BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. PUGET SOUND ENERGY, INC., Respondent.	Docket No. UE-031725

PUGET SOUND ENERGY, INC.'S

INITIAL BRIEF

March 12, 2004

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I. INTRODUCTION.

1 This proceeding arises from a proposal by Puget Sound Energy, Inc. ("PSE" or "the Company") to adjust the baseline of power costs that it can recover in rates. The largest single adjustment flows from PSE's October 2003 decision to purchase a significant interest in a new generation facility – the Frederickson 1 facility – in order to help the Company meet its customers' growing energy needs. Other significant elements in the proposal include an increase in projected fuel costs (to reflect prevailing natural gas market prices) and updates to the Company's other power costs.

2 With the exception of fuel costs, almost all of PSE's proposed adjustments are no longer at issue after agreement reached by the parties. The remaining issues involve the Tenaska and Encogen fuel costs that should be recoverable in rates, and whether PSE should use forward market price data for natural gas to set the power cost baseline rate for this proceeding.

3 The Commission's order in this proceeding should therefore determine:

4 - Whether PSE acted prudently in making the Frederickson 1 acquisition, including whether the decisionmaking tools and processes that PSE employed for the acquisition meet the Commission's expectations.

5 - Whether a 1994 Commission order that imposed a 1.2% disallowance on PSE's recoverable contract charges for the Tenaska facility should now be reinterpreted to impose a fixed cap on the fuel costs that are recoverable in PSE's rates.

6 - Whether PSE acted prudently in managing the fuel supply for the Tenaska and Encogen facilities after PSE restructured the facilities' underlying fuel supply arrangements in the late 1990s.

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7 • Whether the Commission should reject proposals by the opposing parties to impose severe financial penalties on the Company to remedy allegedly imprudent fuel management decisions because, in hindsight, natural gas prices are higher now than levels predicted in the past.

8 • Whether PSE's longstanding use of forward market prices to determine the Company's estimated gas costs should be abandoned in favor of ICNU's artificial number that is unrelated to actual and predicted gas prices in the market.

9 Based upon the applicable law, the Commission's own precedent, and the facts in this proceeding, PSE respectfully requests that the Commission approve the power cost baseline rate that PSE has proposed in this proceeding. PSE further requests that the Commission approve PSE's proposed power cost true-up amounts for Tenaska and Encogen fuel costs for the first PCA period in Docket No. UE-031389.

II. LEGAL STANDARDS AND GOVERNING PRINCIPLES.

A. Applicable Legal Standards.

10 Pursuant to RCW 81.28.010, PSE's proposed rates for electric service must be "just, fair, reasonable and sufficient." RCW 81.04.130 places the burden of proof on PSE to show that its proposed tariff adjustments are just and reasonable.[1] Additional provisions in Chapters 80.01, 80.04 and 80.28 RCW and Chapters 480-07, 480-80 and 480-100 WAC apply generally.

11 The Commission has applied a reasonableness standard in reviewing the prudence of decisions relating to power costs:

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[1] *See, e.g., WUTC v. Puget Sound Power & Light Co.,* Docket No. UE-921262, Eleventh Supplemental Order (September 21, 1993) at 19.

> 12 In evaluating prudency it is generally conceded that one cannot use the advantage of hindsight. The test this Commission applies to measure prudency is *what would a reasonable board of directors and company management have decided given what they knew or reasonably should have known to be true at the time they made a decision*. This test applies both to the question of need and the appropriateness of the expenditures.[2]

> 13 The Commission relies upon a reasonableness standard. The company must establish that it adequately studied the question of whether to purchase these resources and made a reasonable decision, using the data and methods that a reasonable management would have used at the time the decisions were made.[3]

B. PSE's Power Cost Adjustment Mechanism.

14 The rate adjustments that PSE proposes in this proceeding must also be reviewed in the context of its Power Cost Adjustment ("PCA") mechanism that the Commission approved in Docket UE-011570. The PCA mechanism accounts for and allocates the differences in PSE's modified actual power costs relative to a power cost baseline.

15 As the Commission acknowledged, the approved PCA settlement – as amended by the Commission – allows for single-issue ratemaking through periodic, voluntary Power Cost Only Rate reviews:[4]

> 16 **Power Cost Only Rate Review**: In addition to the yearly adjustment for power cost variances, there could be a periodic proceeding specific to power costs that would true up the Power Cost Rate to *all power costs* identified in the Power Cost Rate. The Company can also initiate a power cost only proceeding to add new resources to the Power Cost Rate. In either case, the Company would submit a Power Cost Only Rate filing proposing such changes. This filing shall include testimony and exhibits that include the following:

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2 *WUTC v. Puget Sound Power & Light Co*., Cause No. U-83-54, Fourth Supplemental Order (September 28, 1984) at 32 (emphasis added).

3 *WUTC v. Puget Sound Power & Light Co*., Docket No. UE-921262, *et al*., Nineteenth Supplemental Order (September 27, 1994) at 10 (hereinafter "Prudence Order") (*citing WUTC v. Puget Sound Power & Light Co.*, Cause No. U-85-53, Second Supplemental Order (May 16, 1986) and *WUTC v. Washington Water Power Co.*, Cause No. U-83-26, Fifth Supplemental Order (January 19, 1984)). The Prudence Order was introduced as an exhibit in this proceeding. *See* Exh. No. 82.

4 *WUTC v. Puget Sound Energy, Inc*., Docket No. UE-011570 and UG-011571 (consolidated), Twelfth Supplemental Order (June 20, 2002) at 12-13 (emphasis added).

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- Current or updated least cost plan
- Description of the need for additional resources (if applicable)
- Evaluation of alternatives under various scenarios
- Adjustments to the Fixed Rate Component
- Adjustments to the Variable Rate Component
- A calculation of proforma production cost schedules that are consistent with this docket, including power supply and other adjustments impacting then current production costs.[5]

18 This proceeding – PSE's first Power Cost Only Rate Case ("PCORC") proceeding – involves two parts of the PCA mechanism: (1) the Power Cost Rate that will begin on April 1, 2004, and that will be established as a result of PSE's PCORC filing in October 2003; and (2) the amount of fuel supply costs that the Company incurred to operate the Tenaska and Encogen facilities during the year beginning July 1, 2002. The second part (the so-called Tenaska and Encogen "impasse issue") was inserted into this proceeding in mid-January 2004 – after the Company had prefiled direct testimony and exhibits, and after the parties had settled all issues in Docket No. UE-031389 concerning the 2003 PCA true-up other than the impasse issue.[6]

III. UNCONTESTED ADJUSTMENTS.

A. The Frederickson 1 Acquisition: PSE Acted Prudently When It Agreed To Acquire An Interest In The Frederickson 1 Generation Facility.

19 PSE initiated this PCORC proceeding on October 24, 2003. The largest single power cost adjustment in the proceeding is necessitated by PSE's agreement, in October 2003, to acquire a 49.85% ownership interest in the Frederickson 1 generation facility. PSE's Senior Vice President of Energy Resources, Mr. Markell, discussed the acquisition in detail in his prefiled direct and rebuttal testimony. He summarized the acquisition as the "culmination of a robust planning and analytical process; a broad review of

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[5] Exh. No. 17 at 5 (emphasis original); *see also id.* at 13.

[6] *In re the Petition of Puget Sound Energy, Inc. for Approval of its 2003 Power Cost Adjustment Mechanism Report*, Docket No. UE-031389, Order No. 04 (January 14, 2004) at para. 5-9.

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available opportunities; extensive due diligence; and tough negotiations."[7] According to Mr. Markell, the acquisition represents a "modest but important first step towards meeting PSE's growing power supply needs."[8]

20 This section reviews the Frederickson 1 acquisition. It begins by discussing the factors that – according to the Commission – determine the prudence of a resource decision. The section then describes PSE's determination that it requires substantial additional resources; its identification of different resource opportunities to help meet that need; and the evaluation process that it conducted (which ultimately led to the Frederickson acquisition). The section reviews Commission Staff's conclusion that PSE acted prudently in acquiring the Frederickson 1 resource, and that PSE made the acquisition at a reasonable cost. Finally, the section addresses the single point in dispute concerning the acquisition.

1. The Commission Has Cited Several Specific Factors That Determine The Prudence Of A Resource Decision.

21 In addition to the reasonableness standard cited above, the Commission has cited several specific factors that determine the prudence of a utility's decision to acquire a new resource.[9] These factors include, among others, the following:

22
- The utility must first determine whether new resources are necessary. Once a need has been identified, the utility must determine how to fill that need in a cost-effective manner. When a utility is considering the purchase of a resource, it must evaluate that resource against the standards of what other purchases are available, and against the standard of what it would cost to build the resource itself.[10]

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7 Exh. No. 131 at 4: 25-26 (Markell).

8 Exh. No. 182 at 3: 12-13 (Markell).

9 *See generally* Exh. No. 16.

10 *See, e.g.,* Exh. No. 82 at 11 (Prudence Order).

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23 • The utility must analyze the resource alternatives using current information that adjusts for such factors as end effects, capital costs, dispatchability, transmission costs, and whatever other factors need specific analysis at the time of a purchase decision.[11]

24 • The utility should inform its board of directors about the purchase decision and its costs. The utility should also involve the board in the decision process.[12]

25 • The utility must keep adequate contemporaneous records that will allow the Commission to evaluate its actions with respect to the decision process. The Commission should be able to follow the utility's decision process; understand the elements that the utility used; and determine the manner in which the utility valued these elements.[13]

2. PSE Applied The Prudence Factors During The Process That Led To The Frederickson Acquisition.

a. PSE Determined That It Requires Substantial Additional Resources.

26 The Company's need for additional electric resources is substantial and undisputed. To address its load-resource deficit, PSE developed a multi-staged and diversified resource acquisition strategy – a component of which is the Frederickson acquisition.

27 PSE began a comprehensive effort to evaluate its resource needs in October 2001, when it formed a load-resource strategies team to assess the Company's load and available resources. In April 2002, the team projected PSE's energy sales and inventoried PSE's available supply resources. The team found that, over the next decade, and primarily due to the expiration of certain long-term power supply

[11] *Id.* at 2, 37.
[12] *Id.* at 37, 46.
[13] *Id.* at 2, 6, 37.

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contracts, PSE would experience a significant loss of contracted resources. The expiring resources meant an expected loss of 688 MW of capacity and 264 aMW of energy from 2002 to 2010.[14]

28 After an extensive collaborative process with Commission Staff, Public Counsel and interested parties that began in the summer of 2002, PSE filed its 2003 Least Cost Plan ("2003 LCP") with the Commission in April 2003, and an Update to the 2003 LCP in August 2003.[15] The processes and analyses that went into the 2003 LCP and the Update resulted in a determination that PSE requires additional electric resources (in addition to the Company's significant commitment to conservation). Due primarily to the expiration of long-term power purchase contracts and to a lesser extent load growth, PSE estimated that it would require, in the near-term (*i.e.*, by January 2005), approximately 476 aMW of additional energy resources to meet its load obligations (before conservation) – which requirement was forecast to increase to approximately 1,715 aMW in January 2013.[16]

b. PSE Identified And Evaluated Opportunities That Could Help The Company Meet Its Resource Needs.

29 Beginning in 2002 and continuing through mid-2003, PSE employed a thorough and systematic process to identify and evaluate different opportunities that could help the Company meet its resource needs. The resource evaluation process was closely tied to PSE's ongoing least cost planning process. In particular, the Portfolio Screening

[14] Exh. No. 11 at 9: 4 – 10: 11 (Gaines); Exh. No. 14 at 6; Exh. No. 15 at 10.

