BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

PUGET SOUND ENERGY, INC.'S REPLY BRIEF

March 19, 2004

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I. INTRODUCTION.

1 Chairwoman Showalter asked a prescient question on the first day of hearing: "My question is whether the electricity environment today is more risky in an absolute sense than it was say five years ago."[1] Mr. Markell answered that the current regulatory environment is more "confused" (*i.e.*, uncertain) than at any other time over the last 25 years.[2]

2 The Commission need not look any further than this proceeding to see the regulatory uncertainty that utilities face today. Puget Sound Energy, Inc. ("PSE" or the "Company") assiduously tried to meet the Commission's expectations when it engaged in a robust planning, evaluation and negotiation process to acquire an interest in a new generation resource (the Frederickson facility). PSE filed a power cost only rate case to gain approval of the costs of that resource and to reset the power cost baseline to current costs – all as expressly contemplated by the Power Cost Adjustment ("PCA") Mechanism that the Commission approved less than two years ago, in PSE's last general rate case.

3 But now this case has taken on a whole new life. Commission Staff, Public Counsel, and ICNU use this proceeding as a stage to argue that tens of millions of dollars in power costs should be absorbed by the Company's shareholders.[3] They assert a potpourri of issues – not asserted in PSE's last general rate case – that have the combined effect of wiping out the rate adjustment that PSE sought in this proceeding due to the Frederickson acquisition and a true-up of the Company's power costs. ICNU even proposes an overall rate *decrease*.

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1 TR. 106: 18-21.

2 TR. 107: 5-10 (Markell).

3 Mr. Story discussed in his prefiled rebuttal testimony how the parties' proposed adjustments (if adopted) would likely have a significant impact on the Company. *See* Exh. No. 220 at 11: 11 – 12: 10 (Story); *see also* the discussion in Section III(E) of this Reply Brief.

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4 These new issues cover a broad range. The parties first assert that the Commission's 1994 Prudence Order imposed a fixed cap on recoverable Tenaska contract costs – despite the fact that the Order's plain language and its implementation over the past 10 years are completely devoid of any such intent. Then, applying the luxury of 20/20 hindsight, and without ever acknowledging that the 2000-2001 Western Power Market Crisis occurred, the parties argue that PSE mismanaged the fuel procurement for the Tenaska and Encogen facilities during the last several years (after the Company restructured the fuel supply arrangements for those facilities). ICNU goes one step further, by arguing that PSE's projected gas costs should no longer be based on relevant market-based price information, but on an entirely different approach that yields an artificially low gas price untethered to market realities.

5 The Commission should not give credence to any of these issues, and in particular the opposing parties' proposal to use hindsight to evaluate PSE's resource decisions. Such a hindsight approach will only foster greater regulatory uncertainty – the same type of uncertainty that Mr. Markell discussed at hearing. Instead, and consistent with its longstanding precedent[4] and the record in this proceeding, the Commission should conclude that PSE's decisions were reasonable when made *given the context of the time and the information that was available to PSE at the time*. PSE is confident that its process and decisions at issue were reasonable under this standard.

II. THE PRUDENCE ORDER DID NOT IMPOSE A FIXED CAP ON THE RECOVERABLE COSTS UNDER THE TENASKA CONTRACT.

6 Commission Staff contends that the Prudence Order established a fixed "dollar per megawatt hour" cap on PSE's recovery of the Tenaska contract costs. To reach this conclusion, Commission Staff selectively parses the language in the Prudence Order; ignores critical context for the Commission's findings of fact; and dismisses as

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4 *See, e.g., WUTC v. Avista Corp., d/b/a Avista Utilities,* Docket No. UE-030751, Order No. 5 (January 30, 2004) (hereinafter "Avista Order") at ¶¶ 37, 39 (rejection of hindsight analysis).

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irrelevant the parties' uniform understanding and application of the disallowance over the past 10 years. This strained and revisionist interpretation of the Prudence Order should be rejected.

A. PSE Contests Commission Staff's Fixed-Cap Adjustment Calculation.

7 PSE's focus on whether a cap exists does not mean, as Commission Staff suggests, that PSE agrees with Staff's suggested adjustment calculation that is based on a fixed cap. Commission Staff, ICNU, and PSE have agreed that the 1.2% disallowance of Tenaska contract costs was correctly calculated in the agreed adjustments to the PCORC power cost baseline.[5] But PSE fundamentally disagrees with the calculation of Staff's proposed additional adjustment – the adjustment that is premised on a fixed cap – because nothing in the Prudence Order supports such a cap.[6]

B. The Language In The Prudence Order Established A Straightforward 1.2% Disallowance, Not A Fixed Cap.

8 As PSE discussed in its Initial Brief, the Prudence Order disallowed "1.2% of net contract charges for Tenaska."[7] All of the parties have consistently interpreted this provision to require a straightforward 1.2% disallowance of the net contract charge under the Tenaska contract. This interpretation has been uniformly applied and universally accepted during the past 10 years.[8]

9 Commission Staff insists in this proceeding, however, that a disallowance described by the Commission as "1.2% of net contract charges for Tenaska" means the *same thing* as a "cap" that limits recoverable costs to a specific "dollar per megawatt hour" limit.[9] To

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5 TR. 461: 9-13 (McIntosh); TR. 555: 13-18 (Russell); TR. 372: 22 – 373: 8 (Schoenbeck); Exh. No. 45 at 5: 11-15 (Gaines rev. 2/19/04).

6 Exh. No. 220 at 14: 1-4 (Story).

7 PSE Initial Brief at ¶¶ 70-72; *see also* Exh. No. 82 at 32: ¶4 (Prudence Order).

8 *See* PSE Initial Brief at ¶ 77.

9 Exh. No. 301HC at 7: 1-2 (Schooley); TR. 488: 25 – 490: 2 (Schooley); Commission Staff Initial Brief at ¶ 17.

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interpret the Prudence Order in this manner, one must set aside the Order's plain language (which established a percentage disallowance) and read into the Order a significant, but unexpressed, finding (the existence of a fixed cap).

10 Commission Staff does not articulate why the Commission should depart from the plain language in the Prudence Order. Instead, Commission Staff strings together selected excerpts from the Prudence Order – excerpts often taken out of context – and argues that the Prudence Order's language and historical application do not expressly contradict Staff's interpretation.[10]

11 This issue turns, however, on the proper legal interpretation that should be given to language in the 10-year old Prudence Order. For this reason, it is not enough for Commission Staff to simply assert that its interpretation can be somehow harmonized with the Order's words.[11] Absent a compelling reason to depart from the Prudence Order's plain language and the historical application of the Tenaska disallowance, that plain language should be given the same effect in this proceeding.

1. The Cap Argument Misconstrues The Language In The Prudence Order.

12 Not only does Commission Staff ask the Commission to inject new findings into the Prudence Order, it wants the Commission to misconstrue the Order's existing language. One noteworthy example is the Prudence Order's "extra costs" statement, oft-quoted by Commission Staff and discussed in more detail later in this Reply Brief. That language, however, does not refer to the costs that exceed a fixed cap. Rather "the extra costs" that are cited in the second sentence of Finding of Fact 8 simply refer to

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[10] Commission Staff Initial Brief at ¶¶ 16, 21-23.

[11] Because the cap issue involves a purely legal, rather than factual dispute, neither party bears the burden of proof on the issue (because there are no facts to "prove"). However, a party that advocates a new reading of a Commission order – particularly after the order has been interpreted an entirely different way for 10 years – should be expected to explain why that new reading is warranted, and why the Commission should depart from the order's plain language.

