BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

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POST-HEARING BRIEF OF COMMISSION STAFF

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Mr. Wooten, outside expert for Puget Sound Energy, Inc. on fuel cost risk management, July 25, 2000

I. INTRODUCTION

1 There are two issues in this Power Cost Only Rate Case as between Puget Sound Energy, Inc. ("PSE" or the "Company") and Commission Staff.[1] Both issues involve the Tenaska and Encogen cogeneration facilities located in Whatcom County.

2 The first issue concerns Staff's recommendation to disallow power supply costs for Tenaska in order to implement the Commission's 19th and 20th Supplemental Orders in the Prudence Review in Docket Nos. UE-921262, *et al.* Those Orders set a maximum amount of Tenaska power costs that can be recovered in rates over the life of the contract. Staff's adjustment disallows costs that exceed that maximum amount.

3 For the 12-month "PCA" period ended June 30, 2003, Staff reduces the cost

[1] Exhibit 318 lists these contested issues and all other issues that were resolved during the course of this case. While the contested issues have been narrowed considerably, they account for a very large overall difference ($47 million) in revenue requirement as between Staff ($7.1 million) and the Company ($54.5 million). (Ex. 318 at line 23.)

of power from Tenaska by $22,089,509.[2] (Ex. 301HC at 9-13; Ex. 303HC.) For the 12-month "PCORC" period ended April 2005, Staff reduces the cost of power from Tenaska by $19,842,000.[3] (Ex. 301HC at 13-15; Ex. 304C; Ex. 312, page 2, column entitled "New Adjustment 12-UE-92162 Adjustment".)

4 PSE does not contest the calculation of the Staff adjustment. The Company does, however, contest Staff's interpretation of the Prudence Review Orders that underlies Staff's adjustment. We discuss this issue in Section II.

5 The second issue concerns Staff's recommendation to disallow fuel costs for Tenaska and Encogen under restructured contracts that made PSE responsible for managing the fuel supply for those facilities. The Company imprudently managed the fuel supply for Tenaska and Encogen. Staff's adjustment holds ratepayers harmless for PSE's mismanagement by providing customers the fuel cost savings the Company expected to achieve specifically to offset the cost of the contract reformations.

6 For the 12-month "PCA" period ended June 30, 2003, Staff disallows $39.2 million for Tenaska and Encogen fuel costs. (Ex. 301HC at 14-17; Ex. 305C.) For the 12-month "PCORC" period ended April 2005, Staff disallows $45.3 million in

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[2] This is the period of time covered by the Company's Power Cost Adjustment annual review in Docket No. UE-031389. The Company, Staff and Public Counsel agreed in that case that issues related to Tenaska and Encogen would be litigated in this Power Cost Only Rate Case. The Commission adopted that procedure by Order No. 04, issued January 14, 2004, in Docket No. UE-031389.

[3] This is the period of time that rates set in Docket No. UE-031725 are expected to be effective.

fuel costs for both projects.[4] (Ex. 301HC at 17-18; Ex. 306C; Ex. 312, page 2, column entitled "New Adjustment 13-Encogen & Tenaska Fuel Adjustment".)

7 Again, the Company does not dispute the calculation of Staff's adjustment.[5] The Company does, however, dispute that it imprudently managed the fuel supply for Tenaska and Encogen. We discuss this issue in Section III.

8 Finally, we discuss in Section IV the "WUTC Approval" clause of the Frederickson acquisition. Staff recommends that the Commission find that clause inconsistent with the public interest and sound regulatory policy.[6] Staff does not recommend any disallowance related to this issue.

II. STAFF'S POWER SUPPLY ADJUSTMENT IMPLEMENTS THE COMMISSION'S PRUDENCE REVIEW ORDERS BY DISALLOWING COSTS THAT EXCEED THE ORIGINAL TENASKA CONTRACT

A. The Staff Adjustment Implements Existing and Effective Orders of the Commission from the Prudence Review.

9 The issue concerns the application of the 19th and 20th Supplemental Orders in the Prudence Review in Docket Nos. UE-921262, *et al.* (Exs. 82 and 83, respectively.) Those orders remain in effect today.

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[4] If the Commission accepts this adjustment, New Adjustment 12 related only to implementation of the Prudence Review orders is unnecessary. (Ex. 281 at 5: 2-5; Tr. 526-28.)

[5] The Staff adjustment involves only fuel cost. The amortization of the regulatory assets is still included in the calculation of baseline power costs. (Ex. 281HC at 11: 16-18.)

[6] PSE's acquisition of a minority interest in the Frederickson cogeneration facility itself is not contested. However, if that plant is not placed in service at the time rates in this proceeding become effective, then the Commission should order that the associated rate base, depreciation, and other Frederickson fixed costs should be removed from the Power Cost Adjustment deferral calculations to account for the delay.

10 The Prudence Review stemmed from a general rate case filed by Puget Sound Power & Light ("Puget") in 1992. Puget sought to recover the increased cost of new power supply resources. The Commission found initially that Puget had failed to carry its burden to prove that these acquisitions were prudent. *WUTC v. Puget Sound Power & Light Company*, 11th Supplemental Order, Docket Nos. UE-921262, *et al.* (1993). However, the Commission allowed Puget to submit additional evidence on that issue. The Tenaska acquisition was included in this Prudence Review. *WUTC v. Puget Sound Power & Light Company*, 18th Supplemental Order, Docket Nos. UE-921262, *et al.* (1994).

11 Following the submission of additional evidence and hearings, the Commission held that Puget's acquisition of Tenaska, March Point Phase II and Sumas were imprudent. The Company in the current case characterized the Commission's holding as limited merely to documentation deficiencies. (Tr. 230.) In fact, the Commission's holding was directed to the fundamental nature of Puget's decision-making and management. Finding of Fact No. 5 in the 19th Supplemental Order stated clearly that:

> Puget has not carried the burden to demonstrate that its new resource acquisitions were prudent. Puget mismanaged its contract selection and evaluation. Puget was imprudent in its failure to move from the flexible planning process to a rigorous, specific evaluation of the merits of resources at the time their acquisition was being considered. The company's decision-making process was not adequate and was not adequately documented.

(Ex. 82 at 45.) Conclusion of Law 2 echoed these serious criticisms:

> Puget failed to carry its burden of proof to demonstrate its new power purchases were prudent. Puget's mismanagement of its resource acquisition process was imprudent.

(Ex. 82 at 47.)

12 Having found that Puget was imprudent, the Commission then turned to the measure of "damages" to ensure that ratepayers would not suffer the excessive costs caused by Puget's mismanagement of the resource selection process:

> As the result of Puget's actions, it has not obtained some resources at a reasonable cost. Because this is Puget's responsibility, ratepayers should not bear the extra costs. For the Tenaska and the March Point II, Puget's failure to factor in the value of dispatchability caused Puget to pay too much for the contracts. Future ratemaking treatment for these contracts should include the percentage disallowances to reflect these excess amounts, as follows: Tenaska 1.2% . . . .

(Ex. 82 at 45, Finding of Fact 7.) The Commission emphasized that Puget, not ratepayers, would be held responsible for these extra costs:

> The contract prices should be adjusted for ratemaking purposes to disallow the excessive costs caused by the company's imprudent actions. The adjustments are listed in the Findings of Fact.

(Ex. 82 at 47, Conclusion of Law 3.)

13 Thus, by disallowing the excessive costs, the Commission established the maximum amount of Tenaska power costs that the Company may recover over the life of the contract. (Tr. 491-92.) Staff's adjustment implements the

Commission's 19th Supplemental Order by disallowing costs under the restructured Tenaska contract that exceed the maximum amount allowed under the original contract. (Ex. 308.)

B. The Staff Adjustment is a Reasonable Interpretation of the Commission's Prudence Review Orders that Set the Company's Avoided Cost as the Ceiling for Allowable Tenaska Costs.

