BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

DOCKET No. UE-031725

DIRECT TESTIMONY OF JIM LAZAR (JL-1T)

ON BEHALF OF

PUBLIC COUNSEL

JANUARY 30, 2004

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Q: Please state your name, address, and occupation?

A: Jim Lazar, 1063 Capitol Way S. #202, Olympia, WA 98501. I am a consulting economist specializing in electric and gas utility regulation.

Q: Please briefly summarize your qualifications?

A: I have been engaged in utility consulting continuously since 1982. I have appeared before this commission on many occasions, including virtually every rate-related proceeding involving Puget Power and Puget Sound Energy since 1978. My other clients have included this Commission, the state Commissions of Idaho and Arizona, and numerous federal, state, and local governmental agencies. I was the lead consultant to Public Counsel in creating the Power Cost Adjustment (PCA) mechanism in 2002.

Q: What is the purpose of your testimony in this proceeding?

A: I address the Tenaska contract issues that were reserved to this proceeding from the PCA docket, Docket No. UE-031389. I have compared the proposed current cost of Tenaska to two different benchmarks. The first is the amount allowed for Tenaska in the Prudence Review proceeding, Docket UE-921262, in which the Commission found the original contract to be imprudent. The second is the amount that Puget would now be incurring if they had exercised the option they had to secure a long-term, low-cost supply of gas for this project at the time that the contract was reformed in 1997.

Q: What are your conclusions with respect to the cost of the power from Tenaska compared with these benchmarks, taking into account the costs associated with the Regulatory Asset created in 1997 when the contract was reformed?

A: The Commission should, at a minimum, disallow the excess fuel costs of Tenaska from rates for the PCA and Power Cost Only Rate Case (PCORC) periods. The total cost of power the Company is seeking to recover for Tenaska significantly exceeds the prudent level approved by the Commission in Docket UE-921262, and vastly exceeds the cost that the Company could have secured for this resource when a low-cost fuel contract was proposed in 1997. It would be appropriate for the Commission to exclude cost recovery at either of these levels.

Alternatively, it would be appropriate for the Commission to address this problem in a way that recognizes the ongoing nature of the Tenaska contract dispute. The Commission could exclude the carrying costs of the Tenaska Regulatory Asset until such time as the Company demonstrates that the total cost of power from Tenaska is lower than the level approved in the original prudence review.

Q: What is the magnitude of the excess cost?

A: On a present value basis over the remaining contract life, the cost of power from Tenaska under the current fuel policy is approximately **[Begin Confidential ** [End Confidential]** million above the amount that was found prudent by the Commission in the 1992 prudence review. On a present value basis, the cost of power from Tenaska under the current fuel policy is approximately $474 million above the amount that Puget (and its ratepayers) would be exposed to if Puget had entered into the long-term, low-cost fuel supply arrangement that was available to it when the contract was reformed.

Q: Have you prepared an exhibit detailing these calculations?

A: Yes, it is contained in Exhibit JL-2C. The exhibit has three pages.

The first compares the original contract price of power for Tenaska, the fuel component built into that price, the effective fuel price allowed after removing the disallowed amount of the contract, and the current fuel cost. I have measured the costs over the entire remaining life of the contract, so that the savings that are expected to accrue in future years are fully taken into account. This shows that if the Commission were to hold the line at the previously approved level, it would disallow approximately **Begin Confidential ** [End Confidential]** million from cost recovery. This demonstrates that while the current cost of power from Tenaska is greatly above the value the Commission previously found prudent, in the later years of the contract, the restructuring still has some benefits.

The second page compares the cost of fuel for Tenaska that Puget could have achieved had it entered into the fuel contract that it indicated were available to it at the time the contract was restructured in 1997. These low fuel prices were the basis for the approval of restructuring, and the subsequent creation of the regulatory asset. This set of calculations shows that, on a present value basis, the currently estimated cost of Tenaska will total about **[Begin Confidential ** [End Confidential]** million above the level that would have been experienced had Puget accepted the long-term low-cost fuel contracts that were available to it in 1997. Puget sought and obtained approval of the restructuring based in large measure on asserted significant gas cost savings represented to be available at the time.[1]

The third page contains the calculations necessary for the Commission to make changes to the 2003 PCA and 2004 PCORC costs of approximately **[Begin Confidential] ** [End Confidential** million for 2003 and **[Begin Confidential ** [End Confidential]** million for 2004 year, based on an average of the two fuel cost methodologies I just described. It also contains a calculation should the Commission wish to address the Regulatory Asset rather than fuel costs.

