

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION	1
II. ARGUMENT	1
A. PSE Has Not Met its Burden to Demonstrate That It Has Managed the Tenaska Gas Supply in a Reasonable and Prudent Manner.....	1
1. PSE Created the Expectation that Cost Savings Would Flow From the Tenaska Buyout.....	3
2. The PSE Timeline is the Type of After-the-Fact Analysis that the Company Claims is Improper	5
3. Information Available to the Company at the Time It Made Its Decisions Demonstrates that PSE’s Actions Were Imprudent	7
a. The Commission Ordered PSE to Provide Reasoned Analysis and Contemporaneous Evidence to Justify Its Tenaska Decisions	8
b. PSE Has Provided No Reasoned Analysis or Contemporaneous Evidence to Support its Decisions With Respect to the Tenaska Gas Supplies.....	9
i. PSE Had No Strategy for Procuring Tenaska Gas or Managing Risk from 1997-2000	9
ii. PSE Has Not Rebutted the Evidence of Its Imprudence Following the Western Power Crisis	15
B. The California Energy Commission Forecast is a Reliable, Fundamentals-Based Projection of a Normalized Gas Cost to be Used in the PCA.....	19
1. The CEC Forecast is Reliable	19
2. The Baseline Should Reflect Normalized Power Costs.....	21

3.	The CEC Report Includes Reliable Gas Price Forecasts Derived from a Fundamentals Model	23
a.	The Pacific Gas & Electric Application Used the CEC Forecast to Calculate the Competitive Transition Charge	23
b.	No Commission Precedent Requires Use of a NYMEX Average	24
c.	The Values in PSE’s Fundamentals Analysis Undermine its Criticisms of the CEC Forecast Prices	25
C.	The Commission Should Exercise Its Discretion to Adopt Any One of a Number of Appropriate Remedies in this Proceeding	27
1.	Staff’s Initial Brief Demonstrates the Importance of the Gas Price Issue	27
2.	The Tenaska Regulatory Asset Should be Removed from Rate Base to Reflect PSE’s Imprudent Management.....	29
III.	CONCLUSION.....	32

I. INTRODUCTION

1 In Puget Sound Energy's ("PSE" or the "Company") Initial Brief ("PSE Brief"), the Company argues that the Washington Utilities and Transportation Commission ("WUTC" or the "Commission") should not adopt the adjustments proposed in this proceeding that relate to: 1) PSE's inflated Sumas gas price; and 2) the Company's imprudent and unreasonably risky management of the Tenaska gas supply since the Company bought out the Tenaska contract in 1997. The Industrial Customers of Northwest Utilities ("ICNU") submits this Reply Brief and urges the Commission to reject PSE's arguments and adopt the adjustments proposed by ICNU. If the Commission adopts ICNU's recommendations, it would reduce the overall revenue requirement requested by PSE for the period April 2004 to March 2005 (the "Rate Period") by approximately \$64.4 million.

II. ARGUMENT

A. PSE Has Not Met its Burden to Demonstrate That It Has Managed the Tenaska Gas Supply in a Reasonable and Prudent Manner

2 PSE argues that it has justified recovery of its Tenaska costs during the Rate Period for the following reasons: 1) PSE did not "guarantee" any benefit of the Tenaska buyout; 2) the Staff and ICNU adjustments are based on hindsight; and 3) Staff and ICNU have not alleged specific instances of imprudence or mismanagement by the Company.^{1/} These arguments are erroneous and fail to demonstrate that PSE's actions were prudent or reasonable.

^{1/} PSE Brief at 26-27, 29; Exh. No. 77C at 25.

3

PSE fails to recognize that the Company mismanaged the Tenaska gas supply regardless of whether the Company “guaranteed” a benefit to customers. All of PSE’s representations regarding the Tenaska restructuring, including those made to the Commission, PSE’s shareholders, Board of Directors, and customers indicated that the Company would achieve savings.^{2/} PSE’s failure to achieve any of the promised gas cost savings was a result of a combination of factors, all of which demonstrate the Company’s imprudence.

4

In addition, PSE has not demonstrated that its management of the Tenaska gas supply and its failure to produce customer benefit was prudent. To meet this burden to demonstrate prudence, PSE must: 1) initially present “reasoned analysis” and contemporaneous evidence from the time the Company’s decisions were made to demonstrate its prudence and justify recovery; and 2) rebut the evidence of imprudence put forth by Staff and ICNU with contrary evidence that demonstrates the Company’s actions were reasonable.^{3/} PSE has not met either of these requirements. PSE has produced no contemporaneous evidence of its decisions at the time they were made. PSE has also failed to provide reasoned analysis justifying its actions or rebutting the evidence put forth by ICNU and Staff. The evidence that PSE has put forth, which consists of unsupported assertions and post-hoc timelines, is insufficient.

5

The evidence in the record demonstrates that, despite PSE’s representations that it would manage the Tenaska gas requirements in the early years

^{2/} Exh. No. 283C at 27; TR. 271: 3-6, 314: 3-12 (Gaines); Staff Brief at 16-20.

^{3/} Exh. No. 82 at 15-16; see Re PacifiCorp, Oregon Public Utility Commission Docket No. UE 116, Order No. 01-787 at 6 (Sept. 7, 2001).

following the buyout, the Company had no management strategy and inadequate risk controls in place during the 1997-1999 period. In addition, in both the early years following the buyout and the period following the Western power crisis, PSE repeatedly passed up the opportunity to secure long-term gas for Tenaska despite its knowledge of the risks involved. PSE's Initial Brief does not sufficiently rebut the evidence of these imprudent actions.

