BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. PUGET SOUND ENERGY, INC. Respondent.	DOCKET NO. UE-031725 OPENING BRIEF OF PUBLIC COUNSEL

I. INTRODUCTION

Public Counsel joins the Commission Staff in recommending significant disallowances of imprudent fuel costs which Puget Sound Energy (PSE) has incurred for its Tenaska contract. Public Counsel does not address, but does not oppose, the treatment of Frederickson proposed in this case.

II. ARGUMENT

A. Expectations and Promises.

A question that has been voiced in this proceeding, particularly in the latter stages, is whether there was a "promise" by PSE to provide a specific dollar amount of savings, or whether there was "only" an "expectation" that such savings would occur. Public Counsel would submit that this is not the right question to ask.

This is not a case where the Commission or other parties seek to enforce a formal commitment made by a company, for example in a settlement agreement. The Commission did not order PSE to execute specific gas contracts when it approved the 1997 reformation of the Tenaska gas contracts.

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This is, and always has been, a prudence issue. Ratepayers reasonably expected power cost savings from the 1997 contract restructuring, though these were not promised in the sense of a written commitment to enter into specific gas purchases. While the company did not "promise" to enter into specific long-term gas contracts, it unequivocally represented that such contracts were available, and that it could manage its costs to achieve costs savings in the range that such contracts could provide. These representations were the core of the company's argument to the Commission in favor of the 1997 petition. Puget chose *not* to enter into these contracts because it thought it could secure *more* savings for shareholders during the rate plan period by not locking up long-term gas costs.

PSE, for its part, expected, but was not promised (i.e. guaranteed), cost recovery of the regulatory asset and future gas supply costs. This absence of any promised recovery was emphasized by Commissioner Hemstad in the 1997 proceeding, when he stated:

> I believe the order should further state that the approval of, in whatever words are most appropriate, that the approval of this accounting treatment does not preclude future review of the modified contract, and that the order should also state that the future review of PSE's performance as a gas supply purchaser will be reviewed in future ratemaking proceedings. (Open meeting transcript of 12/10/97, Ex. 52, p. 10)

Consistent with this statement, the order provided:

> The Company's actions in purchasing the gas sales contract, managing the cost of gas, and restructuring the power purchase agreement is subject to review in future rate proceedings; the *Company bears the burden of proof* in any such proceeding regarding these matters. Any costs determined to be *unreasonable or imprudent* in such proceedings are subject to disallowance.[1] (emphasis added).

[1] *In the Matter of the Petition of PUGET SOUND ENERGY, INC., For an Order Regarding the Accounting Treatment for the Purchase of a Gas Sales Contract,* UE-971619, Order, December 10, 1997, Ordering Paragraph 5, p. 6.

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In addition, the Commission stated that its approval of the petition did not in any way modify its prior orders regarding standards and burdens of proof in determining whether costs are imprudent or unreasonable.[2]

The point is that in 1997 PSE created, for both ratepayers and the Commission, the expectation that the new restructured Tenaska contract arrangement would yield very substantial benefits in the form of major power cost savings. Indeed, if Puget had not expected to achieve savings, it never would have proposed to modify the contract. In this proceeding, customers are faced with a very real bill for restructuring the contract – a $218 million regulatory asset. Customers are also faced with fuel costs which exceed those embedded in the original contract found imprudent in the 1992 proceeding.

Furthermore, the amortization adopted in the 1997 accounting order is only justifiable in the context of the expected future power cost savings which the company represented were reasonably achievable. The original Tenaska contract provided for rising costs over time. The cost of the buyout of the original contract was $215 million, but the company requested and received permission to accrue a deferred return that it incorrectly called "interest" rather than a normal straight-line amortization of the amount.

Now in 2004, after 7 years, the balance of the 14-year note is not half-amortized (i.e. reduced to $107.5 million), but has escalated, up to $218 million.

B. PSE Has Failed In Three Attempts to Prudently Manage Its Tenaska Contract.

The question here is whether PSE reasonably and prudently managed its gas supply so as to make its best efforts to bring the expectations of substantial savings to fruition. The answer is as clear as it is disappointing. The evidence in this proceeding demonstrates that Puget's gas

[2] *Id.*, Ordering Paragraph 6, p. 6.

