the limited scope of this portion of the proceeding, and was beyond the scope of appropriate rebuttal testimony.

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[65] Transcript Pages 5631-5632.

The Commission properly determined certain portions of the prefiled materials should be stricken. Public Counsel's motion was properly granted.

**2. Should the Commission Reconsider its Ruling on the Summary Judgment Motion**

On brief, Puget again argues that the price it paid for the Koma Kulshan, Spokane MSW, March Point Phase I, and Encogen contracts are just and reasonable as a matter of law. This contention was rejected in the Commission's ruling on Puget's motion for summary judgment.

On July 13, after taking written and oral argument, the Commission denied Puget's motion for partial summary judgment. the Commission ruled:

> In the first motion, Puget has argued three bases for its motion. The first is avoided cost. Puget argues that the Spokane and March Point I contracts were priced at or below the avoided costs filed with the Commission, and as such are reasonable. However, this position ignores the procedures set forth in PURPA, and in the Commission's rule in place at the time those contracts were signed, chapter 480-105 WAC.
>
> The filed avoided cost to which Puget refers are only estimated forecast costs intended for consideration as only one of many factors required to be considered in determining a reasonable rate to pay a QF. The estimated avoided costs are indeed filed with the Commission, and reviewed by the Commission pursuant to WAC 480-105-030. However, as can be seen by a plain reading of WAC 480-105-050, these numbers or data are then used along with several other factors to calculate the rate for purchase. Thus, as public counsel argues, the central issue in this case is determining the appropriate avoided cost adjusted for the above factors that a prudent utility manager would have paid for each contract. One can see from reviewing the factors in the rule that this is a question of fact, not a question of law.
>
> The second basis that Puget argues is that the Commission is precluded as a matter of law from reviewing these contracts. Puget argues that as a matter of law the costs incurred for these contracts cannot now be disallowed. Puget seems to confuse the relationship between a utility and a QF, where the Commission cannot retroactively change the avoided cost price in a contract between the utility and the QF,

with the ratemaking issue between the utility and the ratepayers which this Commission governs and which does not appear to be preempted by federal law. Public counsel cites several cases supporting the position that PURPA and FERC's rules implementing PURPA were not intended to divest a state regulatory authority from reviewing PURPA contracts for prudence to determine what amounts will be recovered from ratepayers. Even the case Puget cites and attaches to its brief supports this position. So the Commission has found that it is not precluded as a matter of law from reviewing these contracts.

The third basis is that the contracts have already been approved by the Commission. Puget argues that the Commission has already approved the subject contracts by "accepting" them after favorable staff recommendation. Public counsel and staff point out that Puget has itself acknowledged that the Commission's "acceptance" of a contract was not pre-approval for the purposes of ratemaking, referring to the portion that was read earlier of Puget's January 8, 1992 answer to the petition for rehearing in the Puget energy cost adjustment clause (ECAC) proceeding.

Also, in the Commission's EPACT proceeding, initiated to consider among other things whether to implement procedures for the advance approval of long-term contracts, Puget's witness, Mr. Lauckhart, stated, "The appropriate forum for Commission review of long-term purchases is in rate cases. In each rate case, the costs of purchases are reviewed for inclusion in rates based on whether they are prudent. Advance approval requirements would impose additional transaction, negotiation difficulties and burdens on the company as it pursues individual opportunities and would inappropriately shift managerial responsibility to the Commission."

The Commission finds that the contracts have not been pre-approved by the Commission, so Puget's motion for findings as a matter of law and exclusion of evidence is denied. The Commission is not preempted from considering ratemaking issues surrounding PURPA contracts. Puget must prove that these contracts were just and reasonable. To do so will require the resolution of several factual issues including the appropriate avoided costs. Thus resolution of the reasonableness of these contracts is not appropriate for a motion for summary judgment.

> Finally, the Commission has not approved these contracts for the purposes of ratemaking by "accepting" those contracts following submittal and a favorable staff recommendation as previously acknowledged by Puget itself.[66]

The Commission must determine the proper avoided cost adjusted for various factors that a prudent utility manager would have paid for each contract, which is a question of fact. The Commission found it is not precluded by state or federal law from considering ratemaking issues surrounding these contracts. The Commission did not approve these contracts for ratemaking purposes by "accepting" those contracts following submittal and a favorable Commission Staff recommendation at a Wednesday morning open meeting. After reviewing the Koma Kulshan, Spokane MSW, March Point Phase I and Encogen contracts in this order, the Commission has not approved any ratemaking adjustments to the portion of their prices that may be passed on to ratepayers.