[15] Exh. No. 28; Exh. No. 175.

[16] Exh. No. 27 at 2: 12 (Gaines, adopting prefiled direct testimony of Charles J. Black (CJB-1T) at 6: 26 – 7: 21); Exh. No. 131 at 7: 1-4 (Markell); Exh. No. 176.

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Model that PSE used to support and implement the planning process became the primary analytical tool by which PSE evaluated different resource options.[17]

30 In evaluating its various resource options, the Company determined that it could not rely exclusively upon the short-term power market to meet its resource needs. The Company faces decreased market liquidity today due to fewer market participants and available energy products; credit issues that affect PSE and other energy companies; and regional transmission limitations. PSE's Vice President of Energy Portfolio Management, Ms. Ryan, testified that in order to manage risk effectively and follow a prudent business strategy, PSE should not rely on the short-term power market alone to bridge the significant energy and capacity deficits that the Company faces.[18]

31 The Company considered other ways to meet its resource needs based upon the application of certain evaluation criteria.[19] These options included:

- *Conservation* – acquisition of resources from conservation efforts.
- *Self-Build Option* – construction by PSE of a new generation project.
- *Asset Acquisition Option* – acquisition of one or more generation projects.
- *PPA Option* – execution of one or more purchased power agreements.
- *Hybrid Option* – combination of two or more resource alternatives.

32 The first resource option – conservation – was assessed during the development of the 2003 LCP. The Company identified an estimated "economic potential" of 276 aMW of cumulative electric conservation savings over 20 years and committed itself to an

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[17] Exh. No. 28 at Chapter XI; Exh. No. 101 at 3: 16 (Granowski, adopting prefiled direct testimony of Charles J. Black (CJB-1T) at 17: 18 – 23: 2); .Exh. No. 131 at 11: 7-11 (Markell); Exh. No. 131 at 42: 9 – 43: 15 (Markell); Exh. No. 133HC at 96-130 (tab "Comprehensive Assessment").

[18] Exh. No. 191 at 11: 1 – 21: 18 (Ryan). When PSE modeled the various resources and their impacts on the Company's supply portfolio, it further concluded that a strategy based exclusively on purchases in the short-term power market – referred to as a "market dependent strategy" – would expose the Company to substantial additional costs when compared to an asset-based strategy. *See* Exh. No. 131 at 46: 2-15 (Markell); Exh. No. 166C.

[19] Exh. No. 131 at 11: 14-24, 14: 19 – 16: 15 (Markell); Exh. No. 148HC at 43.

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aggressive goal of acquiring 203 aMW during 2004-2013. PSE integrated these conservation savings levels into the Company's resource portfolio evaluation. PSE determined, however, that it cannot meet its expected resource needs through conservation alone.[20]

33 The second resource option – construction of a new generation project – was analyzed by Tenaska, Inc. ("Tenaska"), a project development/consulting firm that PSE retained in the summer of 2002. Tenaska prepared a report and memorandum that assessed self-build design and construction factors, generic development costs, and time schedules for three equipment configurations on two possible sites in PSE's service area.[21] Based upon Tenaska's work, PSE concluded that the leading asset acquisition and power purchase alternatives (summarized below) were all equal or superior to the self-build option, and did not carry the completion and other risks that were associated with the self-build alternative.[22]

34 PSE also considered the other resource options (asset purchase and power purchase arrangements). In September 2002, the Company advised 53 project owners and developers in the Northwest region that it would consider the acquisition of electric generation facilities that were either in service or in the latter stages of development. In November 2002, the Company advised 75 potential power sellers in the region that it would also consider purchasing, under purchased power agreements ("PPAs"), base-load energy supply resources with seasonal and other dispatch capabilities.[23]

35 The Company received 58 responses to the September and November solicitations. These responses were reviewed, analyzed, and ranked on a preliminary basis according

[20] Exh. No. 101 at 3: 17-18 (Granowski, adopting prefiled direct testimony of Charles J. Black (CJB-1T) at 41: 15-19, 44: 21-24); Exh. No. 131 at 16: 18 – 17: 16 (Markell).

[21] Exh. No. 131 at 29: 25 – 32: 11 (Markell); Exh. No. 155; Exh. No. 156.

[22] Exh. No. 131 at 32: 13-25 (Markell); Exh. No. 133HC at 80.

[23] Exh. No. 131 at 18: 1-5, 24: 26 - 25: 2 (Markell); Exh. No. 149; Exh. No. 151.

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to the evaluation criteria that the Company had developed. By early 2003, the Company reduced the list of acquisition candidates to five gas-fired generation projects (which included the Frederickson 1 facility),[24] and the list of PPA candidates to 11 products offered by eight companies. Mr. Markell discussed the Company's evaluation and ranking process in his prefiled direct testimony.[25]

36 PSE then performed due diligence with respect to the leading resource alternatives. During this process, the Company decided not to pursue two of the acquisition projects due to risks posed by one developer's bankruptcy filing and the other developer's worsening financial condition.[26] The other three acquisition candidates were evaluated according to various factors. Based upon the analysis that PSE conducted, and due to several positive attributes that were identified (including a favorable acquisition cost), the Frederickson 1 resource became the Company's preferred initial acquisition.[27]

37 The Company also evaluated the PPA opportunities in parallel with the acquisition candidates. The Company revisited its PPA assessment in the summer of 2003 with the intent of using then-current market information to identify the top PPA candidates. PSE evaluated these opportunities in conjunction with a possible hybrid approach that would combine various alternatives. Mr. Markell discussed the PPA and hybrid

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[24] The acquisition candidate list originally included three wind projects. For various reasons, PSE deferred the consideration of wind opportunities until later in 2003, when it could review those opportunities in more detail. *See* Exh. No. 131 at 21: 18 – 22: 4 (Markell); Docket No. UE-031353 (PSE Wind RFP).

[25] Exh. No. 131 at 19: 9 – 24: 22, 25: 22 – 28: 20 (Markell). *See also* Exh. No. 143HC; Exh. No. 148HC at 5-7, 10; Ex. No. 150HC; Exh. No. 153HC; Exh. No. 154HC at 4-8.

[26] Mr. Markell discussed the depressed merchant generation sector in his prefiled direct testimony. He also reviewed the specific risk factors that can arise when a project or power seller files for bankruptcy protection. *See* Exh. No. 131 at 7: 16 – 9: 4, 12: 15 – 13: 24 (Markell); *see also* Exh. No. 133HC at 41-49 (tab "Review of Merchant Landscape").

[27] Much of the evaluation that PSE conducted is highly confidential under the terms of the Commission's protective order in this proceeding. The details of this evaluation appear in Mr. Markell's prefiled direct testimony and in certain of his exhibits. *See* Exh. No. 131 at 35: 7 – 39: 3 (Markell); Exh. No. 159HC; Exh. No. 161HC; Exh. No. 162HC.

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alternatives and the Company's evaluation of those alternatives in his prefiled direct testimony.[28]

c. PSE Agreed To Acquire The Frederickson Interest After Evaluating The Resource Opportunities.

38 After evaluating the resource opportunities, PSE management determined that the Frederickson 1 facility represented the least cost alternative considering all factors. The acquisition adds a resource to PSE's supply portfolio that is consistent with the needs that the Company identified in the 2003 LCP. Moreover, the operational benefits of the Frederickson 1 facility are numerous and undisputed. Mr. Markell and Ms. Ryan discussed these benefits in their prefiled direct testimony.[29]

39 Based upon management's recommendation, the Company's Board of Directors granted unanimous authorization in October 2003 to proceed with the Frederickson 1 acquisition.[30] PSE then entered into a series of transaction documents for the purchase, operation and management, shared services, and dispatch of 49.85 % of the Frederickson 1 facility.[31]

3. Commission Staff Concluded That PSE Acted Prudently In Acquiring The Frederickson Resource, And That PSE Made The Acquisition At A Reasonable Cost.

40 Commission Staff's witness, Mr. McIntosh, reviewed the Frederickson 1 acquisition. He reviewed the documentation for the acquisition; interviewed the Company staff and consulting personnel who worked on the acquisition; and reviewed and tested the Portfolio Screening Model that PSE had used in evaluating its resource options. He concluded that PSE acted prudently in acquiring the Frederickson resource, and that the

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[28] Exh. No. 131 at 39: 5 – 42: 7 (Markell). *See also* Exh. No. 143HC; Exh. No. 160C; Exh. No. 161HC; Exh. No. 162HC.

[29] Exh. No. 131 at 44: 18 – 45: 26 (Markell); Exh. No. 191 at 23: 9 – 24: 27 (Ryan).

[30] Exh. No. 131 at 44: 2-12 (Markell); Exh. No. 163HC.

[31] Exh. No. 167HC; Exh. No. 168HC; Exh. No. 169HC; Exh. No. 170HC.

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Company's decision "was based upon appropriate, rational and reasoned methods, utilized appropriate data, and covered specific issues which the Commission listed in the [Prudence Order]."[32]

41 Mr. McIntosh discussed the Company's decision in his prefiled direct testimony. He stated that the Company applied three important methods during the evaluation process: (1) the Portfolio Screening Model; (2) the solicitation process; and (3) the use of scenarios of hydro conditions and fuel costs. He testified that PSE considered specific factors that the Commission had enumerated in the Prudence Order, including end effects, resource reliability, transmission issues, and fuel price and other risk elements. Mr. McIntosh noted that the Company evaluated different resource options, including a self-build alternative, contract purchases, and acquisition of a new resource. He confirmed that the Company has a "clear documented need for power in the near term," and that it applied a "deliberate, organized process for soliciting and evaluating bids." During this process, "[PSE] kept detailed records of crafting the evaluation method, data acquisition, and resource evaluation."[33]

42 Mr. McIntosh also reviewed the cost of the Frederickson 1 acquisition. He concluded that PSE made the acquisition at a reasonable cost and that – based upon currently-available averages – the price level for the Frederickson resource is reasonable on a per-kW basis.[34]

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32 Exh. No. 291HC at 3: 6 – 4: 2 (McIntosh). Mr. McIntosh was the only witness who addressed the Frederickson acquisition of behalf of another party to this proceeding. ICNU and Public Counsel did not address the acquisition in their filings.

33 Exh. No. 291HC at 5: 14 – 8: 3 (McIntosh). In addition to the factors that Mr. McIntosh cited, the Commission has stated that a utility's board of directors should be involved in a decision to acquire a new resource. *See, e.g.*, Exh. No. 82 at 37, 46 (Prudence Order). PSE actively involved its Board of Directors in the evaluation and decision process that led to the Frederickson acquisition. *See, e.g.*, Exh. No. 131 at 9: 16 – 10: 20 (Markell); Exh. No. 136HC.

34 Exh. No. 291HC at 8: 5-9 (McIntosh). Mr. Markell discussed the basis for the Frederickson acquisition cost at hearing and in his testimony and exhibits. *See* TR. 108: 14-23 (Markell); TR. 114: 25 – 116: 12 (Markell); Exh. No. 131 at 38: 19-28 (Markell); Exh. No. 159HC; Exh. No. 182 at 9: 9-23 (Markell).

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4. A Regulatory "Out" Clause Is An Appropriate Contract Provision For The Frederickson Acquisition.

