

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

**BEFORE THE  
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,

Complainant,

Docket No. UE-031725

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**REBUTTAL TESTIMONY OF  
ERIC M. MARKELL  
ON BEHALF OF PUGET SOUND ENERGY, INC.**

**FEBRUARY 13, 2004**

1 **PUGET SOUND ENERGY, INC.**

2 **REBUTTAL TESTIMONY OF ERIC M. MARKELL**

3  
4 **Q: Are you the same Eric M. Markell who submitted direct and supplemental**  
5 **testimony in this proceeding on behalf of Puget Sound Energy, Inc. (“PSE” or**  
6 **“the Company”)?**

7  
8 **A: Yes, I am.**

9  
10 **Q: What is the purpose of your rebuttal testimony?**

11 **A: I summarize the parties’ positions in this proceeding concerning PSE’s acquisition of**  
12 **an ownership interest in the Frederickson 1 facility. The parties agree that PSE acted**  
13 **prudently in acquiring the Frederickson interest, and that PSE has made this acquisition**  
14 **at a reasonable cost.**

15 The only point of dispute concerning the Frederickson transaction involves the  
16 regulatory clause in the Power Sales Agreement (“PSA” or “Agreement”) that gives  
17 either party to the Agreement the right (but not the obligation) to terminate the PSA if  
18 the Commission does not approve the costs of the acquisition in PSE’s rates. Mr. Elgin  
19 suggests that this clause is “contrary to the public interest and sound regulatory  
20 policy.” *See* Ex. \_\_\_ (KLE-1T) at 2 l. 6-7. I disagree. Based upon risk factors that  
21 exist in today’s business environment, the context behind PSE’s recent resource  
22 evaluation, and the nature of the PCORC process, I believe that the regulatory clause is  
23 an appropriate contract provision in the PSA. Further, the inclusion of the regulatory  
24 clause in the PSA did not cause PSE to pay a higher price for the Frederickson interest.

1           **I.           THE PARTIES AGREE THAT PSE ACTED PRUDENTLY WITH RESPECT**  
2                       **TO THE FREDERICKSON ACQUISITION.**

3           **Q:       Do the parties agree that the Frederickson acquisition was a prudent decision?**

4           **A:**       Yes. After reviewing PSE’s direct testimony, exhibits, and discovery responses, and  
5                   after meeting with members of my project acquisition team, Commission Staff  
6                   concluded that PSE acted prudently in acquiring an ownership interest in the  
7                   Frederickson 1 facility, and that PSE made this acquisition at a reasonable cost. *See*  
8                   *generally* Ex. \_\_\_ (HM-1TC/HC) at 3-9. ICNU and Public Counsel did not address the  
9                   acquisition in their filings; therefore, PSE assumes that these parties also support (or at  
10                  least take no issue with) the prudence of PSE’s decision.

11  
12                  As I discussed in my direct testimony, the Frederickson acquisition represents a modest  
13                  but important first step towards meeting PSE’s growing power supply needs. *See* **Ex.**  
14                  \_\_\_ (**EMM-1T**) at 44 l. 11-12. PSE’s determination that it requires additional  
15                  resources resulted from an extensive planning and assessment process, which PSE  
16                  documented in its 2003 Least Cost Plan. Commission Staff, Public Counsel, and  
17                  ICNU contributed significantly to this process. I want to thank the parties for their  
18                  participation and for their helpful comments and suggestions.

19  
20           **Q:       Do you have any other comments with respect to Commission Staff’s position?**

21           **A:**       Yes. Mr. McIntosh states that PSE could improve its resource analysis by accounting  
22                  for variations within hourly core loads. *See* Ex. \_\_\_ (HM-1TC/HC) at 7 l. 10-13. We  
23                  agree with Mr. McIntosh and will apply his suggestion in future analyses.