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purchasing performance is producing higher costs than would have been incurred had the company done nothing at all to the original Tenaska contract. Exhibit 281HC (Elgin), p. 9, line 9; Exhibits 305C, 306C (Schooley).

PSE's management of gas costs under this contract fails a "three strikes and you're out" test. The first strike was entering into a bad contract in 1992. The Commission ruled that the contract was imprudent and disallowed a portion of the Tenaska contract.[3] The order noted that a "larger disallowance would be defensible"[4] and that the amount was "at the low end of a reasonable range."[5] Simply holding Puget to perform to that original level of prudent costs would lead to disallowance of $19.8 million in the Power Cost Only Rate Case, as well as a $22 million PCA adjustment. Exhibit 301HC (Schooley), p.3; Exhibits 302C, 303HC, 304C. The Commission's decision in UE 921262 has already established the prudent level of gas cost recovery for Tenaska, in effect setting a cap on that recovery. The 1992 "Prudence Review" sets a minimum level of disallowance for this proceeding.

The second strike took place in 1997, when PSE bought out the fixed gas contract and the Commission allowed the creation of a regulatory asset and the establishment of a highly unusual amortization schedule. Puget then failed to lock up the estimated savings, or otherwise manage to achieve them. The expectation of hundreds of millions of dollars of savings became the reality of hundreds of millions of dollars of additional costs.

The record is very clear. Puget had specific offers from four different natural gas vendors, shown explicitly by name in Exhibit 244C (Schoenbeck), p.1, offering fixed long-term prices. This is nearly the identical situation addressed by the Nevada Public Utility Commission

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[3] *Washington Utilities and Transportation Commission v. Puget Sound Power & Light*, Docket Numbers UE-920433, 920499, 921262, Nineteenth Supplemental Order ("Prudence Review" Order).

[4] *Id.*, Nineteenth Supplemental Order, p.33.

[5] *Id.*, Twentieth Supplemental Order, p. 7. The recommended disallowances in the record fell in a range from a present value of $103.4 million to $505.9 million. Nineteenth Supplemental Order, p. 25.

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(PUC) in 2002 when Nevada Power came before that commission for recovery of its crisis-era power costs. (See discussion below). But the Puget situation goes a step further, because of the creation of the regulatory asset in 1997, the entire concept of which was dependent upon the expectation of lower power costs.

The third strike is PSE's recent poor management of the gas supply, even after having allowed the 1997 opportunity to slip away. ICNU's testimony and exhibits lay this out well. For example, in its review of the Risk Management Committee minutes, ICNU highlights how PSE watched as the opportunity to again lock in reasonable gas prices passed them by. *See, e.g.,* Exhibit 231C (Schoenbeck), p. 29, line 20 – p. 30, line 1.

The Commission has given PSE plenty of opportunities – it is time to call this course of conduct by its proper name --- a strikeout. That is why the approach of disallowing gas costs is the most reasonable approach for the Commission to take. Ratepayers should not be liable for ongoing imprudent short-term gas purchasing in the wake of an imprudent contract and a failed long-term hedging strategy.

Furthermore, disallowing the gas costs is a more targeted and minimally intrusive regulatory approach than addressing the regulatory asset. In addition, the restructured contract may begin to have net benefits at some time between now and 2011 when compared with the original contract, and future disallowances may not be necessary. For this reason, the issue is best dealt with as a gas cost disallowance rather than a rate base disallowance.

C. There is Precedent For the Disallowance Public Counsel Recommends.

There is recent precedent for this type of disallowance. In the *Nevada Power* case, the Nevada PUC disallowed over $437 million of power costs, out of a total amount at issue of $922

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million.[6] There were several different categories of costs disallowed for imprudence. Of particular note is the disallowance of $180 million which Nevada Power incurred because it failed to secure a contract with Merrill Lynch for 25 percent of its expected power load. Entering into the Merrill-Lynch contract would have secured power at prices below the company's then-average cost of wholesale power purchase. The record showed also that Nevada Power understood there was some risk that wholesale prices could increase in the future. Subsequent to its failure to sign the contract, Nevada Power adopted a purchasing policy under which it purchased 95 percent of its required power "incrementally," rather than through bilateral contracts or RFPs. ¶ 269. The Nevada Commission held:

> More problematic is NPC's failure to obtain a contract with Merrill Lynch in 1999. Had NPC done so, a significant cost to NPC and the ratepayers would have been avoided. Although it is true that no one envisioned that the Western energy market would encounter the incredible turmoil that it did in 1999 to mid-2001, the failure of NPC to enter into the Merrill Lynch contract, seemingly due to a 25-cent disagreement, is inexcusable [sic]. That decision, particularly when examining the costs NPC was paying for power at the time, was imprudent.

