PUGET SOUND ENERGY, INC.

Rebuttal Testimony of William A. Gaines

Q. Please state your name and position.

A. My name is William A. Gaines. I am Vice President Energy Supply for PSE. I previously filed testimony in this proceeding.

Overview

Q. What is the purpose of your rebuttal testimony?

A. I respond to Commission Staff, Public Counsel and ICNU by refocusing on the central issues in this proceeding:

- This proceeding is a proceeding to determine whether PSE should be permitted to sell a minority interest in a generating facility.
- The proposed sale of this minority interest will benefit customers.
- The proposed accounting treatment, including amortization of the gain on the sale, is reasonable and consistent with the Commission's merger order, which explicitly encouraged PSE to "manage its resource cost pressures . . . to achieve savings in order to provide shareholders with an opportunity to earn a reasonable return on investment."

Q. Please explain your position.

A. Our application is based on the following principles:

- **The application seeks approval to sell an asset:** PSE has applied for approval to sell an asset and account for the sale. This proceeding is not – and cannot be – a stranded cost proceeding. By definition, there are no stranded costs unless and until there is industry restructuring mandated in

Washington. The opposition cases' invitation to convert this proceeding into a stranded cost proceeding is not only inappropriate, but is also inconsistent with the careful, deliberate approach the Commission has advocated with respect to these issues.

- **The sale benefits customers:** The sale will reduce near-term and intermediate-term power costs. The sale also will eliminate significant long-term risks associated with continuing ownership of Colstrip.
- **The application is consistent with the merger rate plan and applicable accounting principles:** The rate plan was premised on one fundamental principle: for five years PSE was to manage its business, bearing all risk and retaining all benefits. In return for this opportunity, PSE committed to setting rates at levels well below what could have resulted under traditional ratemaking principles. As a result, and as I explain below, customers have already captured substantial savings and will continue to do so.
- **The opposition cases take extreme and unfounded positions:** The opposition cases mischaracterize the merger order, invite the Commission to redefine the legal standard governing asset transfers, and cannot be reconciled with the facts underlying the proposed sale.

Q. Please summarize why you disagree with the opposition cases' contention that the proposed sale does not benefit customers.

A. Overall, the opposition cases fail to consider the relevant facts and analyses, and instead rely on faulty assumptions and inherently speculative out-year forecasts. There are at least three fundamental flaws in their positions.

First, the opposition cases fail to analyze the transaction within the terms of the

Commission's merger order by ignoring the benefits that customers currently receive under the rate plan. Take, for example, the BPA residential exchange credit. Through March 1999 PSE paid out to customers approximately $108 million more than it has received in exchange credits since the start of the rate plan period. In return for these benefits, the Commission ruled that PSE would be entitled to capture the benefits of its cost-cutting efforts during the rate plan period. The opposition cases largely ignore this point.

Second, Staff and Public Counsel, in summarily recommending that the Commission reject the proposed sale, ignore the substantial risks to customers of continuing to own Colstrip. As a result of the sale, customers will not only recognize substantial savings, but they will also avoid the significant risks of continuing to hold a minority interest in a distant coal-fired generation facility, including the risks associated with carbon taxes and environmental remediation liabilities.

Third, the opportunity to sell Colstrip at the price offered, once lost, cannot be recreated. PSE and its customers are the beneficiaries of a unique set of circumstances. PSE and its customers are receiving a price higher than they would otherwise receive absent Montana's divestiture of its generation assets.

Customers Benefit from the Proposed Transaction

Q. You say customers will benefit from the sale. Explain how.

A. PSE's customers benefit in several quantitative and qualitative ways:

<u>Quantitative</u>: As shown in PSE's and Public Counsel's analyses, customers receive substantial near-term and intermediate-term power cost savings. Indeed, each of Public Counsel's analyses show positive cumulative net present

value benefits through 2010.