43 Only one point of dispute concerns the Frederickson acquisition. This issue involves a clause in the Purchase and Sale Agreement ("PSA")[35] that gives either PSE or the facility seller the right (but not the obligation) to terminate the PSA if, within a specified time, PSE has not received Commission approval to include the costs of the acquisition in PSE's rates.[36] A different Commission Staff witness, Mr. Elgin, claimed that such a clause is "contrary to the public interest and sound regulatory policy."[37]

44 PSE disagrees with Mr. Elgin. In his prefiled rebuttal testimony, Mr. Markell stated that clauses similar to the PSA clause are commonly included in resource acquisition agreements. One reason these clauses are included is to eliminate or reduce the impact of regulatory risk, which (as Mr. Markell testified) is a significant factor in the current energy environment due in part to pending and unresolved issues such as Standard Market Design ("SMD"), Regional Transmission Organizations ("RTOs"), and other developing FERC policies.[38] By negotiating a regulatory "out" provision into an acquisition agreement, and provided that favorable regulatory action is obtained, the parties receive greater certainty that the financial markets will react favorably to the transaction. If the financial markets believe that risks associated with the agreement have been eliminated or reduced, then the parties' financing costs will be lower over time than they would otherwise be – which, in turn, will help to keep down the costs that consumers pay for energy over time.[39]

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[35] The clause is Article 14.1(a)(ix) in the PSA. *See* Exh. No. 167HC at 80-81. Such a clause is often referred to, in contracting parlance, as a regulatory "out" clause.

[36] The costs of the acquisition include the purchase price and certain transaction costs. The estimated costs for the acquisition are summarized in Exh. No. 172HC, and will be trued up to actual costs prior to closing.

[37] Exh. No. 281HC at 2: 6-7 (Elgin).

[38] Exh. No. 182 at 4: 17-26 (Markell); Exh. No. 183 at 3; TR. 118: 7-10 (Markell) ("unknowns coming out of Washington, D.C. … make capital providers cautious").

[39] Exh. No. 182 at 5: 1-19 (Markell).

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45 Mr. Markell expanded upon these themes at hearing. Chairwoman Showalter asked whether there is "more risk in general to allocate" compared to the risk that existed five years ago in the energy environment.[40] In response, Mr. Markell stated that in his experience, there has not been a time since 1978 – when PURPA was passed, and when Mr. Markell became involved with generation issues – that the "regulatory groundwork…is as confused as it is today for someone who wants to get into the generation business."[41]

46 The PSA clause that the Company negotiated for the Frederickson acquisition helped to reduce the impact of prevailing risk factors. Inclusion of that clause did not increase the Company's acquisition cost. Rather, the clause led to a price reduction.[42]

47 In addition, the PSA clause was appropriate due to the nature of the Frederickson 1 acquisition and this proceeding. It appeared to PSE that any resource obtained from the 2002 solicitations would lay the foundation for PSE's future acquisitions. It also appeared that this proceeding – the first PCORC proceeding – would be the forum in which the Commission would evaluate any such resource, and that the Commission's assessment would lay the foundation for regulatory oversight of future transactions.

48 PSE therefore decided that it was important for the Frederickson acquisition to receive timely Commission scrutiny under the PCORC review process that the PCA settlement provided.[43] The Commission's assessment in this PCORC proceeding will "greatly reduce a key risk factor – state regulatory uncertainty."[44] According to Mr. Markell,

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[40] TR. 106: 18-24 (Markell).

[41] TR. 107: 3-10 (Markell).

[42] Exh. No. 182 at 9: 9-23 (Markell); *see also* Exh. No. 184HC. Mr. Markell discussed the basis for the price reduction at hearing in response to a question from Administrative Law Judge Moss. *See* TR. 114: 25 – 116: 12 (Markell).

[43] Exh. No. 182 at 6: 12 – 7: 26 (Markell). Future resource acquisitions may not require a similar level of scrutiny. The Company will assess each such acquisition on an individual basis before deciding whether to seek Commission review. *See* Exh. No. 182 at 8: 21 – 9: 7 (Markell).

[44] Exh. No. 182 at 8: 4 (Markell).

the assessment will also help the Company determine whether "… our processes, our analysis, the way we went about our decision-making with respect to this specific transaction met the burdens of proof set forth in the Commission's standards for prudent management practice."[45]

49 In sum, the PSA clause added a vital component to the Frederickson transaction. PSE therefore asks the Commission to find that it acted appropriately in negotiating the clause for this transaction.

B. The Other Uncontested Adjustments.

50 Like the Frederickson acquisition, most other adjustments to PSE's power cost baseline either were initially uncontested or are now uncontested after a stipulation and other changes discussed in PSE's rebuttal filing.

1. Weather Normalization Stipulation.

51 For the present proceeding and without agreeing to set a precedent, PSE has stipulated to Commission Staff's proposed weather normalization adjustment. The Stipulation[46] is based upon Commission Staff's and PSE's commitment to engage in a collaborative discussion. The Company will work with Commission Staff and attempt to resolve differences concerning the methodological and statistical issues associated with normalizing the effects of weather on PSE's loads. These issues are complex, and it

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[45] TR. 110: 13-17 (Markell). *See also* TR. 104: 14 – 105: 3 (Markell) (the Commission's approval would affirm that "our procedures and analysis and data and our communications with the board were adequate and met those [prudence] standards," and that "we have met the burdens set forth in those general standards").

[46] Exh. No. 1.

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was deemed most appropriate to address them in this manner. No party opposed the Stipulation, and the Commission has approved it.[47]

2. Power Cost Adjustments.

52 Commission Staff's witness, Mr. Russell, testified at hearing that Commission Staff and PSE agreed on the following adjustments:[48]

PCA Baseline Costs	Amount
Per Books (test year)	$862,035,357
Adj – 1 Power Costs	(156,165,127)
Adj – 2 Sales for Resale	152,198,362
Adj – 3 New Plant (Frederickson 1)	42,368,805
Adj – 4 Transmission Income	3,253,602
Adj – 5 Prod. Plant Deprec./Amort	(65,231)
Adj – 6 Property Taxes	152,265
Adj – 7 Montana Energy Tax	86,743
Adj – 8 Property Insurance	126,210
Adj – 9 White River	208,049
Adj – 10 Reg. Assets/ Acq. Adj.	(3,521,669)
Adj – 11 Production Adjustment	(1,353,716)

47 Order No. 10 Accepting Stipulation Concerning Weather Normalization Issue (Docket No. UE-031725) (February 11, 2004).

48 TR. 555: 12 - 556: 2 (Russell). *See also* Exh. No. 317; Exh. No. 318.

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53 Some of these adjustments reflect significant changes from PSE's initial filing:

54 • *Test Year Amounts*: PSE and Commission Staff agreed to exclude $12 million in construction work in progress ("CWIP") associated with the Snoqualmie Falls Project pending FERC approval of the relicensing of that project.

55 • *Adj. 1*: PSE agreed with Commission Staff to – a reduction of $7.4 million from the number originally proposed for winter peaking costs.

56 • *Adj. 1 and 7*: PSE agreed to Commission Staff's adjustment to the costs associated with the Colstrip 3 maintenance outage during the PCORC rate year.

57 • *Adj*. 1: PSE agreed to Commission Staff's calculation of the disallowance of replacement power costs for Tenaska and March Point Phase II (The total reduction for the Colstrip maintenance and March Point adjustment was a $2.8 million reduction).

58 • *Adj. 3*: After its initial filing, PSE received a favorable sales tax ruling from the Washington Department of Revenue that resulted in a reduction of $6.3 million in capitalized sales tax attributable to the purchase of an interest in the Frederickson facility.

59 • *Adj*. 4: PSE agreed to Commission Staff's calculation which used a restated three year average for determining Transmission Income.

60 • *Adj. 9*: PSE and Commission Staff agreed to include White River in the test period at the rate year level and agreed to leave depreciation and amortization at current levels pending future potential developments and action related to disposition of that plant.

61 Public Counsel did not take a position with regard to any of the adjustments discussed above.

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62 When asked about these adjustments at hearing, ICNU's witness, Mr. Schoenbeck agreed that all of the adjustments were acceptable with the exception of the issues identified in Section IV below.[49]

IV. CONTESTED ADJUSTMENTS

63 There are only three remaining contested issues in this proceeding:

64 • Should the Commission impose a fixed cap upon the recoverable costs of the Tenaska contract?

65 • Should some of the fuel costs that PSE seeks to recover for the Tenaska and Encogen facilities be disallowed based on claims that PSE acted imprudently with respect to its earlier fuel management decisions for those facilities?

66 • Should PSE's longstanding use of forward market prices to determine its estimated gas costs be abandoned in favor of the approach that ICNU proposes?

67 PSE asks the Commission to reject a fixed cap on the Tenaska costs; determine that PSE acted prudently with respect to its prior fuel decisions; and retain the longstanding use of forward market prices for the purpose of estimating PSE's gas costs.

A. The Prudence Order Did Not Impose A Fixed Cap Upon The Recoverable Costs Of The Tenaska Contract.

1. Background.

68 The Tenaska facility is a 245 MW natural gas-fired cogeneration plant located adjacent to the Tosco Refinery near Ferndale, Washington. In 1991, Puget Sound Power & Light Company (PSE's predecessor, referred to in this brief as "Puget") entered into a

[49] TR. 373: 2-8 (Schoenbeck).

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long-term Agreement for Firm Power Purchase ("Tenaska Agreement" or "Tenaska contract") with the owner of the plant, Tenaska Washington Partners, L.P., under which Puget agreed to purchase power from the Tenaska facility pursuant to the Public Utilities Regulatory Policy Act ("PURPA").[50] The Tenaska Agreement provided for a term ending in 2011.[51]

69 Puget filed a general rate case in 1992 seeking to recover in its rates the costs of power purchased under the Tenaska Agreement. In the Prudence Order, the Commission found that Puget paid too much for the Tenaska Agreement because it should have "factor[ed] in the value of dispatchability" during the acquisition process.[52] The Commission identified this specific act of imprudence, then proceeded to assess whether a remedy was warranted and how a remedy should be fashioned.[53]

70 After considering a number of possible approaches for calculating a disallowance, the Commission imposed a percentage disallowance equal to certain of Puget's actual costs under the Tenaska Agreement attributable to the value of dispatchability. The Commission decided that, for future ratemaking, it would require a disallowance of "1.2% of net contract charges for Tenaska. The net charge is the amount paid to the contractor, Tenaska …, plus any payments for replacement power resulting from economic dispatch."[54] The Commission's Finding of Fact 8 tracked this approach:

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[50] Exh. No. 45 at 7: 12-18 (Gaines rev. 2/19/04). (In citing to Mr. Gaines's prefiled rebuttal testimony (Exh. No. 45), we use the abbreviation "rev. 2/19/04" to refer to the revised version of that testimony (with errata included) that PSE filed with the Commission on February 19, 2004.)

[51] Exh. No. 45 at 7: 17-18 (Gaines rev. 2/19/04).

[52] Exh. No. 82 at 32: ¶4 (Prudence Order).

[53] The two-stage process that the Commission conducted in Docket No. UE-921262 (first a specific finding of imprudence, then a subsequent disallowance) stands in marked contrast to the process that the opposing parties in this proceeding suggest with respect to the Tenaska and Encogen fuel costs. They propose harsh adjustments to PSE's bottom line without citing *any* specific acts of imprudence. In so doing, they gloss over the first half of the process that the Commission employed in Docket No. UE-921262. *See also* discussion in Section IV(B) of this brief.