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the costs attributable to the value of dispatchability.[12] A fair and complete reading of the Prudence Order leads to no other conclusion.

a. Commission Staff's Recounting Of The Prudence Order's Avoided Cost Analysis Differs From The Commission's Own Analysis.

13 Commission Staff relies heavily on the Commission's discussion of avoided cost in the Prudence Order for its assertion that the Order created a cap.[13] Commission Staff asserts that the disallowance of a percentage of the Tenaska contract impliedly means that the remaining amount constitutes the precise "dollar per megawatt hour" measure of PSE's proper "avoided cost." This "dollar per megawatt hour" measure, Staff argues, therefore constitutes a cap.

14 It is undisputed that PSE's predecessor, Puget Sound Power & Light Company ("Puget"), was required to assess the Tenaska contract in light of its avoided costs. The Prudence Order discussed this requirement at length. Contrary to Commission Staff's assertion, however, the Commission did not attempt to quantify or analyze a specific measure of allowable avoided costs in the Prudence Order. Nor did the Commission set a ceiling on recoverable costs by its descriptions of Puget's estimates of an avoided costs as a ceiling (as Commission Staff suggests).[14]

15 Instead, the Commission analyzed the reasonableness of Puget's *actions* in determining its avoided costs. The Commission found that Puget failed to account for the value of a particular element, *i.e.*, dispatchability. The Commission valued this dispatchability in net present value terms (based on then-applicable discount rates and other variables),

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[12] Exh. No. 82 at 28-32, 45-46 (Prudence Order).

[13] Commission Staff Initial Brief at ¶¶ 18-20.

[14] Commission Staff Initial Brief at ¶ 18-20.

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and assessed the disallowance of this value as a straight 1.2% disallowance of net contract costs for Tenaska over the life of the contract.[15]

16 This distinction matters. The Commission did not perform an independent determination of Puget's allowable avoided costs and impose that amount on Puget. Had it imposed such an amount, the avoided cost ceiling number, or schedule of numbers, would have appeared within the body of the Prudence Order. In fact, as we discuss later in this Reply Brief, the only concrete figure that the Commission *did* calculate was the concrete value of the dispatchability disallowance – the very disallowance that PSE applied in this proceeding. This disallowance should be upheld as proper.

b. Commission Staff Defines "Extra Costs" As Indefinite And Expandable, While The Prudence Order Defines Those Costs As Known And Finite.

17 Perhaps most telling, Commission Staff relies heavily on Finding of Fact 7 in the Prudence Order for its assertion that the Order created a cap. That finding states: "As a 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*."[16] Commission Staff asserts that the Commission's disallowance of the "extra costs" functions as a cap.[17]

18 Contrary to this position, however, the Commission defined the "extra costs" not as those costs above a certain avoided cost amount, but rather as the costs attributable to Puget's imprudent "actions."[18] Those imprudent "actions" in turn, are described in Finding of Fact 6 and referenced in the first sentence of Finding of Fact 7 (also 8): They turn entirely on Puget's failure "*to analyze the value of dispatchability*." The

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[15] Exh. No. 82 at 46 (Prudence Order).

[16] Exh. No. 82 at 45-46 (Finding of Fact 7) (Prudence Order) (emphasis added).

[17] Exh. 301HC at 7: 1-2 (Schooley).

[18] Exh. No. 82 at 45-46 (Prudence Order).

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linkage between the value of dispatchability and the "extra costs" statement is inescapable. The Prudence Order reflects no other adjustments to the costs recoverable under the Tenaska contract.[19]

19 A fundamental problem with Commission Staff's argument is the assertion that the "extra costs" that the Prudence Order disallowed were indefinite and infinitely expandable.[20] The Prudence Order itself, however, makes clear that the "extra costs" were a known and measured dollar amount that the Commission quantified as the value of dispatchability and applied as a straightforward 1.2% disallowance.[21] Staff's view of the "extra costs" as indeterminate and expandable is completely at odds with the Prudence Order's language and analysis.

2. Ten Years Of Straightforward Application Of A 1.2% Disallowance Do Matter.

20 Commission Staff argues that the consistent historical application of the 1.2% disallowance has no bearing on how the Order should be interpreted today.[22]

21 Staff's assertion is incorrect for two primary reasons. First, the disallowance's consistent historical application is solid evidence of what the Commission intended under the Prudence Order, and how PSE and Commission Staff understood and applied the Commission's intent. Second, a consistent and straightforward interpretation of a Commission order – not the convoluted new interpretation that Commission Staff

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[19] *See* TR. 484: 1-13 (Schooley).

[20] Mr. Schooley demonstrated Staff's expansive reading of Finding of Fact 7 when, at hearing, he stated that under the Prudence Order, ratepayers were not to bear "*any* extra costs" related to the Tenaska contract. TR. 490: 2-4 (Schooley) (emphasis added). But that is not what the Prudence Order said. The Prudence Order instead refers to "*the* extra costs," rather than "*any* extra costs" – which implies that the costs at issue were specific and known, not unquantified.

[21] Exh. No. 82 at 28-32 (Prudence Order) (Commission analysis of specific value of dispatchability, the value of which is also the disallowance).

[22] Commission Staff Initial Brief at ¶¶ 21-23.

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advocates in this proceeding – is important for the regulatory process, because it provides all of the parties with appropriate due process and regulatory certainty.

22 While the Commission has broad discretion in handling the cases before it, PSE respectfully asserts that, for reasons of due process, it must be able to count on some degree of certainty with respect to how the Commission applies and interprets its orders. The concept of due process is important; it lies at the heart of Washington State's Administrative Procedures Act ("APA").[23] An administrative agency issues a written order to provide the parties to an administrative proceeding with a specific level of guidance and instruction.[24] The order delineates the parties' rights and, in so doing, creates certain expectations as to how those rights will be interpreted in the future.

23 In this proceeding, Commission Staff's position amounts to a claim that, *even though* the Prudence Order has never been interpreted before to impose a cap, and *even though* nobody has ever argued before that the Order imposes a cap, the Commission can and should impose a cap today – by implicitly inserting new findings into the Order and by discarding its prior application. PSE believes that such an action would be arbitrary and capricious and in violation of the protections afforded the Company under the APA.

C. Conclusion.

24 Commission Staff concedes that the Prudence Order does not describe the disallowance as a cap or a ceiling. It further concedes that the Commission applied the disallowance, even *after* the Tenaska contract was reformed in 1997,[25] as a straightforward

[23] Although administrative decisions are not binding in the same manner as are reported judicial decisions, agencies in Washington State are still required to provide due process, including notice and some level of certainty when applying administrative decisions. *See, e.g.*, *State ex. rel. Puget Sound Nav. Co. v. Department of Transportation*, 33 Wn.2d 448, 486-487, 206 P.2d 456 (1949).

[24] *See, e.g.*, *Kenart & Associates v. Skagit County*, 37 Wash.App. 295, 301-302, 680 P.2d 439, *review denied*, 101 Wash.2d 1021 (1984).

[25] PSE argued in its Initial Brief that, even if the Prudence Order had imposed a cap on recoverable Tenaska costs, the 1997 contract reformation eliminated any basis for thereafter applying the cap.