1. PSE Created the Expectation that Cost Savings Would Flow From the Tenaska Buyout

6 PSE's Initial Brief attempts to minimize the claims of savings the Company made prior to and following the restructuring of the Tenaska agreement in 1997. PSE argues that it "never guaranteed" that it would achieve any savings as a result of the Tenaska buyout and that the Commission and customers "always understood that the level of actual savings achieved from the Tenaska buyout would depend upon the level of actual market prices."^{4/} PSE's argument is completely inconsistent with the representations it made in 1997. Moreover, PSE implies that the Commission erred in approving the restructured Tenaska agreement because the WUTC was informed that the cost of gas for Tenaska would be subject to the whim of the short-term market. In short, PSE attempts to demonstrate its prudence by claiming that the parties were warned that the Company would not make any particular effort to achieve gas cost savings.

7 PSE's discussion of its actions in 1997 is notable for a number of reasons. First, in PSE's account of the proceedings surrounding its 1997 petition, the Company

^{4/} PSE Brief at 30.

cites the actual petition only once.^{5/} PSE fails to mention that, regardless of whether its intent was to move the Tenaska supply to market pricing, the Company still represented that the buyout would result in [REDACTED] of gas cost savings.^{6/} As Staff points out, PSE also made similar representations to the Commission, the Company's Board, shareholders, and the financial community.^{7/} PSE's attempt to minimize the significance of the representations it made at the time of the 1997 restructuring is particularly troubling given the Company's subsequent acknowledgment that it [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]^{8/}

Furthermore, regardless of the Company's current wordplay, Mr. Gaines acknowledged that PSE never represented that there would be no savings from the buyout, which is what has occurred.^{9/}

8 The Company equates disclosure of its intention to manage the Tenaska gas supply as part of its overall portfolio (rather than locking in a long-term supply) with prudence.^{10/} This is not the case. One of the primary reasons PSE was imprudent with respect to Tenaska is that the Company had no strategy to manage the Tenaska gas supply following the buyout.^{11/} PSE's disclosure that it wanted to "manage [Tenaska]

^{5/} PSE Brief at 30 (stating, "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.*" (emphasis in original)).

^{6/} Exh. No. 283C at 27; TR. 271: 3-6, 314: 3-12 (Gaines).

^{7/} Staff Brief at 16-20.

^{8/} Exh. No. 77C at 25.

^{9/} TR. 238: 2-4 (Gaines).

^{10/} See PSE Brief at 31.

^{11/} See ICNU Initial Brief at 24-30.

with the rest of [its] portfolio” is meaningless if the Company’s “management” consisted entirely of purchasing gas in the spot and short-term markets.^{12/}

9 Finally, PSE states: “it was always understood that the level of actual savings achieved from the Tenaska buyout would depend upon the level of actual market prices[,]” implying that the Company had no control over whether savings were realized.^{13/} Customers should not pay for a regulatory asset related to Tenaska if the purpose of the buyout was only to allow PSE to purchase gas in the spot market for fourteen years. This obviously was not the Commission’s or customers’ understanding. PSE admits in its Initial Brief that the rise in gas prices has been “disappointing.”^{14/} Due to PSE’s almost exclusive reliance on the spot and short-term markets for Tenaska gas, this rise in market prices has been particularly “disappointing” to customers—it has cost them ██████████ from 1998-2003.^{15/} PSE should no longer recover the cost of (and a return on) the Tenaska regulatory asset when the Company’s imprudent management of the agreement has resulted in such substantial costs to customers.

2. The PSE Timeline is the Type of After-the-Fact Analysis that the Company Claims is Improper

10 PSE also accuses ICNU and Staff of evaluating the Tenaska contract with hindsight and proposing disallowances “just because gas prices are higher today than the prices that the Company projected in 1997 and 1999.”^{16/} Hindsight analysis is not necessary because the evidence of PSE’s imprudence is so compelling. The documents

^{12/} Exh. No. 52 at 4; Exh. No. 77C at 26.

^{13/} PSE Brief at 30.

^{14/} Id. at 25.

^{15/} Exh. No. 231C at 28: 24 (Schoenbeck).

^{16/} PSE Brief at 27.

from PSE's Risk Management Committee ("RMC") meetings along with the other information obtained in discovery demonstrate that PSE ignored its risk management consultants and repeatedly passed up opportunities to secure long-term gas supplies in search of greater revenues for shareholders. The evidence reflects that PSE passed up those opportunities the first time in the early years following the buyout and then repeated that imprudent decision after the Western power crisis. Even worse, the evidence shows that the Company was almost exclusively focused on generating short-term profits from Tenaska rather than developing a strategy to manage long-term risk.^{17/}

11 In contrast to the contemporaneous evidence of imprudence offered by ICNU and Staff, the evidence that the Company urges the Commission to consider consists entirely of after-the-fact analysis. PSE provides no evidence of its actual decisions or the strategy it had in place to address the Tenaska gas supply. Instead, the primary evidence that PSE relies upon to demonstrate prudence is the "Gas Timeline" that the Company attached to its Initial Brief.^{18/} PSE repeatedly points the Commission to this timeline in order to justify its actions.^{19/} According to PSE, the Gas Timeline is intended to provide a "historical frame of reference" for the Company's decisions.^{20/} This timeline consists entirely of hindsight analysis prepared specifically for this proceeding.^{21/} Thus, it is not evidence upon which PSE can demonstrate prudence. The Commission has made clear to PSE that "reasoned analysis" and contemporaneous

^{17/} Exh. No. 77C at 26.

^{18/} PSE Brief at Attachment A.

^{19/} Id. at 28-29, 34-38.

^{20/} Id. at 29.

^{21/} Exh. No. 51; TR. 326: 15-17 (Gaines).

documentation are necessary to support the Company's Tenaska decisions, not historical context.^{22/}

3. Information Available to the Company at the Time It Made Its Decisions Demonstrates that PSE's Actions Were Imprudent

12 According to PSE, ICNU's and Staff's arguments that the Company failed to meet its burden to demonstrate prudence are improper because they do not identify specific imprudent decisions by the Company.^{23/} PSE is mistaken. ICNU has argued that the Tenaska costs should be disallowed in this proceeding because: 1) PSE failed to meet its burden to demonstrate its prudence; and 2) the evidence in the record demonstrates that the Company made specific, imprudent decisions.^{24/} The specific information in the record from 1997-2000 reflects the Company's inadequate risk controls, lack of gas management strategy, and admissions that it mismanaged the Tenaska agreement.^{25/} Similarly, the evidence of the Company's actions following the Western power crisis demonstrates that PSE ignored the information before it and continued to purchase for only the short-term, despite the Company's acknowledgement that it was unreasonable to do so.^{26/} Finally, despite PSE's protests, it has the burden to demonstrate its prudence in this proceeding based on the evidence in the record. There is nothing improper about a general allegation that the Company failed to meet its burden, especially since the Company has a history of failing to demonstrate its prudence with respect to the Tenaska agreement.