14 The Company argues that the 19th Supplemental Order did not impose a fixed dollar amount for future power supply costs that may be recovered for the Tenaska contract. The Company relies on the Commission's 20th Supplemental Order, which stated that the disallowance is 1.2% times the net cost of the contract that includes: (1) the amount paid for energy actually purchased at the contract rate; (2) the amount paid for displacement; and (3) the amount paid for replacement power. (Ex. 45 at 7-9.)

15 On cross-examination, the Company drew attention to language in the Prudence Review Orders that discussed Tenaska dispatchability as it relates to the Commission's finding of imprudence and its calculation of a disallowance. (Tr. 484-85, 490-92.) The Company also emphasized that the neither the 19th nor 20th Supplemental Orders used expressly the word "cap" or "ceiling". (Tr. 485-87 and 492-94.)

16 None of these arguments undermine the Staff adjustment. First, while the Commission elected a 1.2% disallowance for Tenaska, it concluded that a

disallowance up to 16.6% would also have been appropriate. (Ex. 82 at 32-33.) Indeed, the Commission determined the amount of the disallowance by comparing a reasonable level of costs to the *actual* levelized prices over the term of the contract. (Ex. 82 at 28-33; Ex. 302C; Tr. 487-88.) Thus, the amount of the disallowance would have been greater than 1.2%, if the total cost of the Tenaska contract in the Prudence Review were the amount the Company now seeks to recover in the present case. (Ex. 301HC at 7: 1-5.)

17 Second, the original Tenaska contract was "take *and* pay" at a constant, escalating price for energy. (Tr. 374.) Thus, it is reasonable to interpret the Prudence Review Orders as having set a fixed dollar per megawatt hour price cap on the energy production of the plant. (Tr. 374 and 489.) That is precisely the basis for the calculation of the Staff Prudence Review adjustment. (Ex. 301HC at 9-10; Exs. 303HC and 304C.)

18 Most important, however, the disallowance ordered by the Commission was based upon a comparison of the cost of the plant to the Company's avoided cost, the latter setting the ceiling for recoverable Tenaska power supply costs. The Order states:

> If [Puget] had correctly analyzed its avoided costs to purchase rates which properly valued the two specific projects, as compared to a company built CCCT, it would not have agreed to purchase at the prices its paid.

(Ex. 82 at 32.) The Commission elaborated elsewhere in the 19th Supplemental Order on avoided costs as the basis for the disallowance:

> But because Puget was satisfied with a general, unadjusted estimate of *avoided cost as a ceiling*, and because it failed to document its decision-making process, we cannot know what price Puget could have obtained if it had followed a prudent course. (Emphasis added.)
>
> . . .
>
> In the "Supplemental Bidding", the price Puget was willing to pay was pegged to an outdated estimate of avoided cost. *Puget set a ceiling of 92.5% of its 1989 avoided cost, . . .* Puget purchased the March Point Phase II and Tenaska projects through this process. (Emphasis added.)

(Ex. 82 at 16 and 23.)

19 This discussion led the Commission to conclude that Puget would be not be allowed to recover costs of Tenaska that exceed the Company's avoided cost:

> After consideration of all the evidence, the Commission concludes that Puget paid too much for the Tenaska and March Point Phase II contracts. These resources were not purchased through a competitive bid; the clear standard applied to them as qualifying facilities is that *they must cost less than Puget's avoided cost.* Puget's general avoided cost must be properly adjusted to review the price of the purchased resources. As discussed in the following sections, the properly adjusted *avoided cost is lower than the price Puget paid for the contracts.* (Emphasis added.)

(Ex. 82 at 24-5.)

20 Avoided cost includes all of the costs of acquiring the Tenaska resource and running the plant over the entire term of the power supply contract. Staff's adjustment merely brings the total cost of power from Tenaska after restructuring

back to the maximum allowable level the Commission established in the Prudence Review.

C. Prior Applications of the Prudence Review Disallowance Do Not Undermine the Staff Adjustment.

21 The Company argues that Staff's adjustment is inconsistent with later applications of the Prudence Review disallowance, which, the Company alleges, have "consistently been applied as the product of the net contract charge multiplied times the 1.2% percentage factor." (Ex. 45 at 9: 10-20; Ex. 220 at 12-14.)

22 The argument is surprising given that the Company itself did not propose such a disallowance in its last general rate case filing in Docket No. UE-011570. (Ex. 309 at 2.)

23 The argument also ignores the fact that the current proceeding is the first contested rate case to apply the Prudence Review disallowance *after* the Tenaska contract was restructured. All other cases either predated the Tenaska accounting petition in Docket No. UE-971619 or resulted in settlements that expressly set no precedent for any issue in any later proceeding. (Exs. 308 and 309.) Thus, prior applications of the Prudence Review disallowance do not foreclose Staff's adjustment in the current proceeding.

24 Finally, the Company argues that the Commission's orders in the Tenaska accounting petition gave PSE no reason to believe that there would be a cap on the

recovery of fuel costs incurred after the buy-out or that the percentage disallowance would be applied to the regulatory asset. (Ex. 45 at 9.) That argument, however, is inconsistent with the Commission's order approving the accounting petition that preserved the Orders in the Prudence Review:

> The Commission's approval of the instant petition does not in any manner modify or affect the Commission's prior orders regarding standards or burden of proof in determining whether costs of a utility were imprudent or unreasonable, e.g., *Washington Utilities and Transportation Commission v. Puget Sound Power & Light Company*, Docket Nos. UE-920499, UE-921262 (September 27, 1994).

(Ex. 283C at 37, ¶ 6.)

25 The argument is also inconsistent with language in the 20th Supplemental Order in the Prudence Review that responded directly to a Company petition for reconsideration that questioned whether the disallowance should persist for the life of the Tenaska contract if the contract were amended. (Ex. 83 at 19.) The Commission stated:

> The Commission has made its final decision on the contract disallowance. If Puget amends the contract, it may later present its results and suggested action.

(Ex. 83 at 20.) The Company has never taken up the Commission's invitation to alter the disallowance required in this case by the Prudence Review Orders.

26 Rather, the Company seeks to recover power costs that exceed the level it would have paid under the original Tenaska contract. That request comes despite

the Commission's clear holding that the original contract was the result of Company imprudence, and despite the Commission's clear use of avoided cost as a ceiling for allowable costs over the life of the contract. The Company's request is also unfair on its face. (Tr. 493 and 496.)

27 The Staff adjustment remedies that unfairness and properly places the Company in the position it otherwise would be absent the restructuring of the Tenaska contract. (Tr. 226-28 and 293-95.) The Staff adjustment should be adopted by the Commission.

III. STAFF'S FUEL COST ADJUSTMENT PROTECTS RATEPAYERS FROM THE COMPANY'S IMPRUDENT MANAGEMENT OF THE GAS SUPPLY FOR TENASKA AND ENCOGEN

A. Summary of Staff Recommendation.

28 The preceding section supports an adjustment to the total cost of power from Tenaska in order to implement existing and effective Commission orders from the Prudence Review in Docket No. UE-921262. Implementation of those orders, however, does not end the Commission's inquiry. With respect to fuel costs for Tenaska, the Commission also stated that:

> 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. (Emphasis added.)

(Ex. 283C at 37: *In the Matter of the Petition of Puget Sound Energy, Inc.*, Order at 6, Docket No. UE-971619 (1997).) The Commission issued identical language for the Company's management of Encogen fuel costs. (Ex. 284C at 20: *Petition of Puget Sound Energy, Inc.*, Order at 4, Docket No. UE-991989 (1999).)

29 The record is clear that PSE's management of the fuel supply for Tenaska and Encogen was imprudent and results in unreasonable fuel costs. The Company represented to the Commission, the financial community and its Board of Directors that restructuring the contracts was necessary to produce substantial savings in fuel costs over the remaining lives of the restructured contracts. On the basis of those economic analyses, the Company received authority from the Commission to create regulatory assets for the cost of the buy-outs and amortization schedules were established specifically to match those costs with the fuel cost savings that PSE anticipated over the remaining terms of the contracts. This was done expressly to produce an equitable sharing with ratepayers of the fuel cost reduction benefits over the long-term.