Q: What is the benefit of addressing this on a fuel cost basis?

A: That approach reserves the possibility that the restructured contract will eventually provide benefits, and that those benefits should be shared between shareholders and ratepayers. By calculating the fuel cost disallowance as the mid-point between the "prudence review" level *without* a regulatory asset, and the 1997-identified level *with* a regulatory asset, it assures that the benefits of the restructured contract are shared equitably between ratepayers and shareholders.

Q: In your opinion, are these the only appropriate calculations that could form the basis for a disallowance in this proceeding?

[1] Docket No. UE-971619, Order, December 15, 1997, pp. 2-3

A: No. It is my understanding that Staff has used a slightly different approach, looking only at the current year and the PCA year in preparing their testimony. It is my understanding that ICNU has used yet a different approach, using the power dispatch model to estimate excess costs. Both of these are reasonable approaches.

Q: Why did you use the approach you have chosen?

A: The original Tenaska contract had rapid escalation of fuel costs embedded in it, rising to over $8/mmbtu by 2011. Since even current escalated fuel cost forecasts are lower than this, the restructured contract still has some expected fuel cost benefits in the future. Therefore I used a present value approach over the remaining contract life as the basis for my analysis, giving the Company credit for expected future savings in estimating the imprudent amount.

Q: What is the historical framework that supports your recommendation?

A: Puget entered into the original Tenaska contract in 1990-91. That contract came before the Commission in Docket UE-921262, and the Commission conducted an extensive prudence review of the contract. Staff (through several witnesses) and Public Counsel (through Dr. Glenn Blackmon) presented evidence indicating that the total amount of excess cost was in the $103 - $506 million range.

Puget is today asking that ratepayers pay even more than the original, imprudent contract amount.

Q: How did the Commission evaluate the evidence in that case?

A: The Commission considered the evidence, and examined several different approaches to calculating a disallowance. Ultimately it pieced together an approach using elements of the Staff presentation, elements of Dr. Blackmon's approach, and some data provided by the Company on rebuttal. Most important, however, the Commission found that the contract was imprudent, and that Puget's analysis leading to the contract was inadequate.

Q: What did the Commission find?

A: In its 19th Supplemental Order, the Commission stated:

"Puget paid more than the market price for the March Point Phase II, Tenaska and Sumas contracts."[2]

…

"Puget did not properly evaluate the natural gas market.[3]

...

"Adequate study by Puget would have shown that the avoided costs of the contracts were lower than the prices it paid."[4]

…

"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."[5]

Q: Based on these findings, would you have expected a significantly higher disallowance?

A: While the Commission identified much larger levels of disallowance as appropriate under various analytical approaches, it chose a modest 1.2% adjustment, stating:

"While we conclude that a larger disallowance would be defensible, we also must look ahead.

…

[2] UE-921262, 19th Supp. Order, p. 25
[3] UE-921262, 19th Supp. Order, p. 26
[4] UE-921262, 19th Supp. Order, p. 28
[5] UE-921262, 19th Supp. Order, p. 45

We have, therefore, chosen the "damages" or disallowance option with the least impact on Puget's bottom line."[6]

The Commission then disallowed a small portion of the cost of Tenaska from rates, allowing the balance to be charged to consumers, stating:

"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."[7]

Q: Has Puget sought to change the Tenaska contract since the 1992 approval?

A: Yes. In 1997, in Docket No. UE-971619, the Company returned to the Commission for consideration of a proposal to restructure this contract. The proposal consisted of having Puget pay Tenaska about $200 million to be released from the fixed fuel component of the contract. Puget would then be responsible for providing fuel to the power plant as needed for electric generation.