^{22/} Exh. No. 82 at 15-16.

^{23/} PSE Brief at 26.

^{24/} ICNU Initial Brief at 6-7, 24-30.

^{25/} Exh. No. 77C at 26, 28.

^{26/} Id. at 25.

a. The Commission Ordered PSE to Provide Reasoned Analysis and Contemporaneous Evidence to Justify Its Tenaska Decisions

13 PSE's argument that it is somehow improper for Staff and ICNU to allege that the Company has failed to demonstrate prudence conflicts with the Commission's prior orders regarding the Company's Tenaska decisions. The Commission has been unequivocal that PSE must demonstrate the prudence of its actions with respect to Tenaska and that PSE must provide "reasoned analysis" and contemporaneous documentation to demonstrate prudence.^{27/} The Commission first determined that PSE had acted imprudently in acquiring Tenaska and a number of other resources in 1994. The Commission stated that it was almost "beyond the Commission's comprehension" that PSE did not provide any "reasoned analysis" or maintain "a file on each of these projects in which it tracked its progress in its decision making, and the studies made to support decisions."^{28/} PSE seems to have learned little from its past errors. For example, PSE failed to keep any organized records of the decisions or recommendations of the RMC until 2000, six years after the WUTC issued the order indicating that it would require such documentation.^{29/}

14 In 1997, when the Commission authorized the creation of the Tenaska regulatory asset, the Commission explained that PSE's "actions in purchasing the gas sales contract, managing the cost of gas, and restructuring the power purchase agreement [are] subject to review in future rate proceedings [and that] the Company bears the

^{27/} Exh. No. 82 at 15-16.

^{28/} Id. at 15-16, 47.

^{29/} Exh. No. 208 at 1.

burden of proof in any such proceeding regarding these matters.”^{30/} PSE could have locked in the savings that it promised in order to obtain approval of creating the regulatory asset. Instead, PSE chose to manage the gas supply itself. As a result, it was incumbent on PSE to develop and document a strategy for delivering the savings.

b. PSE Has Provided No Reasoned Analysis or Contemporaneous Evidence to Support its Decisions With Respect to the Tenaska Gas Supplies

15 ICNU has focused its specific allegations of imprudence on two discrete time periods. First, PSE’s management of the Tenaska gas supply was imprudent during the 1997-2000 time period because the Company: 1) had no strategy in place for procuring Tenaska gas supplies; 2) had inadequate risk controls in place to manage its exposure during this period; and 3) was passing up opportunities to secure long-term gas supplies in pursuit of greater short-term savings. Second, after the Western power crisis, PSE again imprudently decided to not secure any long-term gas supplies, even though the Company had determined that its failure to do so during the 1997-2000 period was a mistake and knew the risk of being short.

i. PSE Had No Strategy for Procuring Tenaska Gas or Managing Risk from 1997-2000

16 PSE touts its representations that it intended to “manage” the Tenaska gas supply following the buyout rather than lock in long-term supplies.^{31/} However, the Company has produced absolutely no evidence that it had any coherent strategy for managing the Tenaska gas supply from 1997-2000. The evidence in the record from this

^{30/} Exh. No 283C at 37.

^{31/} PSE Brief at 31, 34-35.

period indicates that PSE's risk management controls were inadequate and that the Company was purchasing in only the spot or short-term markets. Furthermore, the evidence indicates that PSE failed to develop such a strategy in the early years of the buyout because the Company was focused on generating short-term savings rather than minimizing long-term risk exposure. It was imprudent for PSE to fail to implement a plan when the Company knew that it had created the expectation of substantial savings.

17

The evidence in the record demonstrates that PSE was aware of the following facts when it decided to not secure any long-term gas supply for Tenaska in the early years following the buyout:

- The Commission had declared the original Tenaska agreement imprudent and the Company had an ongoing obligation to demonstrate the prudence of its actions in future proceedings by providing a contemporaneous reasoned analysis;^{32/}
- The Company represented to the Commission, its Board of Directors, the financial community, and customers that it expected to produce significant cost savings in managing the Tenaska gas supply;^{33/}
- [REDACTED]^{34/}
- [REDACTED]^{35/}
- PSE was subject to the merger rate plan and the Company would bear the burden and reap the reward of any additional costs or revenues that it incurred.^{36/}

^{32/} Exh. No. 82 at 47; Exh. No. 283C at 37.

^{33/} Exh. No. 283C at 4-18; TR. 307: 22-24 (Gaines).

^{34/} Exh. No. 77C at 26.

^{35/} See Exh. No. 66C at 1-4; ICNU Initial Brief at 26.

^{36/} TR. 315: 5-10 (Gaines).

- The Company was obligated to procure gas for the Tenaska facility for the next fourteen years; and

- [REDACTED]^{37/}

These facts indicate that supplying the Tenaska agreement exclusively with short-term market purchases would be excessively risky. Nevertheless, for the most part, this is exactly what PSE did.^{38/}

18 PSE argues that it minimized the excessive risk associated with the short-term market by employing a number of risk management tools during this period, including a number of hedge transactions.^{39/} The only evidence that PSE provides of its hedging activities consists of four emails that demonstrate: 1) [REDACTED]

[REDACTED]^{40/}

The fact that this is the only evidence that PSE could find to support its claim of prudent management is quite revealing. Seven months of hedging a fourteen-year gas supply requirement hardly represents a comprehensive or coherent hedging strategy. Furthermore, PSE provides no evidence of any other hedges that it entered into for the 1997-2000 period.