[54] Exh. No. 82 at 32: ¶4 (Prudence Order).

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"Future ratemaking treatment for these contracts should include percentage disallowances to reflect the excess amounts, as follows: Tenaska 1.2%…"[55]

71 After the Commission issued the Prudence Order, Puget filed a motion asking the Commission to clarify the Prudence Order's language regarding "net contract charges." In its Twentieth Supplemental Order in the same proceeding, the Commission explained that it could have calculated the disallowance in several ways: "Or, per the order, the disallowance could be calculated as a percentage of the net cost of the contract. This type of disallowance will reward the company for any dispatchability that occurs by reducing the disallowance for the benefits of dispatchability, but only if the dispatch is economical."[56] The Commission revised its Finding of Fact 8 in the Prudence Order to read:

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> Future ratemaking treatment for these contracts should include percentage disallowances to reflect the excess amounts. Those disallowances are: Tenaska 1.2% and March Point Phase II 3.0%. In both cases, the disallowance is calculated as a percentage of the net cost of the contract. The net cost of the contract includes the following three components: (1) the amount paid to the contractor for energy actually purchased at the contract rate; (2) the amount paid to the contractor under the contract's displacement provisions; and (3) the amount paid for replacement power when economic dispatch occurs.[57]

73 In the 10 years since the Commission issued the Prudence Order, the Tenaska dispatchability disallowance has consistently been applied as the product of the net contract charge multiplied times the 1.2% percentage factor. No party ever proposed a different approach until this proceeding.[58]

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55 *Id.* at 46: Finding Of Fact 8.

56 Exh. No. 83 at 18: ¶ 4 (Twentieth Supplemental Order in Docket No. UE-921262).

57 *Id.* at 18.

58 *See generally* TR. 322: 4-12 (Gaines); Exh. No. 45 at 9: 10-22 (Gaines rev. 2/19/04); Exh. No. 220 at 12: 21 - 14: 4 (Story); *accord* Exh. No. 309 (Commission Staff's Response to PSE's Request for Admission re Application of the 1.2% Disallowance).

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2. Commission Staff's Reinterpretation Of The Prudence Order Is Inconsistent With The Order's Plain Language.

74 For the first time since the Commission issued the Prudence Order, Commission Staff now contends that the 1.2% disallowance of "net contract costs" should be understood to function as a cap that limits PSE's recoverable Tenaska costs to a specific "dollar per megawatt hour" amount.[59] Commission Staff relies exclusively for this assertion on the "avoided cost" language of the Prudence Order (at 28-33), the findings regarding the disallowance relating to the value of dispatchability, and on a statement in the Prudence Order that, with respect to the Tenaska Agreement, "ratepayers should not bear the extra costs."[60] Under this reinterpretation, Commission Staff recommends disallowances of $22.1 million for the 2003 PCA true-up (Docket No. UE-031389) and almost $20 million for the cost of gas associated with the Tenaska Agreement for the 2004 power cost baseline (Docket No. UE-031725).[61]

75 Commission Staff has reinterpreted the Prudence Order in a manner that is inconsistent with that Order's plain language. The Commission considered several different potential disallowances in Docket No. UE-921262. The Commission could have established a flat or fixed disallowance figure; limited Puget to a fixed dollar amount of recoverable costs; or required Puget to hold its ratepayers harmless for any costs above a certain amount.[62] Instead, the Commission cited a specific imprudent act by Puget – the failure to properly analyze the value of dispatchability – and disallowed a specific percentage of "net contract costs" representing the value of that dispatchability.[63]

[59] Exh. No. 301HC at 7: 1-2 (Schooley); TR. 488: 24 – 490: 2 (Schooley).

[60] Exh. No. 301HC at 5: 16 – 6: 27 (Schooley) (relying on the Prudence Order for his opinion). *See also* TR. 507: 1 (Schooley) (relying on the Prudence Order and the Twentieth Supplemental Order in Docket No. UE-921262 for his opinion); Exh. No. 308.

[61] Exh. No. 301HC at 3: 10-14 (Schooley).

[62] In this regard, the Commission could have applied the same "hold harmless" concept to the Tenaska costs that it applied to other cost issues. *See* Exh. No. 82 at 47 (Finding of Fact 12 (Prudence Order) (ratepayers "should be held harmless" with respect to any adverse rate impacts associated with the BPA sale).

[63] Exh. No. 82 at 28 (Prudence Order).

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Importantly, the disallowance imposed on Tenaska contract costs in Docket No. UE-921262 – "the extra costs" the ratepayers should not have to bear – reflects *only* the value of dispatchability, not some overarching amount of costs related to fuel supply for the facility.

76 If the Commission had intended to create a cap on Puget's recoverable costs, it could have expressed the disallowance in terms of such a cap. But the Commission did not do so. Under the Prudence Order's plain language, therefore, a cap should not be imposed on PSE's recoverable Tenaska costs.

3. Commission Staff's Reinterpretation Of The Prudence Order Is Inconsistent With The Historical Application Of The Tenaska Disallowance.

a. Generally.

77 During the last 10 years, PSE has consistently interpreted the Prudence Order to require a straightforward 1.2% disallowance of the net contract charge under the Tenaska contract. PSE has calculated the disallowance – and the Commission has consistently accepted PSE's calculation – based upon the product of the net contract charge multiplied times the 1.2% percentage factor.[64] PSE applied this calculation in its PRAM 4 and PRAM 5 cases; it included the calculation in the Stipulation in its Merger Rate Plan (Docket No. UE-951270); and it included the percentage disallowance in the settlement of the Company's 2001 general rate case.[65] Indeed, after PSE's last general rate case, Commission Staff and other parties audited the power cost calculations in PSE's baseline power costs, which included the 1.2% disallowance, and agreed that the

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[64] Exh. No. 45 at 9: 11-13 (Gaines rev. 2/19/04); Exh. No. 220 at 12: 12 – 13: 22 (Story); Exh. No. 309 (Commission Staff's Response to PSE's Request for Admission re Application of the 1.2% Disallowance).

[65] Exh. No. 220 at 13: 5-17 (Story). *See also* Exh. No. 309 (Commission Staff's Response to PSE's Request for Admission re Application of the 1.2% Disallowance); *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-011570, Twelfth Supplemental Order at Exhibit A (PCA Settlement Terms), Exhibit B (Power Costs Subject to PCA Sharing), Line 21 ("Prudence from UE-921262") ("Prudence adj.= 3.0% * March Pt 2 payments; and 1.2% * Tenaska payments").

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costs were properly calculated.[66] At no time during any of these proceedings did Commission Staff ever contend that the Prudence Order created a cost cap.[67]

b. The 1997 Restructuring Of The Tenaska Agreement.

78 Even if the 1994 Prudence Order had imposed a cost cap, the 1997 restructuring of the Tenaska Agreement fundamentally reformed the facility's fuel supply and accounting treatment – and, in so doing, eliminated any possible basis for thereafter applying such a cap.

79 The 1997 restructuring accomplished two important things. As noted in the accounting petition that the Company filed, the restructuring fundamentally reformed the Agreement itself by moving the underlying fuel cost component under the Tenaska contract to variable, market-based pricing.[68] In addition, the restructuring fundamentally reformed the accounting treatment for the Agreement (by creating a regulatory asset on the Company's books).

80 The effect of the restructuring upon a possible cost cap was discussed at hearing in response to questions by Chairwoman Showalter and Commissioner Oshie.[69] Chairwoman Showalter asked Commission Staff's witness, Mr. Schooley, to assume a

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[66] *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-011570, Fifteenth Supplemental Order (May 13, 2003) at para. 8-10, 12 and Exhibit A (Agreement Regarding Resolution of PCA Mechanism Open Issues), Revised Exhibit B (Power Costs Subject to PCA Sharing), Line 21 ("Prudence from UE-921262") ("Prudence adj.= 3.0% * March Pt 2 payments; and 1.2% * Tenaska payments"). Commission Staff submitted comments to the Commission regarding these power cost calculations. The comments are telling according to the Fifteenth Supplemental Order: "Staff's comments indicated that Commission Staff had worked closely with PSE in determining the proposed recalculation and that *Staff agrees with the recalculation, as memorialized in the PCA Verification Agreement that was filed with the application. Staff recommends that the Commission approve the application*." *Id.* at para. 5 (emphasis added).

[67] Exh. No. 220 at 13: 26 (Story).

[68] Exh. No. 283C at 3 (the objective of the restructuring was to "drive the [Tenaska contract's] gas cost element…toward market"). *See also* Exh. No. 52 at 4 (Company's intention was "not to lock in prices"); Exh. No. 53.

[69] *See generally* TR. 500: 9 – 506: 20; TR. 507: 16 – 511: 14.

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hypothetical $10 million cost cap, and that the Company, Commission Staff, and the Commission later agreed to a "different arrangement for the gas component," such that the Company would purchase gas not at a fixed price, but at an indexed price.[70] Mr. Schooley conceded that, under the situation posed by Chairwoman Showalter, the matter of the cost cap "can be reopened" due to "a reformation of the contract."[71]

81 A similar conclusion should be reached in this proceeding. Even assuming for the sake of argument that the Prudence Order may have imposed a cost cap at one time, the 1997 reformation and the Company's amendment of the contract to move from fixed to variable fuel pricing eliminated any basis for thereafter applying such a cap. Indeed, had PSE known in 1997 that any party would later assert that the Prudence Order imposed a cost cap that would be applied to the restructured Tenaska contract, including the regulatory asset created at the time of the buyout, it presumably would have petitioned the Commission to reopen that issue at the time it filed its accounting petition."[72]

82 Chairwoman Showalter also asked Mr. Schooley to explain statements that he made during the December 10, 1997 open meeting at which the Commission considered and approved PSE's accounting petition.[73] Mr. Schooley had stated during that meeting (in response to a question from Commissioner Hemstad) that the reformation of the Tenaska Agreement replaced the facility's gas supply with a "risky gas supply and/or a risky price for the gas supply."[74] Chairwoman Showalter asked Mr. Schooley what

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70 TR. 500: 17 – 501: 2.

71 TR. 502: 14-17 (Schooley).

72 TR. 502: 14-17 (Schooley).

73 *See generally* Exh. No. 53 (transcript of open meeting).

74 *Id*. at 4. Mr. Schooley's admission that the Company faced a potentially "risky price for the gas supply" is significant. It is difficult to reconcile the "risky price" that the Company faced concerning the Tenaska gas supply with Commission Staff's claim in this proceeding that the Company had "promised" ratepayers a fixed level of savings as a result of the restructuring. *See* discussion in Section IV(B)(3)(a) of this brief.

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possible "risk" the ratepayers could have faced if, in fact, the Prudence Order had imposed a cost cap.[75] Mr. Schooley's response that the risk was a "downward risk" is not persuasive.[76]

4. Conclusion.

83 When asked at hearing to examine the details of the Prudence Order and to support his view that the Prudence Order created a cost cap, Mr. Schooley departed from his discussion of the Prudence Order's language. He stated that it "just does not seem fair" at this time to allow PSE to recover costs in excess of those costs that may have been recovered under the original Tenaska contract.[77]

84 However Commission Staff approaches the cap issue, it is undisputed that, in 1997, the Tenaska buyout was projected to reduce future costs associated with the facility, and that the restructuring was a prudent decision at the time. The fact that natural gas prices are higher today than projected back in 1997 may be disappointing -- but passing through PSE's actual fuel costs that it incurs to serve its customers is not "unfair." However, it would be unfair to impose massive financial penalties on PSE in this proceeding – 10 years after the Prudence Order was issued -- based upon a strained and revisionist interpretation of that Order.