(Footnote Continued)(Footnote Continued)

percentage calculation rather than as a fixed cap. Yet Staff nonetheless argues that the Commission should impose a cap today and, in the process, disallow $45 million of PSE's costs.[26]

25 If the Commission had intended to create such a fixed cap on Puget's recoverable costs, it presumably would have said so in the Prudence Order. If Commission Staff had truly believed that the Order created such a cap, it presumably would have said so before this proceeding. Under these circumstances, the Commission should do what it has always done: It should give effect to the plain language in the Prudence Order by applying the disallowance as a straightforward 1.2% calculation of the Tenaska net contract costs.

III. PSE'S FUEL MANAGEMENT DECISIONS WERE REASONABLE.

26 For the first time since PSE restructured the Tenaska and Encogen fuel supply arrangements, the opposing parties challenge the Company's fuel supply decisions going back to 1997, and ask the Commission to impose harsh penalties years after those decisions were made.

27 This challenge is based on nothing more than the use of 20/20 hindsight to second-guess the Company's decisions. The Commission has not used hindsight before to evaluate a utility's resource decisions, and it should decline to use hindsight with respect to the decisions that PSE made. The record in this proceeding demonstrates

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See PSE Initial Brief at ¶¶ 78-82; *see also* TR. 502: 14-17 (Schooley) (contract reformation can warrant reopening a cost cap). In this regard, and contrary to Commission Staff's argument in its Initial Brief (at ¶ 25), the Company was not required to express such a position in the Tenaska accounting petition as a condition to elimination of the cap by the Commission. The Commission is free to modify its orders on its own, and could have done so in 1997 or at any time through the present if it had decided that a change to the Prudence Order was warranted, and if it had given proper notice of the change to the parties. *See* RCW 80.04.210. Further, PSE could not possibly have requested elimination of the cap in the accounting petition, since (1) PSE had no idea that the Order would ever be construed to contain a cap; (2) the Prudence Order's plain language did not refer to a cap; and (3) the interpretations of the Order before 1997 (*e.g.*, in the PRAM proceedings) did not refer to a cap.

[26] Exh. No. 303HC; Exh. No. 304C; Commission Staff Initial Brief at ¶ 118.

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that, given the context of the time when PSE made its decisions, as well as the information that was available to PSE at the time, the Company acted reasonably in managing the fuel supply for the two facilities since 1997.

A. PSE Contests The Adjustment Calculation.

28 Similar to the adjustment calculation for the so-called cap (discussed in Section II(A) of this Reply Brief), PSE has not proposed an alternative disallowance calculation that is attributable to its alleged imprudent fuel management. This lack of a proposed alternative, however, should not be construed as acquiescence. PSE stated that it disagrees with the proposed adjustments.[27] PSE sees many errors in the calculations that the other parties presented.[28]

29 More fundamentally, as Mr. Gaines explained at hearing: "There seems to be a lot of discussion about a damage calculation in Staff's case, but I am not sure where the foundation for it is."[29] Rather than explain a basis for Commission Staff's conclusion that the Company had acted imprudently, the witness for this calculation (Mr. Elgin) stated at hearing that Commission Staff would analyze the information about PSE's fuel management and file a brief to "let our position to the Commission be known at that time."[30] Thus, PSE did not learn the basis for its supposedly-imprudent actions until *after* the parties filed their Initial Briefs. As a result, PSE did not engage and

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27 Exh. No. 220 at 11: 3-8 (Story).

28 Not only does the Company disagree with Mr. Elgin's position regarding recovery of Tenaska and Encogen power costs, the calculation that he submitted to support his position is flawed. In citing to Mr. Schooley's Exh. No. 305C and Exh. No. 306C (Gas Cost Savings per Regulatory Asset Filings compared to Actual and Current Saving Projections, line no. 12), Mr. Elgin included gross gas cost savings in his calculation. *See* Exh. No. 281HC at 11: 6-7 (Elgin). But *gross* gas cost savings do not consider the cost related to the return on and of the regulatory asset as allowed in the Commission's Orders that approved the Tenaska and Encogen accounting petitions. *See* Exh. No. 283C at 19-24; Exh. No. 284C at 17-20. *Net* gas cost savings that consider the return on and of the regulatory asset should have been reflected on line no. 12. The expected savings in Mr. Elgin's calculation would be significantly lower as a result of this correction.

29 TR. 336: 3-6 (Gaines).

30 TR. 530: 13-14 (Elgin).

could not have engaged on the adjustment calculation before the Initial Briefs were filed.

B. PSE Did Not Guarantee A Minimum Level Of Savings From The Tenaska Contract Restructuring.

30 The opposing parties begin their attack on PSE's fuel management by advancing a two-part theory: first, that PSE supposedly "guaranteed" a fixed amount of savings from the Tenaska contract restructuring, and second, that these "guaranteed" savings should become a minimum baseline for determining a prudence adjustment.[31] There are numerous problems with this argument, however. We start with its false premise.

1. PSE Never Made Such A Savings Guarantee.

31 The record is clear that PSE *never guaranteed* a minimum level of savings from the contract restructuring. Regarding the Tenaska buyout, PSE advised the parties that it could not guarantee the expected savings – since the actual savings would go up or down depending on the level of gas prices.[32] Commission Staff knew that these savings could vary; as Mr. Schooley stated, the Tenaska restructure replaced the fixed gas price under the original contract with a "risky price for the gas supply."[33]

32 It is one thing to say that, based on the context of the time and the information that was available at the time, PSE (and others) expected that the restructure would create savings over the contract term. It is quite another, though, to graft an express guarantee upon that expectation. PSE never made a guarantee in its 1997 accounting petition; it never made a guarantee in the ensuing discovery; and it never made a guarantee during the December 1997 Open Meeting when the Commission approved the petition. For

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[31] ICNU makes this claim most explicitly. *See, e.g.*, ICNU Initial Brief at 18 ("the Company virtually guaranteed that there would be huge savings…PSE's subsequent failure to fulfill those expectations is unreasonable and imprudent").

[32] *See generally* PSE Initial Brief at ¶¶ 97-99 and testimony and exhibits cited therein.

[33] Exh. No. 52 at 3.

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these reasons, the record in this proceeding does not contain the requisite evidence to support a finding that PSE guaranteed it would achieve the savings it had originally expected from the Tenaska restructure.

2. The Commission Did Not Hold PSE To A Savings Guarantee In 1997, And It Should Not Do So Now.

33 The Order in Docket No. UE-971619 stated that the Commission's approval of PSE's accounting petition "[did] not in any way modify or affect the Commission's prior orders regarding standards or burdens of proof in determining whether costs of a utility were imprudent or unreasonable."[34] In making this statement, the Commission put PSE on notice that it would evaluate the Tenaska fuel management according to the Commission's historical prudence standard – not a modified standard with new requirements such as whether PSE, in hindsight, was actually able to achieve a savings "guarantee."

34 Thus, PSE was never put on notice that the savings it and others expected in 1997 would, in the future, become a benchmark and the minimum baseline against which the Commission would evaluate prudence. It would be arbitrary and capricious for the Commission to impose such a standard in this proceeding – years after the Commission issued the Order in Docket No. UE-971619, and years after PSE began to manage the restructured fuel supply in reliance upon that Order.

3. The Imposition Of A Savings Guarantee Would Not Account For Significant Market Events After 1997, Such As The Western Power Market Crisis.

