BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	DOCKET NO. UE–031725

2003 POWER COST ONLY RATE CASE

INITIAL BRIEF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

REDACTED VERSION

DATED: March 12, 2004

TABLE OF CONTENTS

Page

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

I. INTRODUCTION

Pursuant to WAC § 480–07–390 and the schedule adopted in Docket No. UE–031725, the Industrial Customers of Northwest Utilities ("ICNU") submits this Initial Brief. ICNU requests that the Washington Utilities and Transportation Commission ("WUTC" or the "Commission") reduce the $54.5 million power cost increase sought by Puget Sound Energy, Inc. ("PSE" or the "Company") in this proceeding by approximately $64.6 million.[1/] This disallowance is necessary to establish a reasonable, normalized power cost baseline (the "Baseline") under PSE's power cost adjustment ("PCA") mechanism and to reflect the removal of the Tenaska regulatory asset from rate base.

PSE has conceded all of ICNU's adjustments to power costs for the period from April 2004 to March 2005 (the "Rate Period") in this proceeding except two.[2/] PSE still contests ICNU's proposed adjustment related to establishing a normalized price for gas at Sumas during the Rate Period. PSE also contests ICNU's proposed adjustment related to PSE's imprudent management of Tenaska gas costs.

PSE proposes using Sumas gas prices to establish the power cost Baseline based on an adjusted average of New York Mercantile Exchange ("NYMEX") future market prices for the Rate Period taken from ten trading days in September 2003. The average gas price that PSE derived from the NYMEX values was substantially higher than the prices used internally by

---

1/ This is only an approximate value because ICNU has not performed an Aurora run to account for the adjustments that PSE made to its original filing in its rebuttal testimony. When the Commission issues its final order in this Docket, it should order PSE to perform an Aurora "compliance" run to quantify the impact of any adjustments that are adopted.

2/ The particular adjustments that PSE already has conceded are described in Section II of this Initial Brief. The Commission should adopt these adjustments, when it establishes PSE's final Baseline in this proceeding.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

PSE's Risk Management Committee ("RMC"), which were based on an analysis of market fundamentals. Furthermore, regardless of the discrepancies between the gas prices utilized by PSE, the September 2003 NYMEX prices are inappropriate for establishing a "normalized" power cost Baseline because: 1) the NYMEX prices are sensitive to short–term market events; and 2) the NYMEX market for the Rate Period was not liquid in September 2003. An illiquid market will not produce an accurate forecast of prices. The Commission should adopt a fundamentals–based forecast gas price that does not reflect the impact of near–term events in order to allow the cost of gas price deviations to properly flow through the PCA.

The other contested issue raised by ICNU is whether the Company should continue to recover the significant cost of the Tenaska regulatory asset, even though the buyout of the Tenaska gas contracts has resulted in increased customer costs and no customer benefit. ICNU, Public Counsel, and Staff each propose some form of adjustment based on PSE's imprudent management of the gas supply under the Tenaska contract since the Company restructured the contract in 1997. At the time PSE restructured the Tenaska gas supply, the Company promised significant ratepayer benefits based on long–term gas quotes from several gas suppliers. Based on PSE's representations regarding these savings, the Commission authorized the Company to create a regulatory asset to recover the $215 million cost of the gas contract buyout. However, recovery of the regulatory asset was conditioned on PSE's prudent management of the Tenaska gas supply.

Since the 1997 buyout, PSE has not secured any long–term gas supplies for Tenaska, and the price of Tenaska gas has been significantly higher than the prices that were used to justify creation of the regulatory asset. PSE chose to maximize its short–term profits by

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

relying on short–term gas supplies in the hope that gas prices would remain low. Documents from PSE's RMC reflect that, even when the Company predicted that it could realize significant savings by locking in long–term gas at a certain price, it opted to not pursue those transactions because it thought that it could "beat" the market by 10%. By choosing to maximize short–term margins rather than lock in economic long–term gas supplies, PSE exposed its customers to an unreasonable risk. As a result of PSE's imprudent management of the Tenaska gas costs, the Commission should order PSE to remove the asset from rate base and write off the remaining $206 million of unamortized regulatory asset.

II. BACKGROUND

On October 24, 2003, PSE filed an Application for Adjustment of its Power Cost Rate pursuant to the Settlement Stipulation for Electric and Common Issues ("Stipulation") approved by the Commission in the Company's last general rate case. WUTC v. PSE, WUTC Docket Nos. UE–011570, UG–011571, Twelfth Supp. Order at 3 (June 20, 2002). ICNU was a party to the Stipulation, which provided an overall resolution of the general rate case issues, but was not a party to the Settlement Terms for the Power Cost Adjustment Mechanism ("PCA Stipulation"), which is the specific agreement under which PSE made its filing in this Docket. Under the PCA Stipulation, PSE was authorized to file a Power Cost Only Rate Review in order to add new resources to the Baseline power cost under the PCA. Id. at Attachment A, Exhibit A to Stipulation at 5. The PCA Stipulation provided that "[o]ne objective of a new resource proceeding is to have the new Power Cost Rate in effect by the time the new resource would go into service." Id. at 6.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

The PCA instituted under the PCA Stipulation sets forth the manner in which the Company and customers share annual deviations in actual power costs from Baseline power costs. The PCA sharing mechanism consists of four bands of power cost deviations with a corresponding sharing percentage. For the first \$20 million deviation (either plus or minus), the Company absorbs 100% of the cost or benefit. The second band is for deviations of \$20 to \$40 million. These amounts are shared equally between the Company and its customers (50%–50%). The third band is for deviations from \$40 to \$120 million with the Company being responsible for 10% and customers for the remaining 90%. Finally, the fourth band is for deviations in excess of \$120 million. In these cases, the Company is responsible for 5% and customers are responsible for the remaining 95%. The third and fourth bands are somewhat illusory, because the PCA also contains a cumulative sharing mechanism for the initial period from July 1, 2002, through June 30, 2006. During this period, customers are responsible for 99% of any deviation should the Company's share of the power costs exceed \$40 million. On February 13, 2004, PSE reported that the PCA balance already was approximately \$43.6 million, exceeding the \$40 million four–year cumulative value. WUTC v. PSE, WUTC Docket No. UE–011570, Quarterly Report of the Power Cost Deferral Calculation (Feb. 13, 2004). As a result, 99% of any further increases in power costs above the current Baseline will be recovered from ratepayers.