85 For these reasons, PSE asks the Commission to interpret the Prudence Order in a manner that is consistent with its plain language and historical context. The Commission should reject Commission Staff's assertion that the Prudence Order created a cap on PSE's recoverable Tenaska costs.

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75 TR. 506: 5-6.

76 TR. 506: 18 (Schooley).

77 TR. 493: 7 (Schooley).

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B. PSE Acted Prudently In Managing The Fuel Supply For The Tenaska And Encogen Facilities.

86 Commission Staff, Public Counsel, and ICNU question PSE's fuel supply decisions for the Tenaska and Encogen facilities. They claim that PSE has not shown that it acted prudently in managing the fuel supply for those facilities after the Company restructured the underlying supply arrangements for the facilities in 1997 (Tenaska) and 1999 (Encogen).[78] In the case of Tenaska, for example, and taking a snapshot view of the 2003 PCA true-up and the PCORC periods midway through the term of a 15-year contract, they project that customers will be sufficiently worse off to warrant a variety of multi-million dollar adjustments to PSE's balance sheet.[79]

87 Commission Staff and ICNU base these harsh proposed adjustments not on specific allegations that PSE acted unreasonably at a particular point in time, but rather on the mere assertion that PSE failed to show prudence.[80] This position is notable for its lack of detail. To date, neither Commission Staff, Public Counsel, nor ICNU have alleged any particular fuel management decision that PSE made was unreasonable when that decision was made (in accordance with the Commission's prudence standard).

88 In fact, the Company has provided extensive information to the parties in the form of data request responses, and has introduced substantial and persuasive evidence in this proceeding, to show that its actions with respect to the Tenaska and Encogen fuel supply were reasonable. No disallowance should be imposed.

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78 *See, e.g.*, Exh. No. 231C at 29: 11-16 (Schoenbeck); Exh. No. 281HC at 1: 19 – 2: 2 (Elgin).

79 ICNU supports a complete write-off of the Tenaska regulatory asset and an associated reduction in PSE's revenue requirement of more than $40 million. Commission Staff recommends a $38.5 million reduction in the cost of fuel supply for the Tenaska project (for the PCORC rate year) and a $7.2 million reduction in the Encogen fuel costs for the same period, for a total fuel cost adjustment of more than $45 million. *See* Exh. No. 231C at 3: 21-22, 30: 8-9 (Schoenbeck); Exh. No. 281HC at 11: 11-13 (Elgin).

80 *See, e.g.*, Exh. No. 281HC at 1: 19 (Elgin) ("PSE has not shown that its actions regarding fuel purchases are prudent…").

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1. The Company Does Not Possess The Luxury Of Hindsight When It Manages Its Resources.

89 Hindsight is the basis for the opposing parties' position. They want the Commission to penalize the Company for fuel management decisions it made several years ago, just because gas prices are higher today than the prices that the Company projected in 1997 and 1999. In taking this position, the parties disregard the context *of the time* and the information that was available to PSE *at the time*. PSE urges the Commission to reject this approach to prudence review and instead affirm that PSE acted prudently in managing the fuel supply for the Tenaska and Encogen facilities from 1997 to the present, based upon information that PSE knew or should have known at the time.

90 In evaluating prudence, the Commission has stated that "it is generally conceded that one cannot use the advantage of hindsight."[81] Rather, the Commission reviews the data and methods that a reasonable management would have used "*at the time the decisions were made*."[82] One witness for Commission Staff holds to a similar view: "The prudent decision is an act *circumscribed by the small time frame just surrounding it*."[83]

91 There is a very good reason why hindsight should not be used to evaluate the Company's resource decisions. PSE's Vice President of Engineering & Contracting, Mr. Gaines,[84] testified that PSE's employees "do not have the luxury of managing [the Company's] resources with any (let alone perfect) hindsight, nor with perfect foresight."[85] In conducting operations and making day-to-day decisions, the Company uses information that is available *at the time* about circumstances in the energy

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81 *WUTC v. Puget Sound Power & Light Co.,* Cause No. U-83-54, Fourth Supplemental Order at (September 28, 1984) at 32 (emphasis added).

82 *See* Exh. No. 82 at 10 (Prudence Order) (emphasis added).

83 Exh. No. 291HC at 4: 27-28 (McIntosh) (emphasis added).

84 Mr. Gaines was PSE's Vice President of Energy Supply from February 1997 through October 2003. *See* Exh. No. 11 at 3: 4-7 (Gaines); Exh. No. 12. Because of the position he held, Mr. Gaines is qualified to explain how the Company managed the fuel supply for the Tenaska and Encogen facilities during and after the 1997 and 1999 buyouts.

85 Exh. No. 45 at 10: 25-27 (Gaines rev. 2/19/04).

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industry; projections (sometimes conflicting) regarding future conditions in the natural gas and power markets; future retail load; and a variety of other matters. These individual pieces of information do not always add up to a solid conclusion regarding the future direction of natural gas or power prices. Later, of course, it may be tempting to second-guess a decision, based upon information that became available or certain only after the decision was made. But that is the classic definition of hindsight – and as Mr. Gaines explained, the Company does not possess such a luxury in the day-to-day management of its resources.

92 In the Company's experience, transactions to obtain a fixed price for power or fuel (whether a physical or financial transaction) that are reasonable at the time they were entered may well appear unfavorable in retrospect – *i.e.*, with the luxury of hindsight – when future market conditions that were unknowable at the time of the transaction differ from the fixed price. Similarly, and as Mr. Gaines testified, the Company's historical decisions *not* to enter into a long-term, fixed-price supply transaction for Tenaska or Encogen should not be found imprudent just because it turns out, with hindsight, that market conditions have become less favorable than a quote for a potential fixed price that may have been available at some point in the past.[86]

93 Mr. Gaines sponsored a timeline exhibit ("Gas Timeline")[87] to help the Commission and the parties understand the timing and context of PSE's fuel management decisions regarding the Tenaska and Encogen facilities. The Gas Timeline is attached to this brief as Attachment A. It places PSE's buyout of the Tenaska contract, its buyout of the Cabot contract, and the Company's subsequent management of fuel supply in historical context, specifically in the context of significant events that have occurred in the energy industry – including, most notably, the 2000-2001 Western Power Market

[86] Exh. No. 45 at 11: 10-17 (Gaines rev. 2/19/04).

[87] Exh. No. 51.

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Crisis. The Gas Timeline overlays these events on a chart that shows actual Sumas Gas Daily and NYMEX Henry Hub monthly settled gas prices from 1991 through 2003.

94 Mr. Gaines discussed the Gas Timeline at hearing.[88] The Gas Timeline is valuable for this proceeding because it provides an historical frame of reference as well as context for PSE's fuel management actions. For that reason, we will come back to the Gas Timeline – and Mr. Gaines's review of the important events in the Gas Timeline – in the following sections of this brief.

2. PSE's Fuel Management Decisions Were Reasonable Given The Information That Was Available To PSE When It Made Those Decisions.

95 None of the opposing parties challenges PSE's buyout of the Tenaska fuel supply contract as imprudent. Similarly, no party claims that PSE's purchase of the Encogen facility and the later buyout of the Cabot fuel supply contract for the facility were imprudent. Instead, the opposing parties use the benefit of 20/20 hindsight to cast doubt on PSE's fuel management decisions since the buyouts. Those decisions were reasonable when made, however, given the information that was available at the time to the Company.

a. The Company Never Guaranteed That The Estimated Savings From The Tenaska Buyout Would Be Realized.

96 Commission Staff's witness, Mr. Elgin, has claimed that PSE "essentially promised to ratepayers" that the estimated power cost savings from the Tenaska buyout would in fact be realized.[89] Mr. Elgin is incorrect. The Commission's approval of PSE's accounting petition for the Tenaska buyout (Docket No. UE-971619) was never

[88] *See generally* TR. 325: 14 – 329: 20 (Gaines).

[89] Exh. No. 281HC at 18: 7 (Elgin).

founded upon a promise or guarantee by PSE that it would lock in fuel prices or that power cost savings would necessarily follow from the Company's actions.

97 This fact is illustrated by a colloquy that occurred at the Commission's December 10, 1997 Open Meeting, when the Commission considered and approved PSE's accounting petition. Commissioner Hemstad posed the question of whether PSE intended to "lock in [the facility's estimated fuel] prices now." The Company's representative, Mr. Karzmar, responded: "The company's intention at this time was not to lock in those prices, although that would be an option. That kind of looks like what we had before. We had locked in forward prices then. We would like to manage this with the rest of our portfolio. That would be the company's preference."[90] Indeed, Commission Staff's memorandum recommending approval of the accounting petition stated: "PSE's stated objective in entering into this agreement was to buy out the gas supply *in order to drive the gas cost to market*."[91]

98 Further, it was always understood that the level of actual savings achieved from the Tenaska buyout would depend upon the level of actual market prices. With respect to forward market gas price quotes and estimated savings, PSE advised Commission Staff in a response to a data request in the proceeding concerning the Tenaska restructuring (Docket No. UE-971619): "If the Company can better these prices in the market, the savings will be greater. *Conversely if prices go up, there will be less savings*."[92]

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[90] Exh. No. 52 at 4. *See also* Exh. No. 45 at 12: 4-13 (Gaines rev. 2/19/04).

[91] Exh. No. 283C at 17 (emphasis added). Notably, Commission Staff's memorandum did *not* state: ". . . in order to execute a new, lower-cost, long-term fixed price gas contract."

[92] Exh. No. 53 (emphasis added); *see also* Exh. No. 45 at 12: 16-20 (Gaines rev. 2/19/04). In response to a question by Commissioner Oshie at hearing in this proceeding, Commission Staff's witness, Mr. Schooley acknowledged that Commission Staff had no expectation at the time of the Tenaska restructuring that PSE would lock into a long-term, fixed-price supply contract. Thus, Commission Staff had no expectation that PSE would depart from the market-based price approach that PSE had stated it would follow, and that it did in fact follow. *See* TR. 510: 11-14 (Schooley).

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99 Mr. Gaines confirmed at hearing that PSE never guaranteed that the level of savings projected at the end of 1997 would be realized. In response to a question from Chairwoman Showalter, Mr. Gaines stated: "Was there a binding promise that the level of savings projected at the end of 1997 at the time of the restructure would be realized, and no, there was not." According to Mr. Gaines: "We made clear to the Commission and all of the parties in the accounting proceeding, we made clear to our board and others that our intention at the time of the restructuring was to provide gas to the Tenaska plant in the short-term market."[93] In other words, the Company's move of the Tenaska facility towards short-term, market-based fuel pricing – where the Company applied near-term hedging and other risk management strategies[94] – is inconsistent with a claim that the Company somehow guaranteed savings to ratepayers equal to some fixed dollar amount.

b. PSE Determined At The Time Of The 1997 Buyout That A Long-Term, Fixed-Price Supply Contract Was Inadvisable for the Tenaska Facility. This Decision Was Reasonable.