Since Puget had since merged with Washington Natural Gas, it had acquired fuel management capabilities that it did not previously have, and wanted to manage the fuel supply for Tenaska itself. The evidence presented to the Commission at that time indicated that very significant fuel cost savings were achievable, and that long-term, fixed-price fuel contracts were available that would lock in these savings. These confidential figures are detailed on page 1 of exhibit JL-2C. The expected savings were large enough to produce a significant benefit for Puget during the 1997-2001 rate plan period, and a significant benefit for ratepayers thereafter to the end of the contract in 2011.

6 UE-921262, 19th Supp. Order, p. 33
7 UE-921262, 19th Supp. Order, p. 45

Q: Did the Company in fact recognize those savings?

A: Puget elected to not execute the long-term fuel contracts, and therefore did not lock in the savings. Instead the Company chose to play the market for fuel. It played and lost. Today, gas prices are dramatically higher than the levels in the long-term contracts that Puget dangled before the Commission to secure approval of the restructuring of the Tenaska contract.

Q: What is the result of this decision for ratepayers?

A: In this proceeding, Puget is asking, in effect, that ratepayers not only pay 100% of the costs previously found imprudent, but also pay for a $219 million regulatory asset created in order to reduce costs below the level previously allowed by the Commission, and pay the sky-high cost of gas that Puget chose not to hedge back in 1997. The sum of these payments for this power vastly exceeds the level used by Puget to secure approval of the restructuring. It hugely exceeds the level previously found prudent by the Commission. It even significantly exceeds the original contract price for Tenaska that the Commission has previously found to be imprudent.

Basically, Puget had a chance to secure savings for both shareholders and ratepayers, and did not take that opportunity. It is now seeking to recover about ten cents a kilowatt-hour for the power from Tenaska when you sum up the cost of the regulatory asset, the cost of fuel in the current market, and the non-fuel payments to Tenaska. This is an imprudent level of cost by current standards, and an imprudent level of costs by the standards in place when the contract was originally entered into and subsequently modified.

Q: What action do you recommend the Commission take at this time?

A: I recommend that the Commission re-price the power from Tenaska at a reasonable level for the PCA and PCORC periods 2003 and 2004, and base a disallowance on that level of cost.

The "ceiling" should be the cost level approved as prudent in the 1992 prudence review; this is 1.2% below the original contract price, as shown on page 3 of Exhibit JL-2C.

The "floor" should be the cost level that would have been achieved if the contract restructuring had gone the way it was expected to, with Puget securing the long-term, low-cost gas supply that was available to it. This is also shown on page 3 of Exhibit JL-2C.

Q: What is the result of this analysis that you have portrayed on page 3 of Exhibit JL-2C?

A: The result is a disallowance, a $41.6 million reduction in deferred power costs, changing the +$27 million PCA balance to -$14 million. It also reduces the proposed increase in the PCORC from +$64 million to +$29 million. There are also minor tax effects, which I have not included. There are other issues being addressed by other parties that may further change these figures.

Q: Was this type of disallowance anticipated when the restructuring of the Tenaska contract was considered by the Commission in 1997?

A: Yes. This would be consistent with the language in the 1997 Order, which states:

"*The Company's actions in purchasing the gas sales contract, managing the cost of gas, and restructuring the power purchase agreement is subject to review in future rate proceedings; the Company bears the burden of proof in any such* *proceeding regarding these matters. Any costs determined to be unreasonable or imprudent in such proceedings, are subject to disallowance."*[8]

Q: What is the basic conclusion with respect to the Tenaska restructuring and current Tenaska fuel costs?

A: The creation of the regulatory asset was expected to provide benefits to consumers. Because Puget chose not to lock in low gas prices, consumers are now faced with *both* the cost of the regulatory asset *and* the high current cost of natural gas for fuel. This results in a total cost that vastly exceeds what was previously found to be the upper limit of prudence (by the Commission's own description, the most favorable interpretation possible for Puget). Puget has not demonstrated that it has managed the gas supply and restructuring of the contract prudently, as required by the 1997 Order.