35 The imposition of a Tenaska savings "guarantee" also would not account for the tumultuous and unforeseen market events that took place after 1997 – including, most notably, the Western Power Market Crisis ("Market Crisis"). Remarkably, the

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[34] Exh. No. 283C at 24 ¶ 6 (*citing* the Prudence Order).

opposing parties ignore the Market Crisis and its catastrophic impact on the Northwest power markets during 2000 and 2001.[35]

36 Considering this overall impact, but also considering the Market Crisis's undisputed effect on regional gas prices and PSE's fuel management efforts,[36] it would be arbitrary and capricious for the Commission to now impose a guarantee (or to hold PSE to a guarantee allegedly made in 1997) based solely on a savings expectation that (1) predated the Market Crisis, and (2) was directly and substantially affected by the Market Crisis. PSE should not be made into a guarantor in the wake of such a tumultuous and unforeseen event – the causes and effects of which were far beyond the Company's control.

4. The Opposing Parties Want The Commission To Replace Its Historical Prudence Standard With A Results-Based Test.

37 If the Commission held PSE to a guaranteed level of savings, it could only evaluate PSE's performance under that guarantee by determining at some future time whether PSE achieved those savings. The prudence review would become a strictly results-based test measured against the guarantee's minimum baseline. Further, and instead of evaluating whether an action is prudent *in the context of the time*, *e.g.* under the "small time frame just surrounding [the action]" standard that Commission Staff recommends,[37] the Commission would have to pick some future date and then do a "look-back" to see whether PSE achieved the guaranteed savings by that date.

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[35] The Market Crisis is not mentioned at all in Commission Staff's or Public Counsel's Initial Briefs. ICNU refers to the Market Crisis on a single page of its Initial Brief, and then only in the context of events after 2000-2001. *See id.* at 27. This failure to discuss such a recent and seminal event is curious, since (as Mr. Gaines testified) the events that surrounded the Market Crisis directly and substantially increased fuel costs and influenced PSE's fuel management efforts after the 1997 restructure. *See generally* Exh. No. 45 at 26: 13-27 (Gaines rev. 2/19/04).

[36] *Id.*; *see also* Exh. No. 51 at 6-7 (Gas Timeline).

[37] *See* Exh. No. 291HC at 4: 27-28 (McIntosh) (discussing the temporal scope that the Commission should apply when it performs a prudence review).

38 A prudence test driven by these factors would be highly problematic in its application. The test would be inflexible. It would fail to account for important intervening events such as the Market Crisis and the industry events that occurred in the years leading to the Market Crisis. It would require the Commission to pick a single date in the future, and assess PSE's fuel management on that date regardless of how well the Company performed before the date or how well the Company expected to perform afterwards. It would fundamentally alter the Company's fuel management strategy, resulting in a 100% long-term fixed-price supply that is completely unresponsive to the market.

39 Most important, the new test would require the Commission to abandon its historical prudence standard. Years of Commission precedent would have to be jettisoned in favor of an inflexible, results-based test that depends on the same sort of hindsight review that the Commission has previously and consistently disapproved.[38] This would be a wholly inappropriate step for the Commission to take, as well as an arbitrary and capricious action.

C. It Was Reasonable For The Company Not To Enter Into A Long-Term, Fixed-Price Fuel Supply Contract In 1997.

1. Undisputed Evidence Supported The Company's Decision.

40 The opposing parties complain that PSE did not enter into a long-term, fixed-price fuel supply contract in 1997, at the time of the Tenaska restructure.[39] They use the benefit of 20/20 hindsight to declare that customers would have been better off if PSE had locked into such a contract at the time.

41 PSE addressed this issue in detail in its Initial Brief. In sum, PSE relied on spot market purchases and near-term hedging at the time of the restructure for three main reasons:

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[38] *See, e.g.*, Exh. No. 82 at 10 (Prudence Order); Avista Order at ¶ 39.

[39] *See, e.g.*, ICNU Initial Brief at 22; Public Counsel Initial Brief at 4. Commission Staff focuses less on what the Company did in 1997 and more on the process that PSE employed thereafter to manage the Tenaska fuel supply. We address the post-1997 issues in Section III(D) of this Reply Brief.

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(1) the then-existing state of the natural gas and electric industries; (2) the market conditions that existed at the time (including forecasted price movements); and (3) the Tenaska facility's marginal position within PSE's resource stack. Each reason supported the decision that the Company made in 1997.[40]

42 Mr. Gaines told the same compelling story in his prefiled rebuttal testimony and his rebuttal exhibits.[41] The opposing parties never question this evidence.[42] They do not frame a different view of the energy industries in 1997. They do not dispute the price conditions that existed in 1997.[43] They do not quarrel with Mr. Gaines's characterization of the Tenaska facility as a marginal resource, or the reasons why it was appropriate for the Company to manage such a resource using short-term monthly and seasonal hedging rather than long-term fuel purchases.

43 In fact, the only response to Mr. Gaines is the vague suggestion – never articulated directly – that, notwithstanding the undisputed price conditions that PSE faced at the time and the evolving state of the energy industries, the Company should have nonetheless purchased long-term gas at one of four indicative price quotes it received in 1997.[44] But this "PSE should have gone long" argument (such as it can be deduced) suffers from three major failings.

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[40] *See generally* PSE Initial Brief at ¶¶ 100-111 and testimony and exhibits cited therein.

[41] *See generally* Exh. No. 45 at 14: 3 – 20: 12 (Gaines rev. 2/19/04) and exhibits cited therein.

[42] Commission Staff mistakenly asserts that, in his prefiled rebuttal testimony, Mr. Gaines discussed the fuel supply for Tenaska and Encogen "only from 2000-2001." *See* Commission Staff Initial Brief at ¶ 76. In fact, Mr. Gaines devoted a substantial portion of his testimony to the fuel supply decisions that occurred *before* this period, as well as the rationale for the decisions that PSE made. *See generally* Exh. No. 45 at 14: 3 - 23: 15 (Gaines rev. 2/19/04).

[43] ICNU claims that PSE relied on a so-called "hope" that gas prices would remain low. *See* ICNU Initial Brief at 3. But ICNU offers no evidence to contradict this "hope." Moreover, the "hope" actually represented a well-supported expectation that gas prices would remain low and stable after 1997. Mr. Gaines testified that this expectation was entirely consistent with then-existing industry events and pricing conditions. *See* Exh. No. 45 at 23: 2-15 (Gaines rev. 2/19/04) and exhibits cited therein; *see also* Exh. No. 51 (Gas Timeline).

[44] Exh. No. 59C (listing 1997 quotes); *see also* Exh. No. 205C at 1 (listing vendor names).

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44 First, Mr. Gaines explained in his prefiled rebuttal testimony why the Company decided not to pursue the long-term quotes, and why that decision was reasonable when made.[45] Among other factors, the long-term quotes started well-above recent historic price levels and commanded significant premiums over then-current and forecasted market prices. Accordingly, it did not appear advisable for the Company to enter into a long-term arrangement – particularly since that arrangement was little different than the original Tenaska arrangement, *i.e.*, a fixed-price supply contract with a significant price escalator.[46]

45 Second, the "PSE should have gone long" argument requires the Commission to apply impermissible hindsight when comparing the decision that the Company made against the alternative of a long-term arrangement. We discuss elsewhere in this Reply Brief why the Commission should not use such hindsight when reviewing the Company's fuel supply decisions.

46 Finally, the "PSE should have gone long" argument begs many important questions. The price, price escalator, and contract duration provisions were all quite different under the indicative quotes that the Company obtained in 1997.[47] Under these circumstances, and even assuming for the sake of argument that PSE should have pursued a long-term arrangement, which specific arrangement should PSE have

[45] The prudence test reviews *only* whether a decision was reasonable – not whether the decision was the best one based on later events and results. In particular, and as Commission Staff concedes, a least-cost result does not necessarily follow from a prudent decision. *See* Exh. No. 291HC at 4: 24-27 (McIntosh).