The motion for partial summary judgment was properly denied.

**B. PUBLIC TESTIMONY**

The Commission usually sets one or more hearings for the purpose of taking testimony from members of the public. In this case, the public hearings were held on June 10 at Olympia and on June 17 at Bellevue. 31 persons testified at the Olympia hearing and 33 persons at the Bellevue hearing. Letters and other documents submitted at the public hearings are included in Exhibits 2147 and 2148.

In addition, letters and other materials were submitted by mail regarding the prudence review. Those documents were included in the record for illustrative purposes as Exhibit 2149.

Generally, the Commission would be pleased by a greater level of public participation. In this case, however, the Commission has strong concerns about the manner in which the public process was manipulated. Letters from Public Counsel and from a group calling itself "Puget Power Shareholders for Fairness" are included in Exhibit 2147 and illustrate the type of information being disseminated about this case.

Many of the letters in Exhibit 2149 include copies of newspaper articles about this case. Many of the letters are form letters which begin "... I join my fellow Puget Power shareholders in asking we be given fair consideration..." The testimony of several witnesses indicated the group "Puget Power

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[66] Transcript Pages 5628-5631.

Shareholders for Fairness" had sent out letters to approximately 20,000 Puget shareholders urging them to attend the public hearings and read the "attached background material" (although the background material is not attached to the copy of the letter given to the Commission for the exhibit).[67] The letter indicates it was sent to Governor Lowry and various legislators, and urged shareholders to contact the Commissioners directly, Public Counsel, the governor, various legislators, and the newspapers.

Not surprisingly, most of the persons testifying at the public hearings were shareholders.

Shareholders, of course, are always welcome to testify. The Commission is legitimately concerned, however, by the company's extensive attempts to resolve the matters at issue in this proceeding outside the hearing room. It mounted a political campaign to pressure the Commission to reach a decision not based upon the record or on Puget's statutory burden to prove the reasonableness (prudence) of these resource acquisitions. The Commission, in future proceedings, will carefully scrutinize any costs incurred by the company in pursuing these tactics.

The Commission is mandated by state law to inquire into the prudence of company actions. Under the APA it must decide the issue exclusively upon the record evidence, within a quasi-judicial framework and setting. If we allowed matters outside the record to control our decision making, we would be violating the law. Efforts to "backdoor" the decision by involving the Governor or legislators in direct contact with Commissioners outside the record are clearly unethical and violate the Administrative Procedure Act, which prohibits parties from making direct or indirect contacts with us or the Administrative Law Judge. RCW 34.05.055. The company and its advisors surely know this is illegal and unethical.

The shareholders who commented in large part blamed the Commission for this prudence review and its possible consequences. Instead of such remonstration, those shareholders should be asking Puget's legal counsel, Officers, and Board of Directors why the company failed to make its decisions in a manner that would allow it to demonstrate prudence, particularly after numerous Commission orders reminding the company such a demonstration would be required.

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[67] Transcript Pages 5313-5314.

**C. Effect of Residential Exchange Credit**

A Public Counsel letter to customers stated that if a disallowance were to occur in this proceeding it was unlikely that residential or small farm customers would see any decrease in their rates because of a resulting decrease in the BPA residential exchange credit.[68] This was based on the probability that, in the current year, a reduction in residential and farm rates would be offset by a reduction in residential exchange credits from the BPA. Some other letters have argued that the outcome of this case does not matter, since residential customers would not have rate savings. This kind of conclusion tends to mislead the public.

The Commission notes that there is no guarantee that residential exchange credits will continue to be available for the life of these contracts. In fact, there are some interests in the region which would like to see the credits "capped." And even if BPA continues to pay exchange credits, as economists like to remind us, there is really no "free lunch."

Such payments increase BPA's costs, to the detriment of the entire region. When the average system cost for Puget increases, the price BPA must pay for the exchange power increases, affecting the rest of the region. If Puget blithely assumes it can pay too much for purchased power because it can always passes such costs through to any class of ratepayer, it is simply not operating efficiently, and such inefficiencies burden the region's economy.

The Commission also rejects any implication that rate increases to industrial and commercial customers are not important. These ratepayers are vital to our state's economy. A monopoly's rate increase has much the same dampening economic effect as a tax increase. Cost increases that are not prudent are not acceptable just because they only impact commercial and industrial customers. Puget needs to control its costs for the benefit of all its customers.

**D. A Call for Balance**

PURPA and least cost planning were designed, in part, to encourage utilities to consider options in addition to their business-as-usual "build" options. Much of the current academic and policy literature is focused on forcing electric companies to consider non-utility generation. Puget has swung to the other extreme; it compared various "buy" alternatives, but did not compare them to a properly calculated "build" option.