Q: Is there an alternative to a disallowance of fuel costs?

A: Yes. The Commission could address the recurring nature of the Tenaska contract dispute by removing the carrying costs of the regulatory asset from rates unless and until Puget can demonstrate that the total cost of power over the life of the contract from Tenaska is lower than the level approved in the prudence review. If and when Puget can make that demonstration, the power from Tenaska should be allowed into rates at a level that allocates one-half of the savings to consumers, and one-half to the Company to offset the cost of the regulatory asset. If Puget is able to achieve all of the savings that it could have locked in, it will fully recover the regulatory asset. If it can achieve even greater savings – that is, if its strategy

[8] Docket UE-971619, Order, p. 6

to “play the market” actually pays off in the long run, it will recover more than the cost of the regulatory asset.

Q: How does this approach compare with disallowing fuel cost recovery?

A: The disallowance is approximately the same. See page 3 of JL-2C.

Q: Have you considered the ramifications of your recommendation on the Company’s financial position?

A: Yes, quite carefully. I continue to be concerned with the Company’s financial health. That was a key concern for Public Counsel in Puget’s last rate case, and indeed one of the reasons we agreed to establish the PCA mechanism and the equity tracker.

Q: If the Commission were to remove this amount of cost from rates, is it possible that Puget might have its bond rating downgraded?

A: I think this is a possible outcome, but I do not think it is a foregone conclusion. The Tenaska contract is only one element of this docket with potential effects on the Company’s finances. The Company is generally healthy and current management continues to rebuild its capital structure in line with the equity tracker targets established in the rate case settlement.

Q: Should this limited risk dissuade the Commission from taking action to limit costs to a prudent level?

A: Absolutely not. The cost to ratepayers of a downgrade, were it to occur, are trivial compared to the overcharge the Company is proposing for this contract.

Puget will not be issuing very much debt in the near future. The Company has less than $300 million in short term debt and maturing long-term debt. Even if it suffered a 100 basis point penalty on this debt as a result of a downgrade, that would only amount to $3 million per year, compared with the $40 million per year in costs to ratepayers that would result if the Commission allows Puget to charge for imprudently incurred power costs. If another $300 million were financed at such a premium in a second year, the cumulative penalty would be $9 million, compared with a cumulative savings of $120 million.

Because the Company continues to rebuild its capital structure under the terms of the settlement of Docket UE-011570, any downgrade should be relatively short-lived. The small cost associated with a temporary downgrade simply does not begin to compare with the cost to ratepayers of paying for imprudent power costs.

Q: Has Puget faced larger disallowances, and been able to continue providing high quality service?

A: Yes. Puget's own disallowances for its nuclear investments were much larger percentages of its equity than is at issue here. In the case of Skagit, the Company took a write-off of about $47 million in 1984; this was equal to about 7% of its equity at the time. By contrast, a $40 million disallowance today is only about one-third of that percentage. Puget's exposure here is relatively minor compared with the prudency disallowance it experienced in the Skagit and Pebble Springs cases (U-82-38 and U-83-54).

Q: **You indicated that your calculations are relatively simple. Is it possible that other witnesses may provide more precise figures for the Commission to base a judgment on?**

A: Yes. I am an economist, not an accountant. I understand that Mr. Schooley, Mr. Elgin, and Mr. Schoenbeck are all addressing this same issue. After their testimony is filed, I may prefer to adopt some or all of their calculations in lieu of my own. Alternatively, the Commission may need to reach specific conceptual conclusions on the treatment of these excess power costs, and have its accounting advisor prepare some analysis of these issues in order to render a complete and accurate order. The purpose of my testimony is to demonstrate that Puget has not met the burden of proof required by the 1997 Order, that the costs requested by Puget are imprudently high, and then to estimate the magnitude of that excess.

If necessary, the Commission should issue an interlocutory decision, and direct the parties to present calculations based upon the concepts of prudence determination which the Commission affirms in that decision.

Q: **Does this conclude your prepared testimony?**

A: Yes.