30 However, rather than adopting a strategy to protect those long-term benefits for ratepayers, the Company relied instead upon fuel purchases in volatile and risky spot and near-term markets specifically to reward shareholders with maximum earnings during the 1997-2001 rate plan period. That strategy eliminated then-present and later opportunities for the Company to reduce

ratepayers' exposure to rising fuel prices after the rate plan.[7] Those rising fuel prices have resulted in the cost of power from Tenaska and Encogen, in fact, being higher today than if PSE had not restructured the contracts. (Ex. 281HC at 9: 7-9; Ex. 301HC at 9: 2-4.)

31 The adjustment sponsored by Staff appropriately holds the Company responsible for the imprudent decisions of management and their consequences.[8] (Ex. 281HC at 10-13.) The adjustment provides ratepayers a reasonable level of benefits the Company anticipated it could obtain in order to offset the cost of the regulatory assets over the lives of the restructured contracts.[9]

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[7] Thus, the Company is incorrect when it states that its management of the Tenaska and Encogen fuel supply prior to June 2002 is irrelevant to these proceedings. (Tr. 324-25.)

[8] In assessing the Company's management of the Tenaska and Encogen fuel supply, the burden of proof falls only upon the Company. RCW 80.04.130(4). In determining that PSE did not carry that burden, Staff applied the Commission's traditional prudence test:

> 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. *WUTC v. Puget Sound Power and Light Co.,* 1st Supplemental Order at 32-33, Cause No. U-85-54 (1984).
>
> 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. *WUTC v. Puget Sound Power & Light Co.,* 19th Supplemental Order at 10, Docket No. UE-921262, *et al.* (1994), citing, 2nd Supplemental Order, Cause No. U-85-53 (1986) and 5th Supplemental Order, Cause No. U-83-26 (1984).

[9] In presenting this adjustment, Staff did not become embroiled in the controversy between the Company and the Industrial Customers of Northwest Utilities ("ICNU") concerning gas price forecasts. We discuss in Section III, E why Staff's participation in that dispute was not required

B. The Company Represented the Tenaska and Encogen Contract Restructurings as an Initiative to Significantly Reduce Fuel Costs Over the Long-Term; It was on that Basis that the Commission Approved the Accounting Petitions that Created the Regulatory Assets and Amortized Them Against the Anticipated Benefits.

1. The Contract Reformations Were Part of a Pre-Existing Plan to Reduce the Company's Cost of Power.

32 The Company represented before the Tenaska and Encogen contract reformations that it would pursue a strategy to reduce its power supply costs over the long-term.

33 In 1997, the Company provided comments on the "Electric Customer Choice Act" sponsored by State Senator Bill Finkbeiner. The Company agreed that it has an obligation to take appropriate action to reduce power costs:

> Utilities, as always, should seek to mitigate power supply costs and legislation should provide avenues (e.g., financing mechanisms to perform "buyout/buydowns") to enhance a utility's ability to perform such mitigation.

(Ex. 99 at 3.)

34 Also in 1997, the Commission authorized the acquisition of the Washington Energy Company by Puget to create PSE as a combined energy utility. *In the Matter of the Proposal of Puget Sound Power & Light* Company, 14th Supplemental Order Accepting Stipulation; Approving Merger, Docket No. UE-

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to support its presentation. In fact, Staff's recommendation allows the Commission to resolve that controversy at a later and more appropriate time, while still setting just and reasonable rates in this proceeding.

960195 (1997). The Commission also approved a 5-year rate plan (1997-2001) that included programmed rate increases, but otherwise precluded the Company from requesting rate adjustments. *Id.*

35 One advantage given for the "merger" was PSE's acquisition of the expertise of the gas company to manage fuel costs. (Ex. 301HC at 7: 13-15.) Another advantage was PSE's ability to reduce its cost of power through "power stretch savings." (Ex. 65 at 21-22; Ex. 281HC at 9: 14-19.) The Company estimated power stretch savings of $150 million over the rate plan period. (Ex. 287 at 2.) It was expected that these savings would be ongoing in order to keep PSE's prices low. (Ex. 287 at 2.) The Tenaska and Encogen contracts were specifically targeted for this power stretch savings campaign. (Ex. 65 at 23.)

2. The Express Premise of the Accounting Petitions was that Fuel Costs Would Be Reduced for the Maximum Benefit of Ratepayers Over the Term of the Contracts.

a. Tenaska (Docket No. UE-971619).

36 The Company agrees that the fundamental basis for the Tenaska restructuring was the expectation that the transaction would save substantial money for ratepayers. (Tr. 232 and 296-97.) The Company's petition in Docket No. UE-971619 was itself unambiguous that a Commission order approving the regulatory asset would allow PSE to significantly reduce the cost of fuel for the benefit of ratepayers. The petition was predicated on an economic analysis in

Exhibit B, which showed almost [redacted] in fuel supply savings over the remaining life of the Tenaska contract based on then-available forward market price quotes for a long-term supply of replacement gas. (Ex. 283C at 19, ¶ 8 and 25-27.) Indeed, in its direct case in the current proceeding, the Company itself relied upon this same economic analysis to justify the amount paid to restructure Tenaska. (Ex. 11 at 28: 14-22.)

37 The petition was also replete with Company representations that restructuring the Tenaska contract would produce substantial fuel supply savings over the life of the contract that would outweigh the cost of the buy-out itself:

- "The transaction, which is scheduled to close on or before December 31, 1997, provides the Company with the opportunity to achieve a restructuring of the power purchase agreement for the cogeneration project that will produce significant saving for customers. These savings are shown on Exhibit B, page 2, line 20. The order requested by this Petition is necessary to enable the Company to enter the transaction" (Ex. 283C at 16.)

- "The Company's objective in entering into this agreement is to drive the gas cost element of a long-term fixed price escalating PURPA power contract toward market, at a price and at a time that provides maximum overall benefit to the Company and its customers." (Ex. 283C at 17-18, ¶ 5.)

- "Delaying this transaction into a later time frame materially lessens the value to customers and increases the purchase price for the gas supply contract due to tax consequences to Supplier." (Ex. 283C at 18, ¶ 6.)

- "This proposal is structured such that the purchase price, financing costs and new power costs are ratably spread forward in proportion to the original contract costs, thereby achieving an equitable power cost savings in each of the remaining years under the Agreement. As a result, a ratable percentage power cost reduction occurs in each year and approximately twice as much savings is delivered in the later years versus the earlier years. The savings is passed on as shown in Exhibit D." (Ex. 283C at 18, ¶ 7.)

- "The purchase of the gas supply contract by Petitioner will result in an effective reduction in the power supply costs under the Agreement in the future. Economically, it is the Company's intent to reflect these reductions in cost of service pro-rata based on the amounts in the original power purchase agreement. This results in the amounts approximating those shown in Exhibit B . . ." (Ex. 283C at 19, ¶ 8.)

- "Petitioner proposes to achieve a restructuring of the power costs under the Agreement based on the original contract price under the existing Agreement less the gas cost savings, as measured by the current forward market gas price quotes. The Rebundled power costs (including the cost to achieve the savings) would be spread over the remaining term of the Agreement in a manner to achieve results approximating those set forth in Exhibit B. This produces an equitable sharing of the power cost reduction benefits over the remaining term of the Agreement . . . Net savings (from line 21 on Exhibit B) is the result that would be targeted for ratemaking purposes after equitably spreading the reduced power costs over the remaining life of the contract." (Ex. 283C at 19-20, ¶ 9.)

- "To achieve the targeted savings, the Company requires an accounting order that obtains the desired effect for ratemaking purposes and satisfies the Company's financial reporting and accounting needs." (Ex. 283C at 20, ¶ 12.)