19 In addition, the four emails that represent PSE's hedging activity during this period illustrate that the Company was not managing the Tenaska gas supply

^{37/} Exh. No. 283C at 27.

^{38/} Id. at 35.

^{39/} Id. at 35-36.

^{40/} PSE Brief at 35; Exh. No. 66C at 1-4.

according to whether it could achieve the “target” gas prices projected in the 1997 petition. Instead, the Company was intent on [REDACTED]:

[REDACTED]

[REDACTED]^{41/}

All additional savings that PSE achieved went solely to shareholders as PSE was subject to the merger rate plan during the early years following the buyout. PSE is now seeking to subject customers to the long-term risk of a spot market strategy that was undertaken to enrich its shareholders.

20

PSE argues that the Company would have been subject to a “risk premium” if it had secured long-term gas in the early years following the buyout.⁴²

However, in light of the fact that [REDACTED], PSE’s argument that it did not execute any long-term transactions due to this risk premium falls flat.^{43/} If PSE was [REDACTED], it must provide some “reasoned analysis” to demonstrate why it was prudent to do so. The record is devoid of any such evidence. In fact, the record is devoid of evidence of any longer-term transactions that PSE ever

^{41/} Exh. No. 66C at 3.

⁴² PSE Brief at 36.

^{43/} Exh. No. 77C at 26; Exh. No. 66C at 3.

considered, any evidence of the amount of the risk premium the PSE claims it was subject to, or how that premium compared to the target prices in Exhibit B. The reasoning in the email indicates that the Company would not have executed any longer-term transaction unless it could have paid the “risk premium” [REDACTED]

[REDACTED]^{44/} Without any reasoned analysis to justify this action (which PSE has not provided), the Commission must conclude that PSE was imprudent.

21 PSE’s ultimate justification for its actions during 1998-1999 is that it was prudent for the Company to rely on the short-term market because “[g]as prices continued [to be] low and stable through 1998 and 1999 as shown in the Gas Timeline.”^{45/} As described above, the Gas Timeline is not contemporaneous documentation that justified PSE’s decisions at the time they were made, but an after-the-fact rationalization of the Company’s actions. PSE has provided no evidence from the late 1990s of any coherent strategy for supplying Tenaska or managing risk during this period.

22 Furthermore, PSE’s claim that gas prices “began to rise unexpectedly in 2000” is inaccurate.^{46/} PSE’s historical data indicates that prices were significantly above those assumed in the Exhibit B analysis by June of 1999 and rarely dropped back down to anything near their former levels.^{47/} In other words, even if the Commission were to accept PSE’s post-hoc explanation of its reliance on spot market and short-term purchases, the Company’s approach worked for only a short time.

^{44/} Exh. No. 66C at 3.

^{45/} PSE Brief at 36.

^{46/} Id. at 37.

^{47/} Exh. No. 97C; TR. 443: 7-445: 16 (Schoenbeck).

PSE also argues that its actions after 1999 were prudent because the long-term forecasts that the Company “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.”^{48/} The December 22, 1999 PIRA U.S. Gas Market Forecast that PSE cites tells a different tale:

[REDACTED]

[REDACTED]

[REDACTED]
^{50/}

A chart in the PIRA report [REDACTED]

[REDACTED]^{51/} This

contemporaneous evidence indicates that the Company should not have continued to rely on the short-term market from 1999 into 2000. PSE has provided no evidence to

demonstrate that it reacted [REDACTED]

[REDACTED] in any manner other than continuing to buy short-term market gas.

^{48/} PSE Brief at 36.

^{49/} Henry Hub is the major clearinghouse for gas. Prices at Sumas have traditionally been lower than at Henry Hub, but there is no basis to believe that these price pressures did not apply at Sumas.

^{50/} Exh. No. 68C at 4.

^{51/} Id.

ii. PSE Has Not Rebutted the Evidence of Its Imprudence Following the Western Power Crisis

24

PSE's decisions with respect to procuring Tenaska gas following the Western power crisis also were imprudent. In June 2000, PSE completed a Tenaska Business Case Analysis in which the Company acknowledged that it should have managed the Tenaska gas supply differently in the early years after the buyout.^{52/} As a result, PSE began to focus more on developing a strategy for procuring the Tenaska gas supply and adopting risk controls. One would expect that PSE would have learned from the Tenaska Business Case Analysis, the advice of newly hired risk management consultants, and the experience of witnessing the extreme market volatility during the Western power crisis. Nevertheless, in early 2002, the Company again imprudently chose to pursue greater savings for shareholders in the short-term market, despite its awareness of the risk of this strategy.

25

PSE has not responded to ICNU's specific allegation of imprudence action during the late 2001 to early 2002 time period. Similarly, PSE has not provided any reasoned analysis or contemporaneous evidence of its actual decisionmaking to rebut ICNU's specific allegations of imprudence following the December 13, 2001 RMC meeting. The record reveals that PSE was aware of the following information following the Western power crisis:

- The short-term gas market could be extremely volatile. PSE had witnessed the crippling effect on other utilities' financial health due to the excessive exposure to the spot market during the Western power crisis;

^{52/} Exh. No. 77C at 28.

- PSE had acknowledged that it was [REDACTED] in terms of risk management controls;^{53/}
- PSE completed the Tenaska Business Case Analysis, in which it acknowledged that during the early years after the buyout the Company [REDACTED]^{54/}
- PSE had employed a risk management consultant that warned the Company [REDACTED]^{55/}
- The risk management consultant also warned, [REDACTED]^{56/}
- PSE had ten years left on the Tenaska contract [REDACTED]^{57/}
- The Federal Energy Regulatory Commission had imposed west-wide price caps in the spot markets for electricity;
- Market prices had come down to a large extent after the Western power crisis;
- PSE knew where it stood in terms of recognizing the savings it had represented on the buyout, because the Company consistently benchmarked current market conditions against the projected savings;^{58/}

^{53/} Exh. No. 77C at 12

^{54/} Id. at 28; TR. 330: 11-16 (Gaines). PSE argues that this quote indicates that the Company actually executed hedging transactions. PSE Brief at 38; TR. 330: 11-20 (Gaines). The plain language and context of the quote contradict PSE's interpretation. In addition, as described above, the Company has provided almost no evidence of any hedge transactions executed during the 1997-2000 period.

