BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

I. INTRODUCTION

1. Public Counsel's Reply Brief in this case responds to two primary areas in Puget Sound Energy's (PSE) Initial Brief: (1) the nature of the prudence test which the Commission must apply in this case to management of its gas costs for Tenaska, and (2) the rationale offered by PSE to defend the reasonableness of its conduct.

II. PSE'S MANAGEMENT OF THE TENASKA GAS SUPPLY WAS IMPRUDENT

A. The Prudence Standard Incorporates a Public Interest Standard.

2. PSE correctly quotes the basic test employed by the Commission:

> 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.[1]

Beyond this citation, PSE's brief spends relatively little time discussing the nature of the prudence standard. Some additional consideration of the standard is helpful, however, in determining its application in this case.

3. The prudence standard has been described as related to the negligence standard.[2] Prudent

[1] Puget Sound Energy, Inc.'s Initial Brief, ¶ 13.
[2] The Process of Ratemaking, Leonard Goodman (1998), p. 856.

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4. management, as the test above states, implies reasonable management. A showing of imprudence does not require any showing of fraud or dishonesty.[3] The "reasonable person" test that is applied in negligence cases is in essence the general standard that regulatory commission apply to prudence review, translated to the utility management context, so that the inquiry focuses on the conduct of the reasonable board of directors and company management.[4]

5. The prudence investment requirement is itself a component of the foundational principle that utility rates must be just and reasonable. A company whose rates are by law required to be just and reasonable is on notice that imprudently incurred expenditures may be disallowed.[5] Moreover, shareholders who make the decision to invest in a regulated utility company are doing so with the knowledge that the company provides an essential public service in a business that is affected with the public interest. The investor agrees, in effect, that charges to the public will be reasonable.[6]

6. The prudence test, then, does not focus on the isolated interest of the company and its shareholders:

> Under the 'reasonable man' test, the fundamental question for decision is whether management acted reasonably *in the public interest*, not merely in the interest of the company or an integrated group of companies. The overriding issue is not the reasonableness of the cost in the abstract, *but a 'reasonable and prudent business expense, which the consuming public may reasonably be required to bear.'* (emphasis added).[7]

This "public interest" component of the test is a key factor in this case. Here, the Commission must consider, not whether PSE acted in the company's own interests in the abstract, but

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[3] Id.

[4] A similar test is applied to management in shareholder derivative suits. Corporate directors are expected to act with the degree of care that that would be exercised by the reasonable and prudent person under similar circumstances. Goodman, p. 856.

[5] Goodman, p. 858. Of course, in this case, PSE was also specifically put on notice by the Commission's order in UE-971619 that the prudence of its management of the cost of gas would be at issue.

[6] Principles of Public Utility Rates, James C. Bonbright (1961), p. 184, n. 15 (citing Justice Brandeis minority opinion in *Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*, 262 U.S. 276, 290 (1923)).

[7] Goodman, p. 857.

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whether the dramatic gas costs incurred, exceeding even the original costs of the reformed contract, are prudently incurred costs which the consuming public, PSE's customers, may reasonably be required to bear.

B. PSE Has Not Carried Its Burden of Proof.

1. PSE's fails to cite contemporaneous documentation to support its decisionmaking.

7. In its brief, PSE acknowledges that in performing a prudence review, this Commission has clearly stated that it will require adequate contemporaneous records from the company as well as demonstrated involvement by the board in the decisionmaking process.[8] The 1994 "Prudence Order" devoted extended discussion to the issue of decisionmaking process and record keeping, concluding:

> In addition to making an adequate study at the time, PSE must keep adequate contemporaneous records of its decision process which will allow the Commission subsequently to evaluate its decisions. This is the minimum standard to which a regulated utility should be held.[9]

PSE lists and addresses these factors in connection with the Frederickson acquisition. By contrast, in the portion of the brief addressing the prudence of its fuel cost management, PSE points to little or no evidence of board involvement or contemporaneous documentation of its decision processes. PSE instead seems to rely merely on general descriptions of market conditions and other contextual factors to argue that its decisions were reasonable. To a large extent these arguments might themselves be criticized as hindsight. There is certainly little evidence provided by the company of careful and contemporaneous record keeping that would allow the Commission to follow the decisionmaking process that occurred in the time following

[8] PSE Initial Brief, ¶¶ 24-25.

[9] Ex. 82, p. 37 (1994 Prudence Order); *see also* UE-921262, Twentieth Supplemental Order, p. 16 (further detailed discussion of requirement of contemporaneous documentation).

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the 1997 contract buyout.[10] Only three years before the buyout, the Prudence Order had provided clear instructions to the company on what evidence it would need to present in order to meet its burden in a prudence review. PSE's inability to present such evidence now is a failure of its burden of proof.

2. PSE prudence analysis is inconsistent with its position at the time of the 1997 buyout.

8. PSE devotes substantial argument in its brief to the assertion that "PSE determined at the time of the 1997 buyout that a long-term fixed price supply contract was inadvisable for the Tenaska facility."[11] PSE argues that this determination was based on the fact that (1) natural gas and electricity markets were in monumental transition; (2) market conditions at the time did not justify a long-term supply contract; and (3) the Tenaska facility's marginal position in PSE's resource stack did not justify such a supply contract.[12]

9. This assertion is jarringly at odds with the representations made to the Commission at that same time. As has been exhaustively brought out in these proceedings,[13] PSE urged approval of its 1997 accounting petition on precisely the opposite grounds –-- i.e. that there would be very significant fuel supply savings over the life of the Tenaska contract based on then-available forward market price quotes for a *long-term supply* of replacement gas. Indeed, bids from specific named vendors were provided to the Commission. These projections provided the hard data upon which the Company justified and the Commission approved the accounting petition and the creation of the regulatory asset. These projections did not include any reference to short-term market prices.