38 These representations convinced Staff that the fuel cost savings that would result from restructuring Tenaska "more than offset the regulatory asset,"

especially in later years under the amortization schedule that was shaped specifically to match the cost of the regulatory asset with those anticipated savings. (Ex. 283C at 30; Ex. 4; Tr. 360-61; Tr. 509-11 and 515.) Thus, Staff recommended approval of the petition despite its fundamental reluctance to recommend the creation of new regulatory assets for electric companies. (Ex. 283C at 30.)

39 The Company's representations also had their desired effect on the Commission. The Commission approved the Tenaska regulatory asset and amortization noting that:

> The transactions will provide the Company with the opportunity to achieve a restructuring of the power purchase agreement for the cogeneration project that will produce significant savings.

(Ex. 283C at 35, Finding of Fact 4.) The Commission relied expressly upon Company analyses that produced an equitable sharing of the "power cost reduction benefits over the remaining life of the Agreement," where the "targeted" savings and their sharing were based specifically upon price quotes for replacement gas in forward markets. (Ex. 283C at 34.)

40 Indeed, the Company's own Risk Management Committee admitted that it had "

" (Ex. 63C at 18; Ex. 77C at 25.)

A December 8, 1997 presentation to the Board also indicated that:

> The existing power purchase agreement between PSE and Tenaska will be amended to restructure and reduce the price paid by PSE for power . . .

(Ex. 65 at 25.) The Company told the Board that the restructured contract was a critical opportunity for PSE to drastically reduce represented stranded costs:

> Based upon current estimates of gas supply costs, the anticipated before tax savings from the Tenaska restructure (gas costs savings net of buy-out costs) are approximately $395 million over the remaining 14 year life of the contacts.

(Ex. 65 at 26.)

41 These representations to the Board did not end when the Board gave approval to restructure the Tenaska contract. An April 4, 2000 presentation to the Board stated that a significant reduction in stranded costs has been achieved from "good progress toward reducing our power costs through our contract restructuring activities." (Ex. 90 at 188.) The Company represented to the Board significant "Power Cost Restructuring Savings" through 2008, including about $30 million in savings in 2004 and 2005, which include the rate year in this proceeding. (Ex. 90 at 190.)

42 Shareholders were also on the receiving end of Company representations that the Tenaska restructuring would significantly reduce the cost of fuel over the long-term. In its 1997 Annual Report, the Company stated that:

> Good progress was achieved in 1997 when we renegotiated two major supply contracts, reducing our costs of power by about $30 million in 1998, and more in coming years.
>
> . . .
>
> Through two major power contract renegotiations the company was able to reduce its purchased power costs by more than $500 million over the remaining lives of those contracts. On an annual basis these savings are also substantial, amounting to approximately $30 million in 1998 and growing in subsequent years. Like the merger, reductions in power costs represent an important part of our strategy to advance our position as the utility industry becomes more competitive.

(Ex. 84 at Annual report pages 5 and 8.) Similar representations were made in the Company's 1999 Annual Report:

> The Company obtained an order from the Washington Commission creating a regulatory asset related to the $215 million restructuring payment . . . These revised arrangements are expected to reduce the Company's power supply costs from the Tenaska project an average of between 15% and 20% over the 14-year period from 1998 through 2011, net of the costs of the restructuring payment.

(Ex. 85 at Annual Report page 32.)

b. Encogen (Docket No. UE-991918).

43 The Company's petition in Docket No. UE-991918 was equally clear that approval of the regulatory asset for the Encogen buy-out would allow PSE to reduce gas costs at the project, thereby, producing substantial savings for ratepayers over the remaining life of the contract. For example, the Company stated that:

> The Gas Purchase Agreement will allow the Company to lower the purchased gas costs at the Encogen facility, thereby producing significant savings for customers.

(Ex. 284C at 2.) Similar representations elsewhere in the Encogen petition echoed the Company's objective to achieve *net* savings for ratepayers over the contract term through a reduced cost of gas at the facility. (Ex. 284C at 3, ¶ ¶ 3 and 4, and 4, ¶ 6.)

44 Like the Tenaska buy-out, the Company also relied predominantly upon Exhibit B that demonstrated substantial fuel cost savings based on forward market price quotes for the cost of replacement gas. The Company again proposed an equitable sharing of the savings with ratepayers over the remaining term of the contract by matching the savings with the amortized costs of the buy-out. (Ex. 284C at 4, ¶ 7 and 9-10.) [redacted] [redacted], again, according to the Company's Risk Management Committee. (Ex. 63C at 113.)

45 Based on these assertions of significant long-term savings for ratepayers that would more than offset the cost of the buy-out, Staff recommended approval of the Encogen petition despite concerns regarding the accounting. (Ex. 284C at 14-16.) The Commission also was convinced by the Company's showing. It approved the petition, stating:

> Assignment of the Gas Purchase Agreement will provide the Company

> with the opportunity to achieve lower purchased gas cost at the Encogen facility, thereby producing significant savings for customers. The order requested by the Petition would allow the Company to spread the costs associated with the Assignment over the remaining term of the Gas Purchase Agreement.

(Ex. 284C at 19, Finding of Fact 3.)

46 Of course, like the Tenaska buy-out, the Commission was not alone in being assured by PSE that restructuring the Encogen contract was necessary to produce significant savings over the long-term. The April 4, 2000 presentation to the Board of Directors estimated "Power Contract Restructuring Savings" for Encogen over the remaining term of the contract, including approximately $10 million in each of 2004 and 2005. (Ex. 90 at 190.) Likewise, shareholders were told that:

> [The Encogen] buy-out, plus the successful renegotiation of certain of the fuel supply contracts for the project, will result in a 17 percent reduction in the annual costs of power from this project. Encogen represents the second favorable renegotiation of the high-cost purchase power contracts that we entered into with independent power producers in the mid to late 1980's under the provisions of the federal Public Utility Regulatory Policies Act.
>
> . . .
>
> In December 1999, the Company bought out the remaining 8.5 years of one of the natural gas supply contracts serving Encogen from Cabot Oil & Gas Corporation which provided approximately 60% of the plant's natural gas requirements. The Company will become the replacement gas supplier to the project for 60% of the supply under the terms of the Cabot Agreement and expects the agreement will reduce this portion of gas costs by 5% to 15% annually.

(Ex. 85 at Annual Report pages 3 and 31.)

47 In sum, the Company created reasonable expectations by the Commission, the Board of Directors, and the financial community that approval of regulatory assets of $215 million for Tenaska and $12.9 million for Encogen would create net benefits for ratepayers, by significantly reducing the cost of fuel over the remaining term of the contracts, and for shareholders, by mitigating stranded cost exposure. The savings themselves were based upon forward market prices for fuel available at the time. The amortizations of the regulatory assets were shaped specifically to match those savings over the remaining terms of the contracts.

48 Consistent with the Commission's prudence standard, one would have expected the Company to develop a long-term strategy for gas procurement for Tenaska and Encogen that would reasonably have met the economic analyses the Company presented as justification for the petitions. The next section demonstrates that the Company failed to adopt such a strategy. Instead, the Company purchased gas in spot and near-term markets in order to maximize earnings for shareholders during the rate plan period. Ratepayers, on the other hand, were exposed to rising fuel prices after the rate plan that the Company now seeks to recover in this proceeding.

C. The Company's Management of the Fuel Supply For Tenaska and Encogen Imprudently Elevated Shareholder Profits Over Ratepayer Benefits.

49 The Company's general approach to managing the fuel supply for Tenaska and Encogen was to procure gas in spot and near-term markets. (Tr. 323.) There are three general themes demonstrating that this approach was imprudent: (1) the Company myopically tied its fuel procurement decisions to annual budget forecasts; (2) the Company used Tenaska as a "heat rate play" to maximize short-term earnings for the benefit of shareholders; and (3) the Company ignored outside expert advise and opportunities to hedge gas in long-term markets at prices that would have secured fuel cost savings for the benefit of ratepayers and offset the cost of the regulatory assets.

1. The Company Measured Its Success in Managing the Cost of Fuel Against Annual Budget Forecasts.

50 Risk Management Committee meeting minutes for March 9, 2000 and July 9, 2000 demonstrate clearly that the Company used its annual budget as the single most important tool for measuring its performance in managing fuel supply. This was a short-sighted approach that ignored the long-term benefits that justified the buy-outs.