^{55/} Exh. No. 77C at 36.

^{56/} Id. at 60.

^{57/} Id. at 78.

^{58/} TR. 281: 14-25 (Gaines).

- [REDACTED] and^{59/}
- [REDACTED]^{60/}

26 Despite having knowledge of the potential to achieve savings and receiving specific warnings about the risks of being short, the Company did not secure any long-term gas supply for Tenaska. This is one of the most stunning elements of PSE imprudent actions: [REDACTED]

[REDACTED]

[REDACTED]^{61/} Once market prices began to rise in March 2002, PSE’s focus on larger shareholder gains had once again caused it to imprudently pass over another opportunity to lock in savings for customers.

27 The only evidence PSE has offered to demonstrate its prudence is generic evidence of its actions following the Western power crisis: 1) the fact that PSE bought some risk assessment software (KW 3000) in 2002; 2) the Company no longer hedges on a facility-specific basis; and 3) market price forecasts supported its decision.^{62/}

28 The fact that PSE purchased risk assessment software does not demonstrate prudence. Notably, the software could not have assisted PSE because it was purchased after PSE made the critical decisions during and after the December 13, 2001

^{59/} Exh. No. 77C at 83, line 15.
^{60/} Id. at 84, line 15.
^{61/} Id. at 77C at 78.
^{62/} PSE Brief at 39-40.

RMC meeting. In any event, PSE's failure to hedge the long-term Tenaska requirement demonstrates that the Company was willing to ignore the warnings of the risk management consultants it hires. Under these circumstances, there is no basis to conclude that risk assessment software would change PSE's behavior.^{63/}

29 Although PSE puts forth unsupported contentions that it "has continued to engage in gas hedging activities since the Western Power Market Crisis ended," the Company has presented no actual evidence of these activities.^{64/} PSE mentions that it implemented a dollar cost averaging strategy, and that the Company "established plans" to reduce its exposure, but there is no evidence that the Company has actually done so.

30 Finally, PSE maintains that market price forecasts in late 2002 justify its prudence because "long-term, fixed-price agreements . . . continued to command a premium over current and projected spot market prices."^{65/} First, price forecasts from late 2002 cannot justify PSE's failure to secure long-term gas supply during 2001 and early 2002, when the Company had identified market conditions that created the opportunity to achieve savings. Second, even if PSE had addressed the specific instances of imprudence, price forecasts alone are not a basis upon which to demonstrate that the Company acted reasonably. At some price level, it would have been reasonable to accept the "risk premium" given the risk involved, especially considering the Company's first-hand knowledge of the long-term effects of purchasing the Tenaska requirement in the spot market. PSE has never provided any evidence that it tried to determine what level of

^{63/} See Exh. No. 77C at 36.

^{64/} PSE Brief at 39.

^{65/} *Id.* at 40.

“risk premium” would be reasonable or whether long-term gas supplies with an acceptable risk premium were available.

B. The California Energy Commission Forecast is a Reliable, Fundamentals-Based Projection of a Normalized Gas Cost to be Used in the PCA

31 PSE argues that its average NYMEX futures price is more appropriate for setting the gas price assumptions in this case than the fundamentals-based value that ICNU derived from the December 2003 California Energy Commission (“CEC”) Report. According to PSE, the Commission should adopt its NYMEX average value because: 1) the NYMEX values are unbiased and reliable; 2) the PCA power cost Baseline (“Baseline”) was intended to reflect actual power costs; and 3) ICNU has not shown that values from the CEC forecast should be used in this proceeding.^{66/} The Company’s arguments in favor of its NYMEX-based value do not demonstrate that an average of future market prices is appropriate. As Mr. Schoenbeck has made clear, normalized values must be used to establish the Baseline in order to ensure that PSE does not over-recover or under-recover its power costs through the PCA.

1. The CEC Forecast is Reliable

32 PSE has questioned both the accuracy and reliability of the CEC forecast as well as the basis for Mr. Schoenbeck’s recommendation that the CEC forecast be used because it is produced using the North American Regional Gas (“NARG”) model with which he is familiar.^{67/}

^{66/} Id. at 46.

^{67/} Id. at 43, 46.

33 PSE's criticisms of the CEC forecast are unpersuasive. PSE claims that NYMEX values are inherently unbiased and reliable, but the Company avoids Mr. Schoenbeck's criticism that the Company's NYMEX average is based on a lack of liquidity in the NYMEX market. PSE asserts that the NYMEX average is accurate because NYMEX prices are "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."^{68/} This statement, however, invites the question: who are the multitude of entities buying and selling for this future period?

34 The evidence in the record demonstrates that it was not a multitude of willing buyers and sellers executing transactions for the Rate Period during the ten-day period in September 2003 that PSE used to calculate its average. In fact, the entities transacting for the Rate Period bought and sold barely 1% of the total transactions volumes on those days.^{69/} The transactions for the majority of the Rate Period constituted 0% of the total transaction volumes.^{70/} In other words, NYMEX prices may be determined as a result of market transactions, but the price that was produced for the Rate Period during September 2003 had little meaning because there were not enough transactions.

35 PSE also implies that the CEC forecast is somehow inappropriate because Mr. Schoenbeck proposed using the results due to his familiarity with the NARG model. As Mr. Schoenbeck explained at hearing, the CEC is an independent organization that

^{68/} Id. at 43.

^{69/} Exh. No. 231C at 14: 6-15: 4 (Schoenbeck).