At the time of filing, PSE billed this case as a review of the Company's acquisition of the Frederickson 1 plant ("Frederickson") in order to reset the Company's Baseline. Careful examination of the Company's filing revealed, however, that Frederickson accounted for only \$18.3 million of the original \$64.4 million rate increase sought by PSE and that the majority (\$46.1 million) of the rate increase was attributable to factors that the Company

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

had not expressly identified. Exh. No. 231C at 2: 9–14 (Schoenbeck). As a result, when ICNU, Staff, and Public Counsel submitted testimony in this proceeding on January 30, 2004, ICNU focused on issues other than the Frederickson acquisition.

In testimony, ICNU, Staff, and Public Counsel each proposed a disallowance based on PSE's management of the gas supply for the Tenaska contract. In addition, ICNU proposed adjustments in order to normalize: 1) PSE's unreasonable increase in the maintenance outage hours of Colstrip Unit 3; 2) PSE's unrealistic assumption that the Company would receive the maximum amount of energy possible from March Point 1; 3) the Company's unjustified inclusion of the costs of winter call options in the Baseline; and 4) the Company's flawed gas price forecast. Id. at 2: 22 – 3: 4 (Schoenbeck). Staff also proposed disallowances based on the normalization of Colstrip availability and the winter peaking options, as well as a disallowance based on PSE's failure to include in power costs the 1.25% and 3.0% prudence disallowances for Tenaska and March Point 2 previously ordered by the Commission in Docket No. UE–921262. Exh. No. 291HC at 2: 11–13, 14: 8 – 15: 13 (McIntosh).

On February 13, 2004, PSE submitted rebuttal testimony, in which it agreed to adjustments regarding: 1) the Colstrip maintenance outage; 2) the level of March Point generation; and 3) the winter peaking options. Exh. No. 45 at 4: 7 – 6: 15 (Gaines). ICNU is in agreement with these adjustments. PSE also acknowledged that it had failed to include in power costs the 1.25% prudence disallowance for Tenaska and the 3.0% disallowance for March Point Phase 2 that the Commission had ordered in Docket No. UE–921262. Id. at 5: 11–15 (Gaines). According to PSE, adoption of all of these adjustments reduced its proposed rate increase by $9.9 million to $54.5 million. Exh. No. 220 at 2: 17 (Story).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

III. ARGUMENT

The PCA Stipulation authorized the Power Cost Only Rate Review in order to: 1) add new resources to PSE's power cost Baseline under the PCA; and 2) true up power costs. PCA Stipulation at 5. PSE filed this case to both add Frederickson to its Baseline costs and true up the Baseline to reflect all power costs. Thus, PSE has the burden to demonstrate that all of the costs proposed to be included in rates in this proceeding are fair, just and reasonable, and prudent. RCW §§ 80.28.010, 80.28.020; WAC § 480–07–540. In a prudence review, the Commission examines what "a reasonable board of directors and company management [would] have decided given what they knew or reasonably should have known to be true at the time they made a decision." WUTC v. Avista Corp., WUTC Docket No. UE–030751, Order No. 5: Approving and Adopting Settlement Stipulation at 10 (Feb. 3, 2004). PSE has failed to meet its burden of demonstrating that its management of the Tenaska gas costs has been prudent or that setting Baseline power costs based on an average of NYMEX prices over 10 trading days in September 2003 is just and reasonable.

In its rebuttal case, PSE proposed to increase the current power cost Baseline by $54.5 million. A substantial portion of this increase relates to PSE's use of a forecast of gas prices that substantially exceeds a reasonable value of gas for the Rate Period. Specifically, PSE forecast its gas prices based on an average of NYMEX prices from ten days in September 2003, even though the NYMEX market for the Rate Period was not liquid and NYMEX prices reflect the impact of near–term events. The Commission should establish the PCA baseline based on a fundamentals analysis, such as the California Energy Commission ("CEC") North American Regional Gas ("NARG") forecast, which does not reflect near–term events. Such an analysis

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

will establish a Baseline that is consistent with the operation of the PCA. In the alternative, the Commission should require PSE to use the median gas forecast produced by the Company's own fundamentals model.

PSE has included substantial costs associated with the Tenaska contract in its Baseline power costs despite the fact that the Company's mismanagement of the gas supply for Tenaska has turned the substantial customer benefit that PSE predicted when it restructured the Tenaska gas supplies in 1997 into a substantial ratepayer cost. PSE pursued a "go short" strategy for its Tenaska gas supply while ignoring warnings that this strategy created significant long–term risks. Exposing customers to such risks was imprudent, especially after PSE witnessed the danger of excessive exposure to the short–term market during the western power crisis in 2000–01. As a result of PSE's imprudent management of Tenaska gas costs, the Commission should order PSE to remove the regulatory asset associated with the Tenaska buyout from rate base, because the asset no longer has value to customers. ICNU also supports a number of alternative recommendations if the Commission wishes to consider other forms of relief. *Supra* Section III.C.3.

A. The Commission Should Establish a Baseline in this Proceeding that Reflects Normalized Power Costs in Order to Allow the PCA to Function Properly

The focus in this case should be to establish a reasonable power cost Baseline based on normalized conditions for use in PSE's PCA. A PCA typically sets power costs at a midpoint, then a utility and its customers share in the risks and rewards created when power costs vary from the midpoint. The sharing mechanism is essential to a PCA, because it provides the utility with an incentive to minimize power costs. It is important to set the midpoint (commonly called the baseline) at the expected value of the range of potential outcomes. If the

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

baseline is set too high, the balance of risk and reward will be upset. This is particularly true in this case.

PSE has exceeded the $40 million cumulative cap under the PCA, thus, any new power costs in excess of the Baseline will be paid 99% by customers and 1% by PSE. If PSE's actual power costs are lower than the Baseline set in this case, then PSE and customers will share the benefit based on the four tiers contained in the PCA sharing mechanism, which are as follows:

Annual Deviation from Baseline	Sharing % (Customers/PSE)
> $120 million	95%/5%
> $40 million, but < $120 million	90%/10%
< $40 million, but > $20 million	50%/50%
< $20 million	0%/100%

To understand the distribution of risk in the PCA, assume one case in which power costs are $43 million more than the Baseline in a year and one case where power costs are $43 million less than the Baseline in a year. If actual costs exceed the baseline by $43 million, the costs would be shared on a 99%/1% basis (i.e., customers would pay $42.57 million and PSE would pay only $430,000), because PSE has exceeded the $40 million cumulative cap. On the other hand, if actual costs are $43 million less than the baseline, under the sharing mechanism, customers would receive $10,300,000 of the benefit, and PSE would receive $30,300,000 of the benefit. In this hypothetical, customers bear almost all of the upside risk, but receive only about

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

24% of the potential benefit.[3] This shows why rates should be set based on normalized gas costs rather than a projection at the high end of the expected value range.