100 Mr. Gaines testified that it would have been inadvisable for PSE to replace its Tenaska fixed-price fuel supply contract with a new fixed-price commitment at the time of the 1997 contract buyout. The Company instead relied on spot market purchases and near-term hedging for several reasons: (1) the state of the natural gas and electric industries at the time; (2) the market conditions that existed at the time; and (3) the Tenaska facility's marginal position within PSE's resource stack.

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[93] TR. 296: 14-21 (Gaines).

[94] TR. 296: 22 – 297: 1, 323: 16-21 (Gaines).

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i. The State Of The Natural Gas and Electric Industries At The Time Did Not Justify Such A Supply Contract.

101 The natural gas and electric industries experienced a monumental transition through the 1990s. In the case of the natural gas industry, a series of actions – including FERC Order No. 636 and other FERC orders – had effectively deregulated the industry by the middle of the decade. Gas prices were falling and projected to remain low into the future.[95]

102 FERC, as well as various states and market participants throughout the country, were pushing toward deregulation in the electric industry as well. Many states moved rapidly toward retail restructuring, and similar legislative efforts were being explored in Washington State at the time. In the event that Washington State moved (or was forced to move) to retail competition, Puget was faced with the prospect of stranded costs and the potential for adverse impact on Puget and its ability to serve its remaining retail customers. Indeed, the Commission stated in late 1995: "[R]egulation cannot and should not be expected to guarantee utilities will, in all circumstances, be made entirely whole for generation or other costs that are determined through actual and fair competition to be stranded or uneconomic."[96]

103 During this time, retail electric customers – particularly large industrial customers – began to press for access to market-based rates rather than rates based on embedded costs of service. A number of Puget's customers began exploring opportunities to bypass Puget's system if they were not granted access to market-based rates. Puget developed Schedule 48 in response, which was predicated upon providing market-sensitive pricing to large customers.[97]

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[95] Exh. No. 45 at 14: 22-23, 17: 20 – 18: 23 (Gaines rev. 2/19/04).

[96] Exh. No. 57 at 34 (30B at 2); *see also* Exh. No. 45 at 14: 23 – 15: 5 (Gaines rev. 2/19/04).

[97] Exh. No. 45 at 15: 8-15 (Gaines rev. 2/19/04).

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104 At around the same time, Puget's long-term fixed-price PURPA contracts – which included the Tenaska resource – were criticized as uneconomic and inflexible. In the merger proceeding between Puget and Washington Energy Company (Docket Nos. UE-951270 and UG-960195 (Consolidated)), Commission Staff testified:

105

> The price increases associated with Puget's PURPA resource contracts are a major source of continued upward rate pressure, and contribute to Puget having the highest retail electric rates in the region.
>
> …

106

> The wide discrepancy between the embedded cost of power in rates and market prices, and power contract-related rate pressures, are occurring during a period of low short-run prices for power in the regional market. The low prices result from federal government open transmission access initiatives, a surplus of generating capacity in the region, the increasing presence of power marketers and brokers, and *continued low natural gas prices. To the extent that the terms and conditions of its long-term PURPA contracts limit the Company's ability to take advantage of low wholesale spot market prices, core customers have little opportunity to achieve lower rates.*[98]

107 In response to these uncertainties, Puget (and later PSE) sought to reduce its dependence upon long-term, fixed-price natural gas supplies under the PURPA contracts. Moving the Tenaska fuel supply (and later the Encogen fuel supply) to market was an important step in this direction.[99] By purchasing gas in short-term markets (as opposed to purchases through contracts for long-term fixed prices), and by applying near-term hedging and other risk management strategies, PSE positioned itself to take greater advantage of gas prices in the short-term gas market. The Company was also able to acquire the increased flexibility it would need to address the rapidly-changing and uncertain industry circumstances.[100]

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98 Exh. No. 57 at 2 (emphasis added). *See also* Exh. No. 45 at 15: 26 – 16: 11 (Gaines rev. 2/19/04).

99 Exh. No. 45 at 16: 24 – 17: 2 (Gaines rev. 2/19/04).

100 The Company documented its analysis of these factors in its 2000-2001 Least Cost Plan ("2001 LCP"). Noting that the Company's traditional resource portfolio contained few market-responsive

(Footnote Continued)(Footnote Continued)

ii. The Market Conditions At The Time Did Not Justify Such A Supply Contract.

108 The Gas Timeline shows that by the time of the Tenaska restructuring, the Sumas gas market had been exhibiting very low spot prices for quite some time – including periods of falling prices.[101] However, the long-term price quotes that PSE received in 1997 started well above recent historic levels.[102]

109 Since PSE had received long-term quotes with significant premiums over then-current and forecasted prices, and considering that relatively stable prices and even falling prices had occurred over several previous years (as shown in the Gas Timeline),[103] it did not appear advisable for the Company to lock into the same sort of supply arrangement for Tenaska that had existed previously – *i.e.*, a fixed-price, escalating contract. The Company therefore decided to supply the Tenaska facility with gas that the Company purchased and hedged on the near-term market.[104]

iii. The Tenaska Facility's Marginal Position In PSE's Resource Stack Did Not Justify Such A Supply Contract.

110 Also by the late 1990s, the Tenaska resource represented one of PSE's marginal resources on an operating cost basis. This meant that PSE would likely displace the

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supply sources, the 2001 LCP reviewed the then-existing energy industry and observed: "In the absence of a resolution of these issues, PSE must manage its electric supply portfolio to be responsive to its customer supply commitments *as they are expected at the current time, recognizing fundamental uncertainties. This uncertainty drives a need for additional flexibility in PSE's electric supply portfolio*." Exh. No. 56 at 9 (emphasis added). Moving the Tenaska and Encogen fuel supply to market thus provided an incremental adjustment to PSE's resource portfolio (toward market-based prices). *See* Exh. No. 45 at 17: 14-17 (Gaines rev. 2/19/04); Exh. No. 58.

101 Exh. No. 51 at 1-3 (Gas Timeline).

102 Exh. No. 59C at 2. *See also* Exh. No. 45 at 17: 20-26 (Gaines rev. 2/19/04).

103 Exh. No. 51 at 1-3 (Gas Timeline). *See also* TR. 326: 21 – 327: 15 (Gaines) ("relatively flat and stable gas prices" prior to and contemporaneous with the Tenaska buyout).

104 Exh. No. 45 at 18: 19-23 (Gaines rev. 2/19/04).

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resource if warranted by its “spark spread” or “heat rate” (*i.e*., the relationship between power prices and natural gas prices).[105]

111 At the same time, the wholesale markets in the Northwest region had become much more active and robust for both power and natural gas. This allowed the Company to take better advantage of the interaction between the relative prices of power and natural gas versus the efficiency of the Tenaska resource. By obtaining its fuel supply for Tenaska through short-term monthly and seasonal hedging, PSE was able to actively manage its spark spread as well as load and resource uncertainties that existed at the time.[106]

c. The Company’s Management Of The Tenaska Fuel Supply In 1998 and 1999, Following The Buyout, Was Reasonable.

112 After the buyout of the Tenaska contract occurred, the Company obtained gas supply for the facility through the wholesale market and its various product offerings. In this process, the Company applied a number of risk management tools. Mr. Gaines discussed the Company’s risk management considerations in his prefiled rebuttal testimony.[107]

113 Specifically with respect to Tenaska, PSE purchased short-term gas supplies; periodically locked in physical supply contracts with a price tied to a market index; and locked in short-term supplies at fixed prices. This hedging was accomplished initially

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[105] Exh. No. 45 at 18: 25-27 (Gaines rev. 2/19/04). The spark spread or heat rate presents an economic question to the Company. In the absence of a long-term, fixed-price fuel supply arrangement for a particular resource, the Company must decide whether it is less expensive to (1) purchase gas and generate power from that resource, or (2) displace the generation and purchase power on the market. When projected market heat rates are low, the likelihood that the Company will use all of its gas-fired generation drops, and the Company’s purchase needs for gas as a generation fuel will also drop. *See* Exh. No. 45 at 19: 6-12 (Gaines rev. 2/19/04).

[106] Exh. No. 45 at 19: 17 - 20: 6 (Gaines rev. 2/19/04). *See also* Exh. No. 63C at 37; Exh. No. 64.

[107] Exh. No. 45 at 20: 17 – 22: 15 (Gaines rev. 2/19/04). *See also* Exh. No. 62C; Exh. No. 63C at 1-28, 34-63; Exh. No. 73C; Exh. No. 191 at 6: 9 – 10: 23 (Ryan).

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through fixed-price physical contracts. In the late 1990s, the Company began to use financial derivative (swap) contracts that contained floating-to-fixed price hedges. The amount and timing of these types of gas purchases were highly dependent upon the projected gas consumption for the Tenaska facility, and were largely based upon the projected market heat rates and expectations concerning forward and potential spot prices. Mr. Gaines sponsored an exhibit that contains specific examples of Tenaska hedging decision documents during the 1998-1999 time period.[108]

114 It was reasonable at the time for the Company to keep Tenaska fuel at market rather than to lock in a long-term, fixed-price supply arrangement. Gas prices continued low and stable through 1998 and 1999 as shown in the Gas Timeline.[109] In response to a question from Chairwoman Showalter, Mr. Gaines testified that "the market prices that we supplied to the generator were actually lower than our original projection."[110]

115 In addition, the price forecasts that PSE received in late 1999 and into early 2000 indicated that natural gas prices were projected to stay relatively flat over the longer term due to new supply availability. PSE's review of actual historical gas prices at the time did not cause it to question the range of prices that were forecasted. Although prices had at times spiked or been volatile, they had generally settled down to levels such that the commodity price risk exposure and potential for market volatility neither justified the premiums that the market demanded for long-term, fixed-price contracts, nor warranted the reduced flexibility that was associated with such contracts.[111]

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[108] Exh. No. 66C. *See also* Exh. No. 45 at 22: 19 – 23: 3 (Gaines rev. 2/19/04).

[109] Exh. No. 51 at 4-5 (Gas Timeline); TR. 327: 24 – 328: 4 (Gaines).

[110] TR. 310: 24 – 311: 2 (Gaines).

[111] Exh. No. 45 at 23: 5-19 (Gaines rev. 2/19/04). *See also* Exh. No. 56 at 30-31; Exh. No. 68C; Exh. No. 69C.

d. PSE's Management Of The Tenaska And Encogen Fuel Supply During 2000 And 2001, When The Western Power Market Crisis Occurred, Was Reasonable.

116 The 2000-2001 time period encompassed the tumultuous Western Power Market Crisis. Gas prices began to rise in 2000 as shown in the Gas Timeline.[112] PSE did not foresee the Western Power Market Crisis as Mr. Gaines testified: "Well, we certainly didn't have an anticipation of that, and I think it's pretty evident that most other market participants didn't either just judging by what happened to even other utilities in this region in terms of the rate impacts and gas fuel costs."[113]

117 In early 2000 (after the buyout of the supply contract that served the Encogen facility), the Company executed a hedge 10,000 MMBtu/day on a long-term basis, at a fixed-price beginning at $2.1025/MMBtu in 2000 and increasing to $2.6200/MMBtu in 2008. This quantity represented approximately half of the restructured gas volume of 21,800 MMBtu/day associated with the original Cabot agreement.[114]

118 After gas prices began to rise unexpectedly in 2000, the Company began a review of its management of the Tenaska and Encogen gas supply since the respective contract buyouts. Mr. Gaines explained at hearing that the impetus for this retrospective review was twofold: (1) the increase in gas prices that began in 2000, and (2) the Company's ongoing efforts at the time to enhance its risk management systems and capabilities.[115]

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112 Exh. No. 51 at 6 (Gas Timeline).