[46] Exh. No. 45 at 18: 19-23 (Gaines rev. 2/19/04). *See also* Exh. No. 205C at 2-6 (reasons why PSE did not procure a long-term, fixed-price arrangement for Tenaska); PSE Initial Brief at ¶¶ 108-109 and testimony and exhibits cited therein.

[47] Exh. No. 59C at 3-4. The differences are illustrated by the four quotes that PSE received. One vendor quoted gas prices just through 2002 – so any supply commitment from that vendor would have expired well before this proceeding began. Still another vendor (but only one) quoted gas prices through 2011, when the Tenaska contract ends. The other two vendors gave quotes with intermediate provisions. *Id.*; *see also* TR. 510: 8-10 (Schooley).

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pursued? At what price? At what premium?[48] For what duration? Under what commercial and non-commercial contract terms? Should PSE have pursued discussions with the vendor that quoted gas supply through the life of the Tenaska contract, but at a rapidly-increasing price? Or should PSE have pursued discussions with the vendor that quoted gas supply just through 2002, nine years before the end of the Tenaska contract (and two years before the beginning of the PCORC rate year)? None of these questions are addressed by the opposing parties.

47 In sum, the Company presented undisputed evidence to support its 1997 decision to rely on spot market purchases and near-term hedging to supply the Tenaska facility. PSE foresaw an opportunity to pursue possible fuel price reductions at that facility. It embraced this opportunity using the available information at the time. The decision that PSE made was reasonable under these circumstances.[49]

2. The Opposing Parties Use Impermissible Hindsight To Evaluate The Company's 1997 Decision.

48 The opposing parties use the benefit of 20/20 hindsight to evaluate the Company's 1997 decision. Enjoying the perspective of six years of recent history, including the run-up in gas prices that occurred during the Market Crisis, they can now look back at 1997 and claim, with hindsight, that PSE should have "lock[ed] up the estimated savings."[50]

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48 The Company introduced evidence to show that long-term, fixed-price supply contracts carried significant premiums in the late 1990s relative to shorter-term arrangements. *See* Exh. No. 45 at 18: 1-23 (Gaines rev. 2/19/04); *see also* Exh. No. 77C at 26 (multi-year contracts carried a premium). The opposing parties do not dispute this evidence. *See* ICNU Initial Brief at 25; Commission Staff Initial Brief at ¶¶ 86-88.

49 Faced with an opportunity in 1997 to potentially lower its fuel costs, PSE would surely have been questioned at some future date had it instead opted for the status quo – *i.e.*, a "do-nothing" strategy that defaulted to the price escalator and the rapidly-increasing prices under the original Tenaska fuel supply arrangement.

50 Public Counsel Initial Brief at 4.

49 Of course, the opposing parties would not make this argument if the Market Crisis had not occurred. Nor would this argument have arisen if gas prices had fallen since the restructure.[51] That is why the use of hindsight to evaluate resource decisions – long after those decisions were made – is now and should remain impermissible under the Commission's prudence standard.

50 The Commission reached a similar conclusion very recently, in the Avista Order. In that proceeding, Public Counsel argued that Avista's costs associated with the disposition of "high priced natural gas contracts . . . have not been adequately justified."[52] The Commission, however, determined that Public Counsel had used "hindsight analysis [that was] inappropriate." The Commission stated, "To propose an adjustment based on what is known now versus what was known at the time is *inconsistent with the Commission's past findings that the decisions of the prudence of costs associated with those decisions should be based on the information that was known at the time*."[53]

51 In sum, and as PSE explained in its Initial Brief, the Company does not possess the luxury of hindsight when it manages its resources.[54] The opposing parties should not be allowed to indulge in that luxury in order to second-guess the Company's decisions long after the fact.

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[51] If PSE had paid a premium in 1997 to "lock up the estimated savings" under a long-term arrangement, but short-term prices had subsequently fallen and remained below long-term levels, then the opposing parties would no doubt claim that PSE had still acted imprudently – because it paid a premium for a long-term arrangement and could not purchase gas at the lower short-term prices. The common theme here is the use of hindsight to second-guess a PSE decision, long after the decision was made and no matter what the nature of the decision. This places PSE in a "damned if you do, damned if you don't" position.

[52] Public Counsel's position in Docket No. UE-030751 stands in contrast to the position it asserts in this proceeding, where it criticizes the Company for not having entered into fixed-price contracts.

[53] Avista Order at ¶¶ 37-39 (emphasis added).

[54] *See generally* PSE Initial Brief at ¶¶ 89-94 and testimony and exhibits cited therein.

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D. The Company Made Reasonable Fuel Supply Decisions After 1997.

1. Management According To Budget.

52 Commission Staff criticizes PSE simply because it did what every utility should do – it attempted to manage its resources according to budget. The claim here is that such management was "myopic" and "short-sighted."[55]

53 PSE agrees that it attempted to manage the Tenaska and Encogen facilities according to budget. The Company did so because it is obligated to manage those resources and its other resources in a fiscally-responsible manner. Commission Staff criticizes the Company because its Chief Financial Officer at the time, Mr. Hawley, was described as "happy" when the Tenaska facility's value was above budget, and "sad" when it was not.[56] But should Mr. Hawley have felt any differently? After all, this is the very role of a CFO – to oversee a company's budgetary efforts and to ensure that the company operates in a fiscally-responsible manner.[57]

54 This need for fiscal restraint was especially acute in the years following the Tenaska and Encogen restructures. During this period, the Company was required to operate under the rate constraints that the Merger Rate Plan had imposed. It thus behooved PSE's management, including Mr. Hawley, to search out opportunities to achieve possible operating efficiencies. That was the whole point of the Merger Rate Plan, as well as the basis for the charge that the Commission gave to the Company in the Merger Order.[58]

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[55] Commission Staff Initial Brief at ¶¶ 49-50.

[56] *Id.* at ¶ 53.

[57] The Company's budgetary efforts were not perfect. According to the minutes from the March 9, 2000 Risk Management Committee meeting, total gas costs for calendar year 2000 were expected to be 5 percent above budget. *See* Exh. No. 77C at 2. Thus, the inference that Commission Staff raises – that PSE rigidly and inflexibly managed its generation resources according to budget – is belied by the facts in the record.

[58] *See* the discussion in Section III(D)(2) of this Reply Brief.

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55 Further, and notwithstanding the criticisms by Commission Staff, the Company freely acknowledges that it attempts to increase the value of its resources. Such an action is, again, fiscally responsible. It is particularly responsible in the case of the Tenaska facility – a marginal resource in the Company's resource stack. As Mr. Gaines testified, in the absence of a fixed-price fuel supply arrangement for a particular generation facility, the Company manages a facility's spark spread or heat rate by deciding whether it is less expensive to displace the facility or, alternatively, to purchase gas and generate power from the facility.[59] In the case of the Tenaska facility, PSE was able to actively manage the spark spread for that facility through the use of short-term monthly and seasonal hedging arrangements. The efforts that PSE undertook were entirely appropriate under these circumstances, and consistent with the well-supported fuel management decisions that PSE made.[60]

2. Decisions Under The Merger Rate Plan.

56 Beginning the year when the Tenaska restructuring occurred (1997) and continuing through the years of the Market Crisis (2000 and 2001) and beyond, the Company operated under the Merger Rate Plan that stemmed from the merger between Puget Sound Power & Electric Company and Washington Energy Company.[61] During the Merger Rate Plan period, the Company was allowed only minimal scheduled rate increases from 1997 through 2001 despite significant and escalating cost pressures.