Another way to state it is that the risk of setting the Baseline too high is far greater than the risk of setting it too low. If the Baseline is set too low and costs turn out higher, customers will pay 99% of the increased costs through the PCA because the cap has been exceeded, and PSE will be exposed to little risk. On the other hand, if the Baseline is set too high and costs turn out lower, two–thirds of the benefit flows to PSE's shareholders.

Another example may help illustrate this point. Mr. Schoenbeck's proposed gas adjustment would lower PSE's proposed Baseline, as well as the rate increase, by roughly $24 million. If the Commission accepts Mr. Schoenbeck's adjustment, but actual gas costs turn out to be $24 million higher, customers would pay 99% of the difference through the PCA. Thus, PSE has virtually no risk if the Commission adopts Mr. Schoenbeck's adjustment. However, if the Commission does not accept the adjustment, and gas costs are $24 million lower than PSE's proposed gas costs, the first $20 million would flow to PSE under the first tier (0%/100%) of the PCA sharing mechanism, and the remaining $4 million would be split 50%/50% under the second tier. Thus, only $2 million of the $24 million in savings would be passed through to customers under the PCA sharing mechanism, which would not compensate customers for the $24 million rate increase that would result from accepting the Company's Baseline proposal.

In summary, the $40 million cumulative cap in the PCA creates an asymmetrical distribution of risk, which suggests that the Commission should err on the side of setting the

[3] PSE's RMC was recently presented with a presentation that illustrates this lopsided distribution of risk and reward in the PCA. Exh. 80HC at 5; TR. 284:4–285:1 (Gaines).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

Baseline too low, rather than too high. The risk to customers of setting the Baseline too high far outweighs the risk to PSE of setting it too low. The Commission's resolution of the appropriate gas cost to establish the Baseline should be determined with this asymmetrical distribution of risk in mind.

B. PSE Inflated the Power Cost Baseline by Calculating its Gas Price Forecast Using an Illiquid Market that Results in Prices that are Higher than the Company's Calculation of Gas Prices for Its Own Internal Risk Analysis

PSE calculated its gas price forecast based on an adjusted average of NYMEX future market values[4/] taken from the ten trading day period of September 5, 2003, to September 18, 2003. PSE's adjusted average price for these ten days was [redacted]. Exh. No. 231C at 12: 20 (Schoenbeck). This is an average of [redacted] higher than the gas prices included in PSE's current rates, which were established in the general rate case that ended in June 2002. WUTC v. PSE, WUTC Docket Nos. UE–011570, UG–011571, Twelfth Supp. Order at 3 (June 20, 2002).

ICNU proposes that the Commission adjust PSE's gas price forecast for two reasons. First, despite the fact that PSE used an average market price for its forecast gas price in this proceeding, the Company has used a market fundamentals analysis to predict gas prices to analyze its portfolio risk, as well as to justify the purchase of Frederickson. Exh. No. 231C at 12: 12–13, 15: 22 – 16: 9 (Schoenbeck); TR. 467 at 19–25 (McIntosh). PSE's fundamentals analysis is a much more rigorous analysis than an average of NYMEX prices and generally produces more realistic results, because it reflects market fundamentals. Exh. No. 231C at 15:

4/ The NYMEX prices are reported for delivery at Henry Hub. PSE adjusted its average price downward by an average basis differential of [redacted] to reflect the fact that the gas price at Sumas is normally lower than at Henry Hub. Exh. No. 231C at 12: 16–19 (Schoenbeck).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

22 – 16: 9 (Schoenbeck); Exh. No. 236C; Exh. No. 237C. PSE prepared and presented a fundamentals analysis to RMC in December 2001, and this analysis includes forecast gas prices that are substantially lower than those assumed in PSE's proposed Baseline. Exh. No. 231C at 16: 13–19, 18: 2–5 (Schoenbeck); Exh. No. 237C. PSE's median fundamentals forecast is validated by the fact that it produces values similar to the CEC NARG forecast used by Mr. Schoenbeck. PSE should not be permitted to use one set of gas prices for its risk analysis and internal decision making, but use different, substantially higher prices for ratemaking purposes.

Second, regardless of the fact that PSE reported a different forecast gas price to the Commission than the Company used in its own internal analysis, the NYMEX prices PSE used in this proceeding generally are not appropriate for establishing the "normalized" gas price that is necessary for the proper operation of the PCA. The NYMEX market tends to react to near–term market events. Hence, an average NYMEX futures price may reflect the influence of those events, making it an unreliable predictor of the market over the long–term. Furthermore, the September 2003 NYMEX prices used by PSE are particularly inappropriate for establishing a gas price for the Rate Period, because the volume of transactions executed for delivery in the Rate Period during those ten days was not significant enough to constitute a liquid market. An illiquid market is not a reliable indicator of market values and should not be used to establish Baseline power costs.

1. The Fundamentals Analysis that PSE Uses for Risk Assessment Produces a More Reliable Forecast of Gas Prices During the Rate Period

PSE calculated a gas price forecast based on an average of NYMEX futures prices to establish its Baseline in this proceeding; however, the Company relies on more detailed and

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

rigorous analysis for analyzing its portfolio risk. This more in depth analysis produces a forecast based on market fundamentals, which PSE described as follows:

> In our fundamental price forecasting model, we simulate 100 different price scenarios using a range of gas and electric prices, hydro energy assumptions, oil pricing, GDP growth, gas statistics, and temperature scenarios. PSE then centers the distribution of prices (generated from the scenarios in the fundamental price forecasting model) around the current forward price curve. The range of prices around the forward price curve is used in a separate set of 100 scenario runs in the KW3000 system, to develop the position and risk analysis of the Company's portfolio.

Exh. No. 201 at 12: 2–10 (Ryan); *see also* Exh. No. 236C at 1. This indicates that PSE performs a much more detailed and thoughtful analysis for internal purposes than merely averaging ten days worth of futures prices from September 2003. PSE not only models 100 separate scenarios in its fundamentals analysis, it also considers a number of different variables and updates its model several times a week as new information becomes available. Exh. No. 236C at 1. Furthermore, the simulation allows the Company to develop a range of possible outcomes and determine a confidence level for certain of those outcomes.

In this case, PSE made its filing on October 24, 2003, and included a forecast gas price of [redacted] based on the average NYMEX price for the ten days in September 2003. Exh. No. 231C at 12: 20 (Schoenbeck). Less than two months later, in December 2003, PSE presented a fundamentals analysis of gas prices to the RMC, which reflected a median forecast gas price for the Rate Period that was [redacted] than the adjusted average NYMEX price for Sumas included in the Company's filing. *See* Exh. No. 231C at 16: 17–19 (Schoenbeck). This "Market Fundamentals" Report reflects all the variables described above in addition to other variables not identified by the Company. Exh. No. 237C at 1–20. A

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

fundamentals analysis that does not take into account near–term or short–term events should be used to forecast the gas price in this proceeding. TR. 376: 12–14 (Schoenbeck).