^{70/} Id.

produces gas forecast without any bias towards utilities or customers.^{71/} As a result of the transparency of the model and Mr. Schoenbeck's familiarity with it, he proposed using the CEC results because the expedited schedule in this case did not permit exploring other options.^{72/} This is hardly a basis upon which to discredit Mr. Schoenbeck's proposals.

2. The Baseline Should Reflect Normalized Power Costs

36 A fundamental question regarding the gas price dispute is whether the gas price assumed in the Baseline should reflect actual costs or normalized costs. PSE claims that Staff agrees with its position that the power cost Baseline should reflect an estimate of "actual power costs;" however, both Staff's Initial Brief and the Staff testimony cited by the Company do not support this contention.^{73/} In its Initial Brief, Staff states that the gas price issue "requires further scrutiny," and suggests that the parties should "establish a proper method for determining a *normalized* fuel cost for ratemaking purposes" in a future case.^{74/} Staff's reference to a "normalized" cost is inconsistent with PSE's use of actual costs.

37 In addition, despite PSE's claim that Staff witness Merton Lott stated support for the use of actual costs in the baseline, Mr. Lott does not make any such statement.^{75/} In fact, Mr. Lott repeatedly states that the PCA was intended to allow the Company to recover only the cost of "major fluctuations in short-term power costs."^{76/}

^{71/} TR. 375: 22-23, 377: 13-14 (Schoenbeck).

^{72/} Id.

^{73/} PSE Brief at 45 *citing* TR. 579: 19-581: 25 (Lott); Staff Brief at 47.

^{74/} Staff Brief at 47 (emphasis added).

^{75/} TR. 579: 19-581: 25 (Lott).

^{76/} TR. 579: 22-23, 580: 17-18, 581: 5-10 (Lott).

This emphasis on major power cost fluctuations is consistent with the example Mr. Schoenbeck put forth to demonstrate why the PCA requires a normalized power cost Baseline.^{77/} If the Baseline was set according to actual power costs that were much higher than normal and a “major” cost increase occurred, PSE would over-recover its actual power costs because customers would be responsible for more of the increase through base rates (in addition to the proportion they bear under the sharing mechanism).^{78/} This would depart from the intent of the PCA, which was to allow the Company and customers to equitably share the burden and benefits of deviations from the Baseline through the PCA sharing bands.^{79/}

38

Finally, PSE indicates that setting the gas price too low will ensure under-recovery of the Company’s costs during the Rate Period.^{80/} As described in ICNU’s Initial Brief, PSE already has exceeded the \$40 million cumulative PCA cap above which customers are responsible for 99% of the Company’s excess costs.^{81/} Thus, the Company’s risk of under-recovery if the Baseline is set too low is much less than the risk of customers over-paying if the Baseline is set too high.^{82/} Furthermore, PSE’s focus on the Rate Period alone is unreasonable. The Baseline established in the proceeding may remain in effect well after the Rate Period because the PCA has no definite termination

^{77/} Exh. No. 231C at 7: 3-18 (Schoenbeck).

^{78/} Id.

^{79/} Id.

^{80/} PSE Brief at 45.

^{81/} ICNU Initial Brief at 9.

^{82/} Id.

date.^{83/} This proceeding should focus on establishing a normalized Baseline for use in the PCA.

3. The CEC Report Includes Reliable Gas Price Forecasts Derived from a Fundamentals Model

39 PSE questions ICNU's use of the CEC forecasts on the basis that: 1) the CEC forecast has not been used to set rates in other regulatory proceedings; and 2) ICNU has not explained why the CEC fundamentals-based forecast price differs from PSE's NYMEX average value.

a. The Pacific Gas & Electric Application Used the CEC Forecast to Calculate the Competitive Transition Charge

40 PSE argues that the CEC forecast is inappropriate for use in this proceeding because other regulatory bodies have not used the forecast in the past.^{84/} PSE also maintains that Mr. Schoenbeck was mistaken that a recent Pacific Gas & Electric ("PG&E") application at the California Public Utilities Commission ("CPUC") included CEC forecast prices.^{85/} PSE is wrong on both counts.

41 In response to a PSE data request in this proceeding, Mr. Schoenbeck stated that he was "aware of two recent CPUC proceedings where reported CEC gas prices were used in deriving rate charges. These are [CPUC Docket Nos.] R.02-01-011 and A.03-10-022. In both cases, a CEC derived value was used to determine a future (rate year) benchmark energy price."^{86/} Furthermore, the same data response indicated that "Mr. Schoenbeck also believes it is likely that a Pacific Gas & Electric filing

^{83/} Exh. No. 17.

^{84/} PSE Brief at 46.

^{85/} Id.

^{86/} Exh. No. 256 at 1.

scheduled for February 13, 2004 will use a CEC benchmark gas value as well.”^{87/} PSE now maintains that Mr. Schoenbeck is mistaken because the PG&E application “uses *NYMEX forward market prices* – not CEC model outputs – to project gas prices for rate setting purposes.”^{88/} Although PSE points out with emphasis that the PG&E application uses NYMEX prices, the Company fails to state that PG&E did not use NYMEX prices exclusively. Indeed, PG&E used “the estimate made by the California Energy Commission (CEC) of the expected levelized costs of a generic gas fired combined cycle unit” to calculate its Competitive Transition Charge.^{89/} Moreover, PG&E took this value from the same December 2003 CEC report from which Mr. Schoenbeck derived his proposed gas price in this case, indicating that PG&E does not share PSE’s concern that the CEC data is “stale.”^{90/}

b. No Commission Precedent Requires Use of a NYMEX Average

42 PSE also indicates that “years of Commission precedent” demand that the Commission establish a gas price in this proceeding based on the NYMEX average; however, no such precedent or policy exists.^{91/} The Commission has not explicitly stated that establishing gas prices based on NYMEX averages is the appropriate method to be used, nor has the Commission condemned the use of a fundamentals-based value. The

^{87/} Id.; see also Re Southern Cal. Edison, CPUC Docket No. A.03-10-022, Proposed Decision of ALJ Fukutome at 5, 9 (Feb. 24, 2004) (recommending adoption of uncontested joint statement incorporating an updated benchmark market cost derived from the October 2003 CEC Report) and CPUC Docket No. R. 02-11-022, Opinion at 108 (Nov. 8, 2002) (adopting a levelized combined cycle proxy value proposed by the Office of Ratepayer Advocates (ORA) based on a CEC report).