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[59] Exh. No. 45 at 19: 17 – 20: 6 (Gaines rev. 2/19/04). *See also* Exh. No. 63C at 37; Exh. No. 64; PSE Initial Brief at ¶¶ 110-111 and exhibits cited therein.

[60] Commission Staff quotes a statement concerning PSE's former arrangement with Duke in a strained attempt to show that PSE's sole objective was to "enhance shareholder profits during the rate plan period." *See* Commission Staff Initial Brief at ¶ 54. The objective of PSE's work with Duke was, indeed, to improve PSE's margins (consistent with the charge in the Merger Order). But that was the objective with respect to the *Duke* arrangement – not *PSE's* sole objective in managing its generation resources, and certainly not its sole objective in managing the Tenaska and Encogen facilities.

[61] *See In The Matter of The Application of Puget Sound Power & Light Company and Washington Natural Gas Company, etc.* Docket Nos. UE-951270 and UE-960195 (Consolidated), Fourteenth Supplemental Order (February 5, 1997) (hereinafter "Merger Order).

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57 The Merger Rate Plan created a nexus and alignment between the interests of shareholders and ratepayers, by giving the merger benefits to the ratepayers up front (in the form of stable, low rates over the Merger Rate Plan period) and by putting the Company and its shareholders at risk during this period for achieving operational power cost savings. Specifically, the Commission encouraged the Company to manage its business affairs in a cost-effective manner in order to achieve these savings. The following statements from the Merger Order are illustrative:

- "[T]he balancing of consumer rate certainty against *the company's opportunity to manage its affairs* can only be considered fair if the company actually takes advantage of the opportunity."[62]
- "We fully expect PSE to pursue *synergy savings and operating cost efficiencies aggressively during the five years of the Rate Plan…*"[63]
- "The rate plan is designed to provide the management of PSE with a *five-year window of opportunity to achieve these savings. Within this five-year window, PSE's financial results will be a function of management's ability to achieve these savings to provide shareholders with an opportunity to earn a reasonable return on investment*."[64]

58 In response to the Commission's charge in the Merger Order, PSE attempted to manage its affairs in a cost-effective manner in order to achieve the operating efficiencies that the Merger Order and the Merger Rate Plan contemplated. The Company sought cost reductions in such items as fuel supply if those reductions were warranted at the time by industry conditions, price forecasts, and other available information. Mr. Gaines

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[62] Merger Order at 26 ¶ 2 (emphasis added).

[63] *Id.* (emphasis added).

[64] *Id.* at Attachment A (Settlement Stipulation) at 4 ¶ 2 (emphasis added).

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testified at length how the Company's decisions were supported by available and solid information.

59 Now the opposing parties assail PSE for having prudently managed its costs during the Merger Rate Plan period. In fact, they fault PSE for having done exactly what it was charged to do during this period. Inexplicably, they recommend harsh penalties just because the Company *did not pay higher costs for fuel supply during a low-cost market*, in the form of long-term commitments.[65]

60 The Commission should not impose these proposed penalties. The basis for these penalties, ultimately, is the course of action that the Company took in strict adherence with the constraints and the charge that the Merger Rate Plan and the Merger Order imposed. It would be arbitrary and capricious to now penalize the Company for having done exactly what it was charged to do.

3. PSE Considered A Wide Range Of Factors When It Made Its Fuel Supply Decisions.

61 As noted earlier, Commission Staff suggests that PSE's fuel supply decisions were "myopic" and "short-sighted" due to its management according to budget and the nature of the Tenaska facility, and notwithstanding the constraints that the Merger Rate Plan imposed on the Company from 1997 onward. Commission Staff suggests that PSE considered only these factors when it made its fuel supply decisions. But this suggestion has no basis.

62 In fact, the Company has consistently considered a wide range of factors when making fuel supply decisions. Risk management has been a hallmark of the Company's fuel management efforts ever since the contract restructures took place. For example, the

[65] ICNU and Commission Staff do not dispute the Company's evidence that, at the time, long-term supplies carried a significant price premium when compared to supplies that were offered under shorter-term commitments. *See* ICNU Initial Brief at 25; Commission Staff Initial Brief at ¶¶ 86-88.

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Company's Energy Price Risk Manual that was in effect at the time of the Tenaska restructuring (*i.e.*, in 1997) stated that the Company would attempt to "prudently manage the price risks inherent in its core electric and gas supply portfolio through the effective integration of electric and gas trading and hedging activities." This was described as a "primary objective" and an "essential element of PSE's ongoing business." The Energy Price Risk Manual listed several risk management strategies that the Company intended to follow in order to "prudently manage the price risks."[66]

63 The Company employed these and other risk management strategies during and after 1997. Following the restructure, the Company procured gas supply for Tenaska using a wide variety of techniques such as fixed-price physical contracts; financial derivative ("swap") contracts with floating-to-fixed price hedges; and other approaches. Mr. Gaines discussed these approaches in his prefiled rebuttal testimony. He explained that the amount and timing of the various types of gas purchases were highly dependent upon the Tenaska facility's projected fuel consumption at a particular time; the projected market heat rates (which determined how much the facility would be operated); and expectations regarding forward and potential spot prices. Mr. Gaines also sponsored an exhibit that contained specific examples of hedging decision documents for Tenaska from the 1998-1999 time period.[67]

64 These risk management efforts continued through 2000 and 2001, when the Market Crisis occurred. As Mr. Gaines explained: "Hedging and portfolio management issues were a regular topic of discussion with the Company [at the time]," together with "fuel supply risks."[68] To aid in these efforts, the Company sought and obtained additional risk management services from the MEGA group from June 2000 through August 2001. These services included: (1) review of substantive risk positions in the portfolio;

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66 Exh. No. 55C at 48, ¶¶ 1.2-1.3.

67 Exh. No. 45 at 22: 15-27 (Gaines rev. 2/19/04); Exh. No. 66C (decision documents).

68 Exh. No. 45 at 23: 24-26 (Gaines rev. 2/19/04).

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(2) development of hedge implementation strategies; (3) advisory services to assist PSE in developing systems; (4) procedures, strategies, and tactics for managing the Company's supply portfolio; (5) training of PSE personnel in identifying and managing risk; (6) assistance in the selection and implementation of a computer-based trading and risk management system; and (7) assistance in the development of risk management practices and procedures.[69]

65 The Company discussed and adopted these practices in the Risk Management Committee ("RMC") meetings that took place in 2000 and in later years. The RMC documents and the portfolio management documents that PSE produced in discovery in this proceeding, and which have been put into the record in various forms,[70] are replete with concrete examples of how PSE managed the fuel supply during this period and what factors it considered.[71]

66 Finally, as PSE discussed in its Initial Brief, Ms. Ryan devoted considerable discussion in her prefiled testimony to the various factors that the Company has considered in recent years and through the present when managing its fuel supply, including the supply for the Tenaska and Encogen facilities.[72] None of this testimony has been questioned.

67 In short, the Company considered a wide range of risk management and other factors when it managed the fuel supply during the post-1997 period. During this time, the Company did not "ignore" the advice it received from the MEGA group. Rather, Mr. Gaines explained in his prefiled direct and rebuttal testimony how PSE selected and

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[69] Exh. No. 45 at 24: 20-28 (Gaines rev. 2/19/04).