1                   **II.     THE REGULATORY CLAUSE IS AN APPROPRIATE CONTRACT**  
2   **PROVISION IN THE PSA.**

3   **Q:     Please summarize the regulatory clause in the PSA.**

4   **A:**     The regulatory clause is Article 14.1(a)(ix) in the PSA. *See Ex. \_\_\_ (EMM-37C)* at  
5           80-81. The clause gives either PSE or the project seller, Frederickson Power L.P.  
6           (“FPLP”), the right (but not the obligation) to terminate the Agreement if, within a  
7           certain time, PSE has not made a PCORC filing and received Commission approval to  
8           include the costs of the Frederickson acquisition in PSE’s rates.

9  
10 **Q:     Are regulatory clauses commonly included in resource acquisition agreements?**

11 **A:**     Yes. These clauses typically condition closing obligations upon the obtaining of  
12           favorable regulatory action or outcomes (such as necessary Hart-Scott-Rodino and  
13           Federal Power Act approvals and local government approvals). Such clauses are  
14           common in resource acquisition agreements.

15  
16 **Q:     Why do acquisition agreements include these clauses?**

17 **A:**     Prudent management practice dictates that a business eliminate or reduce the impact of  
18           risk factors where possible. This is particularly true in the current energy environment.  
19           Utilities and other energy companies face, in addition to operating risks, significant  
20           business model and transactional risks today due to pending and unresolved regulatory  
21           issues, including Standard Market Design (“SMD”); Regional Transmission  
22           Organizations (“RTOs”); other developing FERC policies; Federal and State emissions  
23           standards; and other issues. I discussed many of these regulatory and business model  
24           factors on January 27, 2004, in a presentation I gave in New York City to the EXNET  
25           17<sup>th</sup> Annual Utility Mergers & Acquisition Symposium. *See Ex. \_\_\_ (EMM-46)*  
26           (presentation titled “Bringing Order from Chaos”).

1 A consequence of the business model and regulatory risk factors is that businesses can  
2 be impaired in their ability to access the financial markets on reasonable terms or at all  
3 (since these markets are sensitive to the impact of actual and perceived risk). To help  
4 ensure access to these markets on favorable terms, energy companies take steps where  
5 possible to identify risk systematically, including regulatory risk, and then eliminate or  
6 reduce it.

7  
8 One way to eliminate or reduce risk – in the context of an acquisition agreement for a  
9 significant resource (such as the Frederickson interest) – is to negotiate a regulatory  
10 “out” condition into the agreement. By negotiating such a condition, and provided that  
11 favorable regulatory action is obtained, the parties to the agreement receive greater  
12 certainty that the financial markets will react favorably to the transaction. As a general  
13 matter, if the financial markets believe that actual and perceived risks associated with  
14 the agreement have been eliminated or reduced, then the parties’ financing costs will be  
15 lower over time than they would otherwise be. This is especially true for companies  
16 like PSE that have significant financing needs, particularly those associated with a  
17 resource acquisition program. Contractual and regulatory mechanisms that help  
18 mitigate these risk factors will, in turn, help to keep down the costs that customers pay  
19 over time for energy.

20  
21 **Q: Are there other reasons why acquisition agreements include these clauses?**

22 **A:** Yes. By motivating the parties to seek the same outcome, *i.e.* favorable regulatory  
23 action, a regulatory “out” clause helps to ensure both that the parties’ interests are  
24 aligned toward closing, *and* that their interests are aligned with the regulatory body that  
25 exercises oversight over the transaction.