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[68] Exhibit 2147, Public Counsel letter to customers, Page 5.

Wayne Meek, Executive Director of the Northwest Cogeneration and Industrial Power Coalition, testified at the June 17, 1994, public hearing as follows:

> This case involves the question of how Washington utilities will complete their future resource needs. If the Commission orders a disallowance here, the state regulated utilities will look at purchased power as a risky endeavor. This would be a tragic consequence for competitiveness and for Puget ratepayers.[69]

This order should not be read as a message that only company-built resources should be considered, and that least cost planning and competitive bidding are henceforth in disfavor. That is not the Commission's message. The company needs to fairly consider all of its resource options: supply-side, demand-side, company-built, non-utility. It will then have the information needed to make the best decisions and negotiate effectively on behalf of its customers.

Based on the entire record and the file in this matter, the Commission makes the following findings of fact and conclusions of law.

## *FINDINGS OF FACT*

Having discussed above in detail both the oral and documentary evidence concerning all material matters, and having stated findings and conclusions, the Commission now makes the following summary of those facts. Those portions of the preceding detailed findings pertaining to the ultimate findings are incorporated herein by this reference.

1. The Washington Utilities and Transportation Commission is an agency of the state of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, accounts, securities, and transfers of public service companies, including electric companies.

2. Puget Sound Power & Light Company (respondent herein) is engaged in the business of furnishing electric service within the state of Washington.

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[69] Transcript Pages 5464-5465.

3. The Commission's Eleventh Supplemental Order in these consolidated cases directed the company to file by November 1, 1993, a power supply case which demonstrates the prudence of its resource acquisitions since the last general rate proceeding. Puget was also directed to demonstrate the prudence of its four-year firm energy sale to the BPA.

4. The Commission's Eighteenth Supplemental Order expanded this review to include Puget's contract with Tenaska, by granting a joint motion by the Commission Staff and Public Counsel.

5. Puget has not carried its burden to demonstrate that its new resource acquisitions were prudent. Puget mismanaged its contract selection and evaluation. Puget was imprudent in its failure to move from the flexible planning process to a rigorous, specific evaluation of the merits of resources at the time their acquisition was being considered. The company's decision-making process was not adequate and was not adequately documented.

6. Puget was imprudent because it failed to analyze the value of dispatchability of a company built resource and factor that value into its evaluation of the purchase price it agreed to pay for its power purchase contracts. Because Puget did not make an adequate, contemporaneous, study of the value of those sponsored by the parties. The 1993 BPA study sponsored by Public Counsel is the best proxy, because it measures in-month and inter-month dispatch. This study was based on a CCCT, and the Commission will only apply its results to purchase contracts whose avoided resource was a company built CCCT. Public Counsel used a variable cost estimate of 25 mills as the amount of costs which could be avoided when the CCCT was dispatched. The Commission Staff used an estimate of 20 mills. Puget witness Mr. Litchfield used an estimate of 15 mills. These estimates are all within a range of reasonableness. The Commission will use Mr. Litchfield's 16 mill estimate, since it is the most conservative. Exhibit C-2209 shows the application of the 1993 BPA study to the contracts at issue in this proceeding. The exhibit shows the study results for various levels of avoidable variable costs. The Commission finds the column based on 15 mills to be the appropriate foundation for its adjustment. Applying the study results in adjustments to the March Point Phase II and Tenaska contracts.

7. As the result of Puget's actions, it has not obtained some resources at a reasonable cost. Because this is Puget's responsibility, ratepayers should not bear the extra costs. For the Tenaska and March Point Phase II, Puget's failure to factor in the value of dispatchability caused Puget to pay too much for the contracts. For ratemaking purposes, the portion of

the price the company can recover from ratepayers will be reduced by $1.0 million for the first year. due to dispatchability. Future ratemaking treatment for these contracts should include percentage disallowances to reflect the excess amounts, as follows: Tenaska 1.2% and March Point Phase II 3.0%

8. As the result of Puget's actions, it has not obtained some resources at a reasonable cost. Because this is Puget's responsibility, ratepayers should not bear the extra costs. For the Tenaska and March Point Phase II, Puget's failure to factor in the value of dispatchability caused Puget to pay too much for the contracts. For ratemaking purposes, the portion of the price the company can recover from ratepayers will be reduced by $1.0 million for the first year, due to dispatchability. Future ratemaking treatment for these contracts should include percentage disallowances to reflect the excess amounts, as follows: Tenaska 1.2% and March Point Phase II 3%.