[70] *See generally* rebuttal exhibits sponsored by Mr. Gaines; Exh. No. 77C; Exh. No. 206C.

[71] *See, e.g.*, Exh. No. 77C at 2-3 (testing of the Altra trading system, purchase of 60% of the Tenaska fuel supply, and hedging of turbine capacity). In this regard, one report that the RMC received in June 2000 – titled "Status of PSE's Risk Management Capability Implementation" – laid out a comprehensive list of PSE's risk management strategies and elements, analytical models, management practices and procedures, and various hedging strategies. *See id.* at 19-24.

[72] *See generally* PSE Initial Brief at ¶¶ 122-127 and testimony and exhibits cited therein.

relied on the MEGA group in building the Company's portfolio management team and enhancing its tools and strategies.[73]

68 The few statements that Commission Staff quotes from Mr. Wooten and others at MEGA (all snippets taken from handwritten notes in the Risk Management Committee files[74]) are general observations only – not specific recommendations with respect to either the Tenaska or Encogen facilities. At no time did Mr. Wooten or others with MEGA state that the Company should enter into a long-term, fixed-supply contract to support either facility. Nor did MEGA advise the Company to follow a different strategy for Tenaska and Encogen given the context of the time and the information that was then available. Indeed, MEGA emphasized in its July 25, 2000 formal report to the Company[75] that "flexible supplies provide multiple benefits," including the chance to "capture opportunities in the market."[76] That is precisely the course of action that PSE pursued.

4. The Opposing Parties Cherry-Pick And Misconstrue Isolated Statements From A Voluminous Record.

69 The Company developed a comprehensive narrative that showed why the Tenaska and Encogen fuel management decisions before, during, and after the Market Crisis were all reasonable.[77] In support of this narrative, the Company provided several thousands of pages of documents to the opposing parties – and designated many of those documents as exhibits in this proceeding – concerning the extensive portfolio and risk

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[73] Exh. No. 11 at 8: 6-14 (Gaines); Exh. No. 45 at 22: 5-15 (Gaines rev. 2/19/04). It is difficult to fathom Commission Staff's argument that PSE "ignored" the advice from its consultants. *See* Commission Staff Initial Brief at ¶ 65. In fact, the Company dedicated substantial resources – in conjunction with MEGA's efforts and advice – to the portfolio management function that Mr. Gaines described.

[74] The opposing parties' inappropriate use of these statements is discussed in more detail in Section III(D)(4) of this Reply Brief.

[75] Exh. No. 77C at 37-60 (MEGA report titled "PSE Energy Supply Risk Analysis").

[76] *Id.* at 60.

[77] *See generally* PSE Initial Brief at ¶¶ 112-127 and testimony and exhibits cited therein.

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management activities that the Company had conducted since the contract restructuring. This evidence involved not only PSE's general risk management activities and tools, but also the specific activities it had performed with respect to the Tenaska and Encogen facilities.[78] PSE offered to meet with Commission Staff to explain these activities and tools.[79]

70 The essence of this history has not been challenged by the opposing parties.[80] Rather, they select a few isolated statements – some mundane, others colorful[81] – from the thousands of pages of documents that they received during discovery. They then take those statements, misconstrue them, and in the process try to support a critique of the Company's fuel management efforts.

71 Instead of relying on a few cherry-picked statements that the opposing parties quote, the Commission should focus on certain core themes in this proceeding – specifically, the fuel management decisions that PSE made in the context of the time; the information that was available to PSE when it made those decisions; and the fact that

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[78] *See generally* Exh. No. 45 at 13: 14-28 (Gaines rev. 2/19/04) and testimony and exhibits cited therein; Exh. No. 55C; Exh. No. 201 at 4: 12 – 5: 21 (Ryan) and exhibits cited therein. *See also* TR. 529: 3-11 (Elgin) (describing "approximately two feet" of documents that Commission Staff received from PSE).

[79] TR. 524: 8-21 (Elgin). Mr. Elgin stated at hearing that Commission Staff "did not take advantage" of PSE's offer to meet. *Id.*

[80] Commission Staff claims that the Company's extensive evidence postdates any time period in which it could have hedged its gas costs. *See* Commission Staff Initial Brief at ¶ 76. But in the rebuttal filing, Mr. Gaines discussed the Company's portfolio management from 1997 through 2001, and Ms. Ryan continued that discussion from 2001 through the present. *See generally* Exh. No. 45 at 12: 1 – 30: 7 (Gaines rev. 2/19/04); Exh. No. 201 at 6: 16 – 11: 8 (Ryan). Their testimony thus encompassed all of the time periods at issue with respect to the Tenaska and Encogen fuel management.

[81] One such statement is Mr. Weaver's observation in early 2000 that he had "lost his understanding of the energy supply portfolio." *See, e.g.*, Commission Staff Initial Brief at ¶ 59, *citing* Exh. No. 77C at 4. By this statement, Mr. Weaver may have simply meant that, as PSE's Chief Executive Officer at the time, he wanted a greater understanding of the details of PSE's supply portfolio, and he expected his subordinates to provide him with that understanding. This would not be an unusual request from an officer who is not involved in the day-to-day operations of the power supply area. But Mr. Weaver's statement takes on a much different meaning in the hands of the opposing parties. They build his statement into the much broader notion that, "the Company did not comprehend the risks of managing the fuel supply for [the Tenaska and Encogen] facilities." *See* Commission Staff Initial Brief at ¶ 58. This is not a fair reading of the evidence.

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the opposing parties want to use impermissible hindsight to now evaluate those decisions. If the Commission focuses on these core themes, and rejects the opposing parties' approach, we believe it will find that the Company's decisions were, on balance, reasonable.

5. PSE's Decision In December 2001 With Respect To The Tenaska Facility Was Reasonable.

72 The opposing parties claim that PSE acted imprudently in December 2001 when it did not lock in a certain price for fuel to serve the Tenaska facility.[82] This hindsight judgment is incorrect.

73 Mr. Gaines discussed this issue in his prefiled rebuttal testimony.[83] Based on the direction of gas prices that PSE forecast at the time, the Company set various reasonable target prices for purchasing fuel supply. These prices are shown in Mr. Gaines's testimony. As discussed in the RMC documents and at hearing, because of the "bearish" condition of the gas market that existed in late 2001, as well as the expectation that gas prices would continue to drop, PSE adopted a "market less 10%" approach to purchasing the fuel supply.[84]

74 The condition to executing this approach did not occur, because the prices did not drop to the projected level. This did not mean, however, that the Company lacked a strategy going forward with respect to the Tenaska fuel supply. The Company continued to implement its strategy of ratable purchases in the short-term and seasonal markets, using the same risk management and hedging instruments that were discussed earlier in this Reply Brief.

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[82] *See* ICNU Initial Brief at 28. At the time of the December 2001 decision, the Company was still operating under the constraints imposed by the Merger Order and the Merger Rate Plan. *See* the discussion in Section III(D)(2) of this Reply Brief.

[83] *See generally* Exh. No. 45 at 29: 13 – 30: 2 (Gaines rev. 2/19/04) and exhibits cited therein.

[84] Exh. No. 77C at 81-82. Ms. Ryan stated at hearing that the Company expected prices to go down relative to the prices that the Company faced in December 2001. *See* TR. No. 138: 2-3 (Ryan).