ICNU proposes that the Commission reduce PSE's forecast gas price in this proceeding to $3.61/MMBTU to reflect a "fundamentals" value. Mr. Schoenbeck derived this value from a December 2003 CEC report, which included forecast gas prices based on the NARG fundamentals model. Exh. No. 231C at 18: 17 – 19: 9 (Schoenbeck). [redacted] Nevertheless, this value falls well within the range that includes 95% of the outcomes of the 100 scenarios PSE models. Exh. No. 231C at 16: 8–9 (Schoenbeck); Exh. No. 8 at 2. In contrast, PSE's NYMEX price falls in the upper range of the 100 scenarios.

PSE implicitly acknowledges the value of using a fundamentals model rather than a forward price curve to forecast future prices in that the Company uses the Aurora model (a fundamentals model) to forecast electricity prices for purposes of establishing its power costs Baseline. TR. 417: 23–25 (Schoenbeck). As Mr. Schoenbeck indicated during the hearing, a fundamentals model would be just as useful to develop PSE's forecast gas prices as it was to develop the forecast electricity prices. TR. 418: 17 – 419: 6 (Schoenbeck). Furthermore, PSE's RMC documents indicate that, even when the RMC was presented with NYMEX–based values, the RMC compared those values to fundamentals–based values such as those produced by PIRA. TR. 141: 8–21 (Ryan); Exh. No. 77C at 76; Exh. No. 209C at 10. In short, there is no valid basis for PSE to use one methodology to forecast electricity prices, but use a different methodology to forecast gas prices, especially when the alternative methodology increases gas prices by a

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

substantial amount. Similarly, there is no basis to use one forecast price for making business decisions, but use a different price to set rates.

2. PSE's Criticism of a Fundamentals Price is Unfounded

PSE criticizes the fundamentals analysis that ICNU proposes be used to forecast the gas price in this proceeding on the basis that: 1) the Company does not use the median price of its fundamentals analysis to forecast a single gas price outcome; and 2) Mr. Schoenbeck did not detail the assumption used in the CEC model. Each of these criticisms is misguided, and neither demonstrates that the Company's average future price is superior to the fundamentals–based value proposed by ICNU.

First, although PSE argues that it does not use the median price, it admits that the median price is the "expected value" of all of the 100 scenarios produced by its fundamentals price forecasting model. TR. 145: 6–7 (Ryan). Thus, the median of the 100 scenarios modeled by PSE is a reasonable value. PSE's failure to use a fundamentals–based price is the foundation of ICNU's proposed adjustment. PSE has provided no evidence or explanation as to why its NYMEX average approach is more reasonable or appropriate than a value based on the market fundamentals. Furthermore, although PSE also argues that the CEC results upon which ICNU's proposed $3.61/MMBTU is based do not properly account for short–term market prices, the Company's witnesses acknowledge that normalized costs, which would not reflect the impact of near–term events, should be used in the PCA in order to recover the Company's costs over time. TR. 355: 22–25 (Story); TR. 302: 25 (Gaines). The NYMEX average, which will fluctuate considerably based on near–term events, does not represent a normalized price over the long term.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

Second, PSE's criticism of Mr. Schoenbeck for not detailing the inputs and assumptions of the NARG model is particularly unfounded given that the CEC gas price that he proposes be used in this proceeding differs very little from the median price in PSE's own fundamentals analysis. Exh. No. 231C at 19: 6–9 (Schoenbeck). Mr. Schoenbeck relied on the CEC results because they are fundamentals–based prices that are publicly available, free, and produced by an independent entity. TR. 375: 11–14 (Schoenbeck). This should alleviate concerns about the validity of the assumptions and transparency of the model with respect to any bias towards the Company or customers. TR. 420: 6–20 (Schoenbeck). Moreover, as Mr. Schoenbeck pointed out, many entities have likely used the NARG model as the basis for their own proprietary models for years. TR. 419: 18–25 (Schoenbeck). Thus, the accuracy and reliability of the model has been verified.

Mr. Schoenbeck indicated that one of the primary reasons he relied on the CEC prices was because he was familiar with the NARG model from which the prices were derived, but he was relatively unfamiliar with PSE's fundamentals price forecasting model. Exh. No. 231C at 19: 15 – 20: 7 (Schoenbeck); TR. 420: 23 – 421: 14 (Schoenbeck). However, Mr. Schoenbeck acknowledged that any number of different fundamentals models, including the fundamentals price forecasting model used by PSE, may be appropriate to perform the type of fundamentals analysis that should be used to set the Baseline in this proceeding. TR. 420: 23 – 421: 14 (Schoenbeck).

3. PSE's NYMEX Future Market Prices are Too Sensitive to Short–Term Events to Establish a Normalized Gas Price for the Rate Period

As described above, because the Commission is establishing a Baseline power cost in this proceeding for use under the PCA, the Commission should establish a "normalized"

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

power cost Baseline that will enable the PCA sharing bands to function properly. It is appropriate to use "normalized," rather than projected, gas values for the Baseline, because the Baseline will remain in effect until PSE files another rate case.

One of the problems with PSE's use of average NYMEX prices is that those price forecasts are overly sensitive to current events. Indeed, near–term events can cause movement in NYMEX prices for each of the 36 months being forecast at one time. Exh. No. 231C at 15: 8–10 (Schoenbeck). In fact, Exhibit No. 97C depicts the NYMEX prices that PSE used for the Rate Period for 2004 and 2005, followed by the values from the Company's Least Cost Plan starting in 2006. Exh. No. 97C at 1; TR. 442: 24 – 444: 18 (Schoenbeck). This data demonstrates that, in comparison to the relatively high NYMEX values for 2004–2005, PSE has forecasted that future gas prices will decline. Exh. No. 97C at 1. These declining gas costs were used to justify the purchase of Frederickson. Exhibit No. 97C indicates that PSE's average gas price for 2004–2005 is [redacted], while the average price that the Company forecasts for 2006–2011 (the remainder of the contract) is [redacted]. In other words, the sensitivity of the NYMEX prices to near–term events makes a NYMEX price forecast inappropriate for establishing a normalized gas price, and PSE's long–term projections confirm this.