1 The clause also signals that, at the inception of a possible transaction, the parties are  
2 aware that significant changes to the assumptions and facts surrounding a transaction  
3 may exist or soon develop, and that these changes may warrant renegotiation of the  
4 transaction's terms and conditions. In the Frederickson transaction, for example,  
5 obtaining favorable tax treatment for the acquisition structure was one such condition.  
6 The regulatory clause in the PSA reserved to PSE's management and to the  
7 Commission significant discretion to address material and changed conditions, but  
8 without the usual and often-significant cost of a "break-up fee." (This fee was not  
9 attached to the PSA clause even though such a fee is customarily included in  
10 acquisition transactions with termination rights.)  
11

12 **Q: Please explain why PSE negotiated the regulatory clause in the PSA.**

13 **A:** As I discussed in my direct testimony, PSE has been mindful of the Commission's  
14 regulatory expectations throughout the Company's recent efforts to enhance its  
15 planning capabilities and to assess different resource opportunities. We have  
16 considered the Commission's prudence requirement. *See, e.g., Ex. \_\_\_ (EMM-1T) at*  
17 *6 l. 12-16; Ex. \_\_\_ (WAG-1T) at 13-14; Ex. \_\_\_ (WAG-6).* We have also considered  
18 the process by which the Commission now evaluates new PSE resources (in a PCORC  
19 proceeding). In this regard, the Settlement Terms for the PCA from the Company's  
20 last general rate case (Docket Nos. UE-011570/011571) state in part: "One objective  
21 of a new resource proceeding is to have the new Power Cost rate in effect by the time  
22 the new resource would go into service." *See Ex. \_\_\_ (WAG-7) at 6.*  
23

24 PSE respects the prudence requirement and the PCORC process. It is important to PSE  
25 that its resource acquisitions meet the Commission's expectations – not only with  
26 respect to the Frederickson acquisition, but also with respect to acquisitions that the  
27 Company may make in the future. But it is also important that we know and  
28

1 understand precisely what the Commission expects of us. In that way, the Company  
2 can better plan and execute the next phases of its resource acquisition program. The  
3 Company can also send a signal to the transactional and financial markets that PSE is a  
4 reasonable party with which to transact and invest capital.

5  
6 The 2002 Asset and PPA Solicitations represented PSE's first significant attempts to  
7 apply its enhanced planning and resource evaluation capabilities. It appeared to PSE at  
8 the time that any resource obtained as a result of the 2002 Solicitations would lay the  
9 foundation for PSE's future acquisitions. It also appeared to PSE that this proceeding –  
10 the first PCORC proceeding – would be the forum in which the Commission would  
11 evaluate any such resource, and that the Commission's assessment would lay the  
12 foundation for regulatory oversight of future acquisitions.

13  
14 Thus, in order to obtain greater "process certainty" and alignment of interests, and to  
15 reduce regulatory risk for future acquisitions, PSE decided that any resource obtained  
16 as a result of the 2002 Solicitations would need to receive Commission review. We  
17 included language to that effect in the Solicitations and communicated our intent to the  
18 resource owners and developers who responded. None of them balked at the prospect  
19 of Commission scrutiny.

20  
21 PSE negotiated the PSA clause for these reasons. Contrary to Mr. Elgin's testimony,  
22 we do not seek "pre-approval" of the Frederickson acquisition. PSE acknowledges that  
23 Commission approval is not legally required for closing to occur. However, we do ask  
24 the Commission to assess PSE's actions with respect to the Frederickson transaction, in  
25 the context of the PCORC process and this initial PCORC proceeding. PSE can then  
26 decide whether to proceed with the acquisition.

1 **Q: Is the PCORC process important to PSE's resource acquisition program?**

2 **A:** Yes. The PCORC process is a critically important tool in our efforts to obtain  
3 additional resources. While the PCORC process may not be useful or needed for all  
4 resource transactions, it greatly reduces a key risk factor – state regulatory uncertainty  
5 – and allows the Company to focus its attention on eliminating or reducing the other  
6 risk factors that I discussed.

7  
8 Further, the PCORC process will allow PSE to complete the Frederickson acquisition  
9 with the benefit of Commission review. The guidance that the Company receives from  
10 the Commission will set the stage for future phases of PSE's resource acquisition  
11 program.