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75 With the luxury of hindsight, of course, it is easy to say that – in December 2001 – the Company should not have adopted a "market less 10%" approach, and instead should have procured supplies at the "market" price (which turned out, in hindsight, to be a dip in the market). But PSE had no way of knowing that the market was experiencing a low point at the time. The information that was available to PSE when it made its decision indicated that prices should have *fallen*, not increased. Fundamentally, the review in this proceeding should be whether the Company's decision was reasonable given the context of the time and the information available at the time – not whether that decision was the best decision after considering later events and results.[85]

76 Under the context of the time and using the information it possessed, PSE made a reasonable decision to hold off procuring supplies at the then-existing market price. No party has shown otherwise.

6. ICNU And Commission Staff Mischaracterize The Hindsight Analyses That PSE Performed In 2000.

77 ICNU and Commission Staff refer to the hindsight "Business Case Analyses" that the Company performed in mid-2000 with respect to the Tenaska and Encogen facilities.[86] Unfortunately, they mischaracterize the testimony that Mr. Gaines gave at hearing concerning the Analyses.

78 Mr. Gaines discussed the Analyses in his prefiled rebuttal testimony and at hearing. He stated that the impetus for the retrospective review was twofold: (1) the increase in gas prices that began in 2000 (at the time of the Market Crisis), and (2) the Company's ongoing efforts at the time to enhance its risk management systems and capabilities. In

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85 *See* Exh. No. 291HC at 4: 24-27 (McIntosh) (least-cost result does not necessarily follow from prudent decision). *See also* Exh. No. 204C at 1-4 (discussion of reasons why PSE did not enter into a long-term, fixed-price fuel supply arrangement for the Tenaska facility in 2001 and 2002).

86 ICNU Initial Brief at 26-27; Commission Staff Initial Brief at ¶¶ 70-71; *see also* Exh. No. 63C at 108-112 and 113-115, respectively.

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the Analyses, the Company asked itself with hindsight "what should have been done" to manage the Tenaska and Encogen fuel supply.[87]

79 Mr. Gaines was asked at hearing what the Analyses meant by the phrase "what should have been done." His answer was to the point: "It means that that's what a prudent gas manager should do. *And, in fact, it's what we did do during this period*." Mr. Gaines elaborated that the phrase should *not* be read as a conclusion that the Company did not perform the listed strategies. As Mr. Gaines explained, "Oh, no, no, it's not intended that way at all."[88]

80 ICNU and Commission Staff ignore Mr. Gaines's testimony when they discuss the Analyses. They instead opine that "in other words, the Company did not have all of these objectives in mind" (Staff) and that "these admissions demonstrate that PSE recognized that its management of the Tenaska gas supply was imprudent" (ICNU).[89] But that is not what Mr. Gaines said, and it is not what the phrase in the Analyses meant. There is no evidence in the record that supports ICNU's and Commission Staff's mischaracterization of the Analyses.[90]

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87 TR. 328: 21 – 329: 6, 331: 5-17 (Gaines); Exh. No. 45 at 24: 13 – 25: 28 (Gaines rev. 2/19/04). *See also* PSE Initial Brief at ¶¶ 118-119.

88 TR. 330: 11-24 (Gaines) (emphasis added).

89 ICNU Initial Brief at 27; Commission Staff Initial Brief at ¶ 71.

90 Both ICNU and Commission Staff were quick to seize on the Analyses and to advance speculative interpretations concerning the language in those documents. Besides being contrary to Mr. Gaines's testimony, this sort of mischaracterization could have a chilling effect on the willingness of PSE and other companies that the Commission regulates to perform similar "look-backs" in the future. The Commission should encourage frank reevaluations of resource decisions, and not permit the resulting documentation to be cherry-picked by parties in rate proceedings for the purpose of recommending harsh disallowances. *See generally WUTC v. Washington Water Power Co.*, Cause No. U-83-26, Fifth Supplemental Order (January 19, 1984) at 13 (reevaluation cited as part of prudent utility decisionmaking).

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E. Commission Staff Misinterprets FAS 71.

81 PSE's final point concerning the Tenaska restructuring involves Commission Staff's misinterpretation of FAS 71.[91]

82 Commission Staff argues that the context of the time period described by Mr. Gaines somehow negates the Company's creation of a regulatory asset in 1997.[92] But there is no contradiction between the context that Mr. Gaines described and the Company's actions with respect to Tenaska. PSE restructured the Tenaska fuel supply arrangement in order to reduce costs and to reduce the possibility of stranded costs. As Commission Staff agreed at the time, creation of a regulatory asset was perfectly appropriate to spread equitably the costs and benefits from the restructuring through the Tenaska contract's remaining period.[93] These are examples of the criteria that must be considered under FAS 71.

83 Commission Staff creates further confusion by citing Paragraph 58 in FAS 71 as "[requiring] an assumption that future economic benefits would be created."[94] But as Mr. Story explained at hearing, Paragraph 58 requires an assessment of the economic value of the revenues generated by the regulatory asset – not, as Commission Staff suggests, an assessment of the asset that generates this value.[95]

84 Finally, Commission Staff asserts that PSE's allegedly-imprudent management of the Tenaska and Encogen fuel supply may, under FAS 71, require it to "write-off the

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[91] Exh. No. 3.

[92] Commission Staff Initial Brief at ¶¶ 79-80.

[93] *See generally* Exh. No. 52 (transcript of December 10, 1997 Open Meeting); Exh. No. 283C at 16-18.

[94] Commission Staff Initial Brief at ¶ 83.

[95] TR. 345: 17 - 346: 14 (Story); *see also* Exh. No. 228 at 24, ¶ 58.

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unamortized balance of the regulatory assets that still remains on PSE's books."[96] But FAS 71 is simply not applied in the manner that Commission Staff suggests.

IV. ICNU'S GAS PRICING PROPOSAL HAS NO MERIT.

85 ICNU has offered nothing new to support its gas pricing proposal. Consequently, there is no adequate record that is sufficient to replace the current PCA gas pricing mechanism with ICNU's proposed approach.

86 Rather than providing evidence and legal authority to support its position, ICNU relies on the current balance in the PCA sharing mechanism. Even though PSE has already lost over $40 million, ICNU wants the Commission to make the Company lose even more money – by setting a projected gas price that is artificially low.[97]

87 This deliberate and results-based tipping of the scales against the Company does not reflect the intent of the PCA mechanism or good ratemaking policy. Cost-based ratemaking should be based on the best and most accurate information that is available – not on an unsubstantiated number from another state's model that (1) has no relevance to the actual gas costs that PSE bears; (2) has no relevance to the gas markets that PSE expects to face during the PCORC rate year; and (3) has never been used for ratesetting purposes by any utility anywhere.

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[96] Commission Staff Initial Brief at ¶ 84.

[97] ICNU Initial Brief at 7-10 (*e.g.*, "…the Commission should err on the side of setting the Baseline too low, rather than too high.")

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V. SUMMARY.

88 PSE reiterates its request that the Commission approve the power cost baseline rate that PSE has proposed in this proceeding. PSE further requests that the Commission approve the power cost true-up amounts for Tenaska and Encogen fuel costs for the first PCA period in Docket No. UE-031389.

89 PSE again asks the Commission to make the following findings:

90 • PSE acted prudently in making the Frederickson acquisition, and the decisionmaking tools and processes that PSE employed for the acquisition meet the Commission's expectations.

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

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

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

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94 • PSE's longstanding use of forward market prices to determine its estimated gas costs is reasonable and should not be abandoned in this proceeding.

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Respectfully Submitted,

/s/

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