Another drawback of the NYMEX market is the increasing amount of speculative trading taking place in that market. Exh. No. 231C at 15: 13–19 (Schoenbeck); *see* TR. 196: 23–24 (Ryan). Parties entering into speculative trades are not executing transactions to reduce risk or serve load. Rather, speculative trades reflect the opportunity for arbitrage that particular participants perceive in the market. Such transactions may skew the reported prices, making the NYMEX market even less appropriate for use as a forecast of market conditions for the Rate

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

Period. Finally, the NYMEX contract is used mainly as a financial hedging instrument, which is demonstrated by the fact that few NYMEX contracts result in physical delivery. TR. 203: 11–2 (Ryan). It is more appropriate to use a fundamentals model that predicts the price of physical gas supplies.

4. The NYMEX Market for the Rate Period Was Not Liquid from September 5–18, 2003

Another fundamental problem with PSE's decision to use a NYMEX average is that the volume of transactions during the ten–day period in September 2003 for power delivery during the Rate Period was not significant enough to constitute a liquid market. An illiquid market will not accurately depict market prices. The lack of liquidity shows little market confidence in executing trades at the posted prices. PSE's derivation of forecast prices for the Rate Period from average values taken from an illiquid market was unreasonable.

Market liquidity is generally thought of as a function of the number of transactions conducted during the relevant time period. For this case, the relevant time period is the Rate Period, April 2004 to March 2005. Exhibit No. 235C includes the NYMEX trading volumes during the ten–day period from which PSE derived its average price. This exhibit demonstrates that most of the transactions executed during the ten–day period were for the months immediately following September 2003. Exh. No. 235C at 3. Indeed, only 7% of the transactions executed during the ten–day period were for delivery during the Rate Period, and this 7% represents transactions for delivery in April to June 2004 only. Transactions for delivery in each month from July 2004 to March 2005 did not even amount to 1% of the total transactions executed during the ten days in September. Id. PSE acknowledged at hearing that the transactions for the forward months represented a relatively small amount of the overall volume

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

of gas traded during the ten days in September 2003, indicating that there is "less liquidity." TR. 196: 10 – 197: 18 (Ryan). Furthermore, the market prices for the forward periods may be skewed because the parties trading that far in advance likely place more significant value on long–term purchases. TR. 197: 19–23 (Ryan). As Staff Witness McIntosh acknowledged at hearing, it was "hard to accept" that these transaction volumes represent a liquid market. TR. 548: 3 (McIntosh). A market with such a relatively small volume of transactions for delivery in the Rate Period is not meaningful or robust enough to obtain a realistic forecast of gas prices for the Rate Period.

C. PSE Has Mismanaged the Tenaska Gas Supply Since the Company Restructured the Gas Supply Contracts in 1997

In 1997, PSE paid $215 million to buyout the long–term fixed price gas contract related to the Tenaska plant. There is little doubt that the buyout of the gas contracts has been a bad deal for customers. From 1998 to 2003, the buyout cost ratepayers [redacted]. Exh. No. 231C at 28: 24 (Schoenbeck). In the current rate period, the effective cost of Tenaska power (base contract price plus return on and return of the regulatory asset) is [redacted]. Id. at 28: 2. If the buyout had not occurred, the cost under the original contract would have been [redacted]. Id. at 28: 8. Thus, the cost of Tenaska during the Rate Period is [redacted] higher than the cost of the original contract would have been, if the buyout had not occurred. Id. at 11. This cost stands in stark contrast to PSE's original Exhibit B analysis, which projected a [redacted] savings from the buyout in 2004 and a [redacted] savings in 2005, compared to the original contract. Exh. No. 244C at 1.

In its petition for an accounting order to approve creation of a regulatory asset related to the buyout costs, the Company virtually guaranteed that there would be huge savings

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

as a result of the buyout. The record demonstrates and PSE's witnesses acknowledge that the Company created the expectation that the contract buyout would result in [redacted] in net present value after tax savings. Exh. No. 244C at 1; TR. 217: 6 (Gaines). This expectation formed the basis for the Commission's approval for creating the $215 million regulatory asset associated with the buyout cost. PSE's subsequent failure to fulfill those expectations is unreasonable and imprudent.

PSE's management of the Tenaska gas supply since the buyout has been imprudent, which has turned the expected ratepayer benefit into an actual [redacted] ratepayer cost to date. Exh. No. 231C at 28: 14–24 (Schoenbeck). The cost associated with the Tenaska buyout is a direct result of a repeated gamble by PSE to rely on the short–term market to meet its Tenaska gas requirements.

The record shows that when gas prices were low following the 1997 buyout, PSE was focused on maximizing short–term margins for shareholders rather than locking in long–term gains for customers. PSE pursued this "go short" strategy despite: 1) warnings from PSE's risk management consultants that the biggest risk was leaving itself in a short position over the long–term (which is exactly what PSE did); and 2) evidence that the projected savings from the buyout was eroding as gas prices increased. Documents from PSE's RMC meetings reflect that even when the Company knew that it could lock in the gas supply for the plant and achieve significant savings, it imprudently bet that it could "beat" the gas market by 10% and generate additional revenues. By making unsupported assumptions that it could beat its own market forecasts, and by ignoring its consultants in order to maximize short–term revenues at the expense of ratepayers, PSE imprudently exposed customers to unreasonable risks. ICNU, Staff,

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

and Public Counsel all support some form of adjustment in this proceeding to address PSE's mismanagement of the Tenaska gas supply contract since the Company bought out the long–term gas supply contracts related to the Tenaska project in 1997. The Commission should order PSE to remove the Tenaska regulatory asset from rate base and write off the remaining $206 million of the unamortized balance. The revenue requirement reduction associated with the write off would be $40.3 million during the rate year. In the alternative, the Commission should adopt one or more of the Tenaska adjustments proposed by Staff.

1. PSE Promised that Restructuring the Tenaska Contract Would Create Substantial Ratepayer Benefits

Puget Sound Power and Light ("Puget") first entered into an agreement related to the Tenaska plant in 1991, when it signed a long–term agreement to purchase power from the plant through 2011. Exh. No. 45 at 7: 14–18 (Gaines). In 1994, the Commission issued a general rate case order in which it commented on the prudence of PSE's resource acquisition procedures since the Company's last general rate case, and the Company's failure to properly analyze and document those acquisitions:

> 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 the evidence. When the Commission Staff received a briefing from Puget on its new contracts, the Commission Staff presumed that a reasoned analysis existed. It is still almost beyond the Commission's comprehension that Puget, which was the recipient of the Commission's order in the Skagit proceeding, and was aware of the Kettle Falls order, 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

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

> ad hoc basis, with little or no structured analysis. The Commission is constrained to conclude that Puget has mismanaged its resource acquisition process.