^{88/} PSE Brief at 46 (emphasis in original).

^{89/} Exh. No. 262 at 97.

^{90/} Id. at 97 n.9; PSE Brief at 47.

^{91/} PSE Brief at 47.

fact that the Commission may have approved rates for PSE in the past that include price forecasts based on NYMEX averages in no way establishes “years of Commission precedent.” PSE points out that in Docket No. UE-011570, for example, the Commission approved a Stipulation that included the Company’s NYMEX average gas price.^{92/} The fact that the Commission approved a Stipulation that produced an overall result that was just and reasonable does not establish precedent for the methodologies used. In fact, the Stipulation explicitly provided that “no Participating Party shall be deemed to have accepted or consented to the facts, principles, methods, or theories employed in arriving at the Settlement Stipulation [or that the Stipulation] is appropriate for resolving in any issues is any other proceeding.”^{93/}

c. The Values in PSE’s Fundamentals Analysis Undermine its Criticisms of the CEC Forecast Prices

43

PSE’s final argument is that the Commission should reject the CEC forecast because ICNU has not explained why the CEC forecast departs from the average forward market price.^{94/} This argument ignores the foundation of ICNU’s adjustment—PSE’s NYMEX-based average price is unreasonably high.^{95/} As pointed out in Mr. Schoenbeck’s direct testimony and ICNU’s Initial Brief, the NYMEX price reflects near-term price pressures.^{96/} Thus, an average of NYMEX prices may produce an unreasonably high value to forecast a gas price for use in the PCA. ICNU’s proposal to

^{92/} Id. at 44; WUTC v. PSE, WUTC Docket Nos. UE-011570, UG-011571, Twelfth Supp. Order (June 20, 2002).

^{93/} WUTC Docket Nos. UE-011570, UG-011571, Twelfth Supp. Order at Appendix A at 7.

^{94/} PSE Brief at 47.

^{95/} Exh. No. 231C at 13: 11-16 (Schoenbeck).

^{96/} Id. at 15: 7-19 (Schoenbeck); ICNU Initial Brief at 16.

use a fundamentals value does not, as PSE indicates in its Initial Brief, “disregard current market information.”^{97/} Rather, the fundamentals-based value proposed by ICNU merely establishes a reasonable forecast from which deviations in actual costs may be shared through the PCA.

44

PSE’s request that ICNU explain why the CEC values are lower than the NYMEX average only invites further criticism of the Company’s forecast. PSE uses its fundamentals price forecasting model to generate 100 price scenarios for the purposes of its internal risk assessment. In December 2003, only a few months after PSE made its initial filing in this docket, the Company reported the results of its fundamentals price forecast to the RMC.^{98/} [REDACTED]

[REDACTED] Under these circumstances, in which PSE has proposed to include a forecast gas price that was derived from an illiquid NYMEX market that reflects near term events, while ICNU has proposed a fundamentals-based value that is [REDACTED] [REDACTED] it is PSE that should justify the deviation in its proposed gas price and not ICNU.

^{97/} PSE Brief at 46.

^{98/} Exh. No. 237C at 1-20.

^{99/} Exh. No. 231C at 19: 6-9 (Schoenbeck).

C. The Commission Should Exercise Its Discretion to Adopt Any One of a Number of Appropriate Remedies in this Proceeding

45 ICNU has proposed adjustments in this case that address both PSE's unreasonably high gas price and the Company's imprudent management of the Tenaska gas supply. Due to the manner in which these issues interrelate, ICNU urges the Commission to carefully examine all available relief if a disallowance is adopted. If the Commission adopts an adjustment related to either of the contested issues,^{100/} it should order PSE to perform an Aurora "compliance" run to quantify the impact of any adjustments.

1. Staff's Initial Brief Demonstrates the Importance of the Gas Price Issue

46 The evidence in the record reflects two alternatives with respect to establishing the forecast gas price in this case: 1) ICNU's \$3.61/MMBTU value based on the CEC forecast using a fundamentals model; and 2) PSE's [REDACTED] value based on an average of NYMEX futures prices. PSE states that Staff agrees with the Company's use of actual gas prices; however, as described above, Staff's Initial Brief and Staff's witness indicate no such agreement.^{101/} Staff suggests that the Commission resolve the issue of how to determine an appropriate "normalized" fuel cost in a future proceeding.^{102/}

^{100/} Staff points out in its Initial Brief that PSE's acquisition of Frederickson is not contested. Staff Brief at 3 n.6. However, Staff suggests that if Frederickson is not placed in service at the time the rates in this proceeding become effective, then the rate base, depreciation and other Frederickson-related costs should be removed from the PCA deferral calculations to account for the delay. Id. ICNU supports this adjustment in the event that Frederickson is not in service at the time rates in this proceeding take effect.

^{101/} Staff Brief at 47.

^{102/} Id.

47

Staff's discussion of the gas price issue reflects both the importance of this issue as well as its interrelation with Staff's Tenaska and Encogen disallowances.^{103/} Staff's suggestion that the Commission postpone resolving the gas price issue is based, in part, on Staff's Tenaska and Encogen adjustments, which would significantly reduce PSE's gas costs for the year because the adjustments effectively cap the cost of gas for those plants.^{104/} Staff states that the gas price issue is not significant under its recommendation.^{105/}

48

Staff implicitly acknowledges that the gas price issue would be of much greater concern if Staff's Tenaska and Encogen recommendations are not accepted. Staff indicates that PSE's gas price forecast generally is a much more significant issue due to PSE's acquisition of additional gas-fired resources (e.g. Frederickson).^{106/} As a result of PSE's increased gas purchase volumes, customers will pay more substantial amounts for fuel if gas prices are overstated by even a small amount. Staff's recognition of the importance of gas prices to PSE's overall resource portfolio indicates that gas prices are a very significant issue in this case in the absence of Staff's Tenaska and Encogen adjustments. As a result, ICNU urges the Commission to resolve the Tenaska and gas price adjustments separately and to adopt the forecast gas price proposed by ICNU.