Qualitative: As Staff acknowledges, there are many crucial factors that do not lend themselves easily to analytical modeling. Nonetheless, these financial risks of continuing to own Colstrip are significant. If, for example, a carbon tax is enacted at the lowest level forecast by the Northwest Power Planning Counsel, customers will be worse off for the next 20 years if PSE is forced to continue to own Colstrip. PSE's proposed sale of Colstrip mitigates potential harm in at least the following ways:

- The sale will eliminate significant risks associated with coal-fired generation.
- The sale will reduce risks by permitting increased flexibility in power supply strategy at a time when there is a great deal of uncertainty about how changes in industry structure and potential technological advancements will affect the provision of energy.
- The sale will limit exposure to environmental liabilities.
- The sale will eliminate the operational challenges that arise from holding a minority interest in a distant facility.

Q. Did your opponents acknowledge these qualitative benefits?

A. Yes, but only in passing. Mr. Elgin states that he agrees "with Mr. Gaines regarding many of the qualitative factors that went into the decision to sell Colstrip," but he does not address the importance of those factors in his recommendation that the Commission reject the transaction.

Q. Did PSE rely solely on the model in its analysis of the proposed transaction?

A. No. The model was developed to analyze a multitude of assumptions and scenarios that lent themselves more readily to quantification than others. Qualitative factors were considered outside of the modeling process. PSE did not rely on any single scenario as the basis on which to make its decision. PSE considered all the scenarios, the unique facts of the sale opportunity itself and the qualitative factors not reflected in the model runs. Based on all of this information, PSE concluded that the sale and accounting treatment proposed in the application benefits both customers and shareholders.

Q. What is the major driving factor in the quantitative analyses performed by PSE?

A. The most important variable is the forecast of future power market costs, which for purposes of the Company's Exhibit 7 analyses is assumed to be the cost of replacement power for Colstrip. The first page of Exhibit 7 summarizes the sensitivity of the analytical outcomes to the very wide range of market prices forecast by the Northwest Power Planning Council. Where in this range actual market prices may fall, or indeed whether this or any forecast of ever-increasing market costs will prove accurate is unknowable, and the uncertainty grows in the later years. Indeed, there is debate about whether competition and technological advancement may instead result in declining commodity prices for electricity, as has occurred in other deregulated markets including the natural gas market (which has experienced declining real prices). Given these uncertainties, the decision to sell Colstrip should focus on the relatively more certain analytical outcomes in the early years of the study period, as well as qualitative factors that do not lend themselves to direct numerical analysis but are of no less importance.

Q. Do you contend that the customers could be harmed if the Commission rejects PSE's application?

A. Yes. As described by Mr. Story in his testimony, a refined and restated analysis based on reasonable assumptions regarding a variety of factors, including imposition of a moderate carbon tax, shows the risks to customers. The magnitude of these risks are large. As Mr. Story's analysis shows, part of the benefit customers receive as a result of the sale is the elimination of these significant risks.

Q. Do you agree with Staff that the Commission should define a new "public interest" standard to determine whether this transaction should be approved?

A. No. The Commission devoted a great deal of time and attention in the merger proceedings to defining the factors to be considered in evaluating whether transactions such as the transaction proposed here are consistent with the public interest. The Commission's order sets forth four factors, all of which should be considered. The factors themselves were the product of a careful analysis of precedent and the statutory framework underlying the public interest standard. The merger order standard should be applied here.

Nevertheless, even under Staff and Public Counsel's proposed new standard – which requires an affirmative showing of consumer benefits – the proposed sale should be approved.

Q. Staff also argues that under PSE's proposal "profits are privatized" and "losses are socialized." Do you agree?

A. No. To the contrary, PSE committed to providing customers with substantial up-front benefits by implementing the merger rate plan. As part of that commitment, PSE accepted the challenge of finding and implementing unidentified cost-savings to make up what by any measure would be considered potentially ruinous revenue shortfalls. PSE followed through on its commitment to provide benefits; Staff now seeks to confiscate the savings PSE seeks to generate to help pay the cost of those benefits.