Exh. No. 82 at 15–16 (internal citations omitted); WUTC v. Puget, WUTC Docket Nos. UE–920433, UE–920499 and UE–921262, Nineteenth Supp. Order at 32 (Sept. 27, 1994). With respect to Tenaska specifically, the Commission ordered a prudence disallowance of 1.2% related to the original Tenaska contract due to Puget's failure to factor in the value of dispatchability in the contract price. Exh. No. 82 at 15–16. Since the original contract had fixed prices, the 1.2% disallowance effectively created a price cap. Exh. No. 301HC at 6: 20–27 (Schooley). Any cost above that cap would presumptively be imprudent.

On November 7, 1997, PSE sought an accounting order regarding the ratemaking and accounting treatment associated with the buy out of the Tenaska fuel supply contract. Exh. No. 283C at 1. PSE subsequently filed a revised petition related to the Tenaska buyout on December 8, 1997. Id. at 15. Following the buyout, PSE would be responsible for procuring the gas supply for the plant. To compensate the Company for the $215 million buyout costs, PSE requested authorization to create a regulatory asset for subsequent recovery in rates.

PSE's petitions for approval of the contract buyout demonstrate a number of points that are important to remember when considering the adjustments proposed in this proceeding. First, although PSE has argued in this case that it did not "guarantee" any benefit of the buyout, the Company's petition stated that "[t]he savings in power contract costs provided as a result of this transaction are substantial as evidenced by the total shown on line 20 of Exhibit B page 2 of 2." Exh. No. 283C at 18; TR. 232: 16 (Gaines) (emphasis added). Exhibit B to the

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

petition forecasted an overall gas cost savings of approximately [redacted].[5] Exh. No. 283C at 27; TR. 314: 3–12, 271: 2 (Gaines). The petition and Exhibit B taken together appear to create a firm commitment; the petition says the savings will be provided as a result of the Transaction. There are no caveats, and there are no qualifications that the savings are merely likely. While PSE does not agree that it "guaranteed" savings, the Company does admit that it "[redacted]" that ratepayers would experience significant savings as a result of the restructuring. Exh. No. 45 at 12: 14–16 (Gaines); Exh. No. 77C at 25. The savings from the buyout were calculated in Exhibit B based on long–term gas price quotes obtained by PSE that are listed in Exhibit E to the petition. Exh. No. 59C at 2–3.

The petition stated "[t]he Company's objective in entering into this agreement is to drive the gas cost element of a long–term fixed price escalating PURPA power contract toward market, at a price and at a time that provides maximum overall benefit to the Company and its customers." Exh. No. 283C at 3–4, 17–18. PSE now argues that the purpose of the buyout was to replace the long–term fixed price gas supply for Tenaska with gas priced at market. Exh. No. 45 at 14: 15–17 (Gaines). PSE interprets this as an indication that it would buy gas for Tenaska in the short–term market. If that was the case, why did PSE rely on long–term fixed price quotes to generate the savings projections used to justify creation of the regulatory asset? The only reasonable reading of the term "market" is that it means the then current long–term fixed price for gas. It would have been disingenuous for PSE to have intended

[5] The after tax savings after paying the return on and return of the regulatory asset was projected to be approximately [redacted]. Exh. No. 231C at 28:14–15 (Schoenbeck); TR. 217: 2 (Gaines).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

to rely on the spot market, while relying on long–term fixed gas quotes to justify creation of the regulatory asset.

The petition also demonstrated that "approximately twice as much savings is delivered in the later years [of the agreement] versus the earlier years." Exh. No. 283C at 4, 18; TR. 307: 22–24 (Gaines). Exhibit D to the petition depicted the increasing benefit to customers over the long–term. Exh. No. 95C at 4. As a result, amortization of the regulatory asset was delayed to match the benefits. Exh. No. 281HC at 7: 9–11 (Elgin). In other words, PSE represented that it would "deliver" substantial savings to customers in the long–term in order to offset the amortization of greater amounts of the cost of the buyout in the later years. The later years have now arrived, and the Rate Period costs of the return on and return of the regulatory asset are in excess of $40 million. However, there is no gas cost savings to offset the cost of the regulatory asset.

The Commission should consider PSE's request to create the regulatory asset in context. PSE requested expedited treatment of the petition, because of the potential for a "material loss in economic value related to timing . . . ." Exh. No. 283C at 2, 16. The implication was that gas prices could change, which would adversely affect the economics of the buyout. As a result, Staff had little opportunity to conduct its own analysis. TR. 509:10–17 (Schooley). The proposal was approved only 30 days after it was filed. Id. Despite Staff's belief that it was "inadvisable for the Commission to authorize new regulatory assets," Staff recommended approval of the petition. Exh. No. 283C at 30. This recommendation was based on PSE's representation that "the savings in gas costs more than offset the regulatory asset." Id.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

The Commission granted PSE's request for approval of the Tenaska buyout; however, the Commission specifically reserved the right to review the Company's management of the contract in the future:

> 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.

Re Puget, WUTC Docket No. UE–971619, Order at 6 (Dec. 10, 1997). While PSE was not required to enter into long–term fixed price gas commitments after the buyout, it was required to prudently manage those costs, given the benchmark set by the long–term quotes used to justify the buyout. As a result, PSE is obligated to demonstrate the reasonableness of the Tenaska gas costs in this case, taking into account the projections that were used to justify creation of the regulatory asset.

2. PSE's Mismanagement of the Tenaska Contract Has Turned the Expected Ratepayer Benefit into a Significant Ratepayer Cost

A series of imprudent decisions by PSE management has resulted in the elimination of any ratepayer benefit with respect to the Tenaska buyout. The chronology of events is important to understanding PSE's imprudence with respect to the Tenaska gas supply.

a. PSE Did Not Lock in Long–Term Gas Shortly After the Buyout Because the Company Wanted to Maximize Short–Term Profits During the Merger Rate Plan

The first important issue that PSE faced with respect to the Tenaska gas supply following the buyout was whether to procure a long–term gas supply. PSE opted not to lock in any long–term gas supplies in the early years following the buyout, despite the relatively low gas

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

prices available at that time. PSE has indicated that it decided to manage the Tenaska gas supply as part of its overall portfolio during this period; however, the Company's internal business case analysis indicated that the Company was not focused on evaluating and managing portfolio risk during this period. Exh. No. 77C at 26.

At the time that PSE bought out the Tenaska contract, the Company was subject to the rate plan related to the merger of Puget and Washington Natural Gas Company. In re Puget, WUTC Docket Nos. UE–951270, UE–960195, Fourteenth Supp. Order Accepting Stipulation; Approving Merger (Feb. 5, 1997). The merger rate plan was in effect from 1997 to 2002. Under the rate plan, PSE's rates were on a fixed schedule that called for an immediate rate reduction in 1997, and then a 1.0% to 1.5% increase each year from 1998 to 2001. Id. at 21. As Mr. Gaines admitted at hearing, the Company was particularly cost conscious during this period because shareholders absorbed any additional costs. *See* TR. 315: 5–10 (Gaines). According to RMC documents, [redacted] Exh. No. 77C at 26.