113 TR. 328: 12-16 (Gaines). *See also* Exh. No. 71 at 47.

114 Exh. No. 45 at 23: 23 – 24: 10 (Gaines rev. 2/19/04); Exh. No. 67C. The Company made similar attempts during this time to hedge the Tenaska fuel supply, based upon certain target prices. However, the Company was unable to find opportunities to lock in a long-term price within the target limits. Market prices could and sometimes did rise quickly during this period such that long-term supply arrangements could not be obtained within the approved price range. *See* Exh. No. 45 at 29: 16 – 30: 1-2 (Gaines rev. 2/19/04); Exh. No. 63C at 127, 154-155, 158, 197-207; Exh. No. 75C.

115 TR. 328: 21 – 329: 6, 331: 5-17 (Gaines). *See also* Exh. No. 45 at 24: 13 – 25: 28 (Gaines rev. 2/19/04).

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119 The Company prepared two reports – the “Tenaska Gas Price Situation Business Case Analysis,” and the “Cabot Gas Price Situation Business Case Analysis” – as a result of its retrospective review. These reports[116] were presented to the Company’s Risk Management Committee on June 9, 2000. In the reports, PSE asked itself with hindsight “what should have been done” to manage Tenaska and Encogen fuel supply costs given both information available to PSE at the time and information that the Company had learned since the buyouts occurred. Mr. Gaines stated at hearing that the Company had, in fact, made reasonable hedging decisions with respect to developing and implementing short, intermediate, and long-term plans for hedging its gas costs.[117]

120 Gas prices, however, continued to increase through the rest of 2000 – reaching extreme levels at the end of that year and in early 2001, at the height of the Western Power Market Crisis.[118] Throughout this period, PSE sought to manage its fuel costs in the face of unprecedented cost pressures and conflicting information about possible resulting events, such as whether FERC would impose a west-wide power price cap.[119]

121 As the Western Power Market Crisis abated, and as gas prices began to moderate, PSE decided against purchasing any long-term gas supply because market prices for such contracts were too high relative to fundamental analysis and market signals. Instead, PSE sought to manage its portfolio through continued use of shorter-term hedging tools with the expectation that prices would moderate in the longer term.[120]

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[116] *See* Exh. No. 63C at 108-112 and 113-115, respectively.

[117] TR. 330: 11-20 (Gaines).

[118] Exh. No. 51 at 6-7 (Gas Timeline); Exh. No. 71 at 44-48.

[119] Exh. No. 45 at 26: 16-20 (Gaines rev. 2/19/04); Exh. No. 63C at 101-211; Exh. No. 72C; Exh. No. 75C.

[120] Exh. No. 45 at 27: 21 – 28: 25 (Gaines rev. 2/19/04). *See also* Exh. No. 63C at 184-188.

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e. PSE's Management Of The Tenaska And Encogen Fuel Supply, Since The Western Power Market Crisis, Has Been Reasonable.

122 Due to the Company's load-serving obligation and its sense of heightened market risks (following the Western Power Market Crisis), PSE has sought to reduce its exposure to spot market uncertainty. The KW3000 system that PSE purchased in 2002 is used in several ways to model possible risk exposure. This system helps the Company to better manage its resources, including the Tenaska facility.[121]

123 The Company has continued to engage in gas hedging activities since the Western Power Market Crisis ended. As Ms. Ryan discussed in her prefiled rebuttal testimony, PSE has made gas purchase decisions in recent years not on a facility-specific basis, but on an aggregated portfolio basis. The Company tests each hedging strategy against the overall portfolio. This becomes important as the resources are dispatched depending upon market conditions, as noted earlier with respect to the Tenaska facility.[122]

124 In early 2003 the Company developed a dollar-cost averaging strategy that helps the Company protect against volatility in wholesale markets, such as the extreme pricing volatility that PSE experienced during the Western Power Market Crisis. In applying this strategy, PSE established plans to purchase hedges for specific forward time frames, with the goal of reducing a defined amount of exposure by purchasing power and gas in order to ratably reduce the deficit positions by a small amount each month.[123]

125 During this time, the Company has considered locking in prices under long-term, fixed-price supply contracts. Although the Company has actively hedged its gas supply by

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[121] Exh. No. 201 at 8: 5-20 (Ryan).

[122] Exh. No. 201 at 8: 23 – 9: 2 (Ryan).

[123] Exh. No. 201 at 9: 4-14 (Ryan). *See also* Exh. No. 202 at 3; TR. 191: 20-23 (Ryan).

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locking in prices for shorter periods, it has not been able to lock in long-term supply at fixed prices that justify such a step.[124]

126 Ms. Ryan explained in her prefiled rebuttal testimony that the Company considers various factors before locking into such long-term arrangements.[125] Among these factors are price forecasts. In this proceeding, PSE introduced evidence to show that, in the first part of 2002, forward gas prices carried a large premium over short-term prices. These prices then increased in the latter part of 2002, remaining at levels that did not warrant contract commitments at long-term fixed prices.[126]

127 Further, long-term forecasts in late 2002 showed prices falling in the 2004-2008 timeframe, rising to less than current levels by 2011. When updated for more conservative assumptions as of August 2003, the various industry forecasts showed periods of falling prices in 004-2006; an increase in 2006-2008; and then a sharp decline from 2008 through 2012. The supply constraints that formed the basis for the 2003 forecasts may not materialize, however, since (according to Ms. Ryan) higher prices may result in increased drilling, and federal energy policy may result in greater opportunity for expanded exploration and production activity. In view of these various price forecasts and supply uncertainties, PSE did not believe that it was appropriate to enter into long-term, fixed-price agreements that have continued to command a premium over current and projected spot market prices.[127]

3. Conclusion.

128 PSE does not dispute that it (and others) originally projected significant savings from the restructuring of the Tenaska and Encogen fuel supply arrangements. That was the

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[124] Exh. No. 201 at 9: 18-22 (Ryan). *See also* Exh. No. 204C.

[125] Exh. No. 201 at 9: 24 – 10: 13 (Ryan).

[126] Exh. No. 201 at 10: 16-23 (Ryan); Exh. No. 204C at 4.

[127] Exh. No. 173C at 4-10; Exh. No. 201 at 10: 25 – 11: 8 (Ryan).

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whole point of the restructuring decisions that the Company made in 1997 and 1999. But this expectation must be placed in the proper context. In the case of Tenaska, for example, most of the savings were not expected to occur until *after* 2004.[128] Indeed, PSE still believes that the restructuring and the Company's reformation strategy will benefit customers over the remaining term of the Tenaska contract. That strategy should not be judged by a single snapshot taken in the middle of a 15-year contract term.

129 It is also important to consider the nature of this proceeding. The relevant periods here are the PCORC rate year (from April 2004 through March 2005) and, by reference, the period from the PCA compliance docket (Docket No. UE-031389). As Mr. Gaines testified, though, the gas purchasing and hedging transactions that the Company performed in the years immediately following the Tenaska buyout have *no lingering effect* on the PCA period or the PCORC period.[129] The harsh penalties that the opposing parties recommend should not be imposed during these periods.

130 Finally, the potential effect of these penalties should be understood. The complete write-off of the Tenaska regulatory asset that ICNU proposes would basically eliminate the Company's earnings for a year. The impact on the Company's credit rating would obviously be negative, and its ability to trade in the wholesale markets could be severely impacted. In addition, both Commission Staff and ICNU propose significant adjustments to the recovery of allowable costs for the regulatory assets associated with the gas contract restructures. As Mr. Story discussed in his prefiled rebuttal testimony, the impact of these adjustments is difficult to quantify, but it is likely that the Company's credit rating and earnings would also be adversely impacted.[130]

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128 TR. 324: 10-16 (Gaines); Exh. No. 95C at 4.

129 TR. 324: 24 – 325: 13 (Gaines).

130 Exh. No. 220 at 11: 11 – 12: 10 (Story).

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131 In sum, there is no basis for the harsh penalties that the opposing parties propose. PSE has made prudent decisions with respect to the Tenaska and Encogen fuel supply since the contract buyouts took place. The Company introduced substantial and persuasive evidence about the information that was available to the Company *at the time*, the context *of the time*, and the reasonable fuel management decisions that the Company made *at the time*. Hindsight should not be used to second-guess those decisions.

C. PSE's Market-Based Pricing Methodology Is A Recognized And Appropriate Approach To Set Gas Prices.

132 Using the same methodology employed at the time the PCA mechanism was created and approved, PSE relied upon forward market prices in order to project natural gas prices for the 2004 PCORC Baseline Rate in this proceeding.[131] PSE used an average of forward market prices that was published over a 10-day consecutive period ending September 18, 2003, in preparation for the PCORC filing that the Company made on October 24, 2003. The Company selected the September period because it wanted to file prices that were the most indicative of the then-current forward market.[132]

133 Only ICNU challenges PSE's market-based pricing methodology. ICNU proposes that the Commission instead employ an output from a planning model used by the California Energy Commission ("CEC").[133] For a number of reasons, however, the Commission should not follow ICNU's approach. The Commission should instead adopt PSE's proposed market-based methodology – the same methodology that PSE has used in several other proceedings to project gas prices.

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[131] Exh. No. 220 at 5: 13-17 (Story). Under the PCA Settlement, PSE is actually required to file production cost schedules that are consistent with the PCA Settlement. *See* Exh. No. 17 at 5.

[132] Exh. No. 45 at 30: 26 – 31: 3 (Gaines rev. 2/19/04).

[133] Exh. No. 231 at 18-20.

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1. Forward NYMEX Prices Represent A Reasonable Input For Projecting Near-Term Power Prices.

134 The Company used forward market prices at the New York Mercantile Exchange ("NYMEX"), which is an exchange-traded market that it the most widely used and followed market in the natural gas industry.[134] NYMEX is the largest physical market for natural gas and actual settlement of natural gas contracts, and represents an important benchmark market for all North American gas markets.[135]

135 PSE applied a regional market basis differential to the NYMEX Henry Hub price to calculate the base gas price that it incorporated into its PCORC filing. Because NYMEX prices for natural gas assume a trading point for delivery at the Henry Hub in Louisiana (the principal pricing point for domestic natural gas markets), trading prices for natural gas at other locations in North America typically reflect a basis differential off the Henry Hub pricing point. PSE therefore adjusted NYMEX forward gas prices by market quotes of the basis differential between the Henry Hub price and the price for several trading hubs in the WECC. These regional gas price forecasts were then used in PSE's AURORA model to estimate the Company's power costs.[136]

136 The forward prices that the Company obtained are reliable because they are inherently unbiased and not developed by any individual entity. The prices are instead determined as a result of market transactions by the multitude of entities who actually agree to buy and sell energy products for delivery in the future. These market transactions objectively measure the willingness of buyers and sellers to commit to future natural gas transactions at various points in time – a willingness that reflects future market expectations in concrete price terms.[137]

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134 Exh. No. 45 at 31: 7-8 (Gaines rev. 2/19/04).