The Company's Proposed Accounting Treatment is Both Reasonable and Consistent with the Commission's Merger Order

Q. How is the proposed sale consistent with the merger rate plan?

A. The Commission explicitly stated the basic premise of the rate plan:

> The Stipulation recognizes cost pressures facing Puget during the five-year Rate plan due to increases in purchased power, production, and transmission expenses, and is based upon recovery of various power cost components for 1997 - 2001. Considering these cost pressures and the potential for savings associated with the merger, the Rate Plan reflects the implicit balance struck by the stipulating parties between five years of "rate certainty" for customers, and five years of opportunity for the company to manage its resource cost pressures. Within the five-year window, PSE's financial results will be a function of management's ability to achieve savings in order to provide shareholders with an opportunity to earn a reasonable return on investment.

Merger Order at 21. The rate plan was thus premised on several fundamental principles. First, other than small programmed increases in electrical rates, PSE could not (absent conditions sufficient to justify emergency rate relief) seek or obtain rate increases. Second, PSE was responsible for and had to absorb all cost increases during this time period, no matter the source of the increase. Third, PSE was encouraged to pursue aggressive cost cutting – and, consistent with the plan itself, PSE was entitled to capture all of the benefits of its cost cutting during the rate plan period. Production costs are explicitly identified as part of the anticipated savings. These savings were necessary for PSE to realize even minimally acceptable financial results during the rate plan period. In short, the entire plan was premised on the principle that all gains and shortfalls during this time period would fall on PSE and PSE alone. The opposition cases ignore these principles and encourage the Commission to do the same.

Q. Why do you contend that the opposition cases are inviting the Commission to rewrite the merger order?

A. Because the opposition cases seek to deny PSE the ability to retain any of the savings associated with the proposed sale – while continuing to require PSE to absorb all cost pressures. These cost pressures are significant. For example, during the rate plan period PSE is absorbing approximately $303 million in additional costs by funding Residential Exchange benefits. Furthermore, PSE started the rate plan period with a significant revenue shortfall; but for the rate plan, PSE would have pursued a $74 million / year rate increase.

Q. Do you agree that all of the gain and all of the power cost savings should be deferred until after the end of the rate period?

A. No. This proposal – made by Staff and Public Counsel – also would violate the rate plan by preventing PSE from retaining any of the benefits from the sale while continuing to require PSE to absorb all cost pressures.

This Application Seeks Approval to Sell a Minority Interest in a Generation Asset

Q. Why shouldn't the Commission convert this proceeding into a stranded costs proceeding?

A. This application seeks approval to sell a minority interest in a generation asset. It does not raise stranded cost issues, nor does it seek an order addressing stranded costs. It is difficult at this point to determine how and when open access in the State of Washington will be implemented; or even whether the State will mandate open access restructuring at any time in the foreseeable future. Hence, it is inappropriate to anticipate or implement stranded cost recovery procedures as part of this proceeding. It is clear that an asset sale proceeding is not the appropriate place to resolve stranded cost issues. Indeed, as recognized in the definition of "stranded costs" provided by ICNU, the "stranded cost" issue only arises, by definition, when direct access is provided to customers. The policy issues underlying whether and how direct access should be provided to electricity customers has been thoroughly debated but remains unresolved here in Washington and at the national level as well.

Q. Is the oppositions' testimony consistent with the Commission's cautious policy regarding stranded costs?

A. Staff and Public Counsel propose to summarily dismiss and arbitrarily "resolve" stranded costs in this proceeding. In contrast, to date, the Commission has advocated an approach for this state that emphasizes a careful, deliberate path. *See* WUTC letter to Bill Finkbeiner, Chairman, Senate Energy and Utilities Committee, Washington State Senate (September 9, 1997); Washington State Electricity System Study (submitted to the Washington State Legislature by the WUTC and Washington Department of Community, Trade and Economic Development in compliance with Engrossed Substitute Senate Bill 6560, dated December 31, 1998); WUTC Policy Statement: Guiding Principles for Regulation in an Evolving Electricity Industry, Docket No. UE-940932 (December 13, 1995); Letter to Congress regarding "Low Cost Electric States Initiative" from 23 NARUC member public utility commissions (including WUTC) (December 3, 1998).

Q. Do you have any final comments?

A. Yes. This transaction has a limited shelf life. If PSE does not take advantage of it, it will not be available in the future. It is the result of a unique set of circumstances – circumstances that cannot be duplicated.

Q. Does this conclude your testimony, Mr. Gaines?

A. Yes.