Instead of paying a short–term premium to lock in long–term savings for customers, PSE chose to buy on the spot market to improve its earnings. As a result, PSE entered into short–term transactions because the Company would not incur any additional costs. This approach worked at first; however, as early as May of 1999 (a little over a year into the restructured agreement), PSE recognized that it was no longer able to purchase gas at the prices anticipated in its petition. Exh. No. 77C at 26.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

b. PSE had Inadequate Portfolio Risk Controls in the Early Years Following the Contract Buyout

PSE's gas supply strategy for Tenaska was inconsistent with advice given to the RMC. Notes from the June 2000 RMC meeting indicate that PSE was [redacted] Exh. No. 77C at 12. At an earlier RMC meeting, PSE's CEO indicated that he had [redacted] Exh. No. 77C at 4. PSE worked on developing more effective risk management strategies; however, the Company's actions show that it continued to ignore the advice of its risk management consultants. In the July 25, 2000 RMC meeting, a consultant from Merchant Energy Group of the Americas ("MEGA") indicated to PSE that [redacted] Exh. No. 77C at 36. Although PSE says that this warning related to power supply, it applies equally to gas. TR. 281: 3–6 (Gaines). Materials from the same meeting indicate that PSE recognized that [redacted] Exh. No. 77C at 60.

c. The Tenaska Business Case Analysis Shows that PSE's Failure to Hedge Tenaska Gas Costs Was Imprudent

In June 2000, PSE evaluated its management of the Tenaska gas supply up to that point in the Tenaska Business Case Analysis. Exh. No. 77C at 25. This Business Case Analysis confirmed that PSE was focused on short–term margins during the early years of the contract, not managing its portfolio in a manner that would insulate the Company and customers from the risk of the short–term market: [redacted]

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

[redacted] Exh. No. 77C at 26. In addition, the Business Case Analysis also demonstrates that PSE was not willing to pay a premium during this period to provide risk protections, because it would have impacted short-term earnings. Id.

The Business Case Analysis also depicts the lack of risk management strategy at PSE following the contract buyout. In evaluating the Tenaska gas supply, PSE recognized "that it would have benefited if it had entered into more long–term fixed–price gas supply contracts at late–1990s prices." Exh. No. 45 at 26: 22–25 (Gaines); Exh. No. 77C at 27. The Tenaska Business case Analysis concludes that the Company [redacted] Exh. No. 77C at 28. These admissions demonstrate that PSE recognized that its management of the Tenaska gas supply was imprudent or unreasonable according to the Company's own standards.

d. PSE Still Did Not Lock Any Gas Supply for Tenaska After Market Prices Went Back Down Following the Power Crisis

Throughout 2001, PSE watched as market prices declined after the Western power crisis and market conditions stabilized. As this trend continued, the Company appeared to be poised to secure some long–term gas supplies for Tenaska and preserve some of the benefit of the buyout for customers, even if it could not achieve the entire benefit that was predicted in 1997. The presentations to the RMC during this period reflect that PSE was continuously aware of the gas market and was continually benchmarking the price of the gas supply that it could secure for Tenaska against the benefits that were expected at the time of the restructuring. *See* Exh. No. 77C at 65, 70; TR. at 281: 18 (Gaines).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

PSE's search for a long–term gas supply for Tenaska culminated with a [redacted] Exh. No. 77C at 81. PSE has offered no explanation as to why it believed it could beat the market by 10% other than it thought that prices would continue to come down. TR. 138: 2–3 (Ryan).

Despite the RMC's discussion of the opportunity to lock in [redacted] in savings at current market prices in December 2001, PSE did not hedge any of the Tenaska requirement at these prices. Mr. Gaines testified that PSE was unable to implement the Tenaska Hedge Strategy because gas prices went up. Exh. No. 45 at 29: 23–25 (Gaines). However, PSE's RMC

6/ At hearing, PSE sought to recharacterize the Tenaska Hedge Strategy as a discussion rather than a recommendation, despite the fact that Mr. Gaines testified in his rebuttal testimony that the strategy was recommended and approved. Exh. No. 92 at 1; Exh. No. 45 at 29: 23 (Gaines).

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

documents following the December 13, 2001 meeting reflect PSE's failure to act as it observed the continued down trend in gas prices in the first months of 2002, [redacted] Exh. No. 77C at 87; Exh. No. 209C at 10. [redacted] Exh. No. 209C at 28.

PSE's continued failure to lock in a long–term gas supply came full circle in March 2002, when market prices began to rise. By the March 7, 2002 RMC meeting, PSE recognized that the Company would not be able to obtain the December market minus 10% price that it was seeking and that bearish market conditions were no longer in place. By this time, it was too late. Market prices began to rise once again and PSE had once again lost the opportunity to lock in any savings of the Tenaska restructuring for customers. Moreover, the RMC minutes following the March 7, 2002 meeting do not reflect further discussion of potential hedges as market prices rose. As a result of PSE's failure to lock in reasonable gas cost supplies, the once substantial benefit of the Tenaska buyout has turned into a cost to ratepayers of approximately [redacted] from 1998–2003. Exh. No. 231C at 28: 24 (Schoenbeck).

The admissions in the Tenaska Business Case Analysis also highlight the imprudence of the Company's actions following the Western power crisis. Despite PSE's acknowledgments that it mismanaged the Tenaska gas supply in the early years of the contract buyout and that it needed intermediate and longer term plans for hedging Tenaska gas costs, PSE still did not secure any long–term gas supply for the plant. Indeed, the Tenaska gas supply

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

[redacted] even as market conditions stabilized and gas prices went down following the power crisis. Exh. No. 77C at 78.

PSE's repeated failure to lock in any long–term gas supply for Tenaska was imprudent. The standard for prudence is what "a reasonable board of directors and company management [would] have decided given what they knew or reasonably should have known to be true at the time they made a decision." WUTC v. Avista Corp., WUTC Docket No. UE–030751, Order No. 5: Approving and Adopting Settlement Stipulation at 10 (Feb. 3, 2004). As the Commission noted in PSE's 1994 general rate case order, prudence must be demonstrated by a "reasoned analysis." Exh. No. 82 at 15–16. PSE has provided no reasoned analysis why its decision to rely on short–term gas markets was prudent. Mr. Schoenbeck testified that, based on his review of all the RMC meeting documents, PSE was "at fault." TR. 405: 7 – 407: 2 (Schoenbeck).