51 The budget was described as [redacted] and [redacted] with [redacted]

(Ex. 77C at 2, 9 and 23; Ex. 63C at 99.) All decisions relative to fuel supply were based on an analysis that was [redacted] to enable the Company to [redacted] (Ex. 77C at 9.)

52 In fact, Mr. Weaver, the Company's Chief Executive Officer at the time, indicated that it would be "[redacted]"[10] [redacted] (Ex. 77C at 4 and 5.)

53 Mr. Hawley, the Company's Chief Financial Officer at the time, also judged the success of fuel procurement decisions on whether market prices were above or below budget. (Ex. 77C at 3.) A study presented by the Risk Management Committee showed the value of Tenaska power in 2000. [redacted] (Ex. 77C at 10.)

[10] This and certain other citations in this brief are to hand-written notes included in Risk Management Committee meeting minutes. The Company sought to downplay the significance of these notes. (Tr. 217.) The Company did not, however, dispute their accuracy nor did the Company produce other notes that were contradictory. In fact, the handwritten notes are consistent with the "formal" minutes. Compare, *e.g.*, Ex. 77C at 4 with 9, and Ex. 63C at 81 with Ex. 77 at 36. Moreover, the formal minutes are themselves representations of the handwritten notes taken by Risk Management Committee staff. (Tr. 129-30.)

2. The Company Used Tenaska as a "Heat Rate Play" In Order to Maximize Short-Term Earnings for Shareholders at the Expense of Long-Term Benefits for Ratepayers.

54 The record is also clear that PSE managed fuel costs for Tenaska specifically to enhance shareholder profits during the rate plan period. For example, minutes for the June 9, 2000 Risk Management Committee meeting acknowledge that:

(Ex. 63C at 109; Ex. 77C at 26.) Mr. Hawley echoed that theme in the July 25, 2000 Risk Management Committee meeting. He asked, (Ex. 77C at 35.)

55 The June 13, 2000 meeting of the Risk Management Committee is perhaps most revealing of the Company's strategy to manage fuel supply in order to maximize short-term earnings. (Ex. 88C at 2.) The benefits that were identified by the Company were (Ex. 88C at 2), according to the "Elsea study" that was performed in 2000. (Ex. 91C.) That study examined whether the Company

was "Better Off" or "Worse Off" using Tenaska as a "heat rate play," by comparing the value of power produced at Tenaska and sold into secondary energy markets with the increased spot cost of gas to serve retail load. (Tr. 242, 244-46, 258-59, and 309.) [redacted]

[redacted] (Ex. 91C at 2 and 9.) The study also noted that in the rate plan years 1998-2000, [redacted] (Ex. 91C at 3.)

56 Thus, the Elsea study focused management solely on earnings generation over the near-term. The study gave no attention to managing the cost of gas at any point in time over the term of the Tenaska restructured contract. Tenaska was a money-maker for the Company irrespective of cost and it would be managed as such.

57 Managing the cost of gas was also ignored in a March 12, 1999 presentation of the Risk Management Committee. (Ex. 63C at 34-64.) That presentation examined and quantified [redacted] (Ex. 63C at 35-56.) The presentation also recommended [redacted] and a [redacted] . . . ." (Ex. 63C at 57-62.)

The presentation does not address, even in passing, strategies to decrease or combat volatility in cost, let alone the cost of fuel for Tenaska.

3. The Company Was Ignorant of Gas Market Risks; It Sought Outside Expert Advise on Those Risks, But It Ignored that Advise and Reasonable Opportunities to Achieve the Gas Cost Savings Anticipated in the Accounting Petitions.

58 The restructuring of the Tenaska and Encogen contracts occurred in 1997 and 1999, respectively. However, as late as 2000, the Company did not comprehend the risks of managing the fuel supply for those facilities.

59 On March 9, 2000, Mr. Weaver stated that he had [REDACTED] (Ex. 77C at 4.) Mr. McKeon, the Company's general counsel at the time, also indicated that the Company needed [REDACTED] and so the Company could [REDACTED] of its supply position. (Ex. 77C at 5.) The Risk Management Committee itself set a future goal to [REDACTED] including the [REDACTED] and [REDACTED] (Ex. 77C at 7.)

60 Despite that goal, however, the Risk Management Committee was still questioning PSE's capabilities in a meeting on June 9, 2000. The Committee stated that [REDACTED] and that:

(Ex. 77C at 21-22 and 24.)

61 The Company also questioned its risk management capabilities relative to other utilities in the region:

(Ex. 77C at 12-13.)

62 Mr. Weaver repeated his earlier concern that the Company had not yet developed appropriate risk management tools. He indicated that PSE still:

(Ex. 77C at 18.)

63 The Company was quite candid that its risk management capabilities were seriously deficien t at that time:

(Ex. 77C at 15.) Indeed, with respect to managing the fuel supply for Encogen, PSE admitted that it had acted imprudently. It characterized Encogen management as an for which the Company:

64

(Ex. 77C at 16.)

65 The Company responded to these admitted risk management deficiencies in two ways. First, beginning in mid-2000, it sought the risk management consulting services of Merchant Energy Group of the Americas, Inc. ("MEGA"), a power and natural gas trading company. (Tr. 130-31.) Unfortunately, however, the Company ignored MEGA's advice. For example, MEGA advised the Company in a February 7, 2000 Risk Management Committee meeting to adopt a portfolio management principle that:

(Ex. 63C at 81.) MEGA repeated this principle in the July 25, 2000 Risk Management Committee meeting when it stated that (Ex. 77C at 60.) Despite these repeated warnings, the Company continued to procure gas in spot and near-term markets that MEGA expressly characterized as

66 Other risk management advice was provided by MEGA, but again ignored by PSE, in that same July 25, 2000 meeting of the Risk Management Committee. MEGA provided a and it

warned PSE that you

(Ex. 77C at 33, emphasis in original.) This advice was repeated in a written presentation that stated that

(Ex. 77C at 45.)

67 MEGA, in fact, suggested that PSE take

(Emphasis in original.) (Ex. 77C at 33.) In a direct response to a question of whether PSE needed to hedge the price of gas supply into 2001, MEGA indicated:

(Ex. 77C at 34.)

68 Lest MEGA's advise had not gotten through to the Company, Mr. Wooten, one of three MEGA consultants at the July 25th meeting (Tr. 207), responded this way to a direct inquiry from Mr. Hawley regarding the risk of gas supply:

(Ex. 77C at 36.)

69 Again, PSE ignored this advice. In fact, it devised no strategy if the cost of gas *increased*. (Tr. 173.) It also rejected advice to take advantage of *declining* gas

prices. As late as December 13, 2001, the Risk Management Committee recommended long-term hedges for the entire gas requirement for Tenaska (50,000 MMBtu/day) for the entire period 2003-2011, stating that:

(Ex. 77C at 81; Tr. 135-36, 187, 205, 283-84 and 405.) Despite analysis that showed that long-term hedges could be obtained at prices that would result in internal rates of return [11] the Company declined to adopt that recommendation. (Ex. 77C at 78-79.) Thus, Tenaska remained totally un-hedged for the period 2003-2011, despite the opportunity to set gas prices for Tenaska at a level below the price ( ) PSE assumes in the current case. (Tr. 136 and 139.)

70 Beyond seeking (but rejecting) the advise of MEGA as a means to cure the deficiencies of its risk management practices and procedures, the Company also undertook its own "prudence review" of the prior decisions it had made to manage the fuel supply for Tenaska and Encogen. This evaluation was part of the June 9, 2000 Risk Management Committee meeting and it confirmed that the Company had mismanaged the fuel supply for both facilities.

71 With respect to Tenaska, the Company asked itself the

[11] Any positive internal rate-of-return benefits ratepayers even after they compensate the Company for the return "of" and "on" the regulatory asset. (Tr. 314.)