Id., ¶ 281.

While the amount at issue with Puget is smaller, the issue is the same: the Company had a low-cost offer, indeed multiple low-cost offers. It chose not to take them. It ended up with much higher costs.

D. A Disallowance Will Not Significantly Affect PSE's Financial Picture.

PSE's financial health is important for Public Counsel because it affects the company's ratepayers. This is one of the reasons Public Counsel agreed to establish the PCA mechanism

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[6] *In re Application of NEVADA POWER COMPANY for authority to establish a Deferred Energy Accounting Adjustment*, Nevada Public Utility Commission, Docket No. 01-11029, Order, March 29, 2002. The costs were incurred over seven months between March and September 2001. One Commissioner, in a concurring opinion, indicated "ample factual basis" to support an imprudence finding as to all the costs, and stated "the entire amount of $922 million that Nevada Power Company sought to recover should have been disallowed." *Id.*, Concurring Opinion of Richard M. McIntire, Commissioner, p. 1.

and the equity tracker in the last general rate case settlement. If the Commission were to order a disallowance in this case of the magnitude recommended by Staff, Public Counsel does not believe this would cause a bond rating downgrade for the company. PSE is generally healthy. Current management continues to rebuild its capital structure in line with the equity tracker targets established in the rate case settlement. PSE's capital structure will be stronger at the end of this case than it was at the beginning even if Staff recommendation is adopted. Exhibit 271C, p. 11-12.

E. Mr. Schoenbeck's "Option 4" Should Not Be Adopted.

At the end of the hearing, ICNU expert witness Donald Schoenbeck suggested from the witness stand a new option for consideration. For a number of reasons, Public Counsel does not recommend the Commission adopt this approach.

The proposal appears to incorporate several elements, each of which poses problems:

- A gas cost disallowance of the difference between $4.35 per mmbtu and an indeterminate number. The figure $3.61 was mentioned, but only as an illustrative hypothetical, apparently based on modeling. Public Counsel believes this number is far too high and hence too generous to the company, particularly when compared with the known and measurable gas costs available from offers actually made to PSE and presented to the Commission at the time of the restructure. In addition, even if a modeling approach were desired, there is an inadequate record to allow the Commission to choose what the actual number should be. Tr. 591, l. 15 – 15, Tr. 593, ll. 9-18. Tr. 595, l. 20 – Tr. 596, l.1.

- A rate base disallowance of a portion of the disallowance. We do not know what specific rate base disallowance ICNU is suggesting. Mr. Lazar's oral testimony

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indicated it would be quite significant. As discussed earlier, we think this situation is better addressed with a fuel disallowance than a rate base disallowance. Tr. 592, ll. 11-19.

- A restructuring or modification of the PCA to take into account increased gas costs in computing the benchmarks and the deadband. There was no specific proposal as to exactly how that could be done. Tr. 592, ll. 1-10. Even Mr. Gaines, for Puget, agreed that the PCA would need to be modified, but he also did not indicate how this would be done. Tr. 596, ll. 16-21.

F. Public Counsel's Recommendation.

For the foregoing reasons, Public Counsel recommends that the Commission disallow the excess fuel costs of Tenaska from rates during the PCA and Power Cost Only Rate Case (PCORC) periods. The amount of the disallowance should be that recommend by Staff in this proceeding.

III. CONCLUSION

The Tenaska issue has not been a happy one for ratepayers. The original 1992 contract was imprudent. The expectations of major power cost savings that justified the "buyout" in 1997 never materialized because Puget affirmatively chose to gamble on the persistence of low natural gas prices. Even after that decision, PSE missed more recent opportunities to limit its costs to its own benefit and that of its customers. PSE has had its chances. The Commission should decide in this case that the customers are not the only ones to pay the price for this unfortunate

history of questionable decision making by the Company.

Respectfully submitted this 12th day of March, 2004.

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