Since 1997, PSE has had several opportunities to secure gas for Tenaska during periods of low market prices. Each time the Company has foregone potential savings in the hopes of achieving greater returns or maximizing short–term margins. Regardless of whether PSE's reliance on the short–term market prior to the Western power crisis is understandable, the Company's subsequent bet that it could beat the prices in that market was not. Customers should not be responsible for PSE's repeated gambles with the short–term market. PSE had the obligation to pursue a Tenaska gas supply strategy that would deliver as much of the projected savings as possible. PSE intentionally chose to go short. Since the Company voluntarily undertook the risk of going short, it should bear the consequences.

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241–7242

3. The Commission Should Remove the Tenaska Regulatory Asset from the Rate Base, Because it Has Provided No Customer Benefit

The Tenaska regulatory asset is now costing customers more than $40 million at a time when it was supposed to provide the first material benefits. Exh. No. 4C at 3–4. As described above, the cost of the regulatory asset was supposed to be phased in to match the benefit from lower gas costs. Id. In the early years following the buyout, the size of the regulatory asset actually grew. Now, however, the anticipated costs savings are not available to offset the increased amortization, because of PSE's failure to secure gas at a price close to the levels that were used to justify the regulatory asset. The Exhibit B analysis projected gas costs during the Rate Period of [redacted], which is substantially lower than the [redacted] gas costs that PSE seeks in this case. Thus, customers are stuck paying for the amortization of the buyout cost when they should be receiving a benefit.

ICNU and Staff have proposed a number of alternatives for addressing the imprudent Tenaska gas costs. All of these proposals recognize that ratepayers have incurred a net loss in paying for the regulatory asset for a number years, but have not received equivalent benefits. ICNU's primary recommendation is that the Commission order PSE to remove the regulatory asset from rate base and require the Company to write off the unamortized balance of the regulatory asset. Exh. No. 231C at 30: 6–8 (Schoenbeck). This approach, which would reduce PSE's revenue requirement during the Rate Period by approximately $40.3 million, is premised on the assumption that customers already have paid enough for a regulatory asset that has no value. Id. at 30: 8–9 (Schoenbeck).

ICNU also would support limiting the recovery of costs associated with Tenaska to the original contract value adjusted for the 1.2% prudence disallowance previously ordered by

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

the Commission. Id. at 30:3–5 (Schoenbeck). This is the adjustment proposed by Mr. Schooley. Exh. No. 301HC at 13: 9 – 14: 9 (Schooley). This would reduce PSE's requested revenue requirement increase by $19.8 million. Id.

In the alternative, the Commission could impute the gas cost savings used in the analysis performed at the time the Company restructured the gas costs. Exh. No. 231C at 30: 9–10 (Schoenbeck). Under this approach, the Commission would use a gas cost of [redacted] for Tenaska in this proceeding. Id. at 30: 10–11 (Schoenbeck). This would reduce PSE's proposed revenue requirement by approximately $29.0 million if the Commission were to adopt the $3.61/MMBTU Rate Period gas price proposed by ICNU. Id. at 30: 11–12 (Schoenbeck). If the Commission were to adopt the [redacted] Rate Period gas price proposed by PSE, the adjustment would be much greater (approximately $40 million) due to the larger difference between the average gas price assumed by PSE in the original Tenaska analysis [redacted] and the [redacted] assumed in this proceeding. TR. 428: 16–23 (Schoenbeck).

Finally, Mr. Schoenbeck proposed a fourth alternative at hearing, in which the Commission would impute a reasonable price of gas for Tenaska over the remaining term of the contract, and then allow the deviations from that cost to be flowed through a sharing mechanism on a going forward basis. TR. at 400: 7 – 401: 4, 403: 5–20 (Schoenbeck). This approach would allow the Commission to establish a reasonable benchmark price for Tenaska gas now, and then have the Company and customers share the risk of whether gas prices are higher or lower than the benchmark over the remaining years of the agreement. TR. at 401: 23 – 402: 21 (Schoenbeck). The savings from the approach would then be compared to the original Exhibit B

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

analysis, and the regulatory asset would be written down by a prorated amount. This approach would give PSE an incentive to manage the cost of gas for Tenaska through 2011, while still permitting recovery of some portion of the regulatory asset. ICNU continues to support the write off of the regulatory asset as its primary recommendation. Nevertheless, ICNU supports any of the recommendations described above if the Commission wishes to pursue alternative relief.

IV. CONCLUSION

The Commission should establish a normalized Baseline power cost that will allow the PCA sharing bands to function as intended. PSE has failed to meet its burden to establish that the costs it proposes to include in rates in this proceeding are reasonable.

PSE's forecast gas price for the Rate Period substantially exceeds a reasonable normalized value. As a result of the asymmetrical distribution of risk under the PCA, the risk associated with setting the Baseline too high is much greater than the risk associated with setting the Baseline too low. PSE proposed a NYMEX average gas price for this proceeding, despite the fact that it used a substantially lower market fundamentals forecast for risk management purposes and to justify the purchase of Frederickson. An average NYMEX price based on an illiquid market should not be used to set a normalized power cost Baseline. PSE has offered no reason why its NYMEX average price is more appropriate for use than the fundamentals–based price proposed by ICNU, especially considering that the ICNU value [redacted]. In addition, for purposes of setting the Baseline, PSE should use a normalized gas forecast based on a fundamentals model just as it does for projecting electric costs. Given the asymmetrical sharing of risk under the PCA, the Commission should err on the side of setting the Baseline too low

DAVISON VAN CLEVE, P.C.
1000 SW Broadway Ave., Suite 2460
Portland, OR 97205
Telephone (503) 241-7242

rather than too high. In light of this fact, Mr. Schoenbeck's fundamentals gas price is more reasonable than PSE's NYMEX price.

With respect to Tenaska, PSE virtually guaranteed "substantial" ratepayer benefits when it requested Commission authorization to buyout the gas contracts in 1997. Since that time, PSE has pursued a "go short" strategy for Tenaska gas, which ignored the advice of its consultants and numerous opportunities to lock in savings. The "go short" strategy was imprudent. Since the substantial ratepayer benefits from the buyout have not materialized, there is no longer any justification for recovery of the regulatory asset. Therefore, the Commission should order PSE to remove the Tenaska regulatory asset from rate base and write off the remaining unamortized balance.

DATED this 12th day of March, 2004.

Respectfully Submitted,

DAVISON VAN CLEVE, P.C.

S. Bradley Van Cleve

S. Bradley Van Cleve
Matthew Perkins
Davison Van Cleve, P.C.
1000 SW Broadway, Suite 2460
Portland, OR 97205
(503) 241-7242 phone
(503) 241-8160 fax
mail@dvclaw.com
Of Attorneys for the Industrial Customers
of Northwest Utilities