The Company's answer to that question states that PSE:

(Ex. 77C at 27.) In other words, the Company did not have all of these objectives in mind when it adopted a strategy to manage the fuel cost for Tenaska at the time of the restructuring.

72 The same internal review also stated that the Company (Ex. 77C at 28.) Had the Company done so, both the Commission and the Board would have been able to evaluate the strategy PSE did, in fact, adopt to use Tenaska as a heat rate play to enhance margin generation during the rate plan, rather than to secure anticipated savings or stranded cost mitigation. Whether the Commission

or Board would have approved the restructuring with that knowledge is an open question.

73 The Company closed its internal review of Tenaska by recognizing the shortcomings of its fuel cost risk management practices:

(Ex. 77C at 28.)

74 The Company's answer to that question again highlighted its risk management deficiencies:

(Ex. 77C at 31-32.) The Company also indicated for Encogen that it needed to

(Ex. 77C at 32.)

D. The Company Cannot Rebut the Conclusion that It Was Imprudent in Managing the Gas Supply for Tenaska and Encogen.

75 The foregoing discussion shows that PSE imprudently managed the fuel supply for Tenaska and Encogen by failing to adopt a strategy to protect the long-term benefits the Company itself claimed would justify the significant cost to buy-out the contracts. The Company's rebuttal to this demonstration falls into several categories, all of which have no merit.

1. The Company's Evidence of Risk Management Activities Post-Date the Critical Point in Time When PSE Had the Opportunity to Hedge the Cost of Gas In Forward Markets in Order to Secure the Savings Anticipated in the Accounting Petitions.

76 Through the testimony of Mr. Gaines and Ms. Ryan, PSE attempted to impress the Commission with the sophistication of its risk management practices and procedures. None of this evidence, however, is relevant to the time period when PSE's failure to properly examine hedging options resulted in lost opportunities to satisfy the economic analyses presented originally to the Commission. Mr. Gaines' direct testimony only discusses risks underlying PSE's *current* power supply portfolio. (Ex. 11 at 19-23.) His rebuttal testimony discusses PSE's management of the Tenaska and Encogen fuel supply, but only from 2000-2001. (Ex. 45 at 23-30.) Otherwise, he merely refers to Ms. Ryan, whose direct testimony and exhibits also focused entirely upon *current* risk

management activities and protocols in today's power markets. (Ex. 191 at 6-21; Ex. 193; Ex 194.)

77 Ms. Ryan's rebuttal testimony does discuss earlier time periods, but, again, only from October 2000 through August 2001 when she participated in an advisory role for PSE's Risk Management Committee as an employee of MEGA. Other than that, she discusses only the period since December 2001 when she joined PSE as Vice President of Energy Portfolio Management. (Ex. 201 at 3: 26 through 4: 2; Ex. 202C; Ex. 203C; Ex. 206C; and Ex. 207C.)

78 The Company does not have risk management documentation prior to March 1999, when critical decisions with long lasting impacts were made. (Ex 208.) The Company did produce its "Energy Price Risk Policy," but that was the only risk management manual in effect for the entire period July 1997 through July 2001. (Ex. 55C at 48-53.) This 5-page manual summarized the

(Ex. 55C at 48.) The discussion set forth in Section III, C demonstrates that PSE focused only on the following stated objective:

(Ex. 55C at 48, ¶ 1.2.)

2. The Company Requested and Received Permission to Book the Tenaska Regulatory Asset Despite the Industry Uncertainty PSE Now Claims Justified Its Management of the Fuel Supply.

79 In an effort to justify its management of the Tenaska and Encogen fuel supply, the Company devotes considerable effort to a description of the state of the energy industry at the time the contracts were restructured. (Ex. 11 at 6-8; Ex. 45 at 14-17; Exs. 51, 54 at 1-3, 56, 57, 64, 65 and 71.) The "bottom line" of that presentation is testimony that, as a result of legislative and industry initiatives toward retail competition, the "natural gas and electric industries were in a state of upheaval, which presented fundamental uncertainties." (Ex. 45 at 14: 13-15.) The Company repeats this theme by stating that "PSE was faced with significant load and resource uncertainties . . . " (Ex. 45 at 19: 16.)

80 The Company's argument is the height of contradiction. In 1997, the Company came before the Commission seeking and receiving permission to book a $215 million regulatory asset for Tenaska. That asset has remained on the Company's books and is now the single largest item on the Company's balance sheet. (Ex. 281HC at 14: 3-6; Tr. 344.) In 1999, a similar request was made for the $12.9 million Encogen regulatory asset.

81 In making these requests PSE was required to meet the provisions of Financial Accounting Standard ("FAS") 71. (Ex. 3.) FAS 71 expressly required

the Company to give "consideration to anticipated changes in levels of demand or competition during the recovery period for any capitalized costs." (Ex. 3 at 4739, ¶ 5.c.; Ex. 84 at Annual Report page 28.)

82 The Company stated that it satisfied this provision of FAS 71 at the time the Tenaska and Encogen regulatory assets were booked and amortized on a schedule specifically designed to match anticipated savings in gas costs over the remaining lives of the contracts. (Tr. 344.) The Company cannot now assert that those same competitive pressures and uncertainties justify fuel supply decisions that did not secure those savings nor allow recovery of the regulatory asset itself.

83 Moreover, when the Commission approved the Tenasaka and Encogen regulatory assets, FAS 71 required an assumption that future economic benefits would be created. (Ex. 3 at 4758, ¶ 58.) The Company's management of the fuel supply for these projects has not satisfied that assumption. Its strategy that focused on short-term earnings impaired the future economic benefits that supported the assets in the first place.

84 Finally, FAS 71 no longer applies if, "Regardless of the actions of the regulator," the Company cannot charge rates sufficient to recover the regulatory asset. (Ex. 3 at 4760, ¶ 66.) Thus, the Company's imprudent management of the fuel supply at Tenaska and Encogen may itself require the Company to write-off the unamortized balance of the regulatory assets that still remains on PSE's

books.[12] (Tr. 349.)

3. The Company Relied Upon Volatile Short-Term Gas Markets With Insufficient Analysis of Long-Term Gas Markets.

85 The Company claims that it was prudent for it to purchase gas in spot markets because it had received "long-term quotes with a significant premium versus current and forecasted gas prices, in an environment of relatively stable prices and even falling prices . . . ." (Ex. 45 at 18: 18-22; Exs. 59C and 60C.) Heavy reliance is placed upon a chart that "illustrates the historic information PSE possessed during late 1997 and early 1998 as well as these forward predictions of future market prices, compared with the premium required to lock-in a long-term fixed-price contract." (Ex. 45 at 18: 1-16; Ex. 61.)

86 The Company, however, did not define "significant." Nor did the Company present any analysis to determine when a premium becomes "significant." The Company also was reluctant to pay any premium during the

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[12] Company witness Story speculated under cross-examination that adoption of the Staff recommendation in this case would require the Company to write off the Tenaska and Encogen regulatory assets. (Tr. 344.) This testimony, however, contradicted his pre-filed rebuttal testimony where he stated that the financial impact of the Staff adjustment was "difficult to quantify." (Ex. 220 at 11: 26-27.)

Moreover, the Company chose to reform the Tenaska and Encogen contracts and accept responsibility not only for managing the fuel supply for those projects, but also for demonstrating to the Commission that such management was prudent and produces reasonable costs. Given the Company's failure to make that demonstration, any reactions from the financial community are a risk that PSE's management accepted for shareholders, not ratepayers. (Ex. 281HC at 17-18.)

rate plan period since that would have had a negative impact only on earnings for shareholders. (Tr. 279 and 315.)

87 Moreover, the chart upon which PSE relies shows that spot prices in the years immediately preceding the Tenaska buy-out were actually rising and were doing so more dramatically than the long-term prices shown on the same chart.