^{103/} Id. at 45-47.

^{104/} Id.

^{105/} Id. at 47.

^{106/} Id.

2. The Tenaska Regulatory Asset Should be Removed from Rate Base to Reflect PSE's Imprudent Management

49 PSE asserts that the effects of adopting any of the adjustments proposed by ICNU and Staff range from elimination of the Company's earnings for a year to impacting its ability to trade in the wholesale markets.^{107/} PSE's claims are entirely speculative and are lacking in evidentiary support. The Commission should give no weight to PSE's claims, especially considering that no party can verify their accuracy at this point in the proceeding. ICNU's primary recommendation and three alternatives are described below.

50 **Alternative No. 1 (ICNU's Primary Recommendation):** ICNU's primary recommendation to address PSE's imprudence with respect to the Tenaska gas supply is that the Company be required to remove the regulatory asset from rate base and write off the remaining unamortized balance.^{108/} This is the most simple and discrete remedy to address PSE's imprudence and is intended to end customer payments for a regulatory asset that is of no benefit.^{109/} Requiring PSE to write off the regulatory asset would reduce the revenue requirement during the Rate Period by approximately \$40.3 million.

51 **Alternative No. 2:** If the Commission decides against removing the regulatory asset from rate base, ICNU would support Mr. Schooley's proposed adjustment, which enforces the cap on Tenaska costs and the 1.2% prudence

^{107/} PSE Brief at 41.

^{108/} Exh. No. 231C at 30: 6-8, 13-15 (Schoenbeck).

^{109/} Id. at 30: 8-9 (Schoenbeck).

disallowance previously ordered by the Commission.^{110/} This measure would reduce PSE's requested revenue requirement increase by \$19.8 million.^{111/}

52 PSE has argued that the Commission's order approving the original Tenaska contract did not create a cap on the cost recovery, and, in the alternative, even if a cap was put in place, the Commission eliminated that cap when it approved the restructuring of the agreement.^{112/} Regardless of PSE's interpretation of the Commission's orders, nothing prevents the Commission from adopting Mr. Schooley's proposal as an appropriate remedy in this proceeding.

53 **Alternative No. 3:** ICNU also would support imputing the gas cost used by PSE in the Exhibit B analysis it provided at the time of the Tenaska contract buyout.^{113/} This remedy would utilize the gas cost in PSE's 1997 petition but the resulting disallowance would depend on the Commission's resolution of the appropriate gas price to be used in this case. If the Commission were to adopt the \$3.61/MMBTU Rate Period gas price proposed by ICNU, Alternative No. 3 would reduce the revenue requirement proposed by PSE by approximately \$29.0 million.^{114/} If the Commission were to adopt the higher gas price proposed by PSE, the adjustment would be approximately \$40 million.^{115/}

^{110/} Exh. No. 301HC at 13: 9-14: 9 (Schooley).

^{111/} Id. at 14: 9 (Schooley).

^{112/} PSE Brief 23-24.

^{113/} Exh. No. 231C at 30: 9-13 (Schoenbeck).

^{114/} Id. at 30: 11-13 (Schoenbeck).

^{115/} TR. 428: 16-23 (Schoenbeck).

Alternative No. 4: Mr. Schoenbeck proposed the fourth alternative at hearing.^{116/} Under this option, the Commission would impute a reasonable benchmark gas price for Tenaska over the remaining term of the contract and then allow the deviations from that cost to be flowed through a sharing mechanism on a going forward basis.^{117/} The benchmark gas price established by the Commission would not necessarily be any of the prices proposed in this proceeding, but rather would be a reasonable price determined by the Commission. PSE and customers would share the burdens or benefits of gas price deviations from the benchmark over the remaining years of the agreement.^{118/} The savings from the approach would be compared to the original Exhibit B analysis and the regulatory asset would be written down by a prorated amount.

Staff and Public Counsel oppose ICNU's Alternative No. 4, in part, because it would be difficult to administer under the sharing bands in the current PCA.^{119/} As described above, if the Commission adopts any of the proposed adjustments, it should exercise its discretion to explore all possibilities available for structuring the appropriate remedy. In recognition of Staff's and Public Counsel's concerns, ICNU suggests developing a sharing mechanism that is separate and distinct from the PCA in the event the Commission adopts ICNU Alternative No. 4. The Commission should determine the manner in which such a mechanism would allocate the gas price deviations between PSE and its customers.

^{116/} TR. at 400: 7-401: 4, 401: 20-403: 20 (Schoenbeck).

^{117/} Id.

^{118/} Id.

^{119/} Public Counsel Brief at 7; Staff Brief at 46 n.14.

III. CONCLUSION

56

PSE has failed to satisfy its burden to demonstrate prudent management of the Tenaska gas supply as explicitly required by the Commission's order approving creation of the regulatory asset. As a result, the Commission should adopt one or more of the remedies proposed by Staff and ICNU. Likewise, PSE has failed to demonstrate that use of the NYMEX gas prices to set the PCA baseline is more reasonable than a fundamentals analysis.

DATED this 19th day of March, 2004.

Respectfully Submitted,

DAVISON VAN CLEVE, P.C.



S. Bradley Van Cleve

Matthew Perkins

Davison Van Cleve, P.C.

1000 SW Broadway, Suite 2460

Portland, OR 97205

(503) 241-7242 phone

(503) 241-8160 fax

mail@dvclaw.com

Of Attorneys for the Industrial Customers
of Northwest Utilities