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[10] Public Counsel notes that Mr. Gaines testified that his notes of risk management meetings were not produced and that "all we have preserved is the formal notes of the committee meetings." Tr. 283 (confidential session).

[11] PSE Initial Brief, p. 31.

[12] PSE Initial Brief, pp. 31-35.

[13] See, e.g., Post Hearing Brief of Commission Staff, ¶¶ 36, 37.

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10. In effect, PSE is now arguing that notwithstanding its representations to the Commission at the time, it knew then that it had no intention of pursuing the savings from long-term supply contracts that it had relied on to "sell" the petition.[14] The disconnect is apparent if one considers whether the buyout would have been given serious consideration, or the accounting petition approved, had PSE told the Commission in 1997:

> "We intend to provide gas for Tenaska from the short-term market and near-term hedging exclusively, notwithstanding the representations we have made regarding savings available in the long-term part of the market. PSE will not, as a matter of policy, enter into long-term contracts because of fear of stranded costs and regulatory and market uncertainty. In any event, Tenaska is only a marginal resource in PSE's stack and would not justify acquiring gas other than in the short-term market. Since the savings we have projected are based solely on long-term supply contracts they are not representative of what, if any, savings might occur under our short-term acquisition strategy. We present no projections of what savings will be achieved under the short-term/near term strategy. In the event no savings materialize and costs are greater than the original Tenaska contract we will seek to recover all of the costs from ratepayers."

Public Counsel submits that Commission approval would have been extremely unlikely if this view had been made known at the time. The inconsistency between PSE's current rationale for

[14] The brief recites Mr. Gaines statement at the hearing that "we made clear to the Commission and all of the parties in the accounting proceeding, we made clear to our board and others that our intention at the time of restructuring was to provide gas to the Tenaska plant in the short-term market." PSE Initial Brief, ¶99. There is no citation to any record evidence supporting the assertion that the Commission was told Tenaska gas was to be provided exclusively from the short-term market. As noted, all the savings were based on long-term projections. The statement in the Staff memo and elsewhere that the purpose of the buyout was to "drive the gas cost to market" cannot be read as notice that only the short-term market was to be considered. On the contrary, based on plain meaning, and read in the context of the language of the petition and the supporting data and projections given to the Commission at the time, the phrase "driving the gas cost to market" is most fairly read to include the long-term market.

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its behavior and the representations it made at the time of the buyout cast further doubt on the reasonableness and prudence of its conduct. [15]

3. The prudence disallowance recommended does not rely on hindsight.

11. PSE attempts to dismiss the arguments of Staff, ICNU and Public Counsel as mere hindsight, seeking disallowance "just because gas prices are higher today than the prices that the Company projected in 1997 and 1999."[16] This is an inaccurate characterization. This case is not a dispute about whether for routine ongoing fuel purchases, in the ordinary course of business; the company should have bought long-term gas instead of short-term gas. The context is critical.

12. The Tenaska contract itself had already been found to be imprudent and partially disallowed only three years before the buyout petition. The contract continued to pose such unacceptable costs that the Company came back to the Commission and proposed a buyout, and creation of a regulatory asset, premised entirely upon the assertion that the very significant cost savings could be achieved, based on an analysis of the long-term market.

13. At no time did PSE say to the Commission, "we are going to do this buyout, and we may do better or worse than the original contract costs, we can't predict, and there is no guarantee." Instead the company represented explicitly and implicitly that it both could and would manage its costs in a reasonable and prudent manner in order to achieve the savings for customers that it had said were reasonably available, in order to extricate itself from the unfavorable original contract. The potential savings were real, and actually available to the company at that time. That is not a matter of hindsight. The company itself, at that time, presented the evidence to the

[15] There can be little disagreement that the costs resulting from PSE's imprudent management are unreasonable. They exceed the original cost. They greatly exceed the cost that could have been achieved as part of the restructuring, and they greatly exceed the current market value of the power.

[16] PSE Initial Brief, ¶ 89.

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Commission of how it could achieve those savings.[17] It chose not to carry out the actions necessary to do that. It has failed to justify or show why it failed to do so, other than with generalities about the energy and regulatory environment at the time.

14. The question in this case is not whether PSE should have bought gas in the short or long-term markets at any given point in time. Instead, the ultimate question is whether PSE has established that it managed its gas supply for the Tenaska contract in the way that a reasonable and prudent management and board of directors would have done, if it had sought to achieve the advertised goals of the 1997 contract buyout, to achieve as nearly as possible the projected savings, and to justify the creation of the regulatory asset.

III. CONCLUSION

15. At a minimum, the disallowance in this proceeding must enforce and implement the terms of the Commission's 1994 Prudence Review of the Tenaska contract. For the foregoing reasons, however, and for the reasons set forth in its initial brief, Public Counsel urges the Commission to disallow the gas costs incurred by PSE as a result of their imprudent management of the Tenaska gas supply, in the amounts quantified in Commission Staff's testimony.

Respectfully submitted this 19th day of March, 2004.

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[17] A prudence disallowance based on facts and circumstances that were known or reasonably should have been known by the company at the time is not based on hindsight. *ABATE v.Michigan Public Service Commission*, 208 Mich. App. 248, 527 NW 2d 533, 542 (1994), appeal denied, 539 NW 2d 507 (1995).

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