88 Spot prices were also extremely volatile preceding the buy-out and, in fact, reached levels that met or exceeded long-term price quotes through the 2004-2005 time frame. Thus, when spot prices were $1.51/MMBtu in 1997 and long-term prices were $1.73/MMBtu for 1998 (Ex. 45 at 17: 22-25), the Company rejected a $.22/MMBtu "premium" that could have eliminated the variability of spot prices in the first few years after the contract restructuring.

89 Most important, the Company's chart does not tell the "whole story." The long-term prices shown on the chart are average market quotes. Thus, they are based upon a spread of price quotes that represent the willingness of sellers to sell and buyers to buy.[13] (Tr. 142-44 and 147.) The Company, however, did not estimate or analyze that potential variability. It exposed ratepayers to the risks inherent in short-term markets without a reasonable understanding of the long-term market alternatives.

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[13] This is seen best in ICNU's Exhibit 237, pages 15-17, which show a variability in long-term price quotes of 2 standard deviations around a median.

4. The Company's Management of the Tenaska Fuel Supply Violated Its Open Meeting Presentation to the Commission.

90 The Company argues that Commission approval of the Tenaska accounting petition was not premised on an understanding that PSE would lock-in future fuel prices for the unit. In support of this argument, the Company relies upon statements it made at the December 10, 1997 Open Meeting that PSE did not intend to lock-in prices. (Ex. 45 at 12: 4-13; Ex. 52 at 5.) The Company also relies upon its response to a data request in Docket No. UE-971619 that gas cost savings could be more or less than the savings reflected in the economic analyses upon which the petition was based. (Ex. 45 at 12: 16-20; Ex. 53.)

91 The Company's argument misses the point. It has never been Staff's position that the Company *should* have locked-in fuel prices for Tenaska or Encogen at the time the accounting petitions were approved. Rather, it is Staff's position that the Company has a statutory obligation to provide safe, adequate and efficient service at fair, just, reasonable and sufficient rates. RCW 80.28.010(1) and (2). That obligation requires the Company to continually evaluate *all* opportunities to obtain fuel for its power plants, and to demonstrate to the Commission that it has done so in a prudent manner and at a reasonable cost. (Ex. 281C at 13: 13-16.) The Company failed to satisfy that obligation by

adopting a narrowly focused strategy for fuel purchases that elevated margin generation over the interests of core customers.

92 Moreover, while the Company indicated at the Open Meeting that the level of savings could increase or decrease, it never stated or implied that there would be *no* savings. (Tr. 238.) Nor did PSE state or imply that the cost of Tenaska would rise above the original contract amount. In fact, the Company advised the Commission, its Board of Directors and the financial community that the savings would be substantial and would outweigh the cost of the buy-outs. Contrary to that advice, including the cost of the regulatory asset, the cost of power under the restructured Tenaska contract now exceeds the cost of power under the original contract. (Ex. 301HC at 9: 2-6.)

93 Finally, at the Open Meeting the Company stated that it intended to manage the fuel supply for Tenaska based upon market prices. (Ex. 52 at 5.) The Company echoed that idea in its petition, stating that restructuring the Tenaska contract would drive the gas cost element of the contract toward "market. . . ." (Ex. 283C at 17, ¶ 5.)

94 The Company's argument *now* narrowly defines "market" to include only near-term markets (Tr. 296), when no such limitation was ever stated to the Commission at the Open Meeting in 1997. In doing so, the argument also ignores the Company's objective that market prices would be those that would "provide

maximum overall benefit to the Company and its customers." (Ex. 283C at 17, ¶ 5; Ex, 283C at 29 and 33.) Thus, a "market" can include near-term or long-term markets, and anything in between. (Tr. 517.)

95 Moreover, Tenaska is a fixed, long-term power resource committed to serving core retail load. (Ex. 281HC at 10: 12-13; Ex. 86 at 2000 Annual Report page 3; Tr. 299.) The restructuring of the power contract also provided PSE the opportunity to mitigate, if not eliminate, $395 million of costs that could have been stranded with retail competition. (Ex. 65 at 26.) The Company should have adopted a strategy for fuel purchases that would rely on *all* markets to protect those interests. It failed to do so.

5. The Company Did Not Manage Fuel Supply for Tenaska and Encogen on a Broad Portfolio Basis.

96 Finally, the Company argues that its fuel management decisions for Tenaska and Encogen cannot be evaluated solely by reference to decisions for those specific plants because those decisions were made on a broad, portfolio basis. (Ex. 45 at 20: 14-20 and 24: 18-20.) At the December 10, 1997 Open Meeting, PSE also represented that the Company wished to manage Tenaska with the rest of the portfolio. (Ex. 52 at 5.)

97 In fact, however, the Company did not manage Tenaska and Encogen as part of a broad portfolio of resources. The Company did not begin to make gas

purchase decisions for its electric generation needs on an aggregated portfolio basis [redacted]. (Ex. 202C at 1.) In fact, the record includes specific examples of fuel purchase decisions and recommendations made individually for Tenaska. (Exs. 66C and 77C at 77-86.)

98 Thus, [redacted], the Company made fuel management decisions for Tenaska and Encogen on a plant-specific basis, and those decisions can and should be evaluated as such.

99 For the reasons set forth above, the Company adopted an imprudent strategy to manage the fuel supply for Tenaska and Encogen. Staff's adjustment ensures that ratepayers are held harmless from the Company's mismanagement by providing ratepayers the level of benefits that supported the cost to restructure the contracts in the first instance. Staff's adjustment should be adopted by the Commission.

E. Resolution of the Gas Price Forecast Debate Can Be Delayed to a Later and More Appropriate Time Under the Staff Recommendation.

100 There was a significant amount of debate concerning the appropriate forecast to use in this case to establish a normalized level of gas cost for

ratemaking purposes.[14] The Company forecasts gas prices of [redacted] using the average NYMEX future prices published during the period September 5, 2003 through September 18, 2003. This period included 10 days of published monthly prices for the rate year.

101 ICNU forecast a gas price of [redacted] using the North American Regional Gas model published by the California Energy Commission.

102 Staff did not forecast gas prices. Rather, it adjusted the normalized level of fuel costs for Tenaska and Encogen using the fixed gas prices that were available to PSE at the time the Company restructured the contracts, but then imprudently managed the fuel supply for those projects. For all other fuel purchases on PSE's system, Staff adopted the Company's NYMEX-based forecast as adequate for purposes of this proceeding. (Tr. 537.)

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[14] There were also some "last minute" hearing proposals by ICNU and the Company with respect to fuel cost for Tenaska. ICNU suggested that the Commission set a normalized cost of gas for Tenaska and then run the actual cost of fuel through the existing Power Cost Adjustment mechanism. (Tr. 399-401.) Staff, Public Counsel and the Company were united in their opposition to this proposal, in part, because the proposal is inconsistent with the intent of the PCA. The proposal would also shift to ratepayers a disproportionate share of the actual costs of Tenaska because those costs would consume a large portion of the PCA "deadband." (Tr. 576-98.) The Commission should reject ICNU's "Alternative 4."

The Company suggested that the Commission modify the PCA to allow gas costs associated with power generation to be passed-through directly to retail electricity customers in a manner similar to the cost of gas purchased by PSE as a local distribution company for retail gas customers. (Tr. 598.) There are, however, more intricate risks and incentives associated with gas purchased to generate electricity for sale to retail customers or into secondary markets, than there are for gas purchased only to meet the needs of retail gas customers. That elevated complexity makes gas purchased for generation ill-suited for direct pass-through. Thus, Staff recommends that the Commission reject the Company's suggestion to directly pass-through the cost of gas to generate electricity in the same manner the Company recovers the cost of gas purchased for retail gas customers.

103 The Staff approach is a reasonable resolution of the gas price forecast debate for this case. Tenaska and Encogen represent the bulk of the gas supply purchased by the Company.[15] Staff proposes to price that gas supply at adjusted levels for ratemaking purposes. Thus, under Staff's recommendation, the controversy regarding gas price forecasts is not significant.