9. The company did not act unreasonably in relying on the Commission's order in Docket No. U-86-119 in failing to use end effects adjustments to evaluate these resources. Nevertheless, end effects adjustments are necessary to accurately compare resource options with different lives. The company will be expected to use end effects adjustments in the future.

10. The Commission will not make an adjustment in this prudence review based on capital cost or capital structure. The company in the future should use information available about rating agencies' views of purchased power to quantify the impact of future resource acquisitions on capital cost and capital structure. These factors require evaluation during the decision-making process.

11. Puget in the future should keep its Board of Directors better informed about resource acquisitions of significant magnitude and their costs. The company should maintain all documents related to its decisions to enter into specific contracts. The company should also improve its model for estimating power costs. Puget should specifically analyze any resource alternative it is considering for acquisition, using up to date information and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning process and common practice have disclosed need specific analysis at the time of a purchase decision. In addition to making an adequate study at the time, Puget must keep a record of its decision-making process which will allow the Commission to evaluate its decisions.

12. Puget did not perform an appropriate evaluation of the likely range of future scenarios before entering the BPA sale. Ratepayers should be held harmless with regard to any adverse rate impacts. To the extent it can be shown in future cases that the BPA sale has or will result in a cumulative increase in Puget's net power supply expenses, the Commission will allow an appropriate offsetting adjustment.

13. The Commission properly denied Puget's motion for partial summary judgment. The Commission must determine the proper avoided cost adjusted for various factors that a prudent utility manager would have paid for each contract, which is a question of fact. The Commission is not precluded by state or federal law from considering ratemaking issues surrounding these contracts. The Commission did not approve these contracts for ratemaking purposes by "accepting" those contracts following submittal and a favorable Commission Staff recommendation at a Wednesday morning open meeting.

14. The Commission properly granted Public Counsel's motion to exclude portions of the prefiled testimony of Donald E. Gaines and Charles E. Olson. The portions stricken are outside the scope of this prudence review. They were not proper rebuttal testimony.

15. The following parties filed motions to correct transcript: Puget on August 19 and Commission Staff on August 16. No party filed an answer to either motion. The motions should be granted and the transcripts corrected as indicated in the motions.

From the foregoing findings of fact, the Commission enters the following conclusions of law.

## *CONCLUSIONS OF LAW*

1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of this case and the parties thereto.

2. Puget failed to carry its burden to demonstrate its new power purchases were prudent. Puget's mismanagement of its resource acquisition process was imprudent. Puget also failed to demonstrate the prudence of its four-year sale to BPA.

3. The contract prices should be adjusted for ratemaking purposes to disallow the excessive costs caused by the company's imprudent actions. The adjustments are listed in the Findings of Fact.

4. Ratepayers should be held harmless with regard to any adverse rate impacts of Puget's four-year sale to BPA. To the extent it can be shown in future cases that the BPA sale has or will result in a cumulative increase in Puget's net power supply expenses, the Commission will allow an appropriate offsetting adjustment.

5. At the point of making future decisions about adding resources, the company must make a specific evaluation of alternatives and their costs. In the future, the Commission will expect the company to specifically analyze any resource alternative it is considering, using up to date information and adjusting for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors its planning and common practice has disclosed need specific analysis at the time of a purchase decision. In addition to making an adequate study at the time, Puget must keep a record of its decision-making process which will allow the Commission to evaluate its adequacy include end effects adjustments; evaluate dispatchability; use up-to-date information; and make capital cost analyses, weighing the trade-offs.

6. The motions to correct transcript filed on August 16 and 19 should be granted.

7. All motions made in the course of these proceedings which are consistent with findings and conclusions made herein should be granted, and those inconsistent therewith should be denied.

Based on the foregoing analysis of evidence, findings and conclusions, the Washington Utilities and Transportation Commission enters the following order.

## *ORDER*

## *THE COMMISSION ORDERS:*

1. Respondent is hereby required to reflect the disallowances in the PRAM rate revisions ordered in the Third Supplemental Order in Docket Nos. UE-910689 and UE-940728, entered September 27, 1994.

2. The motions to correct transcript filed on August 16 and 19 are granted.

3. All motions made in the course of these proceedings which are consistent with findings and conclusions made herein are granted, and those inconsistent therewith are denied.

4. The Commission retains jurisdiction to effect the provisions of this order.

DATED at Olympia, Washington, and effective this 27th day of September 1994.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

SHARON L. NELSON, Chairman

RICHARD HEMSTAD, Commissioner

**NOTICE TO PARTIES:**

**This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).**