12  
13 Finally, and as a general rule, the Company would prefer to recover its resource  
14 acquisition costs contemporaneous with the acquisition itself, rather than by filing a  
15 general rate case and waiting the eleven months it takes to obtain cost recovery. The  
16 PCORC process specifically provides for this contemporaneous recovery. The PCA  
17 Settlement Terms state – as a PCORC objective – that the Company's new Power Cost  
18 rate should take effect by the in-service date for any new resource that the filing  
19 proposes. *See Ex. \_\_\_ (WAG-7)* at 6.

20  
21 **Q: Will the Company necessarily make a PCORC filing for every future acquisition?**

22 **A:** No. The Company could decide that it is either unnecessary or impractical to make a  
23 PCORC filing for an acquisition that PSE may decide to make in the future. The  
24 Company could base a decision not to make a PCORC filing upon the type and size of  
25 a resource, timing, cost, counterparty concerns, risk assessment, transaction terms and  
26 conditions, and other issues that may relate to the particular acquisition.



1 Each transaction has to be evaluated on an individual basis in order to give appropriate  
2 latitude to PSE management during the negotiating process. Mr. Elgin seems to agree  
3 when he states: “The Commission’s objective is not to interfere with management  
4 decision-making.” See **Ex. \_\_\_\_ (KLE-1T)** at 21 l. 4-5. Yet if PSE were denied the  
5 right to negotiate a contract clause that contemplates a PCORC filing, we would be  
6 hampered in the exercise of our managerial discretion. A “one size fits all” approach to  
7 contract language is not the best way to optimize PSE’s resource acquisition program.  
8

9 **Q: Does the PSA’s regulatory clause increase the Frederickson acquisition cost?**

10 **A:** No. Mr. Elgin claims that PSE indicated as such in its response to Staff Data Request  
11 No. 68. But in fact, the complete response – which I have attached as **Ex. \_\_\_\_ (EMM-  
12 47HC)** – shows that PSE actually obtained a *lower* price for the Frederickson interest  
13 due to PSE’s need to seek Commission review. PSE took the position with FPLP that,  
14 because it would take time for this review to occur, the PSA should include as an  
15 additional downward adjustment to the purchase price the non-cash charges that FPLP  
16 was incurring between the date that the parties signed the PSA and the closing date.  
17 After much hard bargaining, FPLP reluctantly agreed to this adjustment which gave  
18 PSE virtually all of the discount that it had sought. The parties thereafter reduced the  
19 Frederickson price to account for depreciation during the time that the Commission  
20 reviewed the acquisition in this proceeding. Thus, Mr. Elgin is mistaken when he  
21 claims that the PSA clause increased the acquisition cost. Indeed, actions that limit  
22 management’s ability to negotiate with a full array of tools and tactics will ultimately  
23 increase resource acquisition costs over time.  
24

25 **Q: In summary, is the PSA’s regulatory clause “contrary to the public interest”?**

26 **A:** No. A regulatory “out” clause, with or without an accompanying break-up fee, adds  
27 vital flexibility to any asset acquisition transaction. Such a clause reduces risk in the  
28

1 current business environment, and gives our customers and capital providers alike a  
2 measure of assurance that capital will be deployed in a properly risk-adjusted manner.

3  
4 For these reasons, the regulatory clause is an appropriate contract provision in the PSA.

5  
6 **Q: Are you sponsoring any rebuttal exhibits?**

7 **A:** Yes. I am sponsoring the following rebuttal exhibits:

8 **EXHIBIT LIST**

9

	Description of Exhibit	Exhibit Number
10 EMM-45T	Rebuttal Testimony of Eric M. Markell	
11 EMM-46	January 27, 2004 Presentation: <i>Bringing Order from Chaos</i>	
12 EMM-47HC	PSE's Response to WUTC Staff Data Request No. 68 (12-22-03)	

13  
14  
15

16 **Q: Does this conclude your rebuttal testimony?**

17 **A:** Yes, it does.

18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28