135 TR. 167: 4-17, 194: 23-24 (Ryan).

136 Exh. No. 45 at 31: 18 (Gaines rev. 2/19/04).

137 Exh. No. 45 at 31: 21-28 (Gaines rev. 2/19/04).

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137 PSE's approach in this proceeding is not novel or unprecedented. PSE has used forward market prices in other Commission proceedings in order to project gas prices. PSE used this same methodology in its 2001 general rate case filing, and the Commission-approved settlement of that case (which created the PCA mechanism) used this approach.[138] These prices were used in the Company's Purchase Gas Adjustment ("PGA") filings.[139] Most recently, PSE relied upon forward market prices for short-term gas price projections in its 2003 LCP and in its decision to acquire the Frederickson resource – both uses that Commission Staff deemed appropriate.[140]

2. ICNU's Suggested Approach Is Inappropriate For This Ratemaking Proceeding.

138 As discussed above, ICNU is the only party that takes issue with PSE's use of market-based forward gas prices. ICNU asserts through its witness, Mr. Schoenbeck, that normalized costs, rather than expected costs, should be used to project gas prices in the rate year.[141]

139 Specifically, Mr. Schoenbeck proposes that the Commission use a "normalized" base gas cost that is theoretically free from "short-term" market impacts.[142] Relying on the CEC's North American Regional Gas ("NARG") model, he asks the Commission to set a Sumas price of \$3.61/MMBtu[143] – although as Mr. Gaines testified, that price falls well below current forward prices and does not match any current or expected market price at Sumas.[144]

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138 TR. 471: 19-24 (McIntosh).

139 Exh. No. 45 at 32: 3-11 (Gaines rev. 2/19/04); Exh. No. 76; Exh. No. 220 at 5: 13-17 (Story); TR. 301: 4-9 (Gaines).

140 TR. 471: 14-18, 473: 14-19 (McIntosh).

141 Exh. No. 231C at 6: 22 - 7: 2 (Schoenbeck).

142 Exh. No. 231C at 18: 12-14 (Schoenbeck).

143 Exh. No. 231C at 19: 4-6 (Schoenbeck).

144 Exh. No. 45 at 34: 13-14 (Gaines rev. 2/19/04).

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a. ICNU's Approach Is Inconsistent With The PCA Mechanism's Purpose.

140 Commission Staff and PSE agree that the PCA was devised such that the power cost baseline would reflect a neutral and unbiased estimate of actual power costs.[145] This is due, in part, to the sharing bands in the PCA mechanism, which allocate responsibility for power costs as between PSE and its customers. The objective of this PCORC proceeding is to set a gas price that, in the process, will estimate PSE's future power costs as accurately as possible, so that an equal chance of over- and under-recovery will exist.[146]

141 The approach that Mr. Schoenbeck proposes, however, is inconsistent with the PCA Mechanism's basic objective (to establish a neutral estimate of actual power costs). The Sumas price of $3.61/MMBtu that Mr. Schoenbeck proposes is far too low. He admits that it is highly unlikely that this price will reflect PSE's actual gas costs during the near term – the only period in which the base gas price set in this proceeding should be in effect.[147] Further, PSE will be not be able to manage around this unrealistically low gas price. Mr. Schoenbeck explains this away by stating that the Company's inability to purchase gas at his suggested price will simply force it to use up a portion of the PCA sharing mechanism's dead band.[148]

142 For these reasons, Mr. Schoenbeck's proposal would "tilt" the PCA "scale" and unbalance the PCA mechanism.[149] The use of an unrealistically low gas price would almost certainly ensure that PSE underrecovers its actual power costs during the PCORC rate year. This would undermine the purpose of the PCA mechanism and the purpose of this PCORC proceeding.

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[145] Exh. No. 45 at 32: 18-22 (Gaines rev. 2/19/04); TR. 579: 19 – 581: 25 (Lott).

[146] Exh. No. 220 at 5: 22-24 (Story).

[147] TR. 435: 25 – 436: 7 (Schoenbeck).

[148] TR. 436: 8-23 (Schoenbeck).

[149] TR. 582: 21 – 584: 10 (Lott).

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b. ICNU Has Not Shown Why The Commission Should Employ The CEC Model In This Proceeding.

143 ICNU has not established a foundation for the use of the CEC model as a ratemaking tool. Mr. Schoenbeck is not aware of a case in which a regulatory body has used the model to set rates.[150] At most, he asserts that PG&E incorporated CEC model results into an application that is currently pending before the California Public Utilities Commission ("CPUC"). But in fact, the application reveals that, for bundled retail service in a proceeding to set PG&E's 2004 baseline power rates (*i.e.*, a proceeding very similar to a PCORC proceeding), PG&E uses *NYMEX forward market prices* – not CEC model outputs – to project gas prices for rate setting purposes.[151]

144 Indeed, PG&E's dependence upon NYMEX market data for its baseline fuel cost assumptions tracks the CEC's most recent revision of its gas price modeling analysis. In its December 2003 *Electricity and Natural Gas Assessment Report*, the CEC began to use NYMEX data for near-term gas price modeling: "In order to capture the current market conditions experienced by power generation sectors, electricity generation simulations and price assessment incorporate *short-term NYMEX price information for the earlier years of the analysis*."[152] Thus, even the CEC does not disregard current market information (as ICNU proposes to do in this proceeding).

145 Nor has ICNU introduced evidence to show that output from the CEC model should be used in this proceeding. The gist of Mr. Schoenbeck's testimony is that the CEC model is a "unique model for the circumstances we have before us;" he is "familiar with it;"

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[150] TR. 393: 20-25 (Schoenbeck); Exh. No. 254 ("Mr. Schoenbeck is unaware of a proceeding in which the use of a CEC forecast was proposed or advocated by any party for use by the Commission in a rate proceeding"); Exh. No. 257 ("Other than the CPUC and CEC, Mr. Schoenbeck is unaware of any other state regulatory commissions that use the results from the CEC forecasting efforts").

[151] Exh. No. 262 at 056: 7-15.

[152] Exh. No. 259 at 41 (emphasis added); *see also id.* at 42 (chart reflecting NYMEX data), 56.

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and the model is "free."[153] This is a scant basis upon which to overturn years of Commission precedent that support the use of market-based pricing data to estimate gas costs.[154]

146 In any event, the Commission should not adopt the CEC methodology without an adequate explanation for the difference between actual forward market prices and the CEC model output. ICNU has not provided that explanation. In fact, Mr. Schoenbeck admitted at hearing that the data in his suggested model were not current (although he claimed that the use of such stale data is insignificant).[155]

147 Further, Mr. Schoenbeck impliedly asserts that the difference between NYMEX forward market prices and CEC output prices is due to "short-term" market impacts that Mr. Schoenbeck asserts should be excluded from PSE's base gas price. Yet ICNU has provided no evidence to show that discrepancies between NYMEX forward prices and CEC model results are actually caused by the type of "short-term" market impacts that (according to Mr. Schoenbeck) the Commission should not consider. The fact that Mr. Schoenbeck admits that PSE cannot buy gas today or at the beginning of the PCORC rate year at his suggested price of $3.61/MMBtu (which he supposedly derived from the CEC model) undercuts the viability of that model as a predictor of the gas price in the PCORC rate year.[156]

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153 Exh. No. 231C at 19: 13 - 20: 4 (Schoenbeck); TR. 375: 19-23 (Schoenbeck); TR. 377: 10-14 (Schoenbeck).

154 Exh. No. 45 at 33: 28 - 34: 4 (Gaines rev. 2/19/04).

155 TR. 383: 23 – 385: 2 (Schoenbeck).

156 TR. 435: 25 – 436: 4 (Schoenbeck).

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c. PSE’s Risk Management Tools Should Not Be Used To Set PSE’s Base Gas Price, As They Are Not Designed for Ratemaking Purposes.

148 As an alternative to output from the CEC model, ICNU suggests that PSE’s risk management tools could be used to project market prices and set PSE’s base gas cost. Mr. Schoenbeck claims that the Commission could use the “median case” result from PSE’s risk management price scenarios. Yet Ms. Ryan, the PSE officer in charge of developing PSE’s risk management tools and the witness most familiar with them, made clear in her prefiled rebuttal testimony and at hearing that the Company does not use the forecasting model as a rate-setting tool. The use of the “median case” for that purpose in this proceeding would therefore be inappropriate.[157]

d. ICNU’s Gas Pricing “Alternative No. 4” Is Also Inappropriate For Ratemaking Purposes.

149 ICNU raised yet another gas pricing approach at hearing – the so-called “Alternative No. 4.” Mr. Schoenbeck said that the Commission could set a benchmark gas price for the Tenaska fuel today (without specificity) against which PSE’s actual gas costs would be measured through the end of the contract in 2011. Any differences between actual gas costs and the benchmark price would, according to Mr. Schoenbeck, become part of the PCA cost-sharing mechanism.

150 Not only does “Alternative No. 4” suffer from the same infirmities described above, it would hardwire an underrecovery into PSE’s rates; complicate the Company’s risk management of its fuel portfolio; undercut the intent of the PCA Mechanism; and possibly necessitate a write-off or write-down of the Tenaska regulatory asset. The

[157] Exh. No. 201 at 11: 18 – 12: 10 (Ryan); TR. 221: 16 – 222: 9 (Ryan).

record in this proceeding simply does not support an action that carries such significant consequences.[158]

3. Conclusion.

151 PSE's use of forward prices adjusted for Sumas and other locations remains the best indicator of the appropriate gas price estimate for this proceeding. While there may be no perfect gas price benchmark, forward prices accurately reflect the market dynamics that bear on future prices without the reliability concerns that are raised by more subjective alternatives.[159] These prices are the most objective indicators of future market prices, and therefore of the likely price of gas during the duration of the PCORC rate year. PSE's market-based methodology is widely recognized as reliable; it has a history of use in ratemaking proceedings; and it is more appropriate than any other alternative presented in this proceeding.

152 As Mr. Gaines testified on the last day of hearing, PSE simply wants to set a gas price that most accurately estimates its actual future gas cost. PSE is amenable to a different measurement or averaging period and future discussions concerning other regulatory mechanisms that eliminate the possibility of cost over- and under-recovery. But PSE cannot agree to a gas price that is set artificially lower than the Company's projected fuel costs.

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[158] TR. 595: 14 - 597: 11 (Gaines).

[159] TR. 304: 3-6 (Gaines).

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V. SUMMARY OF REQUESTED ACTION.

153 PSE respectfully requests that the Commission approve the power cost baseline rate that PSE has proposed in this proceeding. PSE further requests that the Commission approve the power cost true-up amounts for the first PCA period as currently set forth in Docket No. UE-031389, without any further reduction based on disallowance of Tenaska or Encogen fuel costs.

154 PSE also requests the following Commission findings and conclusions:

155
- PSE acted prudently in making the Frederickson acquisition, and the decisionmaking tools and processes that PSE employed for the acquisition meet the Commission’s expectations.

156
- The 1994 Commission order that imposed a 1.2% disallowance on PSE’s recoverable contract charges for the Tenaska facility did not impose a fixed cap on the fuel costs that are recoverable in PSE’s rates.

157
- PSE acted prudently in managing the fuel supply for the Tenaska and Encogen facilities after PSE restructured the facilities’ underlying fuel supply arrangements in the late 1990s.

158
- No disallowance of Tenaska or Encogen fuel costs is appropriate based on PSE's management of fuel supply for these facilities from 1997 to the present.

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159 • PSE's longstanding use of forward market prices to determine the Company's estimated gas costs is reasonable and should not be abandoned.

DATED: March 12, 2004 Respectfully Submitted,

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ATTACHMENT A

(GAS TIMELINE, EXH. NO. 51)

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Signed at Seattle, Washington this 12 day of March, 2004.

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