104 As Frederickson and other natural gas turbines become a larger part of PSE's resource portfolio, the debate over gas price forecasts will increase in importance. In a future general rate case or Power Cost Only Rate Case, the parties will be able to devote the time necessary to establish a proper method for determining a normalized fuel cost for ratemaking purposes. (Tr. 538-41.) Indeed, there are indications that a general rate case may soon be filed. Thus, any normalized gas cost that the Commission may set in this case based upon forecasts may be short-lived in any event. (Tr. 539.)

105 As Mr. Schoenbeck stated, this is "a very critical issue that the Commission get this gas price right." (Tr. 387.) Staff believes that the issue requires further scrutiny. It has recommended a course of action that allows the Commission to determine just and reasonable rates in this proceeding, while also reserving the gas price forecast issue for additional study and analysis.

[15] For the rate year, Tenaska and Encogen represent about 81% of the Company's fuel purchases. If Frederickson is actually acquired, that percentage will drop to about 61%. (Exs. 19 and 20.)

IV. THE FREDERICKSON "WUTC APPROVALS" CLAUSE IS INCONSISTENT WITH THE PUBLIC INTEREST AND SOUND REGULATORY POLICY

106 This proceeding allowed the Commission to examine the Company's acquisition of a minority interest in the Frederickson I cogeneration facility in Pierce County. Staff concluded that the acquisition is prudent and the cost reasonable. (Ex. 291HC at 3-9.)

107 The Frederickson agreement, however, contains a clause that allows PSE to terminate the acquisition prior to closing if it does not receive timely "WUTC Approvals". (Ex. 167HC at 80, Article 14.1(a)(ix).) The term "WUTC Approvals" is defined in the same exhibit at pages 22 and 92. In essence, it means a Commission order granting rate recovery of the costs and investment associated with the facility.

108 Staff recommends that the Commission find that this clause is contrary to the public interest and existing sound regulatory policy. (Ex. 281HC at 18-24.)

109 First, as stated above, the Company's statutory obligations are to provide adequate, safe and efficient service at just, fair, reasonable and sufficient rates. RCW 80.28.010(1) and (2). WAC 480-100-238(1) further defines the Company's obligation with regard to resource acquisitions:

> Each electric utility regulated by the commission has the responsibility to meet its load with a least cost mix of generating resources and improvements in the efficient use of electricity.

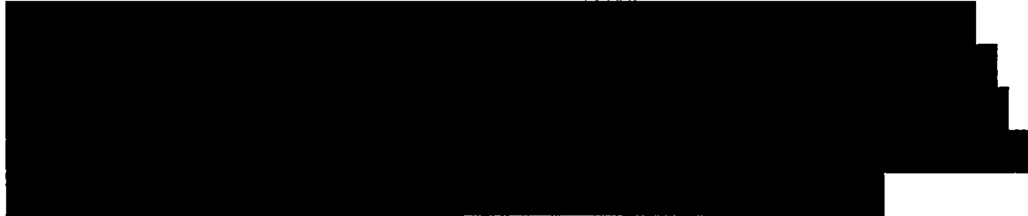
The WUTC Approvals clause improperly shifts the responsibility for fulfilling these obligations from the Company to the Commission. Rather than the Company acquiring resources and then seeking rate recovery from the Commission of reasonable and prudent costs, the WUTC Approvals clause requires the Commission to first provide rate recovery before the Company will consummate a transaction to acquire a resource. (Ex. 281HC at 22: 17-20.) Such "pre-approval" contradicts sound Commission practice and policy that has been in effect since the mid-1980's. (Ex. 281HC at 20-22.)

110 Second, the WUTC Approvals clause also manipulates a Power Cost Only Rate Case to ease the Company's burden to prove that it has prudently acquired resources at reasonable cost. Admittedly, a Power Cost Only Rate Case is single-issue rate proceeding to add new resources and update baseline power costs. (Ex. 281HC at 22: 14-18.) And, the process was designed to expedite ratemaking so that the Company could have rates sufficient to recover the cost of a new resource when that resource went "on-line." (Ex. 17 at 6, ¶ 11.)

111 That process was not, however, intended to eliminate or alter the prudence review of new resource decisions by the Company. (Tr. 103.) The Company is well aware of its obligations before the Commission, having included a lengthy and detailed description of Commission precedent on

prudence standards. (Ex. 16.) It does not require more information, more process certainty, or more understanding of regulatory risks to "know and understand precisely what the Commission expects of us" when the Company plans and executes its resource acquisition program. (Ex. 182 at 7: 1-16.)

112 Third, the WUTC Approvals clause may also affect the solicitation process and bid prices for new resources. The evidence demonstrates that PSE would only consider proposals if it could terminate the contract in the event the Commission did not approve full ratemaking of the acquisition. This was the clear message that PSE communicated in negotiations with prospective resource developers or sellers:



(Ex. 184HC at 1.) Thus, while Staff does not question the prudence of the Frederickson acquisition, the Company's negotiation strategy may restrict the universe of project developers that respond to a solicitation. Indeed, the Company admitted that it could not know if there were developers that did not respond to PSE's solicitation because of the WUTC Approvals clause. (Tr. 105.)

113 Fourth, since the Company does not own its share of Frederickson until it receives WUTC Approvals, the facility was not available to PSE earlier to use in

its resource portfolio either to serve retail load or to generate electricity for sale into secondary markets. Thus, through the WUTC Approvals clause, the Company lost value that earlier ownership of Frederickson would have provided even though it was not yet included in rates.

114 Finally, there was disagreement between Staff (Ex. 281HC at 23-24 and Ex. 288) and the Company (Ex. 182 at 9: 9-23) as to whether the WUTC Approvals clause increased the cost of the Frederickson acquisition. The disagreement centered on Exhibit 184HC.

115 It is difficult for either party to quantify the impact the clause had on cost since the clause was negotiated as part of the entire contract and, thus, many variables affected the consideration paid or relinquished. (Ex. 281HC at 24: 6-8; Tr. 96.) However, the Company negotiated the WUTC Approvals clause in order to reduce regulatory risk. (Ex. 182 at 4: 16-26.) It admitted that there may be a cost attributable to that objective. (Tr. 97.)

116 The Company also admitted that the seller expressed a "concern" during the negotiations regarding the length of time necessary for PSE to obtain Commission approval. (Ex. 184HC at 2; Ex. 288.) That concern would have translated into additional risk for the seller that would require some compensation. In fact, the Company agreed that the seller's concern would have

been eliminated had the WUTC Approvals clause not been required by PSE. (Tr. 101.)

117 The WUTC Approval clause requires the Commission to determine whether and at what amount ratepayers should be compensated for risks that are more properly aligned with shareholder interests. (Ex. 281HC at 24: 8-10.) The Commission should avoid being placed in that position by finding that the clause is not consistent with the public interest and sound regulatory policy.

V. CONCLUSION

118 For the reasons set forth above, the Commission, at a minimum, should adopt Staff's adjustment to disallow power costs for Tenaska in order to implement the 19th and 20th Supplemental Orders in the Prudence Review.

119 Beyond that, Staff's fuel cost adjustment is fully supported by evidence of PSE's imprudent management of the Tenaska and Encogen restructured contracts and the unreasonable costs that have resulted from that mismanagement. The Commission should adopt the Staff adjustment, which provides ratepayers the benefits that PSE itself presented to justify restructuring the contracts in the first instance.

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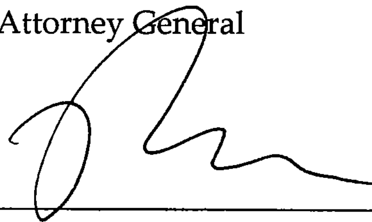
120 Finally, the Commission should find that the "WUTC Approvals" clause contained in the Frederickson acquisition contract is inconsistent with the public interest and sound regulatory policy.

DATED This 12th day of March, 2004.

Respectfully submitted,

CHRISTINE O. GREGOIRE
Attorney General



Robert D. Cedarbaum, WSBA #11770
Senior Counsel
Washington Utilities and
Transportation Commission
(360) 664-1188